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Marc I. Steinberg

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MARC I. STEINBERG*

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I. THE ALI DRAFT RESTATEMENT

The American Law Institute's Draft Restatement on Corporate Governance has received, at best, mixed reactions. Critics contend that adoption of the Draft Restatement would substantially change the methods by which corporations function by interposing rigid rules antithetical to the composition and operation of profit-maximizing boards. According to these views, adoption of the Draft would cause a proliferation of shareholder derivative suits, thereby increasing directors' exposure to liability and de-

* Associate Professor, School of Law, University of Maryland; A.B., University of Michigan; J.D., University of California, Los Angeles; LL.M., Yale University; Member, California and District of Columbia Bars.

4. See, e.g., Block & Prussin, supra note 2, at 12; Lewin, supra note 2, at D6, cols. 5-6 (view of the Business Roundtable's Corporate Responsibility Task Force).
5. See authorities cited supra note 4.
terrning qualified candidates from serving on corporate boards. Indeed, some critics characterize the Restatement effort as “presumptuous” and “appallingly arrogant.”

In view of these harsh criticisms, it is surprising that the Reporters for the Draft Restatement believe that they have not proposed any massive reforms. In a way they are correct. Under current practice, a majority of large publicly held corporations may be “monitored,” rather than managed, by their boards of directors. These corporations may have boards composed of a majority of “outside” directors. They may also have audit committees con-

6. See Lewin, supra note 2, at D6, col. 6 (view of John Stichnoth, General Counsel, Union Carbide Corporation).
7. Id. at D6, col. 5 (view of Roderick M. Hills, former chairman of the Securities and Exchange Commission).
8. Id. at D6, col. 4 (view of Andrew Sigler, President and Chairman of Champion International Corporation and Chairman of the Business Roundtable’s Corporate Responsibility Task Force).
9. Id. (views of Stanley A. Kaplan and Harvey J. Goldschmid, Chief and Deputy Chief Reporter, respectively, of the ALI Draft Restatement).
10. See Restatement, supra note 1, §§ 3.01-.02; Committee on Corporate Laws, ABA Section of Corporation, Banking and Business Law, Corporate Director’s Guidebook, 33 Bus. Law. 1591, 1603 (1978) [hereinafter cited as Corporate Director’s Guidebook] (responsibility of board of directors is limited to “overseeing” the operation of the business). As disclosed by the President of the ALI, the ALI Council replaced the term “monitor” with the term “oversee” in order “to meet the concern expressed by some that an obligation to ‘monitor’ involved a more active and wide-ranging obligation than was contemplated.” R. Perkins, Background and Status of ALI Corporate Governance Project and Commentary on Papers of Professors Andrews, Demsetz, and MacAvoy (Exhibits A, B and C to Feb. 1983 Statement of the Business Roundtable) app. at 1 (remarks at forum at the Association of the Bar of the City of New York, Mar. 14, 1983).
11. The term “outside” in this context refers to directors who are not affiliated with the corporation, its senior executives, or its controlling shareholders. Looking at directors who have relationships with the corporation that require disclosure under Item 6(b) of Schedule 14A of the SEC’s proxy rules, 17 C.F.R. § 240.14a-101 (1983), however, there is a question whether most publicly held corporations have boards composed of a majority of “disinterested” directors. See Restatement, supra note 1, § 3.03 comment a, at 72-73 (studies cited therein). If this is indeed the case, then section 3.03(a) may effect a change in current practice by requiring that a majority of directors “shall be free of any significant relationships [as defined in section 1.24] with the corporation’s senior executives.” Id. § 3.03(a).
12. See Restatement, supra note 1, § 3.03 comment a, at 72-73 (studies cited therein). For example, in 1978 the New York Stock Exchange (“NYSE”) conducted a corporate governance survey. The American Association of Corporate Secretaries mailed questionnaires to their 1700 members, of which 993 responded (58% of the membership). Six hundred fifty-five of these respondents were NYSE companies. The survey indicated that approximately 80% of the companies responding had a board of directors composed of a majority of nonmanagerial directors. It also indicated a marked increase, as compared to 1975, in the number of companies that had established audit, compensation, and nominating committees, as well as a marked increase in the number of such committees composed of nonmanagerial directors. Of the companies responding (both NYSE and non-NYSE companies), 92% maintained an audit committee composed of nonmanagerial directors. Subse-
sisting solely of outside directors. By setting forth these standards and monitoring mechanisms, the Draft Restatement is simply a reflection of current practice. Moreover, in view of the Delaware Supreme Court’s decision in Zapata Corp. v. Maldonado, the Draft Restatement’s treatment of the business judgment rule in the context of the special litigation committee is not a radical departure from present law.

Unlike current practice, however, under which corporations have voluntarily established “independent” boards and audit committees, the Draft Restatement takes the step of requiring such measures. In the implicit view of its critics, such mandatory practices are perhaps the Restatement’s greatest deficiency. They represent a departure from the established norm that the internal affairs of corporate life are generally best left to private regulation. Governmental intervention in corporate governance is warranted only when required by meritorious countervailing interests, such as those of the shareholders or the state. Even the Securities and Exchange Commission (“SEC”), during the chairmanship of Harold M. Williams, generally called for voluntary action. Although Chairman Williams proposed that the ideal board of directors should consist of independent directors (except for the chief execu-

13. See Restatement, supra note 1, § 3.05 comment a, at 85-86 (studies cited therein). An SEC staff survey of 1200 corporations revealed that 85% had audit committees and that a majority of these committees were made up solely of independent directors. Securities and Exchange Commission, 96th Cong., 2d Sess., Staff Report on Corporate Accountability 488 (Comm. Print 1980) [hereinafter cited as SEC Staff Corporate Accountability Report].

