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ECONOMIC ANALYSIS, CORPORATE LAW, AND THE ALI CORPORATE GOVERNANCE PROJECT*

Elliott J. Weiss†

INTRODUCTION

Debate about the corporate governance system now is focused on the American Law Institute's Corporate Governance Project.¹ The scholarly articles and professional discussions that presaged the Project showed clearly that the rules governing the rights and obligations of the principal participants in publicly held corporations reflect the somewhat serendipitous influence of a variety of historical, political, economic, and social forces, rather than a coherent theory of shareholder/manager relationships.² The Project's stated goal—to create a “new art form,” a set

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¹ This Article refers to the three drafts of the American Law Institute Corporate Governance Project, *PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS* (Tent. Draft No. 1, 1982) [hereinafter cited as ALI Draft No. 1] and *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* (Tent. Drafts No. 2 & No. 3, 1984) [hereinafter cited ALI Draft No. 2 and ALI Draft No. 3] as the “ALI Project,” the “ALI,” or the “Project.”

² See *COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE* (D. Schwartz ed. 1979) (report on series of meetings sponsored by the ALI and the American Bar Association) [hereinafter cited as *COMMENTARIES*]; Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 *Bus. Law.* 883 (1976) (report on conference sponsored by the ABA Section on Banking, Business and Corporation Law); *Corporate Governance in America*, 54 *THE AMERICAN ASSEMBLY* 1 (1978).

In the early part of the 20th century, corporate law consisted largely of economic restrictions on corporate activities and the structure of shareholder/manager relationships. These restrictions reflected long-standing legislative suspicions about the potential power of corporations, a judicial tradition of viewing corporate charters as contracts among shareholders and between corporations and the state, and notions of fiduciary obligation and organizational structure more appropriate to trusts or to small, closely held corporations than to large, publicly held, business organizations. A corporation's internal affairs are governed by the laws of its state of incorporation, but the corporation otherwise is free to engage in a variety of businesses in other states. This freedom has caused many managers to incorporate in states whose laws imposed the fewest restrictions on their operations. See *Liggett Co. v. Lee*, 288 U.S. 517, 548 (1933) (Brandeis, J., dissenting) (outlining historical restrictions embodied in corporate law).

One major theme in the literature is that state corporate law largely reflects efforts by state legislatures and courts to pander to the self-aggrandizing inclinations of corporate fidu-

of proposals that would transcend mere restatement of existing doctrines³—recognized implicitly the less than satisfactory condition of the field of corporate law.

To date, the ALI Project has addressed all important areas of corporate law except transactions involving control. The Project's proposals cover corporate purpose and structure, directors' duties of due care and loyalty, and remedies.⁴ In general, the Project has recommended relatively modest, incremental changes in current doctrine, most of which would limit managers' autonomy or increase their vulnerability to shareholder derivative suits. These recommendations have met with predictable opposition from the corporate community, led by The Business Roundtable.⁵ But they also have evoked largely critical responses from academic commentators, who have pointed out that the ALI proposals suffer from an absence of coherence similar to that which plagues the existing corporate governance system.⁶

These early reactions highlight the need for the ALI Project to

ciaries. See, e.g., Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (criticizing Delaware's corporate jurisprudence as too permissive). Some commentators claim this criticism is unbalanced, in that it does not credit cases in which state courts have imposed liability on corporate fiduciaries or disallowed conduct that they viewed as exploitative. See, e.g., Arsh, *Reply to Professor Cary*, 31 BUS. LAW. 1113, 1114-16 (1976). Others dispute this criticism on economic grounds. See, e.g., Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUDIES 251, 256-57 (1977). Professor Winter argues that investors are sensitive to risks of managerial exploitation and, therefore, will pay less for shares of a corporation domiciled in a jurisdiction that permits such exploitation. He concludes that such corporations will pay more for capital, ultimately impairing their ability to compete or forcing them to relocate in jurisdictions where they can raise capital on the same terms as their competitors. All these comments have some merit, but none is wholly persuasive.

³ See COMMENTARIES, *supra* note 2, at 554 (remarks of Louis Loss).

⁴ In May 1982, the American Law Institute discussed its ALI Draft No. 1, which dealt with corporate objectives, corporate structure, the duty of care, and remedies. The ALI subsequently retitled the project and issued two additional drafts. ALI Draft No. 2, *supra* note 1 (modifying recommendations made in first draft concerning corporate objectives and corporate structure); ALI Draft No. 3, *supra* note 1 (modifying recommendations on duty of care and adding new proposals concerning duty of loyalty). At its 1984 meeting, the Institute tentatively approved §§ 2.01 (The Objective and Conduct of the Business Corporation), 3.01 (Management of the Corporation's Business: Power and Functions of Senior Executives), and 3.02 (Powers and Functions of the Board of Directors). See *Membership Reviews Latest Drafts at 1984 Annual Meeting*, 6 ALI REPORTER 1, 7 (July 1984). The Institute was not asked to vote on ALI Draft No. 3 because the ALI Council had not completed consideration of that draft. Although ALI Draft No. 1 discussed remedies, neither the second nor the third drafts deal with that subject.

⁵ See STATEMENT OF THE BUSINESS ROUNDTABLE ON THE AMERICAN LAW INSTITUTE'S PROPOSED "PRINCIPLES OF CORPORATE GOVERNMENT AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS" (1983) [hereinafter cited as ROUNDTABLE STATEMENT].

⁶ See Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 Stan. L. Rev. 927 (1983); Fischel, *The Corporate Governance Movement*, 35 Vand. L. Rev. 1259 (1982); Branson, *Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance and Structure*, 68 MINN. L. REV. 53 (1983).

more thoroughly examine existing corporate law doctrines and to recommend more radical, nonincremental changes to the present system.⁷ If the Project's recommendations are to command the respect, if not the support, of the bench, the bar, the academy, and the corporate community, they must constitute a comprehensive and internally consistent set of rules for corporate governance. Analysis of the recent literature of corporate governance suggests developing such rules is feasible. A widespread consensus has developed about most important aspects of corporate structure and shareholder/manager relationships. Consequently, the ALI Project needs to resolve only a few basic issues.

Professor Kenneth Scott's thoughtful critique of the ALI Project's first round of proposals is suggestive of the approach the Project should employ.⁸ He recommends that the ALI consider explicitly the growing body of economic literature dealing with corporate governance issues, as well as recent judicial trends. The economic literature, Professor Scott argues, supports a number of dramatic changes in corporate law, including abolishing liability for breaches of the duty of due care and restructuring the derivative suit to deter more effectively breaches of the duty of loyalty. Judicial attitudes, he suggests, are not likely to change, and must be appreciated by any who propose to revise corporate law doctrines.

This Article adopts a systematic approach, similar to that suggested by Professor Scott, to develop a more comprehensive outline of the key elements of the corporate governance system. The Article endorses Professor Scott's specific proposals concerning duty of care liability and shareholder derivative suits; it makes additional proposals concerning outside directors, the duty of loyalty, and the regulation of transactions involving potential changes in corporate control; and, finally, it comments briefly on the need for corporate law rules regulating disclosure of corporate information and on the ALI Project's approach to corporate social accountability. First, however, the Article describes briefly the consensus view of the major elements in the corporate governance system and summarizes the ALI Project's approach to critical corporate governance issues.

A. The Structure of the System

The following propositions are widely accepted and serve as premises on which a system of rules for the governance of publicly held corpo-

⁷ The threat of controversy should not lead the ALI to abandon efforts to rethink basic issues of corporate law. In addition to Professor Scott, *see* Scott, *supra* note 6, Bayless Manning has called on the ALI Project to propose nonincremental changes, especially with regard to the duty of care. Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time For Reality*, 39 BUS. LAW. 1477, 1478-80 (1983).

⁸ Scott, *supra* note 6.

rations should be based:⁹

— The corporate form of organization provides suppliers of capital (“shareholders”) and suppliers of entrepreneurial skills (“managers”) with a potentially efficient vehicle for pursuing economic gain.

— Shareholders and managers have a joint interest in enhancing corporate profits. Shareholders benefit from increases in their corporation’s assets due to profitable operations. Managers will be more secure in their jobs and are likely to receive greater compensation if their firms operate profitably; in addition, their value as managers will increase. Finally, if a firm’s profits increase, the firm will be able to raise capital on more favorable terms, lowering its production costs and thus enhancing its ability to compete successfully.

— Despite shareholders’ and managers’ shared interest in enhancing corporate profits, managers inevitably will make some decisions that result in losses. Some losses will be due to managers’ bad judgments, others to bad luck.

— Apart from the impact of managers’ bad judgments, shareholders will realize less than their full share of a corporation’s potential income because sometimes managers’ interests will conflict with those of shareholders and some managers will choose to impose “agency costs” on their corporations. For example, inept managers may use corporate resources to resist efforts to oust them from their positions, and self-aggrandizing managers will enrich themselves at the expense of their corporations. Moreover, managers whose conduct is likely to be deemed unsatisfactory or improper often will cover up or misrepresent what they have done.

— Shareholders can take a number of actions to protect themselves against the impact of agency costs.¹⁰ They can diversify their investments among a number of corporations (which also provides protection against bad luck), and they can discount the price they are prepared to pay for any given corporation’s stock. If they already own stock and become dissatisfied with managers’ performance, they can exit, or sell their stock, or they can voice their dissatisfaction by voting to elect new managers or by suing to remedy breaches of fiduciary duty.¹¹ Because exit is cheap and “voice” often is expensive,

⁹ These propositions are consistent with works of legal scholarship reflecting such widely divergent points of view as Scott, *id.*; Fischel, *supra* note 6; Winter, *supra* note 2; Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 U.C.L.A. L. REV. 343 (1981); and M. EISENBERG, *THE STRUCTURE OF THE CORPORATION* (1976). They also draw heavily on relevant economic and management literature, which is well summarized in Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537 (1981) (stressing need for analysis that takes account not only of market forces and economic theory, but of “bounded rationality”—humans’ limited ability to analyze and solve complex problems—and “opportunism”—self-aggrandizing behavior combined with guile). The ALI Project acknowledges the relevance of this literature. See ALI Draft No. 2, *supra* note 1, § 3.02 reporter’s note 2.

¹⁰ As used here, “agency costs” include both the costs of managers’ bad judgments and the costs of their self-serving use of corporate resources.

¹¹ For a seminal work on the need to analyze institutional arrangements in terms of the

ineffective, or both, most shareholders will favor exit.

— The “voice” mechanisms remain significant in two contexts. First, new shareholders prepared to buy a substantial portion of a corporation’s stock or existing shareholders prepared to finance a proxy contest can use shareholder voting rights to replace inept or self-aggrandizing managers. Second, attorneys prepared to represent shareholders on a contingency fee basis can use derivative suits to police managers’ breaches of their fiduciary duties. In both contexts, the mechanisms’ effectiveness depends significantly on the availability of information about managers’ performance and self-dealing.

— Outside, or nonmanagement, directors have the potential to monitor managers’ performance more efficiently than shareholders, potential shareholders, or plaintiffs’ attorneys. Outside directors are not always effective monitors, though, and there is little evidence that corporations with boards consisting primarily of outside directors are more profitable or more highly valued by investors than other corporations.

