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## The Director's Duty of Care in Negotiated Dispositions

Melvin Aron Eisenberg

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# The Director's Duty of Care in Negotiated Dispositions

MELVIN ARON EISENBERG\*

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## I. INTRODUCTION: STANDARDS OF CONDUCT AND STANDARDS OF REVIEW

This Article concerns the director's duty of care in a negotiated disposition. By a *disposition*, I mean a transfer of a corporation's assets or of control of a corporation through any legal mode that involves board action. By a *negotiated disposition*, I mean a disposition in which the transferor and the transferee are unrelated, so that, for example, neither is controlled by the other or by shareholders, directors, or managers of the other.

The two major fiduciary duties of directors are the duty of care and the duty of loyalty. The duty of care concerns the standards of conduct and review applicable to a director who acts or fails to act in a matter that does not involve his own self-interest. The duty of loyalty concerns the standards of conduct and review applicable to a director who acts or fails to act in a matter that does involve his own self-interest. In a negotiated disposition the central fiduciary duty of the directors is the duty of care, and that duty will be the major (although not the only) subject of this Article.

An analysis of the duty of care must begin by distinguishing between roles, functions, duties, standards of conduct, and standards of review. A *role* is a position in society that an actor undertakes. A *function* is an activity that is proper to a role. A *standard of conduct* states how an actor should play a given role or conduct a given function. A

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\* This Article draws in significant part on portions of the Comments and Reporter's Notes of ALI, Principles of Corporate Governance (1994), of which I was Chief Reporter, and on Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 *FORD. L. REV.* 437 (1993).

I thank Steve Barnett, Jack Jacobs, and Marshall Small for their extremely helpful comments on earlier drafts, and Paula Blizzard for her excellent research assistance.

*duty* is an obligation to follow a standard of conduct. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.

In many or most areas of law, standards of conduct and standards of review tend to be conflated. For example, the standard of conduct that governs automobile drivers is that they should drive carefully,<sup>1</sup> and the standard of review in a liability claim against a driver is whether he drove carefully.<sup>2</sup> Similarly, the standard of conduct that governs an agent who engages in a transaction with his principal that involves the subject matter of the agency is that the agent must deal fairly,<sup>3</sup> and the standard of review in a liability claim by a principal against an agent based on such a transaction is whether the agent dealt fairly.<sup>4</sup>

The conflation of standards of conduct and standards of review is so common that it is easy to overlook the fact that whether the two kinds of standards are or should be identical in any given area is a matter of prudential judgment. Perhaps standards of conduct and standards of review in corporate law would always be identical in a world in which information was perfect, the risk of liability for undertaking a given corporate role was always commensurate with the incentives for undertaking the role, and institutional considerations never required deference to a corporate organ. In the real world, however, these conditions seldom hold, and accordingly the standards of review in American corporate law pervasively diverge from the standards of conduct.

Traditionally, the standards of review in duty of care and duty of loyalty cases have been bipolar. At one pole have been standards of review that are hard for a director to satisfy, such as the standards of reasonability and fairness. At the other pole have been standards of review that are easy for a director to satisfy, such as the standard of business judgment. Within the last twenty or twenty-five years, American courts have developed variations on these polar standards, which are applicable to certain kinds of cases in which directors take actions that do not involve their self-interest in the traditional sense.

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1. See, e.g., *Levesque v. Anchor Motor Freight, Inc.*, 832 F.2d 702, 704 (1st Cir. 1987) ("a driver's duty is to use care which is reasonable under the circumstances"); *Thomason v. Willingham*, 165 S.E.2d 865, 867 (Ga. Ct. App. 1968) (stating that a driver has a common law duty to exercise ordinary care).

2. See *Levesque*, 832 F.2d at 704.

3. See RESTATEMENT (SECOND) OF AGENCY § 390 (1958).

4. See *id.* § 390 cmt. g.

## II. FUNCTIONS, DUTIES, AND STANDARDS OF CONDUCT OF DIRECTORS

The duty of care of corporate directors is a special case of the duty of care imposed throughout the law under the general heading of negligence. All law builds on moral, policy, and experiential propositions. The law of negligence is no exception. Under the moral and policy propositions that underlie the law of negligence, if a person undertakes a role whose performance involves the risk of injury to others, he is under a duty to perform the functions of that role carefully and is subject to blame if he fails to do so. For example, one who undertakes the role of driver is under a duty to drive carefully and one who undertakes the role of doctor is under a duty to practice medicine carefully.

Under modern corporate law and practice, those who assume the role of director have several fairly distinct functions to perform. One of these functions is to make decisions on certain kinds of matters, such as dispositions.

The general standard of conduct applicable to directors in the performance of their functions in matters in which they are not interested is set forth in section 4.01 of the American Law Institute's *Principles of Corporate Governance*:

A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.<sup>5</sup>

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5. AMERICAN LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE ANALYSIS AND RECOMMENDATIONS* § 4.01 (1994) [hereinafter *PRINCIPLES OF CORPORATE GOVERNANCE*]. Compare section 8.30(a) of the Revised Model Business Corporation Act:

- (a) A director shall discharge his duties as a director, including his duties as a member of a committee:
  - (1) in good faith;
  - (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
  - (3) in a manner he reasonably believes to be in the best interests of the corporation.

REVISED MODEL BUS. CORP. ACT § 8.30(a) (1984) [hereinafter *MODEL ACT*].

Under section 8.42 of the *MODEL ACT*, the same standard applies to officers. Comparable standards are found in case law. See *Hoye v. Meek*, 795 F.2d 893, 895 (10th Cir. 1986) (Oklahoma law); *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264, 273 (2d Cir. 1986) (New York law); *Meyers v. Moody*, 693 F.2d 1196, 1209 (5th Cir. 1982) (Texas law), *cert. denied*, 464 U.S. 920 (1983); *Harman v. Willbern*, 374 F. Supp. 1149, 1161 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Heit v. Bixby*, 276 F. Supp. 217, 230 (E.D. Mo. 1967); *Johnson v. Coleman*, 20 S.W.2d 186, 188 (Ark. 1929); *Speer v. Dighton Grain, Inc.*, 624 P.2d 952, 955-56 (Kan. 1981); *Dykema v. Muskegon Piston Ring Co.*, 82 N.W.2d 467, 471 (Mich. 1957); *Francis v. United Jersey Bank*, 432 A.2d 814, 820 (N.J. 1981); *FMA Acceptance Co. v. Leatherby Ins. Co.*,

The application of this standard of conduct to *decisionmaking* by directors results in two distinct although closely related duties. First, directors should employ a reasonable decisionmaking *process* to make decisions on matters that the board is obliged or chooses to act upon. Secondly, directors should make reasonable *decisions*.

### III. THE STANDARD OF REVIEW APPLICABLE TO THE QUALITY OF DECISIONS: THE BUSINESS JUDGMENT RULE

On their face, the duties of directors are fairly demanding, insofar as they are measured by reasonability. In practice, however, the standards of review applied to the performance of these duties are less stringent than the standards of conduct on which the duties are based. This is especially true when the quality of a decision—that is, the reasonableness of the decision, as opposed to the reasonableness of the decision-making process—is called into question. In such cases a much less demanding standard of review may apply, under the business judgment rule.<sup>6</sup>

The business judgment rule consists of four conditions and, if the four conditions are satisfied, a special standard of review applicable to claims that are based on the quality of a decision.