14. See Restatement, supra note 1, §§ 3.01-.03, .05.

15. See supra notes 10-13 and accompanying text.


17. It appears that the ALI Council, although retaining the requirement of “independent” audit committees for large publicly held corporations, has changed the Draft Restatement’s mandate that there be a majority of outside directors of such corporations to that of “good corporate practice.” R. Perkins, supra note 10, at 11.


tive officer who would not serve as chairman of the board), that audit and nominating committees be comprised solely of independent directors, and that neither the general inside nor outside counsel should serve as director to the corporation, he called upon the corporate community to implement these measures. Although these "exhortations" may have had an in terrorem impact, they reveal that even the SEC was wary of regulating corporate governance in the absence of compelling justification. Indeed, during hearings in the 96th Congress, Chairman Williams testified against enactment of the Metzenbaum bill, which would have imposed such regulation on corporate boards. Describing his "severe

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20. See Williams, Corporate Accountability and Corporate Power, in H. Williams & I. Shapiro, Power and Accountability: The Changing Role of the Corporate Board of Directors (1979) (The 1979 Benjamin F. Fairless Memorial Lectures); H. Williams, Corporate Accountability, Address before the Fifth Annual Securities Regulation Institute, San Diego, Cal., at 26 (Jan. 18, 1978) (available from the Securities and Exchange Commission).


23. See Steinberg, supra note 12, at 182.

24. For example, at Chairman Williams’ request, the New York Stock Exchange required that, to be listed, domestic firms had to maintain audit committees composed solely of outside directors. Some commentators contend that the Commission compelled the NYSE to adopt this measure. See Coffee, Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response, 63 Va. L. Rev. 1099, 1274 (1977) (“[T]he SEC virtually thrust the audit committee rule upon the New York Stock Exchange.”); Kripke, supra note 18, at 190 (“[T]o characterize the New York Stock Exchange’s action as that of a self-regulatory agency providing voluntary leadership... is unreal.” (footnote omitted)).

reservations about the wisdom of legislation designed to regulate the corporate boardroom," Chairman Williams declared that enactment of the bill might "retard" the goals that its drafters intended to achieve.26

The Draft Restatement, according to its critics, thus dictates to the corporate community the "proper" structure and role of the board.27 If a number of these corporate monitoring mechanisms are already in place, however, these criticisms may be "much ado about nothing." But the Draft Restatement requires more of the corporate community than is currently in practice. Although a clear minority of large publicly held corporations currently have nominating committees,28 the Draft Restatement mandates this mechanism.29 Even more unsettling is the Restatement's defining of the board's monitoring function. The Draft Restatement limits the board's participation in management to observation and objec-

entitled to vote on major corporate transactions, and that extensive disclosure be required in regard to such matters as employment discrimination, compliance with environmental controls, tax rates, cost of legal and accounting fees, and planned plant closings. See generally Metzenbaum, Legislative Approaches to Corporate Governance, 56 Notre Dame Law. 926, 926 (1981) ("There is widespread agreement within and without the business community that reforms are necessary in the governance of the nation's major corporations."); Millspaugh, The Corporate Democracy Act—A Renaissance or Death Knell for the Corporate World?, 4 Corp. L. Rev. 291 (1981) (suggesting that any major rewriting of corporate law should proceed with great caution).

26. Protection of Shareholders' Rights Act of 1980: Hearings on S. 2567 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess. 23 (1980) (statement of Harold M. Williams, Chairman, SEC). In his testimony, Chairman Williams stated that "the views which I express today are my own and not necessarily those of my fellow Commissioners—although I believe that at least a majority would agree with my conclusion at this time." Id. at 39.


27. See authorities cited supra note 2.

28. SEC Staff Corporate Accountability Report, supra note 13, at 525 (finding that only 29% of publicly held corporations, principally the larger ones, had created such committees). But see Andrews, supra note 2, at 36 ("Nominating and compensation committees are so nearly universal that requiring them does not appear onerous.").

29. Restatement, supra note 1, § 3.06. The ALI Council apparently has deleted this requirement, making the use of nominating committees a matter of "good corporate practice." R. Perkins, supra note 10, app. at 2.
tive oversight of management conduct. The drafters' exclusive adoption of the monitoring model ignores the presence of at least four other types of corporate boards, thereby rendering the Restatement's approach "simplistic, over-formal, and self-defeating."

The Draft Restatement's intervention into the corporate governance structure is also unnecessary at this juncture because established authority, as well as most publicly held corporations, recognize the need for the implementation of appropriate accountability mechanisms and controls. Moreover, because reasonable minds may differ as to whether certain mechanisms

30. Restatement, supra note 1, § 3.02; see Andrews, supra note 2, at 39.
31. Andrews, supra note 2, at 39 ("At least five kinds of boards have been categorized in a recent study: the legitimating (most perfunctory), the advisory (somewhat less distant but casual), the judicial (closest to the monitoring model), the dominating (highly managerial), and the participating board." (citing J. Lynch, Activating the Board of Directors (1979) (unpublished doctoral thesis, Harvard Business School)); see also Dent, The Revolution in Corporate Governance, The Monitoring Board, and the Director's Duty of Care, 61 B.U.L. Rev. 623 (1981) ("[E]xpositions of the monitoring model to date have been rudimentary. Its proponents have not suggested what forces will prompt corporations to adopt the model and thereby move it from theory to widely accepted reality." Id. at 624. At a later point, Professor Dent opined, "Acceptance of monitoring by commentators and corporations has led the Corporate Director's Guidebook and some other authorities to speak of a duty of monitoring as if it were established fact rather than a remote ideal." Id. at 633 (footnote omitted)).
32. Andrews, supra note 2, at 39. The ALI Council apparently has heeded this criticism and "now propose[es] that the board of directors may undertake such management if it desires." R. Perkins, supra note 10, app. at 1.
33. Such mechanisms include audit committees composed of disinterested directors and the maintenance of law compliance monitoring systems. See supra notes 12-13 and accompanying text; infra notes 34, 62-67 and accompanying text.
34. See infra notes 62-67 and accompanying text; see also SEC Staff Corporate Accountability Report, supra note 13:

The audit committee today has become so well established that any company which has chosen not to establish such a committee, composed solely of directors independent of management, should weigh carefully the costs of such a decision in terms of liability and loss of control against the reasons, if any, for not establishing an audit committee.