B. Recommendations of the ALI Project

The most central of the ALI Corporate Governance Project’s recommendations are those concerning corporate structure.¹² The Project distinguishes between senior executives, who actually manage a corporation’s business, and boards of directors, which oversee, or monitor, management’s performance. The Project endorses the view that outside directors potentially are the most efficient monitors of management performance and encourages publicly held corporations to have outside directors play an enhanced role in selecting executives, reviewing major corporate decisions, passing on the propriety of conflict-of-interest transactions, and ensuring the integrity of their corporations’ financial reports. However, the Project does not address explicitly critical issues concerning the extent to which corporate law can or should be the vehicle for ensuring that outside directors perform these duties effectively.

The Project does approach this issue indirectly, through its discussion of the duty of care.¹³ It recommends increasing the threat of liability for breach of the duty to stimulate directors to perform diligently. However, the Project recognizes that fear of personal liability may lead directors to avoid reasonable business risks or may discourage qualified people from serving as directors.¹⁴ Therefore, the Project recommends that the increased threat of liability be limited largely to losses due to

comparative influence of market forces (or “exit”) and members’ participation (or “voice”), see A. HIRSCHMAN, *EXIT, VOICE AND LOYALTY* (1970).

¹² See ALI Draft No. 2, *supra* note 1, Part III (Structure of the Corporation).

¹³ See ALI Draft No. 3, *supra* note 1, Part IV (Duty of Care and the Business Judgment Rule).

¹⁴ See ALI Draft No. 1, *supra* note 1, § 7.06 (Damages Resulting From a Breach of Duty: Minimum and Maximum Limits).

errors of omission, and that a dollar limit be placed on directors' potential liability for merely negligent omissions. It is noteworthy that the Project does not discuss whether the costs of enforcing the duty of care through threats of liability outweigh the benefits generated by such threats.

The ALI Project appears to accept the view that the purpose of the duty of loyalty is to ensure that the terms of covered transactions—those in which the interests of directors, managers, or controlling shareholders conflict directly or indirectly with those of the corporation—are at least as favorable to the corporation as would be the terms of an arm's length transaction negotiated with an unrelated party.¹⁵ As concerns the critical issue of how the duty of loyalty best can be enforced, the ALI Project emphasizes the benefits of having independent decisionmakers, who may be directors or shareholders, approve duty of loyalty transactions. If an independent decisionmaker approves a transaction, the Project would limit a shareholder challenging that transaction largely to questioning whether the decisionmaker was provided with all material information about the transaction. Absent approval by an independent decisionmaker, the Project would place on the party defending the transaction the burden of proving the transaction was fair. The ALI also proposes to encourage derivative suits alleging breaches of the duty of loyalty, but it would retain some special procedural requirements to guard against potentially exploitative derivative suits.¹⁶

The ALI Project plans to treat transactions involving managers' use of corporate resources to fend off threats to their control separately from those covered by the duty of care, even though they often involve unrelated parties, and separately from those covered by the duty of loyalty, even though they often advance managers' personal interests at the expense of a corporation and its shareholders. The Project has not otherwise discussed these transactions.¹⁷ If the Project's approach in other areas is indicative of the approach it will take here, it is reasonable to expect the Project to recommend that use of corporate resources to protect control be allowed only where independent directors approve a defensive action and can prove that their decision was reasonable, or fair.

A subsidiary issue relating both to duty of loyalty transactions and to the market for corporate control concerns the extent to which corporate law should require corporations to disclose to shareholders information about corporate financial performance. The ALI Project only deals with disclosure questions indirectly, in its discussion of the responsibili-

¹⁵ See ALI Draft No. 3, *supra* note 1, Part V (Duty of Loyalty).

¹⁶ See ALI Draft No. 1, *supra* note 1, Part VII (Remedies).

¹⁷ The ALI Project designated Part VI "Transactions in Control." ALI Draft Nos. 1-3 have not addressed this part. See *id.* at xv.

ties of audit committees.¹⁸ Thus, it adopts implicitly the traditional view that these questions are to be dealt with primarily by the federal securities laws.

Finally, there is the question of the extent to which corporate law should require or allow corporations to use their resources to advance the interests of nonshareholders. The issues here, though more political than technical, were prominent in the discussions that preceded the ALI Project¹⁹ and have been addressed briefly by the Project. It specifies that managers must remain within the law while engaged in the pursuit of corporate profits. The ALI also recommends that managers be allowed to expend corporate resources to advance social or ethical objectives relevant to their corporations' businesses, in addition to using reasonable amounts of corporate resources to support charitable activities.²⁰

I

INDEPENDENT DIRECTORS AND THE RULE OF LAW

The ALI Project assigns a central role in the corporate governance process to boards of directors composed primarily of nonmanagement directors who have no other significant relationships with their corporation or its senior executives.²¹ These boards would devote their energies largely to monitoring management's performance.²² To this end, the Project would require large, publicly held corporations²³ to have audit committees composed entirely of nonemployee directors,²⁴ at least a majority of whom would be unaffiliated.²⁵ The Project also recommends, "as a matter of corporate practice,"²⁶ that every publicly held corporation have at least three unaffiliated directors, and that large, publicly held corporations have a majority of unaffiliated directors.²⁷ It further

¹⁸ See ALI Draft No. 2, *supra* note 1, §§ 3.03 (Audit Committee in First Tier Corporations), 3.05 (Audit Committee in Second-Tier Corporations; Powers and Functions of the Audit Committee).

¹⁹ See COMMENTARIES, *supra* note 2, at 245-83.

²⁰ See ALI Draft No. 2, *supra* note 1, § 2.01 (The Objective and Conduct of the Business Corporation).

²¹ For the purposes of this Article, directors lacking significant relationships to a corporation or its senior management personnel shall be referred to as "unaffiliated directors."

²² See ALI Draft No. 1, *supra* note 1, § 3.02.

²³ A large, publicly held corporation is defined as a corporation having 2,000 or more record holders of its equity securities and \$100 million of total assets. ALI Draft No. 1, *supra* note 1, § 1.15.

²⁴ An outside, or nonemployee director, as distinguished from an unaffiliated director, is not an employee of the corporation but has some significant relation to the corporation, such as a member of a law firm or investment bank which handles a significant amount of the corporation's business.

²⁵ ALI Draft No. 2, *supra* note 1, § 3.03.

²⁶ *Id.* § 3.04.

²⁷ *Id.*

suggests that smaller publicly held companies have audit committees,²⁸ and that as a rule all publicly held companies have nominating committees²⁹ and compensation committees.³⁰ Both committees should be composed entirely of nonemployee directors and have a majority of unaffiliated directors.³¹ Thus, the Project would place unaffiliated directors in a position to exert substantial influence over a corporation's (1) senior executives, (2) financial reports, (3) nomination of directors, and (4) executive compensation arrangements.

The Project's structural recommendations are well within the mainstream of current thinking about boards of directors.³² A board comprised primarily of unaffiliated directors may contribute to corporate governance in several respects:

- A board can improve the quality of managers' business decisions. Unaffiliated directors can help managers reach better decisions by forcing them to present their recommendations lucidly, by asking probing questions, and by drawing upon their own diverse experiences, even though these directors may not share management's understanding of specific transactions or strategic choices.³³
- A board can facilitate needed changes in executive personnel. A board has unique access to information about who makes corporate decisions and how they are made. It is in the best position to evaluate a corporation's senior executives, promote those who are most capable, and remove the incompetent.
- A board can improve the integrity of a corporation's financial reports. Unaffiliated directors usually have less incentive than do a

²⁸ *Id.* § 3.05.

²⁹ *Id.* § 3.06.

³⁰ *Id.* § 3.07.

³¹ *Id.* §§ 3.06-.07.

³² The concept of monitoring boards of directors comprised primarily of unaffiliated directors has been endorsed by legal scholars, *see, e.g.*, Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 *BUS. LAW.* 1799 (1976); Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors and Accountants*, 63 *CALIF. L. REV.* 375 (1975); *but cf.* Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 *HARV. L. REV.* 597 (1982) (arguing that greater use of independent directors will not promote social responsibility, integrity, or efficiency); Branson, *supra* note 6, at 97-101; business school researchers, *see, e.g.*, Andrews, *Directors' responsibility for corporate strategy*, *HARV. BUS. REV.*, Nov.-Dec. 1980, at 30; Lewis, *Choosing and Using Outside Directors*, *HARV. BUS. REV.*, July-Aug. 1974, at 70; the American Bar Association Committee on Corporate Laws, *see* Committee on Corporate News, *Corporate Directors' Guidebook*, 33 *BUS. LAW.* 1591, 1619-30 (1978); Committee on Corporate Laws, *The Overview Committees of the Board of Directors*, 34 *BUS. LAW.* 1837 (1979); and The Business Roundtable, *see* Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 *BUS. LAW.* 2083, 2107-13 (1978).

³³ *See* J. Lynch, *Activating the Board of Directors: A Study of the Process of Increasing Board Effectiveness* 340-41 (1979) (Harv. Bus. School doctoral dissertation). Because outside directors are less involved in their corporations than are the managers, the outside directors are less likely to screen out relevant information due to a phenomenon similar to cognitive dissonance called "irreversible investment." *See* Arrow, *On the Agenda of Organizations*, in *THE CORPORATE SOCIETY* 214, 228 (R. Marris ed. 1974).

corporation's executives to engage in "cute accounting"³⁴ so as to distort a corporation's reported financial results. Directors can select the corporation's public accountants and insulate them from management's demands, in order to promote full and accurate disclosure of the corporation's financial situation and the results of its operations.

— A board can deter unfair self-dealing, and can prevent management from receiving excessive compensation. Unaffiliated directors can reach informed judgments about the fairness of proposed transactions between corporations and affiliated persons. They have the power, *de facto* if not *de jure*, to veto such transactions.³⁵ Similarly, they possess both the information and the authority to evaluate senior executives' performance and to structure compensation arrangements that will encourage efficient executive performance.

A substantial body of behavioral research suggests that boards composed primarily of unaffiliated directors, because they tend to behave more as peer groups than as hierarchical bodies, are likely to make better decisions than boards composed primarily of management directors.³⁶ Other studies indicate that subordinate executives usually are passive directors, thus creating hierarchical boards. The response of one inside director to a question about his role in a key board decision is typical: "I don't worry too much about the 'director's role'—when the guy you report to is the chairman [of the board], nobody really expects to hear your private opinions anyway."³⁷

Professor Scott objects to the ALI's proposals concerning boards of directors, commenting: "From [an] economic perspective, the ALI position seems dubious at best."³⁸ He suggests that boards composed of outside directors may be more capable of "passive" than of "active" monitoring, and that boards composed of inside directors might better serve shareholders' interests.³⁹ In his view, empirical study is needed to answer both questions.⁴⁰

Professor Scott's distinction between active and passive boards seems overstated; thus, the basis of his objection to the ALI model is not clear. Professor Scott describes the ALI's "active model" as one in

³⁴ Treadway, *Accounting Shenanigans and the Commission's 1984 Response 3* (1984) (remarks to Financial Executives Institute).

³⁵ Courts are likely to attach great weight to opinions of independent directors that a conflict-of-interest transaction is unfair. Affiliated persons, aware of that possibility, are not likely to press for transactions disapproved by such directors.