The four conditions are as follows:

*First*, the director must have made a decision. So, for example, a director's failure to make due inquiry, or any other simple failure to take action (as opposed to a deliberative decision not to act), does not qualify for protection under the business judgment rule.<sup>7</sup>

*Second*, the director must have informed himself with respect to the business judgment to the extent he reasonably believes appropriate under the circumstances—that is, he must have employed a reasonable decisionmaking process.<sup>8</sup>

*Third*, the decision must have been made in good faith—a condition that is not satisfied if, among other things, the director knows that the decision violates the law.<sup>9</sup>

*Fourth*, the director may not have a financial interest in the subject matter of the decision.<sup>10</sup> For example, the business judgment rule is

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594 P.2d 1332, 1334 (Utah 1979). Different standards are found in some statutes, *see, e.g.*, VA. CODE ANN. § 13.1-690 (Michie 1993), but the majority of statutes are comparable to the MODEL ACT.

6. *See* PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 5, § 4.01(c).

7. *See id.*

8. *See id.* § 4.01(c)(2).

9. *See id.* § 4.01(c).

10. *See id.* § 4.01(c)(1).

inapplicable to a director's decision to approve the corporation's purchase of his own property.

If the conditions of the business judgment rule are *not* satisfied, then the standard by which the quality of a decision is reviewed is comparable to the standard of conduct for making the decision—that is, the standard of review is based on entire fairness or reasonability. This is nicely illustrated by the Delaware Supreme Court's decision in *Cede & Co. v. Technicolor, Inc.*, in 1993.<sup>11</sup>

In that case, Perelman, the CEO of MacAndrews & Forbes, Inc. ("MAF"), entered into negotiations with Kamerman, the CEO of Technicolor, with a view to an acquisition of Technicolor by MAF. Goldman Sachs, the investment banker, told Kamerman, on the basis of limited information, that a price of \$20-22 per share was worth pursuing, that a \$25 price might be feasible, and that Kamerman should consider other possible purchasers. Six days later, Kamerman and Perelman agreed on a price of \$23. That evening, Kamerman called a special meeting of Technicolor's Board, to be held two days later. At the meeting, the board approved an agreement with Pantry Pride that reflected the \$23 price, and recommended that Technicolor's shareholders accept that price.

At the trial, the Chancellor found that it was a matter of grave doubt whether Technicolor's board had exercised due care in making its decision for the following reasons, among others: (1) The agreement was not preceded by a prudent search of alternatives. (2) Given the terms of the merger and the circumstances, the directors had no reasonable basis to assume that a better offer from a third party could be expected once the agreement was signed. (3) Most of the directors had little or no knowledge of an impending sale of the company until they arrived at the meeting, and only a few of them had any knowledge of the terms of the sale.

On the basis of these conclusions, the Delaware Supreme Court held that Technicolor's board failed to reach an informed decision when it made its decision, so that the business judgment rule did not apply. As a result, the directors had the burden of showing that the transaction was entirely fair. If the \$23 price was not entirely fair, the directors would be liable for damages. And, the court added, because the business judgment rule did not apply the directors had the burden of proving that the price was entirely fair.<sup>12</sup>

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11. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994), *on remand*, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

12. The court said:

The [business judgment] rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not

In contrast, if the four conditions of the business judgment rule *are* satisfied, then the quality of a director's decision will be reviewed, not to determine whether the decision was reasonable, but only under a much more limited standard. There is some difference of opinion as to how that limited standard should be formulated. A few courts have stated that the standard is whether the director acted in good faith.<sup>13</sup> However, the prevalent formulation of the standard of review under the business judgment rule, if the four conditions of the rule have been satisfied, is that the decision must be rational, or must have a rational basis, or the like.<sup>14</sup> In the balance of this Article, I will refer to this standard of review as the *business-judgment standard*.

An example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained. For example, in *Selheimer v. Manganese Corp. of America*,<sup>15</sup> a corporation's managers poured the corporation's funds into the development of a single plant even though they knew that the plant could not be operated profitably for a number of reasons, including lack of a railroad siding and proper storage areas.<sup>16</sup> The court imposed liability because the managers' conduct "defie[d] explanation; in fact, the defendants have failed to give any satisfactory explanation or advance any justification for [the] expenditures."<sup>17</sup> (In contrast, a decision may be unreasonable if there are good reasons for and against the decision but under the circumstances a person of sound judgment, giving appropriate weight to the reasons for and against, would not have made the decision. Accordingly, a decision may be unreasonable even though it was supported by some affirmative rea-

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be overturned by the courts unless it cannot be "attributed to any rational business purpose." Thus, a shareholder plaintiff challenging a board decision has the burden at the outset to rebut the rule's presumption. . . . If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the "entire fairness" of the transaction to the shareholder plaintiff. . . . Further, in the review of a transaction involving a sale of a company, the directors have the burden of establishing that the price offered was the highest value reasonably available under the circumstances.

*Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (citations omitted). On remand the Chancellor held that the price was entirely fair, and the Delaware Supreme Court affirmed.

13. See, e.g., *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94194, at 91,710 n.13 (Del. Ch. Jan. 31, 1989).

14. See PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 5, § 4.01(c)(3); see also *Meyers*, 693 F.2d at 1210-11; S. Samuel Arsht & Joseph Hinsey IV, *Codified Standard—Same Harbor But Charted Channel: A Response*, 35 BUS. LAW. 947, 954 (1980) ("a belief which motivates a director who is acting in good faith to approve a matter must, a *fortiori*, be one that is held on a reasonable or rational basis").

15. 224 A.2d 634 (Pa. 1966).

16. *Id.* at 639.

17. *Id.* at 646.

sons and was therefore explicable, although on balance objectively undesirable.)

Although, as *Selheimer* shows, the rationality test has a bite, under the business-judgment standard of review a director will not be liable for a decision that resulted in a loss to the corporation *even if the decision is unreasonable*, as long as the conditions of the business judgment rule have been satisfied and the decision is rational. This standard of review is very much easier to satisfy than a reasonability standard. To see how exceptional a rationality standard is, we need only think about the judgments we make in everyday life. It is common to characterize a person's conduct as imprudent or unreasonable, but it is very uncommon to characterize a person's conduct as irrational.

Why should such a relatively undemanding standard of review, which differs so radically from the standard of conduct applicable to directors (and from the standards of both conduct and review applicable to persons who play most other life-roles) apply to the quality of decisions made by corporate directors? The answer to this question involves considerations of both fairness and policy.

To begin with, the application of a reasonableness standard of review to the quality of disinterested decisions by directors could result in the unfair imposition of liability. In paradigm negligence cases involving relatively simple decisions, such as automobile accidents, there is often little difference between decisions that turn out badly and bad decisions. In such cases, typically only one reasonable decision could have been made under a given set of circumstances, and decisions that turn out badly therefore almost inevitably turn out to have been bad decisions.