Id. at 583; Small, The Evolving Role of the Director in Corporate Governance, 30 Hastings L.J. 1353 (1979) ("Although directors may be unable to verify personally that adequate controls are in place to protect the corporation against loss of assets or insure compliance with applicable laws, directors do have certain minimal obligations in this area." Id. at 1374. In a footnote, Mr. Small stated, "Whatever may have been the purport of prior case law, in the light of developing trends it would be foolhardy of directors not to receive assurances that appropriate loss prevention and legal compliance programs are in place." Id. at 1361 n.35); Veasey & Manning, Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law, 35 Bus. Law. 919, 930 (1980) ("[T]he expected role of a director has grown to include the installation of legal compliance systems.").
such as nominating committees should be implemented, the Restatement process may not be the appropriate forum for resolving these issues. In light of the corporate community's acknowledgment of the need for and subsequent adoption of monitoring measures, disputed issues in this area should be addressed through such channels as the Business Roundtable, bar associations, self-regulatory organizations, and governmental "exhortations" until a consensus has been reached. The institution of internal corporate mechanisms as a legal norm should therefore be saved for situations in which their adoption would clearly be in the shareholders' and public's best interests.

This article will next turn to the business judgment rule and related principles under the Draft Restatement. The discussion will entail such subjects as the duty of care, the propriety of requiring demand on directors before derivative litigation may be commenced, and the application of the business judgment rule in the special litigation committee setting.

II. THE BUSINESS JUDGMENT RULE AND RELATED PRINCIPLES

The Draft Restatement's provisions regarding the business judgment rule and shareholder derivative suits have engendered further controversy. Opponents of the Draft Restatement fear that it weakens directors' defenses against claims of negligence and facilitates shareholder derivative suits. Examination of these provisions, however, reveals the drafters' effort to implement a rational and effective theory of director accountability and a needed mechanism for shareholder protection.

A. The Business Judgment Rule

Section 4.01(d) of the Draft Restatement provides corporate directors and officers with the protection of the business judgment rule. In order to come within the ambit of the rule, the subject director or officer must have "(1) informed himself and made reasonable inquiry with respect to the business judgment; (2) acted in good faith and without a disabling conflict of interest; and (3) had a rational basis for the business judgment."
Under the Draft Restatement, the safe harbor of the business judgment rule is available to directors’ and officers’ “deliberative” decisions only,39 i.e., decisions that “a director or officer has attentively and directly focused on and as to which judgment has, in fact, been exercised.”40 A major criticism of the provision is its restriction of the application of the business judgment rule to decisions in which judgment has in fact been exercised. According to this view, the number of situations coming within the scope of the Draft rule is severely limited. Consequently, corporate fiduciaries will focus on normally insignificant details. Their workload will drastically increase, exposing them to liability for failing to “focus” on a detail that at the time appeared immaterial.41

This criticism is an overreaction, for the trend in the case law and scholarly commentary supports only a “deliberative” decision as coming within the purview of the business judgment rule. Moreover, the commentary to the Draft Restatement explains that “deliberative” decisions encompass directors’ and officers’ judgments “to abstain from action as well as to act.”42 To extend the scope of the Draft’s business judgment rule to include “non-deliberative” conduct would broaden the rule to an unacceptable degree: it would transform the rule into a sword ready to pierce legitimate shareholder interests.43 Moreover, the concern that corporate fiduciaries would be held liable for neglecting to “focus” on what “reasonably” appeared to be an insignificant detail is simply not valid. Under the Draft Restatement, the subject director or officer would have complied with the duty of due care and, hence,

39. Id. § 4.01 comment a, at 145.
40. Id. The ALI Council apparently has deleted the term “deliberative.” Under the new formulation, the business judgment rule would protect decisions as to which “judgment has in fact been exercised.” R. Perkins, supra note 10, at 9.
41. See Andrews, supra note 2, at 38; Block & Prussin, supra note 2, at 12.
44. RESTATEMENT, supra note 1, § 4.01(d) comment a2, at 195.
45. See generally Steinberg, Application of the Business Judgment Rule and Related Judicial Principles—Reflections from a Corporate Accountability Perspective, 56 NOTRE DAME LAW. 903, 915 (1981) (“[A]lthough courts should apply the business judgment rule and related judicial principles in appropriate situations to shield management’s conduct, they should be careful to ensure that their processes are not used as a sword by recalcitrant management to pierce legitimate shareholder interests.”).
would be absolved from liability.

The requirement of section 4.01(d) that the corporate fiduciary have "a rational basis for the business judgment" has also attracted controversy. Opponents of the Draft argue that the "rational basis" standard creates an uncertain culpability standard, almost resembling that of negligence. The commentary to the provision effectively refutes this argument by defining decisions lacking a rational basis as beyond "the level of ordinary negligence by being egregiously unreasonable." Such a formulation, of course, is not amenable to precision. Like most legal terms, it will acquire meaning through application to concrete facts and circumstances.

Case law bolsters the Draft’s "rational basis" component of the business judgment rule. Courts have soundly held that, even though a director or officer may be adequately informed and may reasonably inquire, he may still make an irrational decision. The law should not insulate such decisions because the interests of shareholders and innocent third parties outweigh any societal benefits of such an expansive business judgment rule.