³⁶ See Haft, *Business Decisions by the New Board: Behavioral Science and Corporate Law*, 80 MICH. L. REV. 1 (1981) (reviewing relevant research in behavioral sciences).

³⁷ See Levy, *Remco Metals and Refining 3* (Harv. Bus. School Case No. 0-381-129, 1981).

³⁸ Scott, *supra* note 6, at 934.

³⁹ Professor Scott believes that the investment of time and knowledge necessary for informed participation in the formulation of corporate policy is far more likely to be made by inside directors. *Id.*

⁴⁰ *Id.* at 934-35.

which "the board selects management, reviews and approves major corporate plans and policies, observes trends and performance, and holds management accountable for producing adequate results."⁴¹ His postulated "passive model" would substitute "rendering advice and suggestions but ratifying the course management determines to pursue"⁴² for "review[ing] major corporate plans and policies."⁴³ Surely Professor Scott does not intend to suggest that a board formally renounce its right to approve corporate plans and policies, with the result that it always will ratify management's recommendations regardless of management's reaction to directors' advice and suggestions.⁴⁴ But unless Professor Scott intends to go that far, the distinction he draws between "active" and "passive" monitoring is merely one of emphasis.

How "active" or "passive" any given board should be depends on a variety of circumstances.⁴⁵ The thrust of the ALI Project's recommendations is to allow each board to monitor management as actively or as passively as it thinks appropriate. These recommendations appear unobjectionable, unless, as may be the case with Professor Scott, one is concerned that they increase directors' potential liability for breach of the duty of care.⁴⁶

Professor Scott's argument about inside versus outside directors is based largely on studies showing no correlation between changes from inside to outside boards or from one board organizational structure to another, and corporations' economic performance or stock prices.⁴⁷ These studies do not constitute convincing evidence that outside directors cannot improve corporate performance. They are based on the premise that all directors who meet certain objective criteria of independence, and all boards that have certain committees comprised of certain kinds of directors, are alike. This premise may well reflect the ALI Project's thinking about boards of directors, but it is false.

Every board of directors has certain unique characteristics, as does every board-management relationship. Moreover, every board and board-management relationship changes over time. A board that fails

⁴¹ *Id.* at 934 (citation omitted).

⁴² *Id.* at 935.

⁴³ *Id.* at 934 (citation omitted).

⁴⁴ *Id.* at 934-35. Professor Scott's description of the role of passive directors as "ex post facto monitoring" seems ill-advised. The logical extension of such a role would seem to be a board powerless to prevent a transaction disastrous to the corporation.

⁴⁵ See J. Lynch, *supra* note 33, at 329-31.

⁴⁶ The Business Roundtable is concerned that the recommendations will become the basis for holdings that directors and boards not organized in accord with those recommendations are operating in violation of the duty of care. See *ROUNDTABLE STATEMENT*, *supra* note 5; see also Andrews, *Rigid rules will not make good boards*, *HARV. BUS. REV.*, Nov.-Dec. 1982, at 34.

⁴⁷ See MacAvoy, *ALI Proposals for Increased Control of the Corporation by the Board of Directors: An Economic Analysis, Exhibit C* in *ROUNDTABLE STATEMENT*, *supra* note 5, at C-26. Professor Scott proposes a study of stock prices. Scott, *supra* note 6, at 934-35.

to comply with the ALI's structural recommendations may be less likely to perform effectively, but formal compliance with those recommendations will not guarantee improved performance. A board comprised entirely of inside directors may contribute more to a corporation's well-being than a board of unaffiliated directors who are uninterested in effective monitoring.⁴⁸

Professor Scott's argument and the economic studies he cites highlight the difficulty of using objective indicia of board membership or organization to predict how any given board will perform. Directors' competence, integrity, and commitment is the key to effective board performance,⁴⁹ and predictions about how directors will behave vary greatly, as recent statements by Irwin Borowski and Richard W. Duesenberg demonstrate. Mr. Borowski, who dealt with many corporations that had issued false financial reports or had made questionable payments to foreign government officials during the years he served as Associate Director of the SEC Division of Enforcement, is openly skeptical:

The [outside] director . . . may get most of the benefits of position simply from being a director. Consequently, he will do those things that make him attractive as a directorial candidate. These things may include being easy to get along with, not rocking the boat, and generally being favorably disposed to management's interests.⁵⁰

Mr. Duesenberg, who is vice president, general counsel, and secretary of Monsanto Corporation, thinks much more highly of directors and managers:

To believe that boards and managers consciously skirt close to the margin of illegality or moral turpitude to achieve private aggrandizement or gain competitive advantage is to indulge in fantasy Directors and managers of American enterprises are products of the same culture as other professionals, including lawyers, judges, and law professors, and their integrity and sense of justice and injustice are no less finely tuned, nor more flawed in execution.⁵¹

⁴⁸ Professor Scott, in his discussion of "passive" and "active" boards, assumes that a board that adopts the active mode of operation will contribute more than a board that adopts the passive mode. See Scott, *supra* note 6, at 934-35. But a researcher cannot ascertain, on the basis of publicly available data, whether any given board is monitoring management passively or actively, or how carefully it is reviewing management's performance. Professor Scott also acknowledges implicitly, in his discussion of special litigation committees and their power to dismiss derivative suits, that compliant outside directors, with their power to dismiss even breach of loyalty suits with shareholder approval, may impose costs on a corporation that inside directors could not impose. See *id.* at 944-45.

⁴⁹ An additional important factor is the chief executive officer's attitude toward the board. See J. Lynch, *supra* note 33, at 333-34.

⁵⁰ Borowski, *Corporate Accountability: The Role of the Independent Director*, 9 J. CORP. L. 455, 461 (1984) (footnote omitted).

⁵¹ Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View From the Inside*, 60 WASH. U.L.Q. 311, 332 (1982).

Both Mr. Borowski and Mr. Duesenberg no doubt are right about some directors and wrong about others. The only prediction likely to receive widespread support is that directors' performance will vary. This truism, however, is far from trivial. It suggests that corporate law can do little to *ensure* that competent and committed people will serve as unaffiliated directors or that those who do serve will perform adequately.⁵²

An economist would say that the ALI Project aspires to have unaffiliated directors produce positive externalities—benefits greater in value than the consideration they receive for serving on corporate boards.⁵³ Both economic and legal analysts long have recognized the difficulty in using the law, an essentially coercive force, to stimulate the production of positive externalities.⁵⁴ The ALI Project should recognize this reality and desist threatening liability in a futile attempt to stimulate the development of effective boards of directors.

The Project also should acknowledge that a director will not necessarily be an effective monitor simply because he has no identifiable affiliation with a corporation and no direct or indirect financial interest in a transaction he is reviewing. Similarly, the Project should acknowledge that although boards and board committees comprised largely of unaffiliated directors may be more likely to protect shareholder interests than those comprised of inside directors, unaffiliated boards frequently will do little more than rubber-stamp management's recommendations.⁵⁵

Nevertheless, the ALI Project should not withdraw or modify its specific proposals concerning the membership and organization of cor-

⁵² See Weiss, *supra* note 9, at 442-43. The most important and least surmountable problem that the ALI Corporate Governance Project faces is to ensure that capable persons are placed in the corporate governance system. The key to improved corporate governance and accountability is not the structure suggested by the ALI *per se*, but the operation of that structure through effective boards selecting and overseeing effective managers.

⁵³ See T. WHISLER, *RULES OF THE GAME*, Rule IV(E) (1984) ("No company will offer a director's fee that, in itself, is adequate compensation for your time.").

⁵⁴ See A. HIRSCHMAN, *SHIFTING INVOLVEMENTS* (1982) (discussing factors that lead people to attempt to produce positive externalities through public service).

⁵⁵ See, e.g., *Fradkin v. Ernst*, 571 F. Supp. 829 (N.D. Ohio 1983) (outside directors, including a former U.S. Attorney General, unquestioningly approved very generous "golden parachute" compensation plan before details of plan were finalized, and subsequently approved proxy statement that conveyed misleading impression they had approved plan only after due deliberation); Chandler, Letter to Editor, *HARV. BUS. REV.*, Sept.-Oct. 1984, at 184 (letter from retired chairman of Northern Ill. Gas Co.) ("[M]y impression has been that the proportion of outsiders on boards has improved [since 1975], but little else has."). The former general counsel of General Electric Company suggested that most outside directors view service on boards from their perspective as executives of other corporations and, consequently, are reluctant to restrict materially other executives' powers and prerogatives. See Estes, *The Case For Counsel to Outside Directors*, *HARV. BUS. REV.*, July-Aug. 1976, at 125, 127. Also, because corporate chief executives often control the nominating process, they may tend to pick passive, or "sympathetic," directors. See Lewis, *supra* note 32, at 71.

porate boards of directors.⁵⁶ Those proposals are largely aspirational in character, and statements of aspirations are useful.⁵⁷

On the other hand, the ALI Project should not provide more comprehensive guidance to corporate boards. Most problems boards face are too subtle, too complex, and too often derived from peculiar circumstances to allow for relatively uniform responses. General guidance, even if provided in aspirational terms, is apt to accomplish little.⁵⁸ There may well be a need for an organization devoted to helping corporate directors identify, understand, and resolve problems they face,⁵⁹ but the ALI Project has neither the mandate nor the expertise to be that organization.

The Project's mission, in addition to identifying the role of boards of directors, is to set forth rules to govern shareholder/manager relationships. The foregoing discussion of boards of directors suggests two criteria the ALI should use to evaluate those rules. First, the ALI should focus on whether any given rule will outlaw clearly unacceptable behavior or will deal with problems caused by passive, rubber-stamp boards—not whether the rule will promote truly effective board performance. Second, the ALI should consider whether the rule will discourage competent people from serving as outside directors or will impede boards' efforts to monitor management's performance. It is in terms of these criteria that this Article comments on the ALI's proposals relating to the duty of care, the duty of loyalty, transactions affecting control, and disclosure of corporate information.

II DUTY OF CARE

Directors are charged with a duty to perform their functions in a manner they reasonably believe to be in the best interests of their corporation, using the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar

⁵⁶ A possible exception would be the proposed *requirement* that large publicly held corporations have audit committees composed of outside directors, a majority of whom would have to be unaffiliated. *See* ALI Draft No. 2, *supra* note 1, § 3.03. It might better be framed as a recommendation.

⁵⁷ Manning, *supra* note 7, suggests that a largely aspirational "duty of attention" be substituted for the duty of care.

⁵⁸ The American Bar Association included Ethical Considerations within the Code of Professional Responsibility in an attempt to provide such aspirational guidance. *See* Frankel, *Review*, 43 U. CHI. L. REV. 874, 876-82 (1976). Most lawyers viewed this effort as a failure, and no such statements are included in the revised Code.