In contrast, in the case of business decisions it may often be difficult for fact-finders to distinguish between bad decisions and proper decisions that turn out badly. Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks, so that typically a range of decisions is reasonable. A decisionmaker faced with uncertainty must make a judgment concerning the relevant probability distribution and must act on that judgment. If the decisionmaker makes a reasonable assessment of the probability distribution, and the outcome falls on the unlucky tail, the decisionmaker has not made a bad decision, because in any normal probability distribution some outcomes will inevitably fall on the unlucky tail.

For example, a board faced with a promising but expensive and untried new technology may have to choose between investing in the technology or forgoing such an investment. Each alternative involves certain negative risks. If the board chooses one alternative and the asso-



ciated negative risk materializes, the decision is "wrong" in the very restricted sense that if the board had it to do all over again it would make a different decision, but the decision is not for that reason a bad decision.

As a result of a systematic defect in cognition known as the hindsight bias, however, under a reasonableness standard of review fact-finders might too often erroneously treat decisions that turned out badly as bad decisions, and unfairly hold directors liable for such decisions. Experimental psychology has shown that in hindsight people consistently exaggerate the ease with which outcomes could have been anticipated in foresight. People view what *has* happened as relatively inevitable.<sup>18</sup> (As one historian put this tendency—"Dear Diary, The Hundred Years' War started today.")<sup>19</sup> Accordingly, people who know that a bad outcome resulted from a decision overestimate the extent to which the outcome was predictable and, therefore, the extent to which the decisionmaker was at fault for making a bad decision.<sup>20</sup> Essentially, people find it difficult or even impossible to disregard information they possess about an outcome.<sup>21</sup> That information, in turn, renders the circumstances that pointed to the outcome more salient in their minds, because those circumstances can be integrated into a cohesive story that ends with the actual outcome, while circumstances pointing in other directions cannot:

Typically, judges are called upon to predict the future and to "make sense" out of the past. Attempting to understand why a partic-

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18. See ROBYN M. DAWES, RATIONAL CHOICE IN AN UNCERTAIN WORLD 119-20 (1988); BARUCH FISCHHOFF, FOR THOSE CONDEMNED TO STUDY THE PAST: HEURISTICS AND BIASES IN HINDSIGHT, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335, 341-43 (Daniel Kahneman et al. eds., 1982) [hereinafter HEURISTICS AND BIASES]; Baruch Fischhoff, *Hindsight/Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty*, 1 Journal of Experimental Psychology: Human Perception and Performance, 288-299 (1975); Baruch Fischhoff & Ruth Beyth, "I Knew It Would Happen"—Remembered Probabilities of Once-Future Things, 13 Organizational Behav. and Hum. Performance 1-16 (1975) [hereinafter Fischhoff & Beyth].

19. D.H. FISCHER, HISTORIAN'S FALLACIES: TOWARD A LOGIC OF HISTORICAL THOUGHT (1970), quoted in HEURISTICS AND BIASES, *supra* note 18, at 342.

20. See Hal Arkes & Cindy Schipani, *Medical Malpractice and the Business Judgment Rule*, 73 ORE. L. REV. 587 (1994) [hereinafter Arkes & Schipani, *Medical Malpractice*]; Jonathan Baron & John C. Hershey, *Outcome Bias in Decision Evaluation*, 54 J. PERSONALITY & SOC. PSYCHOL. 569 (1988); Jonathan D. Casper et al., *Juror Decision Making, Attitudes, and the Hindsight Bias*, 13 L. & HUM. BEHAV. 291 (1989) [hereinafter Casper, *Juror Decision Making*]; Scott A. Hawkins & Reid Hastie, *Hindsight Biased Judgments of Past Events After the Outcomes Are Known*, 107 PSYCHOL. BULL. 311 (1990); Raanan Lipshitz, "Either a Medal or a Corporal:" *The Effects of Success and Failure on the Evaluation of Decision Making and Decision Makers*, 44 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 380 (1989) [hereinafter Lipshitz, *Success and Failure*]; Terence R. Mitchell & Laura S. Kalb, *Effects of Outcome of Knowledge and Outcome Valence on Supervisors' Evaluations*, 66 J. APPLIED PSYCHOL. 604 (1981).

21. See Michael J. Saks & Robert F. Kidd, *Human Information processing and Adjudication: Trial by Heuristics*, 15 L. & SOC'Y REV. 123, 144 (1980).

ular outcome occurred seems, among other things, to increase the salience of data and reasons which can be integrated into coherent explanatory patterns. Unintegratable data tend to be forgotten, deemphasized, or reinterpreted to fit the dominant explanation.<sup>22</sup>

The hindsight bias is nicely illustrated by an experiment in which 112 anesthesiologists reviewed the anesthesiological care in 21 paired cases that were based on actual files. Each of the anesthesiologists was presented with only one case from each pair. The patient and the treatments in each of the two paired cases were identical, and the results in all cases were as adverse. However, the files were edited so that in one case in each pair the adverse outcome was described as temporary, while in the other case the outcome was described as permanent. The reviewers were instructed to determine, in each of the 21 cases they reviewed, whether the anesthesiological care was less than appropriate, appropriate, or impossible to judge. When the adverse outcome was described as permanent rather than temporary, the overall distributions of the reviewers' judgments concerning the appropriateness of the care was shifted by 30 percent.<sup>23</sup> Comparable results have been obtained in other experiments, even when the subjects have been explicitly instructed to disregard outcomes in evaluating fault.<sup>24</sup> The hindsight bias is also well-supported by survey evidence concerning the attribution of responsibility, and by casual empiricism.<sup>25</sup>

The business judgment rule protects directors from the unfair imposition of liability as a result of the hindsight bias, by providing them with a large zone of protection when their decisions are attacked. The need for this zone of protection is highlighted by comparing business decisionmakers with other kinds of actors who must make decisions on the basis of incomplete information and in the face of obvious risks. Many such actors—for example, doctors—can often shield themselves from liability for bad outcomes by showing that they arrived at their decisions by following accepted protocols or practices.<sup>26</sup> In contrast,

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22. Fischhoff & Beyeth, *supra* note 18, at 1; *see also*, Casper, *Juror Decision Making*, *supra* note 20, at 293:

The hindsight bias process appears to involve an integration of outcome information into one's understanding of the story, influencing judgments about the inevitability of the outcome, perhaps by affecting the recall of material or its weighting.

*Id.*

23. Robert A. Caplan et al., *Effect of Outcome on Physician Judgments of Appropriateness of Care*, 265 J. AM. MED. ASS'N 1957 (1991). This experiment, as well as the hindsight bias, its application to the business judgment rule, and other hindsight experiments in the medical area, are discussed in a very illuminating way in Arkes & Schipani, *Medical Malpractice*, *supra* note 20.

24. *See, e.g.*, Casper, *Juror Decision Making*, *supra* note 20.

25. *See* Lipshitz, *Success and Failure*, *supra* note 20, at 381-82.