46. See Restatement, supra note 1, § 4.01(a); id. § 4.01(a) comments a-c, at 150-58. As an additional point, it should be noted that "the business judgment rule presupposes that the directors have no conflict of interest," Lewis v. S.L. & E., 629 F.2d 764, 769 (2d Cir. 1980), and act in good faith, Treadway Cos. v. Care Corp., 638 F.2d 357, 380-83 (2d Cir. 1980). See generally Phillips, Managerial Misuse of Property: The Synthesizing Thread in Corporate Doctrine, 32 Rutgers L. Rev. 184 (1979) (historical development of corporate law doctrine).

47. Restatement, supra note 1, § 4.01(d)(3).

48. See Andrews, supra note 2, at 35; All Begins Debate, supra note 2, at 1027.

49. Restatement, supra note 1, § 4.01 comment a, at 147.


51. See Restatement, supra note 1, § 4.01(d) comments d-e, at 209-12; id. § 4.01(d) reporter's notes 1-6, at 212-14; Small, The Rights and Duties of Directors under the Business Judgment Rule, in Standards for Regulating Corporate Internal Affairs 110, 125-29 (D. Fischel ed. 1981); Arsh, supra note 443, at 107; Arsh & Hinsey, Codified Standard—Same Harbor But Charted Channel: A Response, 35 Bus. Law. 947, 955 (1980); Vee-sey, supra note 43, at 1251.

52. See Steinberg, supra note 45, at 905 ("Like any rule of general application, however, [the business judgment rule] can be construed so expansively that virtually any management action may be deemed reasonably made in good faith.").

53. At least three strong policy considerations support the business judgment rule: (1) if management were liable for mere good faith errors in judgment, few capable persons would be willing to incur the financial and emotional risks of serving in such positions, see Corporate Director's Guidebook, supra note 10, at 1603-04, 1615; (2) courts are generally ill equipped to scrutinize business judgments, see Auerbach v. Bennett, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); (3) management has the expertise to
standard adopted thus must reflect these interests without holding corporate fiduciaries to a "hindsight twenty-twenty" level of culpability. Because the "rational basis" standard meets this objective, it should be retained in the Draft Restatement.

B. The Duty of Care

The Draft Restatement's definition of "duty of care" seems uncontroversial because of its similarity to the duty of care standard adopted in the Model Business Corporation Act and by a number of states. The provision insulates from liability a corporate fiduciary who has adhered to the standard of reasonable care in section 4.01(a) even when a "deliberative" decision has not been made.

Traditionally, however, courts have rarely imposed liability for negligent conduct on corporate fiduciaries, notwithstanding the negligence standard of culpability in many state statutory and common law definitions. This is particularly true in the absence of self-dealing or conflicts of interest on the part of such officers or directors. The Draft Restatement seeks to overcome this judicial reluctance by making it explicitly clear that negligent behavior by corporate fiduciaries is actionable and by establishing in section 7.06(d) a ceiling on damages in the absence of culpability surpassing that of negligence. As the defense bar has noted, the consequences of the Draft's approach would be an increase in the number of judgments obtained against directors and officers. And because the ceiling on damages is inapplicable in instances of...
knowing misconduct or recklessness, as a matter of litigation technique and settlement strategy, plaintiffs would normally allege such misconduct.

Notwithstanding the potential costs of exposing corporate fiduciaries to a larger number of litigious complainants, the Draft Restatement's approach, on balance, is commendable. For a number of years, leading members of the corporate bar, bar associations, and the corporate community have declared that corporate fiduciaries must undertake their due diligence obligations, including the need to make inquiry and to focus on the propriety of law compliance and loss prevention programs, with

60. The Draft Restatement, by implication, also seems to remove the ceiling on damages when the defendant acted with gross negligence. Section 7.06(d)(i) establishes such a ceiling in duty of care cases in which the defendant can show that "the conduct or nonfeasance resulting in such defendant's liability did not involve knowing misconduct, or recklessness, or otherwise surpass the level of ordinary negligence." Id. § 7.06(d)(i). In the accompanying commentary, however, the Draft Restatement states that section 7.06(d) chiefly excludes the following types of violations from its scope: "(a) violations of a duty of loyalty, (b) essentially 'reckless' violations of a duty of due care, and (c) duty of care violations where the defendant or certain defined affiliated persons 'improperly' benefit." Id. § 7.06 comment e, at 397. The ALI Council apparently has clarified this issue by inserting "a recklessness test as the basis for exclusion from the benefit of the ceiling." R. Perkins, supra note 10, app. at 5.

61. See Block & Prussin, supra note 2, at 12.

62. See, e.g., Arsh & Hinsey, supra note 51; Small, supra note 34; Veasey & Manning, supra note 34.

63. See, e.g., Corporate Director's Guidebook, supra note 10, at 1600-20.

64. The Business Roundtable, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation, 33 Bus. Law. 2083, 2101 (1978) (emphasizing the need for policies and procedures implementing corporate law compliance programs).

65. See Restatement, supra note 1, § 4.01(b) (encompassing within the duty of care the obligation of a director or officer to make reasonable inquiry when acting upon corporate transactions or otherwise performing his functions”). As pointed out by the Draft Restatement, the duty of a corporate fiduciary to make “reasonable inquiry” is well-established. Id. § 4.01(b) comment a, at 175-76; id. § 4.01(b) reporter's note 1, at 183.