⁵⁹ Although directors' responsibilities resemble those of professionals, surprisingly little has been written concerning how directors should deal with problematic situations. No forum to research or discuss these issues exists.

circumstances.⁶⁰ A director will not ordinarily be held liable for falling short of this standard. In fact, only in a situation in which a director has almost totally abdicated his supervisory responsibilities does he run any significant risk of liability for a breach of the duty of care.⁶¹

Courts are reluctant to subject directors—particularly outside directors—to due care liability. A number of factors explain this reluctance. First, courts realize that no person is obligated to serve as a corporate director, especially an outside director. If corporate law threatened directors who failed to perform at the level of the law's aspirations with liability, "no men [or women] of sense would take the office"⁶² Second, shareholders, as equity investors, can be viewed as having assumed the risk that managers will make some bad judgments resulting in business losses. Third, fact-finders viewing situations retrospectively too often may be inclined to determine that a bad result was due to bad judgment rather than bad luck. Finally, the threat of liability may lead directors or managers to avoid potentially profitable but risky business opportunities or to focus on safeguarding corporate resources.⁶³

The critical choice with regard to the duty of care is whether to maintain the status quo, whether to increase the threat of due care liability, or whether to abolish liability for breach of the duty. The ALI Project proposes rules that would minimize the possibility of director liability in derivative suits challenging a board's considered decisions, but would increase substantially the threat of liability for errors of omission.⁶⁴ Professor Scott, on the other hand, argues that "very . . . little would be lost by outright abolition of the legal duty of care and its accompanying threat of a lawsuit,"⁶⁵ and that substantial doctrinal benefits might result.⁶⁶

⁶⁰ ALI Draft No. 3, *supra* note 1, § 4.01, states the duty of care in these terms, as do MODEL BUSINESS CORP. ACT § 35 (1980) and numerous other statutes.

⁶¹ Professor Bishop's 16-year-old observation, that searching for cases in which corporate directors have been held liable for negligence uncomplicated by self-dealing is a "search for a very small number of needles in a very large haystack," remains valid. See Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). See also Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895, 919 (1972). *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981), much cited by the ALI Project, is remarkable not because a director was actually held liable, but as an illustration of the difficulty courts find in imposing due care liability on directors. The *Francis* director abdicated all her directorial responsibilities for a period of years, allowing her sons (related parties) to loot the corporation. The court held that by virtue of her office, the director had the power to prevent the losses, and had breached her duty to the corporation by her neglect. *Id.* at 45, 432 A.2d at 829.

⁶² *Barnes v. Andrews*, 298 Fed. 614, 617 (S.D.N.Y. 1924).

⁶³ Scott, *supra* note 6, at 935-37, notes these factors, as does Judge Winter in *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982).

⁶⁴ ALI Draft No. 3, *supra* note 1, § 4.01.

⁶⁵ See Scott, *supra* note 6, at 937.

⁶⁶ *Id.*

Professor Scott's position appears more worthy of support. The ALI Project's proposals, except insofar as they represent statements of aspiration, seem likely to produce few benefits and to generate substantial costs. Boards of directors reach most decisions as part of an ongoing process, rather than through quasi-adjudicatory consideration of particular situations.⁶⁷ Moreover, boards in general, and outside directors in particular, devote limited amounts of time to any given corporation's affairs. In light of these realities, it is easy to characterize any board action or inaction as the product of a considered judgment, even if it is only a judgment as to which kinds of decisions should be on the board's agenda and which should be delegated to management.⁶⁸

The ALI Project's proposals do not allay substantially the concerns that courts traditionally have expressed when declining to hold directors liable for losses produced by transactions from which they obtained no personal benefits. Thus, courts probably will continue to seize on the possibility that directors made an informed decision as a basis for exculpating from liability directors whose conduct arguably involved some negligent failure to act carefully.⁶⁹ Only in instances where directors have come close to abdicating totally will the ALI's proposals make imposition of liability somewhat more likely.⁷⁰

Adoption of the ALI Project's proposals almost certainly will generate substantial costs, however. Plaintiffs probably will bring more "strike suits" claiming breaches of the duty of care. It is relatively easy to frame a claim that directors were negligent (or grossly negligent) in failing to inform themselves of some material fact or to authorize some protective action, and relatively difficult to dispose of such claims without a trial on the merits.⁷¹ The threat of strike suits, even though they are unlikely to succeed, will encourage all directors—whether diligent or

⁶⁷ See Manning, *supra* note 7, at 1483 ("The lawyer's professional experience in courts, legislatures, and semi-political bodies tends to lead him to assume that all decisional process is inevitably made up of a series of discrete, separate issues presented one at a time, debated by both or all sides, and voted on. In fact boards of directors do not operate that way at all [and actions are usually by consensus].")

⁶⁸ See ALI Draft No. 3, *supra* note 1, § 4.01(a) comment g(1) ("'Oversight choices' (e.g., an informed decision to review aspect 'x' of a business instead of aspect 'y') . . . should be protected by the business judgment rule.")

⁶⁹ In *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), the Delaware Supreme Court asserted that a distinction should be drawn between a board's conscious and unconscious failures to act, but also acknowledged that cases involving unconscious failures to act "have been adjudicated upon concepts of business judgment." *Id.* at 813 n.7.

⁷⁰ See, e.g., *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981).

⁷¹ An illustrative example, inspired by a recent news report, would be a suit against the directors of Marsh and McLennan alleging that they should have taken steps to prevent the company's chief money market trader from entering into speculative transactions that resulted in more than \$100 million in losses. See *N.Y. Times*, May 3, 1984, at D1, col. 5. The ALI Project also would provide plaintiffs with significant grounds for questioning whether directors have relied appropriately on officers, experts, employees, board committees, and others. ALI Draft No. 3, *supra* note 1, §§ 4.02-.03.

not—to devote more time and resources to precautionary measures. The threat also may deter some qualified people from serving as outside directors.

Professor Scott recognizes some of these costs, and also points out that economic analysis suggests that the benefits gained by threatening directors with due care liability are rather small.⁷² With respect to transactions between the corporation and unrelated parties, the interests of directors and officers align with the interests of shareholders; both groups seek profits, and neither gains from bad business judgments or from subordinates' misuse or defalcation of corporate resources.⁷³

Both the market for corporate control and the market for corporate managers tend to reward managers who increase corporate profits and to penalize managers who do not.⁷⁴ Although neither market is perfectly efficient or instantly responsive, the threat of liability for breaches of the duty of care, as suggested by the ALI Project, will do little to enhance the impact or responsiveness of either market. Directors who simply go through the motions of staying informed about corporate affairs and reviewing management's proposals will contribute little more to the enhancement of corporate profits than will directors who ignore their corporations' affairs. Moreover, eliminating the threat of directors' due care liability does not require exculpating officers who misuse corporate resources. Those officers also have responsibilities as agents of their corporation, and could be held liable under principles of agency law.⁷⁵

More importantly, eliminating the right of shareholders to bring

⁷² See Scott, *supra* note 6, at 932-37.

⁷³ A secondary thrust of the ALI recommendations is to increase the threat the directors will be held liable for losses caused when a board approves unlawful corporate conduct it knows or should know is unlawful, or fails to take reasonable action to deter corporate employees from engaging in unlawful conduct. See ALI Draft No. 3, *supra* note 1, § 4.01. The Project's approach to this subject is based implicitly on a view that corporations should be expected to behave lawfully, and that shareholders should be empowered to enforce this expectation. As to the first expectation, the Project accomplishes its goal by framing the objectives of corporate activity in such a manner as to make clear that corporations cannot defend unlawful conduct on grounds of an absolute obligation to maximize profits. See ALI Draft No. 2, *supra* note 1, § 2.01. As to the goal of enabling shareholders to enforce the corporate obligation of lawful behavior, it is questionable why corporate law, rather than criminal law, and shareholder-plaintiffs, rather than public prosecutors, should enforce these obligations against corporate directors. A better approach might be to revamp the relevant criminal laws if they are ineffective. See COMMENTARIES, *supra* note 2, at 261-63 (remarks of A.A. Sommer, Jr.).

⁷⁴ When managers make bad business judgments, the price of their corporation's stock will decline. Third parties or current shareholders then are likely to find it financially attractive to acquire control of their firms, by way of stock acquisitions and/or solicitation of voting support from other shareholders, and to replace management. See Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965); *infra* notes 120-26 and accompanying text. The market for corporate managers determines managers' compensation. See Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 295 (1980).

⁷⁵ See, e.g., *Garden Hill Estates, Inc. v. Bernstein*, 24 A.D.2d 512, 261 N.Y.S.2d 648

suits charging breach of the duty of care would simplify the development of rules for other aspects of the corporate governance system. Professor Scott explains how eliminating the threat of duty of care "strike suits" would allow the derivative suit to become a more effective device for enforcing the duty of loyalty.⁷⁶ Abolishing the largely academic distinction between a minimal threat of due care liability and no threat at all also would demonstrate clearly that the corporate governance system relies not on litigation but on the market for corporate control, supplemented by the corporate electoral system, to regulate directors' decisions about transactions between their corporations and unrelated parties. Finally, consideration of substantive duty of loyalty rules, in terms of how conflicts of interest should be regulated, would be facilitated by eliminating the largely ephemeral notion that shareholder interests are protected because "directors and officers . . . have a fiduciary duty (with attendant legal liabilities) to the [c]orporation and all of its shareholders to act in their interests."⁷⁷ The sections that follow consider duty of loyalty rules and the market for control.

III DUTY OF LOYALTY

Although the interests of managers and shareholders generally coincide regarding transactions between corporations and unrelated parties, the same cannot be said with regard to transactions between managers and their corporations or transactions in which managers exploit properties or opportunities rightfully belonging to their corporations. Managers who participate in such transactions often will realize personal financial gains that far outweigh the indirect losses they will incur if the transactions cause corporate profits to drop.

If investors operated in a perfectly informed market and had no transaction costs, they could handle the problem posed by these conflicts of interest by anticipating all opportunities for managerial self-enrichment, contracting comprehensively with managers to establish the terms on which they could exploit such opportunities, and enforcing those contracts. But perfect foresight is unattainable, and contracting, monitoring, and enforcement are expensive. A more realistic and economical approach is to subject managers—directors, senior executives, and controlling shareholders—to a fiduciary duty of loyalty enforced by the threat of liability.⁷⁸

No dispute exists over the utility of a duty of loyalty or its quasi-

(1965), *aff'd*, 17 N.Y.2d 525, 267 N.Y.S.2d 906, 215 N.E.2d 163 (1967) (holding former president liable to corporation for losses caused by his misconduct).

⁷⁶ Scott, *supra* note 6, at 937.

⁷⁷ *Abrams v. Mayflower Investors, Inc.*, 62 F.R.D. 316, 369 (N.D. Ill. 1974).

⁷⁸ *See Williamson, supra* note 9, at 1540-46.

contractual substance. Managers should arrange transactions with their corporations, as well as transactions involving properties or opportunities to which they have access as a result of their corporate positions, on terms as favorable to their corporations as terms negotiated in comparable arm's length transactions involving unrelated parties. The key issue is how to enforce the duty of loyalty.⁷⁹

The mere existence of a duty of loyalty does not eliminate managers' incentive to enrich themselves at the expense of their corporations. It does, however, inspire managers to frustrate enforcement of the duty by making it appear that no breach has occurred. The fact that most shareholders own only a small proportion of a company's stock enhances the prospect that such tactics will succeed, because those shareholders have little incentive to incur the cost of closely monitoring management conduct or of maintaining derivative lawsuits to recover corporate losses.