26. *See, e.g.*, *Osborn v. Irwin Memorial Blood Bank*, 5 Cal. App. 4th 234, 278 n.13 (Ct. App.

directors can seldom shield themselves in that way, because almost every business decision is unique. In this respect, perhaps the closest analogy to business decisionmakers would be executive officers of governments, who also cannot arrive at their decisions by applying established protocols and practices, and are also shielded from liability by a qualified immunity.<sup>27</sup> It is also relevant that negligent decisions by directors, unlike most types of negligent decisions, characteristically do not result in either personal injury or economic damages that are catastrophic to an individual. The law may justifiably be less willing to take the risk of erroneously imposing liability in cases where the injury is typically not traumatic to individuals than in cases where it is.

Furthermore, as a matter of policy the shareholders' own best interests may be served by conducting only a very limited review of the quality of directors' decisions. It is often in the interests of shareholders that directors choose the riskier of two alternative decisions, because the expected value of the more risky decision may be greater than the expected value of the less risky decision. For example, suppose that Corporation C has \$100 million in assets. C's board must choose between decision X and decision Y. Each decision requires an investment of \$1 million. Decision X has a 75% likelihood of succeeding. If the decision succeeds, C will gain \$2 million. If it fails, C will lose its \$1 million investment. Decision Y has a 90% chance of succeeding. If the decision succeeds, C will gain \$1 million. If it fails, C will recover its investment. It is in the interest of C's shareholders that the board make decision X, even though it is riskier, because the expected value of decision X is \$1.25 million (75% of \$2 million, minus 25% of \$1 million) while the expected value of decision Y is only \$900,000 (90% of \$1 million). If, however, the board was concerned about liability for making an unreasonable decision it might choose decision Y, because as a practical matter it is almost impossible for a plaintiff to win a duty of care action on the theory that a board should have taken greater risks than it did. A standard of review of the quality of decisions that impose liability on a director for unreasonable, as opposed to irrational, decisions might therefore have the perverse incentive effect of discouraging bold but desirable decisions.<sup>28</sup> Putting this more generally, under such a

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1992) ("compliance with accepted practice [by physicians] is generally taken as conclusive evidence of due care.") (quoting Allan H. McCoid, *The Care Required of Medical Practitioners*, 12 VAND. L. REV. 549, 560 (1959)).

27. See W. Page Keeton et al., PROSSER & KEETON ON THE LAW OF TORTS 1059-60 (5th ed. 1984); Conference Panel Discussion, *The Business Judgment Rule*, 45 OHIO STATE L.J. 629, 648-651 (1984) (remarks of Professor Shipman).

28. To some extent this may also be true of other areas, such as medical malpractice. However, a physician normally can insulate himself in cases that involve significant but desirable risks by obtaining the patient's informed consent. In contrast, it is normally neither feasible nor

standard of review directors might tend to be unduly risk-averse, because if a highly risky decision had a positive outcome the corporation but not the directors would gain, while if it had a negative outcome the directors might be required to make up the corporate loss. The business judgment rule helps to offset that tendency.

Moreover, at least in the case of non-management directors, liability for the losses caused by an unreasonable business decision would often be far out of proportion to the incentives for accepting a directorship. Outside directors of publicly held corporations typically earn approximately \$30,000-\$40,000 annually in directors' fees. In contrast, liability for an imprudent decision can be in the millions. Therefore, in the absence of some brake on such liability, it might become more difficult to attract qualified candidates as non-management directors, which also would be contrary to the shareholders' own best interests.

Finally, a review of the quality of directors' decisions would typically involve a determination of what risk levels the corporation should have accepted and what risks it should have undertaken—a kind of review that would not only be extremely difficult but would threaten to impinge seriously on corporate autonomy.

#### IV. THE STANDARD OF REVIEW APPLICABLE TO THE DECISIONMAKING PROCESS

The business judgment standard is generally applicable to a review of the quality of decisions, but not to a review of the reasonableness of the decisionmaking process. The justifications of the business judgment rule help explain why this should be so.

For one thing, although the law should not discourage directors from making bold decisions, it should encourage directors to pay attention.

Next, a review of the reasonability of the decisionmaking process will typically not involve a determination of what risk levels the corporation should have accepted and what risks it should have undertaken, and is therefore consistent with corporate autonomy.

Finally, the imposition of liability on a director for failure to employ a reasonable decisionmaking process may seem more commensurate with the degree of fault involved than the imposition of liability on a director who employed a reasonable decisionmaking process but arrived at a decision that turned out badly.

Accordingly, the duty to employ a reasonable decisionmaking pro-

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desirable for directors or officers to try to obtain the shareholders' consent to proposed business decisions.

cess is normally not protected by the business judgment rule. On the contrary: the employment of a reasonable decisionmaking process is a condition to the application of the business judgment rule.

Even in the case of decisionmaking, however, the standard of review may depart somewhat from the standard of conduct.

A few courts have expressed this difference by adopting a rule that the standard of review in such cases is whether the director was "grossly negligent."<sup>29</sup> The concept of gross negligence is notoriously ambiguous, and in practice it is common to find that courts that purport to apply that standard actually apply a standard that is either more or less demanding. Courts that purport to adopt a gross negligence standard in reviewing the decisionmaking process probably do so because the performance of these duties seldom presents a cut-and-dried issue, and the gross negligence standard of review emphasizes the importance of leaving a play in the joints in determining whether the relevant standard of conduct was satisfied. A play in the joints, however, is built into the very concept of due care. For example, in *Rabkin v. Phillip A. Hunt Chemical Corp.*, then-Vice-Chancellor Berger stated that even under an ordinary negligence standard corporate directors will not face liability for the failure to focus on an isolated bit of information.<sup>30</sup>

Therefore, an appropriate flexibility can be achieved, without using the problematic gross negligence standard, by making clear that in determining whether directors or officers acted with due care in their decisionmaking process, the courts should consider the complexities of the corporate context and give directors and officers sufficient running room.<sup>31</sup>

The sharp differentiation between the standards of review of the quality of board decisions on the one hand, and the decisionmaking process on the other, may be seen as a special case of a recurrent legal tendency to review procedure much more intensively than substance. In contract law, for example, the courts are much readier to review the fairness of the bargaining process than the fairness of the terms of a bargain. Similarly, the purpose of federal securities law is to require that full disclosure be made rather than to regulate the substantive terms of securities.

## V. SPECIAL STANDARDS OF REVIEW

Within recent years, corporate law has developed variations on the standards of review that are applicable to certain kinds of actions by

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29. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985).

30. 13 DEL. J. CORP. LAW 1210 (Del. Ch. 1987).

31. See PRINCIPLES OF CORPORATE GOVERNANCE Part IV, Introductory Note, § 4.01 cmt. e.

directors who are not self-interested in the traditional sense. In part, these variations are a response to the increased emphasis, in law and practice, on the role of independent directors, coupled with the understanding that even independent directors have structural ties to their colleagues that may bias their judgments. In part too, these variations are a response to the increased importance and incidence of transactions in control.

One such special standard of review is that applied to actions by a target corporation's board to block consummation of a hostile tender offer.