66. See Arsh & Hinsey, supra note 51; Corporate Director's Guidebook, supra note 10; Small, supra note 34; The Business Roundtable, supra note 64. But see Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (Del. 1963), in which the Delaware Supreme Court stated that "absent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." Id. at 85, 188 A.2d at 130. In support of Allis-Chalmers, one commentator has stated that the decision, "rather than being one of the weaker legs in our law, is one of the stronger and one of the more practical applications of reality to the management of corporations and the criticism can be seen as largely, or to a large degree, ivory tower." Ward, Fiduciary Standards Applicable to Officers and Directors and the Business Judgment Rule under Delaware Law, 3 Del. J. Corp. L. 244, 247 (1978). Regardless of whether Allis-Chalmers was correctly decided twenty years ago, most authorities assert that management would be ill-advised to rely on that opinion today. See Restatement, supra note 1, § 4.01(b) comments a-b, at 176-83; id. § 4.01(b) reporter's notes 3-6, at 183-86; Small, supra, at 1360; Veasey & Manning, supra note 34, at 926-30; cf. SEC Staff Corporate
greater vigor. Corporate support and implementation of these practices have prompted some authorities to conclude that courts today will impose ordinary negligence liability on directors and officers.67

In light of recent Supreme Court decisions eroding shareholder protection under federal law,68 a construction of corporate culpability based on negligence principles is consistent with the view that state courts will reverse "the race for the bottom"69 by providing meaningful redress.70 Moreover, if the business judgment rule of the Draft Restatement is to have practical meaning, corporate fiduciaries must be provided greater leeway for error when a "deliberative" decision has been reached. To apply essentially the same culpability standard regardless of whether a "deliberative" decision has been made is not only incongruous but provides little incentive for directors and officers to take the measures required to invoke the protection of the business judgment rule. And although corporate fiduciaries would be vulnerable to an increased number of successful actions for monetary damages under the standard of care formulation of section 4.01(a), the Draft Restatement ameliorates the potential exorbitant recovery for negligence by establishing a ceiling on damages.71

Accountability Report, supra note 13, at 583 (advocating audit committee composed of independent directors); The Business Roundtable, supra, at 2101 (advocating law compliance program).

67. See, e.g., Small, supra note 51, at 121 ("[O]n close analysis, it appears likely that courts will hold directors to a duty to exercise ordinary care and diligence in carrying out their responsibilities."); see also RESTATEMENT, supra note 1, § 4.01 comment f, at 162-64; Vessey & Manning, supra note 34.

68. See, e.g., Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977) ("Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." (quoting Cort v. Ash, 422 U.S. 66, 84 (1975) (emphasis in Santa Fe))). But see Herman & MacLean v. Huddleston, 103 S. Ct. 683 (1983).


70. See, e.g., Singer v. Magnavox Co., 380 A.2d 969, 976 n.6 (Del. 1977) (viewing Santa Fe Indus. v. Green, 430 U.S. 462 (1977), as a "current confirmation by the Supreme Court of the responsibility of a State to govern the internal affairs of corporate life"). But see Weinberger v. UOP, 457 A.2d 701 (Del. 1983).

71. See RESTATEMENT, supra note 1, § 7.06(d)-(e); supra note 60 and accompanying text.
C. The Business Judgment Rule and Related Principles in the Context of Shareholder Derivative Litigation

Critics assert that the Draft Restatement would encourage the initiation of, and discourage the termination of, shareholder derivative suits. There is merit to this contention. Under the Draft Restatement, shareholder standing requirements are more easily met, verification of the complaint is dispensed with, demand on shareholders is not required, and security for expenses is generally eliminated. In addition to easing some of the procedural requirements in derivative actions, the Draft Restatement places a heavy burden upon the corporation to procure the dismissal of a properly instituted derivative action against one or more corporate fiduciaries. An exception to the Draft Restatement's facilitation of derivative suits, however, is its imposition of a rigorous standard for determining when demand on the board of directors is required.

1. DEMAND ON THE BOARD OF DIRECTORS

Under section 7.02(b) of the Draft Restatement, as a prerequisite to the bringing of a derivative suit, a shareholder must make a timely demand upon the board of directors. The shareholder must demand that the board prosecute the suit or take other "suitable" corrective measures, unless the demand would be "clearly futile" due to the board's inability to reach a disinterested determination. There is a trade-off for this stringent demand standard: The determination of whether demand is required is entirely separate from that of the board's ability to terminate the action when a corporate fiduciary is a party.

By severing the issue of demand from that of terminating lit-
gation when a corporate fiduciary is a party, the Draft Restatement departs from what appears to be the traditional and prevailing view. Under that view, if demand is required, a court will dismiss the litigation pursuant to the board's disinterested business judgment that the suit's prosecution is not in the corporation's best interests. Although the Draft adopts this principle when extra-corporate parties are subject to suit, it declines to extend the rule to an action brought against one or more corporate fiduciaries. In adopting this approach, the Draft acknowledges the board's inherent structural bias by assuming that application of the business judgment rule to a board's decision to foreclose a derivative suit is inappropriate whenever a corporate fiduciary is a "legitimate" defendant.

Treatment of the issue of excusing shareholder demand should focus on whether the court would permit the board to prosecute the action if the board so desired, or whether a board faced with meritorious allegations would be willing to implement internal corrective measures. Although the Draft Restatement requires demand on the board to promote the foregoing policy position, it de-

81. See, e.g., United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917); Gall v. Exxon Corp., 418 F. Supp. 508, 515 (S.D.N.Y. 1976); Steinberg v. Hardy, 90 F. Supp. 167, 169 (D. Conn. 1950); Babcock v. Farwell, 245 Ill. 14, 46, 91 N.E. 683, 694 (1910); Barr v. Wackman, 36 N.Y.2d 371, 378, 329 N.E.2d 180, 185-86, 368 N.Y.S.2d 497, 504-05 (1975); Passmore v. Allentown & Reading Traction Co., 267 Pa. 356, 359, 110 A. 240, 241 (1920); 13 W. Fletcher, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 522, at 145 (rev. perm. ed. 1975). But see Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49, 54 n.5 (5th Cir. 1980) ("[W]e do not mean necessarily to equate the showing of interest that would excuse such 'demands' and that necessary to vitiate subsequent director action. The former is more rigorous."); Galef v. Alexander, 615 F.2d 51, 59 (2d Cir. 1980) ("The decision as to whether a demand is excusable, however, does not necessarily answer the question presented here, of whether a resolution by directors to seek summary termination of the suit should be honored."); Heit v. Baird, 567 F.2d 1157, 1162-63 n.6 (1st Cir. 1977) (participation by fiduciaries in alleged misconduct, although not sufficient to excuse the demand requirement, may nevertheless prevent directors from barring a derivative action).