Two economic pressures limit managers' self-aggrandizing behavior. First, investors protect themselves by discounting the price they will pay for a corporation's stock. Discounting serves as a gross limitation on breaches of the duty of loyalty, because a decline in share prices can result in increased costs of capital or, ultimately, in a change in control. Managers presumably indulge in self-enriching transactions only when they believe their benefits will exceed their losses from higher costs of capital and reduced corporate profits. The threat of a change of control perhaps constitutes a more substantial constraint on managerial disloyalty, but it nonetheless allows for a significant amount of improper self-dealing. Takeover bids are expensive and managerial depredations therefore must be substantial before the resulting stock price decline makes such a bid attractive. When those engaging in self-dealing are majority owners, no change in control can occur without their consent. In other situations, the potential gains to managers from self-dealing may exceed the potential cost of losing their positions of control.⁸⁰

The second factor limiting managers' self-aggrandizing behavior is the threat that attorneys interested in earning fees for representing shareholder-plaintiffs will detect breaches of the duty of loyalty and will finance derivative suits. Professor Scott suggests that the ALI Project recognize that plaintiffs' attorneys typically are the real parties in inter-

⁷⁹ This Article does not assume that every manager tries to deal unfairly with his corporation. The duty of loyalty, and its associated threat of liability, is directed at managers who try to enrich themselves at corporate expense. Managers are less disposed to behave improperly in duty of care transactions, where their interests and those of the corporation usually coincide, than they are in duty of loyalty transactions, where their interests conflict with those of the corporation.

⁸⁰ Cf. Scott, *supra* note 6, at 937-38 (explaining that managers generally "may set terms more favorable to [themselves] than would prevail on the open market or in an independent bargain").

est in derivative suits alleging breaches of the duty of loyalty and encourage attorneys to maintain such suits.⁸¹ He supports more generous compensation for attorneys who win duty of loyalty suits and elimination of procedural barriers to derivative suits.⁸²

Derivative suits can effectively deter breaches of the duty of loyalty only if the substantive rules governing duty of loyalty transactions make it likely courts will identify improper self-dealing. Determining whether any given self-dealing transaction is improper often is difficult. The transactions that kindle duty of loyalty lawsuits usually do not involve property or services with readily ascertainable market prices.⁸³ Thus, courts must formulate hypothetical terms for transactions that unrelated parties dealing at arm's length would have agreed upon.

Courts can determine the "fairness" of a particular transaction by focusing on how the transaction was arranged, the substance of the transaction, or some combination of the two. The ALI Project recommends a combined approach, designed to encourage "independent decisionmakers" to represent corporations in conflict-of-interest transactions.⁸⁴ In cases involving disinterested directors, the ALI would require a shareholder challenging a conflict-of-interest transaction to prove the directors lacked any reasonable basis for approving the transaction.⁸⁵ Where disinterested shareholders approved the transaction, the ALI would require a shareholder-plaintiff to prove the transaction involved "waste."⁸⁶ Absent approval by an independent decisionmaker, a plaintiff's proof that there was a conflict-of-interest transaction would shift to the party defending the transaction the burden of proving that the terms of the transaction were "fair."⁸⁷

In an apparent effort to increase shareholders' opportunities to challenge conflict-of-interest transactions, the ALI also proposes author-

⁸¹ *Id.* at 940-41; see also Weiss, *Disclosure and Corporate Accountability*, 34 BUS. LAW. 575, 586 (1969) (awards of attorneys' fees "make it economically attractive for shareholders, or shareholders' counsel," to maintain derivative suits).

⁸² Scott, *supra* note 6, at 941-45. Scott mentions in a footnote that "for most effective enforcement, the recovery in its entirety should go to the attorney—a thought too horrible to contemplate for at least another decade." *Id.* at 941 n.43.

Professor John C. Coffee, Jr., the reporter for the remedies section of the ALI Project, also co-authored an article that discussed the use of derivative suits as a deterrent to breaches of the duty of loyalty. See Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981).

⁸³ *But see* Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947) (transaction involved inventory of leaf tobacco, market value of which could be readily ascertained).

⁸⁴ ALI Draft No. 3, *supra* note 1, § 5.08 comment a.

⁸⁵ *Id.* § 5.08(a)(2)(A).

⁸⁶ *Id.* § 5.08(a)(2)(B).

⁸⁷ *Id.* § 5.08(b). This Article focuses on § 5.08, which covers managers' contracts with their corporations. The ALI Project proposes to use substantially the same approach with regard to all duty of loyalty transactions except those involving executive compensation. See *id.* § 5.08 comment c.

izing shareholders to bring suits challenging the adequacy of managers' disclosures.⁸⁸ Upon finding that a manager had not disclosed all material facts to the individuals who authorized a conflict-of-interest transaction, a court could void the transaction, even if it was fair. The court then could order appropriate relief, unless the manager subsequently had disclosed all material facts and independent directors or shareholders had ratified the transaction.⁸⁹

The ALI Project's approach is ill-conceived. With regard to independent director approval of conflict-of-interest transactions, the recommendation to shift the burden of proof and change the standard of review is based implicitly on two beliefs: first, that courts are able and willing to determine directors' independence; second, that directors who qualify as "independent" consistently will represent corporations effectively in conflict-of-interest situations. Neither belief is well-founded.

Independence, in the sense of having a commitment to and a capacity for making decisions uninfluenced by personal, professional, or collegial relationships, is more a function of a director's character than of objective criteria.⁹⁰ The courts, however, have insisted on using bright-line tests of financial interest to determine whether outside directors are independent, particularly when those directors are "upright, responsible leaders in the business and civic communities."⁹¹ Courts may have legitimate concerns about damaging directors' reputations for integrity. They also may fear discouraging qualified people from serving on boards by subjecting them to searching inquiries. In any event, courts are not likely to pursue aggressively even the limited subjective inquiry the ALI proposes—whether a director has "a business relationship that is sufficiently substantial that it would reasonably be expected to affect his judgment with respect to the transaction in question in a manner adverse to the corporation."⁹²

There is little reason to be confident directors who pass the ALI

⁸⁸ *Id.* § 5.08.

⁸⁹ *Id.* § 5.08 comment c.

⁹⁰ See text accompanying *supra* notes 49-52.

⁹¹ *In re General Tire & Rubber Co. Sec. Litigation*, 726 F.2d 1075, 1084 (6th Cir. 1984) (rejecting plaintiff's effort to question independence of two outside directors, where one also was corporation's outside counsel and other was consultant to corporation); *see also* *Maldonado v. Flynn*, 597 F.2d 789, 795 (2d Cir. 1979) (director "disinterested" for purposes of Rule 10b-5 of Securities and Exchange Act of 1934 "if he has no material personal interest in the transaction or matter under consideration"); *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979) (members of special litigation committee had no prior affiliation with corporation and were not directors prior to challenged transactions, thus eliminating independence as an issue of fact).

⁹² ALI Draft No. 3, *supra* note 1, § 5.01(a)(2). The ALI combines this subjective test with objective tests involving familial and financial relationships. *Id.* § 5.01(a). It also defines, somewhat more broadly, those persons who will be deemed "interested" in a transaction. *See* ALI Draft No. 2, *supra* note 1, § 1.19; *see also id.* § 1.26 (defining when a director has a "significant relationship" with the senior executives of a corporation).

Project's test of independence will represent corporations effectively in conflict-of-interest situations. As with cases involving duty of care, the Project has allowed its aspirations concerning the conduct of effective directors to color its judgments concerning minimum standards of performance. Professor Victor Brudney summarized the factors that make it difficult for even reasonably diligent directors to deal effectively with conflict-of-interest situations: "[l]imited access to information, limited incentives and sanctions, and the constraints of the boardroom context against a background of social and economic relationships with members of management."⁹³ In some cases, ostensibly disinterested directors may not desire to act independently; they may be little more than sycophants, prepared to rubber-stamp virtually any transaction recommended by senior executives or controlling shareholders.⁹⁴ But in all conflict-of-interest situations where ostensibly disinterested directors are involved, the ALI proposes that courts review those directors' decisions using a standard comparable to the business judgment rule. This approach creates a potential for substantial exploitation.

The ALI's proposal concerning independent shareholder approval is troublesome for a different reason. Most shareholders of public corporations will acquiesce in management's recommendations concerning almost any transaction submitted to them for approval. Search costs are too high for most minority shareholders to investigate those transactions sufficiently to decide if they are fair. Notions of "corporate democracy" or shareholder sovereignty have blinded courts to this reality.⁹⁵ Those same notions seem to have led the ALI Project to attach too much weight to shareholder approval or ratification of conflict-of-interest transactions.⁹⁶

Finally, the ALI's proposal that shareholders be allowed to challenge the adequacy of managers' disclosures concerning conflict-of-inter-

⁹³ Brudney, *supra* note 32, at 622. See also Marsh, *Are Directors Trustees?* 22 BUS. LAW. 35, 36-39 (1966) (potential for bias lay behind 19th century prohibition against transactions between directors and their corporations).

⁹⁴ See *supra* note 55.

⁹⁵ See *Michelson v. Duncan*, 407 A.2d 211, 224 (Del. 1979) (ratification of transaction by disinterested shareholders shifts burden of proof to plaintiff to show lack of consideration); see also Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 415 n.16 (1983) (asserting that tradition explains rules concerning shareholder voting on corporate transactions).

⁹⁶ One also can question the success of the ALI's effort to articulate three separate standards for review of duty of loyalty transactions. The first, reasonable belief that a transaction was fair, is described as "an objective standard which adopts the concept of an arm's-length bargain . . . to establish a 'range of reasonableness.'" ALI Draft No. 3, *supra* note 1, § 5.08(a)(2)(A) comment. The second, waste, depends on whether any "person of ordinary sound business judgment would say that the consideration received by the corporation was . . . fair." *Id.* § 5.08(a)(2)(B) comment. The third, fairness, is again described by reference to an arm's-length transaction. *Id.* § 5.08(a)(2)(C) comment. These definitions do not clearly delineate the factual situations to which they would apply. It is not clear what set of facts would fall within, or without, only one of these definitions.

est transactions is problematic in two ways. First, decisions about whether full disclosure was made, which largely depend on whether undisclosed facts were "material" or were "known to" the manager involved,⁹⁷ are likely to become proxies for decisions about the substantive fairness of conflict-of-interest transactions at issue. Courts are particularly likely to take such liberties where approval of the transaction by independent directors or shareholders precludes judicial inquiries into substantive fairness.⁹⁸ Rules that force courts to decide questions of fairness in terms of proxy issues frequently lead to unprincipled decision-making, lack of predictability, and excessive litigation. Illustrative is the Delaware courts' recently abandoned effort to regulate the fairness of cash-out mergers by focusing on whether the purpose of such mergers was to eliminate minority shareholders, an inevitable result of all such mergers.⁹⁹ If the ALI's intent is to protect shareholders against unfair self-dealing by managers, the Project should recommend that courts focus on the real issue of fairness, not on the proxy issue of disclosure.

Second, allowing derivative suits alleging inadequate disclosure invites nonmeritorious claims that cannot be disposed of without extensive (and expensive) pre-trial proceedings. Only after a plaintiff's lawyer has carefully examined a manager's files and deposed the manager does the lawyer have sufficient information to conclude that the manager did not know some undisclosed material fact in a conflict-of-interest transaction. Moreover, the ALI Project does not eliminate this danger with its proposal that corporations be allowed to preclude such litigation by ratifying the challenged transaction after considering the previously undisclosed data.¹⁰⁰ Counsel who initiate suits that lead to such disclosure and reconsideration presumably will receive compensation for promoting integrity in the corporate decisionmaking process.¹⁰¹ Thus, this aspect of the ALI's proposal may lead to more nonmeritorious derivative suits challenging the adequacy of disclosure, not to eliminating such litigation.