The standard of *conduct* that should govern such a blocking action is that the action should be reasonably designed to advance the best interests of the corporation and the shareholders, having regard for interests or groups, other than the shareholders, with respect to which the corporation has a legitimate concern, if to do so would not significantly disfavor the long-term interests of shareholders.

The standard of *review* presents a more complex problem. If a tender offer succeeds, the top managers will normally lose their jobs. Therefore, actions to block tender offers resemble self-interested conduct. Usually, however, blocking actions are authorized by independent directors, not by managers. Unlike managers, independent directors ordinarily have no significant economic self-interest in blocking a tender offer. In evaluating a tender offer, however, independent directors usually rely very heavily on advice from principal senior executives, and those recommendations are self-interested.

Blocking actions also differ from traditional self-interested actions in other respects. Unlike a self-interested transaction, a blocking action may be beneficial to shareholders even if it is taken for the wrong reasons. Because of the obstacles to shareholder collective action in publicly held corporations, it may be desirable for the board to take a blocking action whose effect is to facilitate an auction that will maximize the tender-offer price, even if the board does so for the wrong reason. Moreover, a tender offer is typically a highly complex business transaction, and shareholders will often need management's expertise to evaluate the offer. On the other hand, a blocking action utilizes corporate resources to interfere with an offer made to shareholders.

On balance, therefore, the quality of a blocking action should be and is reviewed under a special, intermediate standard, rather than the business judgment standard, even if the action has been approved by independent directors. Under the *Unocal* test of Delaware law, directors who take a blocking action must show that they had reasonable ground for believing that a danger to corporate policy and effectiveness existed

and that their blocking action was a reasonable response to the threat posed.<sup>32</sup> Under section 6.02(a) of the *Principles of Corporate Governance*, the standard of review is whether the directors' action was a reasonable response to the offer. Under section 6.02(d), however, this standard is applied only in suits to enjoin or set aside a blocking action. Suits to impose liability on directors remain subject to the business judgment rule. One reason for this position is that most of the rationales for the business judgment rule are rooted in fairness and policy concerns relating to the imposition of liability, and these concerns do not apply in actions for injunctive or like relief.

In the case of a tender offer, therefore, the *quality* of a blocking action is reviewed under an enhanced standard—enhanced, that is, as compared with the business judgment standard. In the case of a negotiated disposition there are several reasons why the decisionmaking *process* should be reviewed under a standard of enhanced scrutiny in suits to enjoin or set aside the disposition, even though, unlike blocking actions, negotiated dispositions are not engaged in for entrenchment purposes:

- (i) A disposition is a unique, one-time, often life-and-death event. As such, it deserves special scrutiny by the board, and enhanced scrutiny by the courts will help ensure special scrutiny by the board.
- (ii) In the case of ordinary business decisions, risks can be diversified by making a number of decisions that in the aggregate should yield their weighted expected returns. No such diversification of risk is possible in a decision to sell the corporation or control of the corporation.
- (iii) As a practical matter, the terms of a disposition are likely to be determined by the executives, rather than the board. The executives, however, are likely to be much more skilled at managing the corporation than at valuing it.
- (iv) A decision to dispose of the corporation or control of the corporation often involves conflicts of interest on the part of managers, even if they are not on both sides of the table.

On the basis of these reasons, a special two-part principle, which I will call the disposition principle, should apply to the standard of review of the directors' duty of care in negotiated dispositions: (1) In actions to enjoin or set aside such a disposition, the board's decisionmaking process should be given special scrutiny to determine whether the process provided reasonable assurance that the disposition was at the best price

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

reasonably available. (2) The board's use of an effective market test should be conclusive evidence that the process provided such assurance.

The disposition principle follows section 6.02 of the *Principles of Corporate Governance* in adopting a special standard of review for non-liability actions. Partly this is because most of the reasons for the business judgment rule are rooted in fairness and policy issues surrounding the imposition of liability. Equally or more important, the disposition principle does not really implicate the business judgment rule at all, because it focuses on the decisionmaking process, not on the quality of the decision.

The disposition principle is a standard of review, not a standard of conduct. When the board is considering a disposition, as when it is considering any other matter, the standard of *conduct* is that it must act reasonably. Of course, given the gravity of a disposition the board may be required to exercise more scrutiny over a proposed disposition than over almost any other kind of transaction, but that is only because under the standard of conduct more scrutiny is reasonably required in such a case.

Although the disposition principle stands on its own merits, Delaware law can be read to point in the direction of that principle, as evidenced in four leading cases involving negotiated dispositions—*Smith v. Van Gorkom*,<sup>33</sup> *Cede & Co. v. Technicolor, Inc.*,<sup>34</sup> *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*,<sup>35</sup> and *Paramount Communications Inc. v. QVC Network Inc.*<sup>36</sup>

In *Smith v. Van Gorkom* and *Technicolor* the Delaware Supreme Court essentially applied an enhanced scrutiny standard of review to the board's decisionmaking process in negotiated dispositions, although the Court did so under the guise, so to speak, of a gross negligence standard of review.

In *Van Gorkom*, Trans Union was a publicly traded diversified

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33. 488 A.2d 858 (Del. 1985).

34. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994), *on remand*, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995).

35. 506 A.2d 173 (Del. 1985).

36. 637 A.2d 34 (1994). The conclusion that these cases can be explained by, and in turn support, a special, unified principle governing negotiated dispositions, to some extent parallels Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Law After QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)* 49 BUS. LAW. 1593 (1994) and Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994), to both of which the reader is recommended. Those articles propose more sweeping unifying principles, that would include not only negotiated dispositions but blocking actions in takeover cases and perhaps certain other corporate actions that significantly alter or affect shareholder interests, such as cases in which the board receives an unsolicited proposal to acquire the corporation. See Cunningham & Yablon *supra* at 1621.



holding company whose principal earnings were generated by its railcar leasing business. Trans Union had an annual cash flow of hundreds of millions of dollars and large investment tax credits (ITCs) but had difficulty in generating sufficient taxable income to make use of the ITCs. Van Gorkom was Chairman and CEO of Trans Union and owned 75,000 shares. He was approaching age 65 and mandatory retirement.

On August 27, 1980, Van Gorkom met with Trans Union's senior management and discussed the sale of Trans Union to a company that could make use of the ITCs. Two senior executives did rough calculations to determine the cash flow needed to service the debt that would be incurred in a leveraged buy-out. These calculations indicated that "\$50 would be very easy to do, but \$60 would be very difficult."<sup>37</sup> Van Gorkom stated that he would be willing to take \$55 per share for his own 75,000 shares, but he vetoed a leveraged buy-out by management.

On September 15, without consulting either his board or any members of senior management except Trans Union's controller, Van Gorkom met with Jay Pritzker and proposed that Pritzker purchase Trans Union at a price calculated on the basis of \$55 per share. On September 18, Van Gorkom and Pritzker made a deal for a merger at that price. Pritzker insisted that Trans Union's board act on the merger within three days.

On September 19, Van Gorkom called a special board meeting for noon the next day. Van Gorkom began the meeting with a twenty-minute oral presentation in which he outlined the terms of the proposed agreement with Pritzker. Copies of the agreement were delivered too late for study before or during the meeting. A senior executive told the board that in his opinion \$55 was within the range of a fair price, but at the beginning of the range.