82. Zapata Corp. v. Maldonado, 430 A.2d 779, 784 n.10 (Del. 1981); see cases cited supra note 81.

83. Restatement, supra note 1, § 7.03(a)(i).

84. Id. § 7.03(a)(ii). In an accompanying footnote, the Draft Restatement clarifies that "mere employees, junior officers, and others below the level of the board or the senior executives" are not to be considered as corporate fiduciaries. Id. at 295 n.*.

85. See Restatement, supra note 1, § 7.03 comment a, at 303-04; see also Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49, 52-54 (6th Cir. 1980).

86. The term "legitimate" defendant excludes those corporate fiduciaries who are named as defendants without a factual basis and for whom summary judgment motions would be granted by an impartial tribunal. See Heit v. Baird, 567 F.2d 1157, 1162 (1st Cir. 1977); Lewis v. Valley, 476 F. Supp. 62, 64 (S.D.N.Y. 1979).

87. See Restatement, supra note 1, § 7.02 comment e, at 271.
clines to articulate precise guidelines. For example, the Draft fails to specify if demand is required when the subject directors authorized or "acquiesced" in the allegedly questionable conduct without financially benefiting from it.\(^8\) If the business judgment rule were applied to the board's decision to terminate the litigation, there would be good reason to excuse demand. Such defendant-directors generally would be incapable of exercising impartial judgment about approving the initiation of litigation naming them as defendants.\(^9\) The Draft Restatement's severing of the issue of demand from that of litigation termination in this context, however, presents a more difficult issue.

An argument can be made that a board anticipating judicial review of its decision will be motivated to take corrective measures, even though it may ultimately seek to foreclose the suit.\(^9\) Under this view, demand should be required. On the other hand, it may be asserted that requiring demand would simply serve as a delay mechanism and impel corporate management and counsel to develop "paper trails" for the purpose of persuading a court that the board's motion to foreclose the derivative suit was based on a con-

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88. The Draft Restatement states the following principles: "(1) demand is unnecessary where a majority of the board is alleged to have been closely involved in the alleged misconduct, but (2) a bare conclusive allegation that directors negligently failed to exercise due care with respect to active misconduct committed by others is not alone sufficient to excuse demand." RESTATEMENT, supra note 1, § 7.02 comment e, at 269-70.

89. See M. STEINBERG, supra note 21:

In order to preserve the vitality of the shareholder derivative suit in this context, the . . . courts should excuse the demand requirement whenever a majority of "acquiescent" as well as "interested" directors are named as defendants. Moreover, demand should be excused if a majority of the board is disabled, such as being under the domination of a controlling shareholder. In the above settings, the board should be deemed as "stand[ing] in a dual relation which prevents an unprejudiced exercise of judgment." The reason for this conclusion is fairly clear: If a majority of such directors (including directors who approved the challenged transaction) are given authority to determine whether the suit should proceed, they will necessarily make a judgment, perhaps implicitly, on the propriety of their own conduct. To expect such directors who have authorized or benefited from a challenged transaction (that has perhaps benefited fellow directors as well) to judge in good faith whether the suit naming them as defendants is in the corporation's best interests is futile. By the very nature of their participation in the alleged illegal conduct, such directors are incapable of rendering impartial judgment. A contrary holding discounts the realities of the corporate decision-making process and fundamental principles of corporate accountability.


90. See RESTATEMENT, supra note 1, § 7.02 comment e, at 271.
scientious, thorough, and reasonable evaluation. Although both of these arguments are plausible, in the final analysis the Draft Restatement correctly excuses demand when demand would not prod the board into correcting the wrong.

Finally, it should be emphasized that the Draft Restatement substantially departs from the apparent majority view by severing the issue of demand from that of litigation termination when one or more corporate fiduciaries are defendants. Perhaps the vindication of shareholder interests and the promotion of corporate accountability justify the departure. Nonetheless, the resolution of this issue, although procedural in nature, will have a major substantive impact on the ability of aggrieved shareholders to bring derivative actions.

2. SPECIAL LITIGATION COMMITTEE TERMINATION

Section 7.03 of the Draft Restatement concerns, inter alia, the role of a special litigation committee in terminating shareholder derivative litigation. The section provides that in a derivative action brought against one or more corporate fiduciaries, the board may establish a committee composed of at least three independent directors. The committee, with the assistance of a special counsel, should conduct an investigation and issue a written report documenting its findings on whether the litigation is in the corporation’s best interests. Providing that the board complies with those or comparable procedures, the court, exercising its “independent judgment,” may dismiss the suit if the justification offered by the committee “[a] is not outweighed by the probable recovery or other relief that the court determines is likely to result from the litigation, [b] does not frustrate any authoritatively established public policy, and [c] is advanced in good faith.”