The foregoing analysis suggests that the ALI Project should enforce the duty of loyalty by telling courts to evaluate conflict-of-interest transactions in terms of substantive fairness. There is no simple approach for

⁹⁷ See *id.* § 5.08(a)(1).

⁹⁸ Cf. R. JENNINGS & H. MARSH, JR., *SECURITIES REGULATION* 886-89 (5th ed. 1982) (commenting on pattern of court decisions involving challenges based on federal securities law disclosure requirements).

⁹⁹ For a synopsis of the Delaware case law, see Weiss, *Balancing Interests in Cash-Out Mergers: The Promise of Weinberger v. UOP, Inc.*, 8 DEL. J. CORP. L. 1, 25-38 (1983).

¹⁰⁰ Such reconsideration must be done by the person or persons who approved the transaction, ALI Draft No. 3, *supra* note 1, § 5.08(a)(1), which will make it particularly difficult to cut off suits challenging transactions approved by a corporation's shareholders.

¹⁰¹ Cf. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 389-97 (1970) (plaintiffs who established violations of securities laws awarded attorneys' fees despite lack of express statutory authorization).

determining the terms on which a corporation would have entered into a transaction with an independent party, however. Courts have been reluctant to find a breach of the duty of loyalty unless a challenged conflict-of-interest transaction obviously was unfair, which has led them to treat "fairness" as a zone with ill-defined boundaries. Their approach has created a potential for systematic exploitation because managers have an incentive to structure conflict-of-interest transactions to fall just within the zone of fairness. Moreover, when the transactions in question recur frequently, as do executive compensation arrangements, managers' manipulation can shift both the mid-point and the boundaries of the zone of fairness, creating a potential for steadily increasing exploitation.

The ALI Project should take three steps to counter this potential for exploitation. First, it should state, as a matter of black letter law, that fairness is to be "measured by comparison with an arm's-length transaction with an unrelated third party."¹⁰² Second, it should propose that a manager seeking to uphold a conflict-of-interest transaction should bear the burden of proving the transaction was fair, as it now proposes concerning transactions not approved by an "independent decisionmaker." Finally, the ALI should recommend that if a manager does not meet that burden, a court should treat a conflict-of-interest transaction as voidable, or subject to appropriate equitable relief—such as imposition of a constructive trust—that will "squeeze all possible profits out of [that transaction]."¹⁰³

A duty of loyalty rule with these characteristics, combined with Professor Scott's suggested approach to derivative suits, would provide plaintiffs' lawyers with powerful incentives to act as private attorneys general, identifying and challenging unfair transactions between managers and their corporations. This combination of rules, however, would not necessarily lead to a sharp increase in derivative litigation. The prospect of more derivative suits and the threat of losing all benefits from unfair conflict-of-interest transactions—both unpalatable possibilities—would provide managers a strong incentive to avoid both unfair transactions and those at the outer bounds of the "fairness" zone.¹⁰⁴ One hopes managers would arrange their transactions with their corporations on terms about which no questions of fairness could legitimately

¹⁰² ALI Draft No. 3, *supra* note 1, § 5.08(a)(2)(C) comment. Currently, the ALI Project combines that definition with the following: "Whether the transaction affirmatively will be in the corporation's best interest." *Id.*

¹⁰³ *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir. 1943), *cert. denied*, 320 U.S. 751 (1944) (discussing computation of damages for violation of § 16(b) of the Securities and Exchange Act of 1934).

¹⁰⁴ The fairness zone is the range of values for a given transaction that reasonable people, dealing at arm's length, would be prepared to consider. Scott, *supra* note 6, at 939-40, describes this as the "contract range."

be raised.¹⁰⁵

The proposed rule poses one question and gives rise to two reasonable objections.¹⁰⁶ The question asks to which transactions or persons should the duty of loyalty apply. Professor Scott criticizes current corporation codes for using a definition of the duty of loyalty that "is both too broad and too narrow."¹⁰⁷ He suggests that the duty apply "only with respect to those in actual control"¹⁰⁸ of a corporation, because only those persons can force acceptance of unfair bargains. The difficulty with this suggestion is that defining who is capable of exercising "actual control" poses a problem equally as daunting as defining who is "independent." In one sense, Professor Scott's definition is circular; it posits the existence of an unfair conflict-of-interest transaction as evidence of "actual control."

A better approach would use a slightly over-inclusive list of objective criteria to identify persons whose transactions with the corporation will be governed by the duty of loyalty because of their direct or indirect relationships with the corporation or its managers. As Professor Scott has observed, over-inclusiveness should not cause serious problems; those who do not have actual power to control a corporation generally cannot compel it to enter into unfair transactions. Over-inclusiveness also will ensure that anybody in a position to exercise control almost certainly will be subject to the duty of loyalty.¹⁰⁹

One reasonable objection to the proposed duty of loyalty rule is that it does not give managers an incentive to have disinterested directors review conflict-of-interest transactions. The ALI Project could adopt the proposed rule and quell this objection without requiring courts to pass on directors' subjective independence. It could encourage courts to treat the approval of a transaction by directors with no pecuniary interest in that transaction as probative of its fairness, and to view a manager's failure to obtain disinterested directors' approval of a conflict-of-interest transaction as an indication of unfairness. But since the absence of a financial interest in a transaction cannot be equated with subjective independence, the ALI should not instruct courts to treat dis-

¹⁰⁵ The threat of liability thus would promote the underlying objective of the duty of loyalty—ensuring that transactions between affiliates and their corporations are at terms comparable to those that unrelated parties would agree to in similar transactions negotiated at arm's length.

¹⁰⁶ Counsel for The Business Roundtable have circulated a memorandum asserting that the ALI proposal "would unnecessarily complicate many important corporate transactions." Weil, Gotshal & Manges, A Status Report on the American Law Institute's Proposed Principles of Corporate Governance: Analysis and Recommendations 8 (1984) (unpublished memorandum).

¹⁰⁷ Scott, *supra* note 6, at 938.

¹⁰⁸ *Id.*

¹⁰⁹ Many other issues that relate to the duty of loyalty addressed by the ALI Project, such as how corporate opportunities are to be defined, are outside the coverage of this Article.

interested directors' approval as sufficient either to shift the burden of proof or to change the standard for reviewing the substance of a transaction.

A second objection to the proposed duty of loyalty rule is that it would discourage mutually advantageous transactions between corporations and their managers. This objection is largely a makeweight with regard to transactions between corporations and individual directors and executives. These transactions usually involve routine business arrangements, such as providing professional services or selling products in the ordinary course of business, which easily can be arranged on terms comparable to those available to third parties. In the relatively few transactions that involve unique goods or services, an affiliate's stake in the economic success of his corporation is likely to balance the risk that a seemingly fair transaction will be held, after the fact, to have been unfair.¹¹⁰

A greater danger exists that the proposed duty of loyalty rule would discourage mutually advantageous transactions between controlled subsidiaries and their parent corporations. These transactions are common. They frequently involve unique goods or services, such as rights in research and development programs, for which market values are not readily ascertainable. If parent companies are subjected to the proposed duty of loyalty rule, they would be forced to choose among undesirable alternatives—incurring substantial costs to document the fairness of all transactions with their subsidiaries, defending numerous derivative suits challenging those transactions, or eliminating the minority interests in their subsidiaries.¹¹¹

Corporate law should not compel such a choice, unless some reason exists to treat corporations that maintain controlled, but not wholly owned, subsidiaries with disfavor.¹¹² Parent-subsidiary relationships vary. Allowing corporations to develop customized procedures for handling transactions with their controlled subsidiaries should contribute more to efficient operations than would be lost by imposing on investors

¹¹⁰ Executive compensation arrangements pose unique problems. Two recent articles analyze recent trends in executive compensation. See Patton, *Why So Many Chief Executives Make Too Much*, BUS. WK., Oct. 17, 1983, at 24; Drucker, *Reform Executive Pay or Congress Will*, WALL ST. J., Apr. 24, 1984, at 34, col. 3. The ALI proposes to approach this problem largely by requiring disclosure to and approval by independent decisionmakers. The business judgment rule would insulate their decision from review. See ALI Draft No. 3, *supra* note 1, § 5.09 comments a, c. This may be the best method of overseeing executive compensation, even though it leaves compensation decisions largely to directors who share the recipients' interest in ensuring corporate executives are compensated generously. See Vagts, *Challenges to Executive Compensation: For the Market or the Courts?*, 8 J. CORP. L. 231, 268-71 (1983).

¹¹¹ In many respects, parent companies with controlled subsidiaries currently face such a situation. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971).

¹¹² Such relationships involve a potential for exploitation but are not inherently unfair. Thus no sound reason exists to bar such relationships or saddle them with extraordinary transaction costs.

the costs of identifying, analyzing, and monitoring compliance with the different standards used.¹¹³ Moreover, if investors in a controlled subsidiary are on notice that the parent's transactions with the subsidiary will not be reviewed under the proposed duty of loyalty rules, they can protect themselves by discounting the price they will pay for the subsidiary's stock.

If a parent corporation initiates changes in the duty of loyalty rule governing its relationship with a controlled subsidiary with outstanding minority interests, the minority shareholders should be afforded some relief from the possible adverse impact of those changes. When those shareholders purchased their stock, they might not have had any reason to anticipate that the duty of loyalty rule would be changed. For example, the subsidiary might have been an independent corporation.¹¹⁴

The best protection for minority shareholders' interests might be to allow them to exercise appraisal rights when a parent company proposes changing the duty of loyalty rule governing its relationship with a controlled subsidiary.¹¹⁵ If the parent company's suggested alternative does no more than promote economies within the parent-subsidiary relationship, the price of the subsidiary's stock should not decline, and minority shareholders will have little incentive to pursue the appraisal remedy. But if the alternative rule allows the parent substantial scope for exploiting the subsidiary, the price of the subsidiary's shares should decline, jeopardizing continued minority shareholder participation in the subsidiary and reducing the parent's ability to exploit the minority.¹¹⁶

IV CONTROL TRANSACTIONS

Transactions involving corporate control fall into two categories: those in which control is sold, and those in which control is protected. The duty of loyalty regulates transactions that sell control.¹¹⁷ A person selling a controlling interest in a corporation has no duty to ensure that

¹¹³ Corporations should not be allowed to adopt different duty of loyalty standards in transactions with affiliated individuals. The cost to investors of identifying and analyzing such standards probably outweighs any efficiency gains produced by the use of such standards. *Cf.* *Sharon Steel Corp. v. Chase Manhattan Bank*, 691 F.2d 1039, 1048 (2d Cir. 1982), *cert. denied*, 460 U.S. 1012 (1983) (uniform interpretation of "boilerplate" clauses in bond indentures contributes to efficient operation of capital markets).

¹¹⁴ One could argue that investors always should anticipate the possibility that the duty of loyalty rule might change, and should deal with that possibility through a combination of discounting and diversification. The disadvantage of this approach is that it would force all corporations to bear the cost of such discounting.