After a two-hour meeting, the board approved the proposed merger agreement. The board apparently understood, or directed, as conditions to its approval, that Trans Union reserved the right to accept any better offer made during a 90-day market-test period and could share proprietary information with other potential bidders during that period. The agreement was executed that evening. Neither Van Gorkom nor any other director read the agreement prior to its signing.

On October 8, in response to vigorous dissatisfaction of senior managers with the terms of the merger, Van Gorkom secured the board's approval, sight unseen, of amendments designed to facilitate the market test. The following day, amendments to the merger agreement were prepared by Pritzker and delivered to Van Gorkom for execution. The

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37. *Van Gorkom*, 488 A.2d at 865.

amendments varied considerably from Van Gorkom's representations to the board, and placed serious constraints on Trans Union's ability to negotiate a better deal and withdraw from the merger agreement. Van Gorkom nevertheless executed the amendments.

Plaintiffs brought a derivative action claiming that the directors had violated the duty of care in setting the price for Trans Union. The directors defended on two grounds.

First, the directors argued that they used due care in determining the price at the original board meeting of September 20, based on such factors as their collective experience and sophistication, their knowledge of Trans Union, and the significant premium over market that Pritzker was paying.

Second, the directors argued that the original merger agreement, and then the amendments, allowed Trans Union to sell to a higher bidder if a higher bid was made during the market-test period, or at least they so understood. Accordingly, the directors had provided for a market test of their judgment, which eliminated the need for the board to use any other test of fairness.

The Delaware Supreme Court concluded that the board had violated the duty of care in originally approving the \$55 price:

The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves "prior to making a business decision, of all material information reasonably available to them."

Under the business judgment rule there is no protection for directors who have made "an unintelligent or unadvised judgment."

...

The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency. . . .

Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom's 20-minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of \$55 price per share for sale of the company; and the Board had before it nothing more than Van Gorkom's statement of his understanding of the substance of an agreement which he admittedly had never read,

nor which any member of the Board had ever seen.<sup>38</sup>

The supposed market test, the court said, did not save the directors because under the terms of both the original merger agreement and the amendments the ability of Trans Union to market itself during the 90-day period was fatally limited, and the board should have known that.

In *Cede & Co. v. Technicolor, Inc.*, discussed above,<sup>39</sup> the Delaware Supreme Court held that Technicolor's board had violated its duty of care because it failed to reach an informed decision when it entered into the disposition agreement.

*Van Gorkom* was widely criticized on the ground that the Delaware court had not properly applied the principles of the duty of care to the facts of this case. This criticism is inapt as to Van Gorkom himself, because he was clearly negligent in failing to ensure that the agreement included the effective market test he assured the remaining directors the agreement contained or would contain. However, it is virtually inconceivable that the remaining directors would have been held liable under ordinary due care principles if most other kinds of negotiated transactions had been involved. The special scrutiny of the decisionmaking process in this case therefore can only be explained on the ground that a special standard of review applies to the decisionmaking process in a negotiated disposition.<sup>40</sup>

(Incidentally — or perhaps not so incidentally — *Van Gorkom* shows that directors who authorize a negotiated disposition that has been negotiated solely by the chief executive officer, without the early and active involvement of a committee with at least a majority of independent directors, act at their peril.)

What is true of *Van Gorkom* is for the most part true as well of *Technicolor*: the holding in *Technicolor* can only be explained on the ground that a special standard of review applies when a negotiated disposition is at issue.

The disposition principle, as I have framed it, applies only to actions to enjoin or set aside negotiated dispositions. In contrast, *Van Gorkom* was a liability action. Because the standard of review should be less demanding in a liability action, the support that *Van Gorkom*

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38. *Id.* at 872 (citations omitted).

39. See *supra* notes 11-12 and accompanying text.

40. In my own view, the process employed by the directors other than Van Gorkom satisfied the second prong of the disposition principle, because the board reasonably relied on Van Gorkom's assurances that the merger agreement contained or would contain an effective market test. The court held that the directors could not have reasonably relied on Van Gorkom's representation that there was or would be such a test. I think the court was wrong about whether the directors could have reasonably relied on those assurances, but that is a different issue than the standard of review.

provides to the disposition principle is extremely strong. However, *Van Gorkom* and *Technicolor* support the disposition principle only implicitly. In contrast, in *Revlon v. MacAndrews & Forbes Holdings, Inc.* and *Paramount Communications, Inc. v. QVC Network, Inc.* much of that principle was explicitly adopted.

In *Revlon*, Pantry Pride made an increasingly attractive series of offers to acquire Revlon. These overtures were rebuffed. Eventually, Revlon entered into an agreement to sell its businesses to others, principally Forstmann Little. The agreement with Forstmann Little contained provisions designed to impede an offer by Pantry Pride. Pantry Pride sued Revlon to enjoin the operation of these provisions. The Chancery Court issued an injunction, and the Delaware Supreme Court affirmed on the ground that special procedural obligations attached when a corporation was being sold, even in a negotiated transaction:

The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. . . . The directors' role [then] changed from the defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company. . . .

[T]he break-up of the company . . . had become a reality which even the directors embraced. Selective dealing to fend off a hostile but determined bidder was no longer a proper objective. Instead, obtaining the highest price for the benefit of the stockholders should have been the central theme guiding director action. . . .

In that context the board's action is not entitled to the deference accorded it by the business judgement rule.<sup>41</sup>

*Revlon* held that directors had special obligations when the corporation was to be sold. The exact contours of that obligation were unclear and long debated, but were clarified in *Barkan v. Amstead Industries, Inc.*<sup>42</sup> In that case, the Delaware court reiterated that "[w]hen the board is considering a single offer and has no reliable grounds upon which to judge its adequacy, [the] concern for fairness demands a canvass of the market to determine if higher bids may be elicited."<sup>43</sup> The court did add that "[w]hen . . . the directors possess a body of reliable evidence with which to evaluate the fairness of the transaction, they may approve that transaction without conducting an active survey of the market[.]"<sup>44</sup> but

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41. *Revlon*, 506 A.2d at 181-85.

42. 567 A.2d 1279 (Del. 1989).

43. *Id.* at 1287.

44. *Id.*

stressed that "the circumstances in which this passive approach is acceptable are limited."<sup>45</sup> One relevant circumstance in *Barkan* was that the offeror group included an ESOP and therefore had tax advantages that could allow the group to bid more than anyone else. More important, the corporation had been in play for ten months prior to the actual sale, so that there was an implicit but effective market test. *Revlon*, the court said, "is merely one of an unbroken line of cases that seek to prevent the conflicts of interest that arise in the field of mergers and acquisitions by demanding that directors act with *scrupulous concern* for fairness to shareholders."<sup>46</sup>

In *Paramount Communications, Inc. v. QVC Network, Inc.*, Paramount had entered into a merger agreement with Viacom under which Paramount shareholders would receive approximately \$70 per share, in cash, voting stock, and nonvoting stock, and would end up with a minority equity position in the surviving corporation, which would be controlled by Viacom's CEO and controlling shareholder, Sumner Redstone. The merger agreement contained several provisions designed to make it difficult for a competing bid to succeed, including a no-shop fee, a termination fee, and a stock option. Notwithstanding these obstacles, and the intransigent opposition of Paramount's board, QVC made a bid of \$80 per share for Paramount. After Viacom responded by raising its bid to \$85, QVC bid \$90.