92. See Lewis v. Curtis, 671 F.2d 779, 786 (3d Cir. 1982) (“[T]he court, in determining whether demand is necessary, should consider whether a demand on the directors would be likely to prod them to correct a wrong.”).
93. See supra notes 81-82.
94. See supra notes 79-87 and accompanying text.
95. Restatement, supra note 1, § 7.03(b). For a clarification of the term “corporate fiduciary,” see supra note 84. If the derivative suit is brought exclusively against persons who are not corporate fiduciaries, then the business judgment rule applies to the board’s (or relevant committee’s) determination not to pursue the action. Restatement, supra note 1, § 7.03(a)(i).
96. Restatement, supra note 1, § 7.03(c)(ii). The Draft Restatement contains a number
The commentary accompanying the provision\textsuperscript{97} explains that the section “essentially” adopts the Delaware Supreme Court’s decision in \textit{Zapata Corp. v. Maldonado}\textsuperscript{98} instead of the New York Court of Appeals’ approach in \textit{Auerbach v. Bennett}.\textsuperscript{99}

Both \textit{Maldonado} and \textit{Auerbach} involved shareholder derivative litigation. The difference between the opinions sheds light on the Draft Restatement, for each court applied a different degree of scrutiny to a litigation committee’s decision to bar such an action. The \textit{Auerbach} court employed an expansive business judgment doctrine, asserting that, with the plaintiff bearing the burden of proof, a court need inquire only into the disinterestedness of the committee members and the adequacy of their investigative procedures. Beyond that inquiry, a court may not intrude into the substantive propriety of a decision deemed to be within the board’s discretion.\textsuperscript{100}

The \textit{Maldonado} court’s two-step test demonstrated a stricter scrutiny. Shifting the burden of proof to the defendants, a court analyzes the independence and good faith of the committee and the adequacy and reasonableness of its procedures and conclusions.\textsuperscript{101} After the first test is satisfied, the court may apply its own independent business judgment in determining the propriety of dismissal. According to \textit{Maldonado}, the court should weigh “legit-
mate corporate claims as expressed in a derivative stockholder suit and a corporation's best interests as expressed by an independent investigating committee."\textsuperscript{102} In addition, the court "should, when appropriate, give special consideration to matters of law and public policy."\textsuperscript{103} \textit{Maldonado}'s formula for the exercise of the court's own business judgment contrasts markedly with \textit{Auerbach}'s prohibition against judicial "trespass in the domain of business judgment."\textsuperscript{104}

Critics of the Draft Restatement argue that the business judgment rule applied in \textit{Auerbach}\textsuperscript{105} should be the appropriate standard.\textsuperscript{106} The adoption of such a standard, however, would be unfortunate. As the Draft Restatement recognizes, the use of special litigation committees to bar valid shareholder derivative actions against corporate fiduciaries is extraordinary. The inherent pressure on committee members to discount the corporation's interests when such persons are sued warrants careful scrutiny by the courts. Accordingly, a court should independently scrutinize the type of conduct alleged to have occurred, the suit's potential benefit to the corporation, and the reasonableness of the committee's determination.\textsuperscript{107} It should be stressed, however, that the Draft Restatement extends the \textit{Maldonado} rationale.

Perhaps the Draft's most significant extension of \textit{Maldonado} involves the application of \textit{Maldonado}'s stricter scrutiny to all properly instituted shareholder derivative suits against one or more corporate fiduciaries.\textsuperscript{108} In contrast, \textit{Maldonado} requires the application of its standards of scrutiny only to cases in which de-
mand on the board is excused. Consequently, the Draft provides that derivative actions against a single director or executive officer will trigger the formulation of a special litigation committee with its attendant procedural and substantive measures that must be met before dismissal is granted. By comparison, under Maldonado, an action against a single director or officer normally can be foreclosed pursuant to the business judgment of the disinterested directors. Also, under the Draft Restatement, when a corporate fiduciary is a party to the derivative action, a special litigation committee apparently must be formed. This committee must be composed solely of "independent" directors, which excludes persons affiliated with the corporation’s counsel or investment banker. Moreover, the defendant corporate fiduciaries do not have the authority under the Draft Restatement to nominate or appoint new members to the board who will serve on the special litigation committee.

The Draft Restatement’s more stringent standard is based on the implicit proposition that to allow directors to bar derivative suits against fellow corporate fiduciaries raises serious questions of conflicts of interest and neglects the inherent problem of structural bias. Such a standard, however, does not impose an unduly rig-
rious burden on corporate fiduciaries. If a committee complies with the procedures enumerated in section 7.03, a court, exercising its independent judgment, may grant the motion to dismiss.\textsuperscript{116} In this regard, the Draft Restatement correctly declines to draw a distinction between derivative actions naming a majority and actions naming a minority of corporate fiduciaries as defendants. The impartiality of members of the board (or of the special litigation committee) does not depend on the number of corporate fiduciaries named as defendants. The inherent problems of structural bias persist, irrespective of the number of corporate fiduciaries accused of wrongdoing.

The appearance of impropriety in the special litigation committee context is important. To shareholders seeking redress on the corporation's behalf, judicial deference to a special litigation committee's recommendation to terminate litigation must seem particularly unfair.\textsuperscript{117} To counteract the appearance (or indeed, in some cases, the presence) of impropriety, yet retain the special litigation committee's authority to terminate such actions, the Draft Restatement correctly requires a court's independent scrutiny of the committee's composition and determination before authorizing dismissal of the action.\textsuperscript{118}