¹¹⁵ The recently amended New York appraisal statute could serve as a model. *See* N.Y. BUS. CORP. LAW § 623 (McKinney 1963 & Supp. 1983).

¹¹⁶ Of course, the parent corporation also could offer minority shareholders in the subsidiary additional compensation for their loss.

¹¹⁷ *See* ALI Draft No. 3, *supra* note 1, § 5.11 comment a, § 5.15 comment d, illustration 8.

all shareholders receive the same price per share, but he must resist the temptation to appropriate the benefits of property or opportunities that belong to his corporation or its shareholders. Thus, he may not secretly receive a premium for his shares that otherwise would have been available to all shareholders and then encourage others to sell at a non-premium price.¹¹⁸ He also is prohibited from retaining more than his pro rata share of a payment for the right to allocate corporate resources or otherwise to exercise powers held in trust for the corporation.¹¹⁹

Duty of loyalty rules do not provide a basis for regulating transactions in which incumbent management uses corporate resources to retain its control. The parties directly involved in such a transaction will normally be a corporation and some unrelated person, suggesting that the duty of care should govern the transaction. But these transactions usually will allow managers to retain their corporate offices. Thus, these transactions make unrealistic the duty of care's assumption that managers will behave unselfishly.

Moreover, the market for corporate control in general, and tender offers in particular, are the most important disciplinary factors in the corporate governance system, and should be encouraged. A substantial body of economic literature, both theoretical and empirical, supports this view.¹²⁰ Several recent empirical studies have found that tender offers increase the wealth of target company shareholders and do not significantly diminish the wealth of bidding company shareholders, thus producing a net gain in shareholder wealth. At least one study suggests that this gain results from synergistic benefits produced by combining two companies, or by concentrating ownership in a few shareholders.¹²¹ Internal monitoring costs are much lower than external monitoring costs; thus, acquiring firms probably eliminate agency costs relating to the acquired firms' operations.¹²² These costs probably are associated with business judgments made by acquired firms' managements, particularly judgments about their firms' capital structure.¹²³ In few situa-

¹¹⁸ *Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (Ct. App. 1969).

¹¹⁹ *See Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969); *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955). Looting cases involving rights of access to a corporation's liquid assets, such as *DeBaun v. First W. Bank & Trust Co.*, 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (Ct. App. 1975), and *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 30 N.Y.S.2d 755 (N.Y. Sup. Ct. 1941) also can be viewed as turning on managers' appropriation of corporate property. Assessment of consequential damages against selling shareholders, however, must be based on a different theory, such as aiding and abetting.

¹²⁰ *Symposium on The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. (Jensen ed. 1983), is the most recent collection of empirical work. Manne, *supra* note 74, is the seminal theoretical article.

¹²¹ Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183, 204-06 & 204 n.12 (1983). "[T]he stockholders of unsuccessful bidding firms suffer a significant wealth loss in the wake of an unsuccessful offer." *Id.* at 186.

¹²² *See Williamson*, *supra* note 9, at 1559.

¹²³ A major source of the gains produced by tender offers, both those leading to combina-

tions is the possibility of eliminating managers' unfair self-dealing likely to justify the premiums customarily paid in takeover bids.

The economic literature contains fewer empirical studies of the wealth effects of transactions designed to fend off threats to control, perhaps because analysts find it difficult to classify defensive transactions in a manner that makes feasible collection and analysis of relevant data. Basic market theory suggests that the person prepared to pay the most for a firm is the person most able to employ its resources efficiently. In addition, two recent empirical studies on standstill agreements and targeted stock repurchases have found that these defensive transactions resulted in wealth losses to the firm's remaining shareholders.¹²⁴ The authors of one of those studies concluded that their results cast "serious doubt on the wisdom of . . . judicial rulings" upholding targeted stock repurchases.¹²⁵ The two studies also support, by implication, the arguments of several legal commentators that other defensive actions usually do not advance the interest of the target company's shareholders.¹²⁶

The ALI Project has not yet addressed corporate control transactions. Recent court decisions have allowed incumbent managements steadily increasing latitude to use defensive tactics, ranging from stock repurchases to questionable expansion decisions to sales of important corporate assets. The courts rarely have upset actions authorized by nonmanagement directors, treating such actions as business judgments if the decisions had a rational basis.¹²⁷ Given the ALI Project's general reluctance to depart too far from decided cases, it is probable that the ALI will propose to restrict defensive tactics rather than to prohibit them.¹²⁸ A likely recommendation is that transactions that protect control be treated as unlawful unless a majority of a corporation's unaffili-

tions of firms and those in which the public shareholders are bought out by a management group (i.e., leveraged buy-outs), may result from the highly leveraged capital structure of the acquiring firms. Indirect gains are from the tax advantages inherent in debt, rather than equity, financing. Regulatory restrictions may make it attractive for banks to finance tender offers even if they are not compensated fully for the associated risks.

¹²⁴ Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 J. FIN. ECON. 275 (1983); Bradley & Wakeman, *The Wealth Effects of Targeted Share Repurchases*, 11 J. FIN. ECON. 301 (1983).

¹²⁵ Bradley & Wakeman, *supra* note 124, at 327.

¹²⁶ See, e.g., Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984); Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

¹²⁷ See, e.g., *Panther v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981).

¹²⁸ Professor Coffee, one of the reporters for the ALI Project, referred recently to the constitutional and political problems involved in state regulation of defensive tactics. See Coffee, *supra* note 126, at 1251.

ated directors authorized the transaction and are able to prove they had grounds to believe that it was reasonable, or fair.¹²⁹

Such a recommendation would defeat itself; it would pave the way through "the 'disintegrating erosion' of particular exceptions"¹³⁰ for a return to the current permissive status of the law. The scenario is not unprecedented. Courts once uniformly held that control of corporations must be determined by market forces, not by directors' decisions about what was reasonable or fair. Although the courts have never explicitly reconsidered or rejected this market-oriented rationale, case by case the courts have sanctioned an increasing list of tactics designed to protect control.¹³¹ The first "particular exceptions" may have been motivated by the courts' aversion to potential acquirers.¹³² After opening the door to some defensive tactics, the courts found it difficult to outlaw others because doing so might impose "draconian" liabilities on outside directors who had acted in good faith. Corporate counsel, relying on the courts' early permissive decisions, routinely advised directors that they could approve any defensive transaction they reasonably believed to be in their corporations' best interest, and that the business judgment rule would insulate their decisions from judicial second-guessing.¹³³

The traditional reluctance of courts to saddle outside directors with large liabilities also is likely to undermine any rule that limits but does not prohibit defensive tactics. If the law provides directors (and their counsel) some basis to believe certain defensive transactions are permitted, eventually a board will test the law's limits. Faced with a hostile takeover bid, the board will approve a defensive action that most reasonable people would view as unwise or unwarranted. But when a court must decide whether to impose tens or hundreds of millions of dollars in liability on outside directors who gained very little personally from authorizing the transaction at issue, and who arguably did no more than reach an incorrect decision, the court is likely to resolve its doubts by

¹²⁹ *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964) and *Bennett v. Propp*, 41 Del. Ch. 14, 187 A.2d 405 (1962) provide ample support for such a rule. For a critique of fairness concepts in corporate control situations, see Gilson, *supra* note 126, at 824-31.

¹³⁰ *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1923).

¹³¹ For a more detailed review of these developments, see Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087, 1111-14 (1982).

¹³² The basis for the courts' aversion appears to have varied. Compare *McPhail v. L.S. Starrett Co.*, 257 F.2d 388 (1st Cir. 1958) ("raider" with history of manipulating acquired companies' affairs) with *Cheff v. Mathes*, 41 Del. Ch. 494, 500, 199 A.2d 548, 551 (1964) (potential acquirer, who wanted to change fraudulent sales practices of target company, was "'well known and not highly regarded by any stretch'" in the Kalamazoo-Battle Creek and Detroit areas) (quoting defendant P.T. Cheff).

¹³³ In *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981), plaintiffs sued defendant directors for more than \$200 million. These directors had authorized a number of questionable transactions after consulting experienced takeover lawyers.

holding that the transaction was not unlawful. That decision will expand the list of permissible defensive tactics, as will each ensuing decision by a court reluctant to "penalize" defense-minded outside directors.

The ALI Project should avoid this danger by proposing a bright-line rule prohibiting defensive transactions. Directors presumably would then be reluctant to take prohibited actions, and courts presumably would be prepared to impose liability on directors who have flouted the law's clear command.¹³⁴

The best rule would limit a target company's management to promoting an auction for its shares. Publicly held corporations in the United Kingdom operate subject to such a rule,¹³⁵ and Professor Ronald Gilson has suggested the following adaptation of that rule for use in the United States:

During the period commencing with the date on which target management has reason to believe that a tender offer may be made for part or all of a target company's equity securities, and ending at such time thereafter that the offeror shall have had a reasonable period in which to present the offer to target shareholders, *no action shall be taken by the target company which could interfere with the success of the offer or result in the shareholders of the target company being denied the opportunity to tender their shares*, except that the target company (1) may disclose to the public or its shareholders information bearing on the value or the attractiveness of the offer, and (2) may seek out alternative transactions which it believes may be more favorable to target shareholders.¹³⁶

Professor Gilson's proposal is sound in concept, but it may be read as prohibiting too much, and therefore could be interpreted to prohibit too little. The rule's purpose is not to prevent a target company from taking actions in the ordinary course of business when a tender offer is imminent or outstanding. A court, however, could view every decision directors make as one designed to "interfere with the success of" a pending tender offer, just as the Third Circuit has stated that every such decision "is in part attributable to [a director's] desire to keep shareholders satisfied so that they will not oust him."¹³⁷ Given this possibility, a

¹³⁴ If directors engage in prohibited transactions, courts may be asked to determine their unreasonableness or unfairness in order to assess damages. The prospect of damage suits could be minimized by authorizing bidders to maintain suits to enjoin or void prohibited defensive transactions. Cf. Weiss, *supra* note 131, at 1118-21.

¹³⁵ The rule was written and is administered by an industry group in England, the Panel on Take-overs and Mergers. THE CITY CODE ON TAKE-OVERS AND MERGERS (rev. ed. 1972) (amended 1974) [hereinafter cited as THE CITY CODE]. The Panel cannot impose formal sanctions, but the stock exchange and other organizations penalize members who violate the Code. See generally M. WEINBERG, TAKE-OVERS AND MERGERS 122-29 (3d ed. 1971) (detailing the Panel's sources of power); DeMott, *Current Issues in Tender Offer Regulation: Lessons From the British*, 58 N.Y.U. L. REV. 945 (1983) (comparing British and American regulation).

¹³⁶ Gilson, *supra* note 126, at 878-79 (emphasis added).