Paramount's directors then determined that QVC's \$90 offer was not in the best interests of Paramount's shareholders. QVC brought suit to enjoin the merger agreement's anticompetitive provisions. The Vice-Chancellor granted the injunction, and the Delaware Supreme Court affirmed. The court made clear that where either a shift of control or a break-up of the corporation was involved, the courts will apply a standard of enhanced scrutiny:

Under normal circumstances, neither the courts nor the stockholders should interfere with the managerial decisions of the directors. The business judgment rule embodies the deference to which such decisions are entitled. . . .

Nevertheless, there are rare situations which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by directors. In these situations, a court subjects the directors' conduct to *enhanced scrutiny* to ensure that it is reasonable. The decisions of this Court have clearly established the circumstances where such enhanced scrutiny will be applied. . . .

The consequences of a sale of control impose special obligations

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45. *Id.*

46. *Id.* at 1286-87 (emphasis added).

on the directors of a corporation. In particular, they have the obligation of *acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably. . . .*

In the sale of control context, the directors must focus on one primary objective—to secure the transaction offering the best value reasonably available for the stockholders . . . .

In pursuing this objective, the directors must be especially diligent. . . . In particular, this Court has stressed the importance of the board being adequately informed in negotiating a sale of control: “The need for adequate information is central to the enlightened evaluation of a transaction that a board must make.”. . .

. . . [T]he board’s goal is straightforward: Having informed themselves of all material information reasonably available, the directors must decide which alternative is most likely to offer the best value reasonably available to the stockholders.

Board action in the circumstances presented here is subject to enhanced scrutiny. . . .

The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors’ action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably. . . .

. . . There are few events that have a more significant impact on the stockholders than a sale of control or a corporate break-up. Each event represents a fundamental (and perhaps irrevocable) change in the nature of the corporate enterprise from a practical standpoint. It is the significance of each of these events that justifies: (a) focusing on the directors’ obligation to seek the best value reasonably available to the stockholders; and (b) requiring a close scrutiny of board action which could be contrary to the stockholders’ interests. . . .

Accordingly, when a corporation undertakes a transaction which will cause: (a) a change in corporate control; or (b) a break-up of the corporate entity, the directors’ obligation is to seek the best value reasonably available to the stockholders. . . .

Under the facts of this case, the Paramount directors had the obligation: (a) to be diligent and vigilant in examining critically the Paramount-Viacom transaction and the QVC tender offers; (b) to act in good faith; (c) to obtain, and act with due care on, all material information reasonably available, including information necessary to compare the two offers to determine which of these transactions, or an alternative course of action, would provide the best value reasonably available to the stockholders; and (d) to negotiate actively and

in good faith with both Viacom and QVC to that end.<sup>47</sup>

Before further analyzing the fit between the disposition principle on the one hand, and *Van Gorkom*, *Technicolor*, *Revlon*, and *QVC* on the other, it is worth noting that all four cases exemplify one basis of the disposition principle—that negotiated dispositions, even though nominally at arm's length, typically involve significant conflicts of interest.

In *Van Gorkom*, the Delaware court took pains to point out that Van Gorkom was approaching age 65 and mandatory retirement. An obvious implication was that Van Gorkom knew that his CEO position was about to come to an end, and may have been anxious—too anxious—to sell Trans Union so that his retirement nest egg would be in cash rather than Trans Union stock.

In *Technicolor*, as part of the negotiations for the sale of the company, Kammerman, the CEO, was given an improved employment contract and promised that he would be paid his full salary for the full term of the contract even if he left Technicolor, despite the fact that the market had evaluated Kammerman's regime as a disaster.

In *Revlon*, the Delaware court stated that Revlon's resistance to Pantry Pride was "perhaps in part based on" the Revlon CEO's strong personal antipathy to Pantry Pride's CEO.<sup>48</sup> In the context of a disposition, this kind of ego-gratification at the shareholders' expense impermissibly puts the CEO's vanity ahead of the shareholders' interests.

In *QVC*, Paramount's president was Martin Davis. Paramount and Viacom had been in negotiations on and off over the years, but the negotiations were off in July 1993, when QVC expressed an interest in acquiring Paramount. QVC's CEO was Barry Diller. Barry Diller and Martin Davis had a prior relationship, and based on that relationship it was highly likely that if QVC acquired Paramount, Davis would be out. In contrast, previous negotiations between Davis and Sumner Redstone, who controlled Viacom, had established that if Viacom acquired Paramount, Davis would become CEO of the merged corporation. As between being in and being out, it could safely be assumed that Davis preferred being in.

It might be argued that these transactions did not involve a conflict of interest because the directors other than the CEO were wholly disinterested. The reality, however, is that often a disposition will be negotiated by the CEO and the CEO, inadvisedly, does not put the board fully into the picture during the course of the negotiations. The board is then handed a package, and most if not all the information about the package

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47. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 42-48 (Del. 1994) (emphasis added) (footnotes and citations omitted).

48. *Revlon, Inc. v. MacAndrews & Forbes, Inc.*, 506 A.2d 173, 176 (Del. 1985).

will come from the CEO. Therefore, even a board that contains no subservient directors may have difficulty in evaluating the CEO's proposal. Furthermore, it is unfortunately the case that some corporations still have boards with directors who are nominally independent but actually subservient to the CEO.

The proof of the pudding is in the eating. In all four cases under discussion the boards acted in a way that virtually defies explanation except on the ground of being ill-informed, subservient, or both.

For example, in *Van Gorkom* the directors accepted without a murmur the fact that almost all of them had been kept in the dark about the negotiations with Pritzger (and as far as appears even the prospect of a sale of Trans Union) until the moment they arrived at the board meeting; that a corporate life-and-death board meeting had been called on one day's notice; that the notice did not even state the purpose of the meeting; and that a disposition of a complex company was to be decided upon in a meeting that lasted only two hours.

In *Technicolor*, the board accepted without a murmur the fact that nine directors, three had only limited knowledge of the proposed sale of Technicolor to MAF (and as far as appears, about even the prospect of a sale of Technicolor), three knew nothing of the sale, and even Technicolor's president knew only what he had learned third-hand. Kammerman had kept most of the directors in the dark about the negotiations with MAF.

In *Revlon*, the board sanctioned an auction in which one bidder, Pantry Pride, was given less information than the other, Forstmann, and the board had tried to terminate the auction in Forstmann's favor although Pantry Pride had stated that it would top any bid that Forstmann made.

In *QVC*, the Paramount board was willing to accept an offer of \$70 per share for a corporation that was ultimately sold for \$107 per share, and intransigently resisted every topping offer made by QVC for no objectively convincing reason.