\section*{D. Tender Offers}

The Draft Restatement at the present stage has not addressed the subject of control transactions.\textsuperscript{119} As in the special litigation committee setting, it is crucial for both shareholder protection and corporate accountability that the business judgment rule in the tender offer context is not too broadly applied. A number of courts have interpreted the rule as permitting target managements to utilize a variety of defensive tactics to thwart hostile tender offers. These techniques include announcing unprecedented dividend in-

\begin{itemize}
  \item \textsuperscript{116} See Restatement, supra note 1, § 7.03(c).
  \item \textsuperscript{117} See Maldonado v. Flynn, 413 A.2d 1251, 1263 (Del. Ch. 1980) ("Aggrieved stockholders of Delaware corporations ought to be able to expect that an impartial tribunal, and not a committee appointed by the alleged wrongdoers, will decide whether a stockholder's derivative suit alleging breach of fiduciary duty has any merit." (citing Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980)), rev'd and remanded sub nom. Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981)); see also Steinberg, supra note 99, at 29 n.142; Note, supra note 91, at 629.
  \item \textsuperscript{118} See Restatement, supra note 1, § 7.03(c); see also M. Steinberg, supra note 21.
  \item \textsuperscript{119} Part VI of the Draft Restatement will address "transactions in control." It is not included in the present draft. See Restatement, supra note 1, table of contents at xv; id. introductory note at xxiii.
\end{itemize}
creases, issuing stock to a friendly third party, entering into defensive mergers with "white knights," and acquiring other corporations to raise antitrust obstacles. To shareholders deprived of the opportunity to tender their shares at a substantial premium due to the obstructionist maneuvers of incumbent management, a broad interpretation of the business judgment rule smacks of unfairness. Under an expansive construction of the rule, "[r]egardless of the tactic employed, management can easily manufacture a 'legitimate' corporate purpose for its action, even when it employed the tactic solely to perpetuate its own status." Management's success is practically assured when it employs sophisticated legal counsel and investment bankers to lay a foundation for and to structure its defensive maneuvers.


Unfortunately, the majority here has moved one giant step closer to shredding whatever constraints still remain upon the ability of corporate directors to place self-interest before shareholder interest in resisting a hostile tender offer for control of the corporation. There is abundant evidence in this case to go to the jury on the state claims for breach of fiduciary duty. I emphatically disagree that the business judgment rule should clothe directors, battling blindly to fend off a threat to their control, with an almost irrebuttable presumption of sound business judgment, prevailing over everything but the elusive hobgoblins of fraud, bad faith or abuse of discretion.

Id. Judge Cudahy also asserted:

This case announces to stockholders (if they did not know it before) that they are on their own and may expect little consideration and less enlightenment from their board of directors when a tender offeror appears to challenge the directors for control. [Accordingly,] only the submission to jury verdict of cases like this one can restore confidence in our system of corporate governance.

Id. at 312; see also Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981); M. STEINBERG, supra note 21; Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161 (1981).

122. See Steinberg, supra note 45, at 906-07; see also authorities cited supra notes 120-21; Herzel, Schmidt & Davis, supra note 120, at 103, 120-22, 131 (maintaining that the
For the protection of shareholder interests the Restatement should at least require that courts independently assess whether management's objective was to benefit the subject corporation or to maintain control. If the preservation of control was a substantial motive underlying management's conduct, then the Restatement should require that the subject directors and officers justify the fairness of the maneuvers and transactions. The presence of certain, although not necessarily determinative, factors would illuminate underlying motives in control transactions. One such criterion should be whether the decision to oppose the tender offer and to engage in defensive tactics was made by “independent” directors having no “significant relationship” with the senior executive officers or by those directors and officers whose economic well-being depended on the subject corporation’s continued separate existence.

advice of an investment banker on the financial issues and of legal counsel on the legal issues is desirable.

123. See Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980) (Under New Jersey law, “[i]f a plaintiff demonstrates that a director had an interest in the transaction at issue, the burden shifts to the director to prove that the transaction was fair and reasonable to the corporation.”). But see Panter v. Marshall Field & Co., 646 F.2d 271, 293-95 (7th Cir.), cert. denied, 454 U.S. 1092 (1981) (to rebut presumption of the business judgment rule, plaintiff must show that the defendant's sole or primary motive was to retain control); Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir. 1980) (same). It has been said that the Panter and Johnson cases go too far: “Under such an expansive interpretation, management given the benefit of hindsight and the advice of expert counsel can practically always set forth some rational and proper purpose to explain its conduct.” Steinberg, supra note 45, at 906. For a discussion of judicial treatment of burden of proof when corporate control is a motive for the stock repurchase, see Gruenbaum, Defensive Tactics and the Business Judgment Rule, 4 Corp. L. Rev. 263 (1981) (comparing the approaches taken by the Second and the Third Circuit Courts of Appeals toward the issue of burden of proof); Comment, Buying Out Insurgent Shareholders with Corporate Funds, 70 Yale L.J. 308 (1960).

124. Restatement, supra note 1, §§ 1.24, 7.03(e).


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. Thus, regardless of their technical “independence,”
III. Conclusion

The Reporters to the Draft Restatement should be commended for compiling a comprehensive framework of principles for corporate governance and structure. With respect to certain provisions, it may be argued that the document is too innovative in exacting compliance with certain standards that the law does not—and perhaps should not—require. For the most part, however, the Draft Restatement codifies legal principles having a firm foundation in a number of jurisdictions.

The Draft Restatement's most serious obstacle is sustaining its vitality in an atmosphere of continuing criticism. It would not be surprising if some members of the defense bar and certain self-regulatory organizations and corporations continue their vigorous attempt to "water down" the applicable standards. On a number of matters, these critics may be correct in asserting that certain principles contained in the Draft inordinately intrude into internal corporate affairs and unduly favor shareholder litigants at the expense of corporate fiduciaries. If these criticisms are implemented to an excessive degree, however, the Restatement will serve as an insurance policy for corporate malfeasant. In the final analysis, although some changes may be appropriate, the Draft Restatement must retain its present character if shareholders and corporations are to be adequately protected.

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directors of a target corporation are in a very special position, where the slavish application of the majority's version of the good faith presumption is particularly disturbing.

Id. (footnote omitted). Moreover, it should be recognized that management will often be able to influence outside directors. See MITE Corp. v. Dixon, 633 F.2d 486, 494-95 (7th Cir. 1980), aff'd on other grounds sub nom. Edgar v. MITE Corp., 457 U.S. 624 (1982).