I return now to the issue of fit between disposition principle and Delaware law. *Van Gorkom* and *Technicolor* both implicitly support the disposition principle, because the results in those cases can only be explained on the ground that a special standard of review applies to negotiated dispositions, although those cases go beyond that principle in imposing liability. *Revlon*, as elaborated in *Barkan*, explicitly supports the disposition principle in the case of a sale of the corporation. *QVC* adopts the disposition principle in part, but it is wider than the disposition principle in one respect, and narrower in another.

*QVC* is wider than the disposition principle, because the court



seemed to hold that in cases that fall within the *QVC* doctrine, not only the decisionmaking process but the decision itself would be reviewed under an enhanced-scrutiny standard. For example, the court stated that:

The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of *the reasonableness of the directors' action* in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.<sup>49</sup>

*QVC* is narrower than the disposition principle, because although it applies to cases where the corporation is sold or control is shifted, the court excluded from the sweep of its doctrine cases in which "no control passed to anyone" because "control of both [corporations] remained in a large, fluid, changeable and changing market."<sup>50</sup>

This control-remains-in-the-market concept cannot be taken at face value. The market is not a sentient creature. It does not vote, it does not install managers, it does not remove managers and, in short, it does not have control. If shareholdings are so widely dispersed that no shareholders have control, still *someone* has control. We have known since *Berle & Means* who that someone is—management. Therefore, in any transaction involving the combination of two corporations with widely dispersed shareholdings in which one corporation's management ends up in the driver's seat, control of the other corporation *has* shifted. Of course, in some cases the two managements may combine on more or less equal terms. This condition is, however, pretty unusual.

Perhaps because the control-remains-in-the-market exception is incoherent, in practice it seems to mean something different than what it says. In practice, the exception seems to concern equity mergers between corporations whose shareholdings are widely dispersed (hereafter, "widely held corporations").

There are several ways to reconcile the disposition principle, on the one hand, and the exception for equity mergers between widely held corporations, on the other. To begin with, an equity merger between widely held corporations may not be a disposition. Suppose *A* and *B* organize a corporation, *AB*, and *A* contributes a going business to the *AB*. Generally speaking, neither lawyers nor laymen would say that *A* has "disposed" of his business, because *A* retains an interest in the trans-

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49. *QVC*, 637 A.2d at 45 (emphasis added).

50. *Id.* at 47 (quoting *Paramount Communications Inc. v. Time Inc.*, Del. Ch., No. 10866, 1989 WL 79880 (July 17, 1989)(quoting Chancellor Allen's description of the Time-Warner merger), reprinted at 15 DEL. J. CORP. LAW 700, 739 (Del. Ch.).

ferred business. Now suppose *A* transfers his business to *AB* in exchange for *AB* stock when *AB* is an existing corporation, wholly owned by *B*. Here too the transaction would not normally be described as a "disposition" of his business by *A*, for the same reason: *A*'s continuity of interest in the transferred business.

Furthermore, *QVC* seems to require a review of both the decision-making process and the quality of the decision in those transactions to which the *QVC* doctrine applies. Even if a negotiated equity merger was considered a disposition, the disposition principle would not require the quality of the merger to be reviewed under a standard of enhanced scrutiny.

Finally, the disposition principle normally cannot be meaningfully applied to a negotiated equity merger between widely held corporations. In a disposition for cash, it is possible to say whether the board had adopted a decisionmaking process that provided reasonable assurance that no more cash was likely to have been offered by another buyer. In contrast, a court cannot sensibly ask whether "more stock" would have been provided by another merger partner. Stock, unlike cash, is not commensurable, especially in the context of a negotiated equity merger, because one equity merger may involve synergies, tax advantages, or other benefits that a different merger would not.

On the other hand, even if a negotiated equity merger between widely held corporations does not fall within the disposition principle, the decisionmaking process employed by the nonsurviving corporation's board should be reviewed under an enhanced-scrutiny standard, for the same reasons that the decisionmaking process in a negotiated disposition should be reviewed under such a standard. From the nonsurvivor's perspective, such a merger is a unique, one-time, often life-and-death event; diversification of the risks posed by such a merger is not possible; the terms of the merger are likely to be negotiated by executives who are not expert at such matters; and the executives will often have nontraditional but very strong conflicts of interest. Accordingly, even in the case of a negotiated equity merger between widely held corporations, the decisionmaking process of the nonsurvivor's board requires enhanced scrutiny to ensure that the board had considered both the terms of the merger and the alternatives to the merger in a manner appropriate to the gravity of the transaction and in such a way as to provide reasonable assurance that the merger and its terms were not influenced by nontraditional conflicts of interest on the part of the executives.

The extent to which Delaware law is consistent with this principle is not completely clear. Certainly there is strong language in some Delaware cases which states that a negotiated equity merger between widely

held corporations is not subject to enhanced scrutiny.<sup>51</sup> To the extent that this language means that the quality of such mergers will not be reviewed with enhanced scrutiny, the result would be sound. To the extent this language means that the decisionmaking process of the non-survivor's board will not be subject to enhanced scrutiny in an action to enjoin the merger or set it aside, the result would be unsound. Furthermore, it is hard to believe that the Delaware courts, whatever they say, will require no more in the way of a decisionmaking process of a board that is considering a merger than of a board that is considering the construction of a plant. And under established Delaware doctrine, the enhanced-scrutiny standard will often be applied to the decisionmaking process in a suit for equitable relief, either under *Van Gorkom* and *Technicolor*; under *Blasius Industries, Inc. v. Atlas Corp.*<sup>52</sup> because the merger is coupled with provisions, like high termination fees or options on crown jewels, that impede the right of shareholders to freely reject the merger without suffering a financial penalty; or under *Unocal*, because the merger is coupled with takeover defenses or is itself a takeover defense. So, for example, in *In re Santa Fe Pacific Corp. Shareholder Litigation*,<sup>53</sup> the Delaware court concluded that the equity merger at issue was not reviewable under the *QVC* enhanced-scrutiny standard, but was reviewable under the *Unocal* enhanced-scrutiny standard.

## VI. CONCLUSION

As a matter of policy, the standard of review embodied in the disposition principle should be applied in actions to enjoin or set aside negotiated dispositions, and a related standard of review should be applied to the decisionmaking process of the nonsurvivor's board in actions to enjoin or set aside equity mergers between corporations whose shareholdings are widely dispersed. These principles stand on their own merits, and they also explain and organize the Delaware cases in a simpler and more coherent way than the rhetoric of the cases themselves. Either for that reason, or because these principles are good predictors of what the courts will do, whatever they say they are doing, a prudent lawyer is likely to advise directors engaged in a negotiated disposition or merger to make their decision as if an enhanced-scrutiny rule will be applied to their conduct.

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51. See, e.g., *In re Santa Fe Pacific Corp. Shareholder Litigation*, 669 A.2d 59 (Del. 1995); *Arnold v. Society for Savings Bancorp., Inc.*, 650 A.2d 1270 (Del. 1994).

52. 564 A.2d 651 (1988).

53. 669 A.2d 59 (Del. 1995).