¹³⁷ Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir. 1980).

court faced with a challenged transaction arranged while a tender offer was pending—such as a contract to acquire a factory that competes with one owned by the tender offerer—may feel it must decide whether that transaction represented legitimate profit seeking, or whether it was primarily defensive. The result could be a parade of particular exceptions to the bright-line prohibition Professor Gilson intends.¹³⁸

To avoid this potential problem, the ALI Project should append the following, also adapted from the British rule, to Professor Gilson's proposal:

The following actions shall always be treated as having the potential to interfere with the success of an offer or to result in the shareholders of a target company being denied the opportunity to tender their shares, except where such actions are taken pursuant to a written contract entered into prior to the date on which target management had reason to believe that a tender offer might be made for part or all of a target company's equity securities:

- (1) Issue any authorized but un-issued shares (including treasury shares);
- (2) Issue or grant an option in respect of any un-issued shares;
- (3) Create or issue or permit creation or issue of any securities carrying rights of conversion into or subscription for shares of the company;
- (4) Sell, dispose of, or acquire, or agree to sell, dispose of, or acquire assets of material amounts;
- (5) Acquire, or agree to acquire, any of its own securities, except by means of a tender offer made to all target company shareholders.
- (6) Engage in any other transaction not in the ordinary course of business.¹³⁹

The ALI Project also should deal with the problems posed by an incumbent management's almost unlimited use of corporate resources to solicit proxies, and its ability to repurchase stock from a person threatening a proxy fight. Dissident shareholders or outsiders often find it less attractive to seek control of a corporation by way of a proxy fight than by way of a tender offer.¹⁴⁰ The proxy fight's disadvantaged status

¹³⁸ It is not difficult to believe that a court prepared to disregard "ineptly drawn" minutes of a board meeting, in order to exculpate from liability outside directors who the minutes reported had ratified an improper, defensively-motivated stock repurchase, *see* Bennett v. Propp, 41 Del. Ch. at 24, 187 A.2d at 410, also would disregard the intent of Professor Gilson's proposed rule, if the language of the rule did not explicitly prohibit the behavior in question.

¹³⁹ Compare THE CITY CODE, *supra* note 135, rule 38. The British rule allows prohibited transactions to proceed if they are approved by shareholders. *Id.* Such a modification of the proposed rule would be unobjectionable. Coffee, *supra* note 126, at 1282-89, suggests regulation of certain bidder tactics as well. *See also* DeMott, *supra* note 135, at 1014 ("There is a certain rough justice in the fact that defensive transactions are more difficult to execute in Britain for . . . hostile offers are also generally more difficult to execute in Britain.").

¹⁴⁰ Weiss, *supra* note 81, at 580-84.

should give the Project an incentive to find ways to strengthen it.

Thus, the ALI should propose that the aforementioned prohibitions also apply to the period commencing with the date on which a corporation's management has reason to believe that shareholders of the corporation are likely to solicit proxies or consents in order (1) to elect as a director or directors a person or persons other than those nominated by management; or (2) to withhold approval of any transaction, act, or policy that management has submitted, or indicated it intends to submit, to shareholders for their approval.¹⁴¹

In addition, an incumbent management should be barred from using corporate resources to republish previously disclosed information or to finance proxy solicitation efforts other than those customarily made in uncontested elections. This prohibition, however, should not be construed so strictly that it would prevent a management facing a proxy fight from disclosing to its shareholders a reasonable amount of information bearing on its performance, or on the merits of any transaction or proposal at issue.¹⁴²

V

OTHER ISSUES

Rules relating to managers' fiduciary duties and shareholders' remedies for breach of those duties are the core elements of the corporate governance system. The ALI Project's recommendations affect two other areas: whether disclosure obligations should be made a part of the corporate governance system, and whether corporations should be required or allowed to sacrifice profits to benefit constituencies other than their shareholders.

A. Disclosure Obligations

The federal securities laws impose disclosure requirements on corporations, their directors, and their senior executives. Although these requirements are designed primarily to meet the needs of the securities markets and to ensure the fairness of the proxy solicitation process, they also complement both the exit and the voice components of the corporate governance system.¹⁴³ Shareholders, as well as potential investors, must have access to corporate information in order to decide whether

¹⁴¹ In order to avoid incapacitating a corporation for too long, these prohibitions should terminate after a corporation has conducted its annual shareholders meeting or has held a special meeting to vote on a controverted matter.

¹⁴² That is, an incumbent management should be able to use corporate resources to make sure shareholders are reasonably informed about the issues involved in a proxy contest. *See* *Campbell v. Loew's, Inc.*, 37 Del. Ch. 17, 134 A.2d 852 (1957). *But cf.* Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489 (1970).

¹⁴³ *See* Weiss, *supra* note 81, at 590-95.

they should buy or sell a corporation's shares, replace its management, or initiate litigation on its behalf to remedy breaches of the duty of loyalty.

The ALI Project has signaled its concern about disclosure through two proposals: that large publicly held corporations be required to have audit committees comprised of outside directors and that all publicly held corporations have audit committees responsible for ensuring the accuracy and integrity of corporate financial reports.¹⁴⁴ These proposals are grounded in the belief that self-serving disclosure practices are comparable to a breach of the duty of loyalty. Corporate managers may suppress or misrepresent corporate information to advance their personal interests, even where their actions lead investors to distrust a corporation's disclosures and to discount the price they will pay for its shares, thereby increasing the cost of the corporation's capital.

When the ALI Federal Securities Code was being developed, the reporter proposed a requirement that corporate directors and senior executives exercise due diligence to ensure that the periodic reports filed by registered companies are not materially false or misleading.¹⁴⁵ The Institute neither accepted nor rejected that proposal.

Because disclosure plays such an important role in the corporate governance system, the ALI Corporate Governance Project should revisit this question. Threatening outside directors with liability for failing to ensure the accuracy of their corporation's financial reports is preferable to threatening them with due care liability, which might reduce their willingness to take business risks. Directors could limit the threat of liability for inaccurate disclosures by selecting competent public accountants and ensuring that management did not subject those accountants to inappropriate pressures.¹⁴⁶ Nonetheless, threats of liability may discourage qualified outsiders from serving as directors. Thus, the ALI Project should consider imposing disclosure obligations only on a corporation's senior executives or limiting the dollar amount of directors' potential liability for faulty disclosures, as it now proposes to limit their liability for violations of the duty of due care.¹⁴⁷

¹⁴⁴ See ALI Draft No. 2, *supra* note 1, §§ 3.03, 3.05.

¹⁴⁵ A substantial proportion of the ALP's membership opposed the reporter's proposal, on the grounds that it would increase unduly the threat of liability. The final ALI draft included alternative proposals—the original, due diligence standard, and a standard requiring proof of scienter before a director could be held liable. See FED. SEC. CODE § 1704 (1978).

¹⁴⁶ Accountants may be under increasing pressure to ensure the accuracy and integrity of the financial reports they certify. See, e.g., *Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983) (defendant public accountants not entitled to summary judgment where facts indicate they may be liable to user of financial report, with whom accountants were not in privity, for damages resulting from user's reliance on negligently prepared report).

¹⁴⁷ See ALI Draft No. 1, *supra* note 1, § 7.06(d). If the ALI Project adopts this proposal, it would need to consider a number of subsidiary issues, analysis of which is beyond the scope of this Article. These include deciding who should have standing to enforce a disclosure obliga-

B. Profit Maximization and Ethical Principles

Much of the discussion that preceded the ALI Project focused on whether corporate law should require firms to sacrifice profits to advance the interests of nonshareholder constituencies.¹⁴⁸ The Project has accepted the traditional notion that “[a] business corporation is organized and carried on primarily for the profit of stockholders. The powers of the directors are to be employed to that end.”¹⁴⁹ The Project proposes that corporations be *required* to sacrifice profits only when necessary to conform to the law.¹⁵⁰ In addition, the Project would allow corporations to sacrifice profits to take account of “ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business,”¹⁵¹ and to devote reasonable amounts of their resources to charitable purposes.¹⁵²

This Article’s recommendations concerning due care liability and control transactions would moot the liability implications of the ALI Project’s proposals to allow corporations to use their profits in ways other than to advance shareholders’ interests. Corporate managers would risk no liability by using their company’s resources to advance altruistic objectives, and would be barred from using those resources for defensive transactions that arguably were altruistically motivated.

Whether or not the ALI Project accepts this Article’s recommendations, its proposal that corporations be allowed to sacrifice profits to take account of ethical considerations is unlikely to have significant immediate effects. The ALI, the courts, and sophisticated practitioners recognize that corporate law currently allows, and may even obligate, corporate managers to consider ethical principles when they make business decisions.¹⁵³ Community good will and possible government regulation both bear on most corporations’ ability to continue operating profitably. The business judgment rule shields managers’ decisions to cause their corporations to incur identifiable costs in order to satisfy moral obligations or achieve social objectives. Courts consistently have held that managers who exercised reasonable care and had some ra-

tion, whether defendant directors and executives should bear the burden of demonstrating due diligence once a failure to disclose accurately has been proved, how “material negative information” should be defined, and whether senior executives should be responsible for including negative information in all of a corporation’s public statements or only in specified periodic reports.

¹⁴⁸ See COMMENTARIES, *supra* note 2, at 245-83.

¹⁴⁹ *Dodge v. Ford Motor Co.*, 204 Mich. 459, 507, 170 N.W. 668, 684 (1919); see also ALI Draft No. 2, *supra* note 1, § 2.01 and accompanying comments.

¹⁵⁰ ALI Draft No. 2, *supra* note 1, § 2.01.

¹⁵¹ *Id.* § 2.01(b).

¹⁵² *Id.* § 2.01(c).

¹⁵³ The ALI emphasizes this view in its discussion of the objective of corporate activity. See *id.* § 2.01 comment e.

tional basis for incurring such costs did not breach any duty to their corporations.¹⁵⁴

What, then, is to be gained by explicitly authorizing managers to sacrifice profits to advance ethical goals? The ALI Project says its proposal relates to "ongoing corporations,"¹⁵⁵ but it points to no circumstances that would now prevent the managers of an operating corporation from taking account of ethical considerations. Indeed, the Project illustrates the proposed authority with hypotheticals involving corporations on the verge of dissolution.¹⁵⁶

The ALI may have based its proposal on a belief that managers should not be required to justify as profit-maximizing the ethical decisions they make.¹⁵⁷ Some managers may avoid pursuing ethically motivated courses of conduct because they are concerned about comparing "soft" ethical benefits with "hard" dollar costs.¹⁵⁸ However, corporate law does not require managers to estimate precisely the dollar costs and dollar benefits of every action they take; courts have accepted virtually every argument that socially or ethically motivated conduct should be upheld as "good for business."¹⁵⁹ Thus, the ALI proposal's direct impact on corporate decisionmaking will be minor; managers will be allowed to justify solely in ethical terms decisions they now may feel compelled to explain as profit-oriented.

There is, nonetheless, good reason for the ALI Project to persist with this proposal.¹⁶⁰ Corporate law issues increasingly are being discussed as if corporations are purely economic entities, and as if corporate law's only objective is to reconcile the interests of managers and share-

¹⁵⁴ See, e.g., *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968) (directors of baseball corporation not in breach for failing to install lights for night games resulting in financial loss because directors believed baseball to be daytime sport); *Kelly v. Bell*, 266 A.2d 878 (Del. 1970) (directors of steel company not liable to shareholders for agreement to make payments to county on machinery in lieu of tax that had been abolished).

¹⁵⁵ ALI Draft No. 2, *supra* note 1, § 2.01 comment h.

¹⁵⁶ *Id.* § 2.01 comment h, illustration 11; comment i, illustrations 14, 21.

¹⁵⁷ The ALI justifies its proposal as follows: "[O]bservation suggests that corporate decisions are not infrequently made on the basis of ethical consideration even when doing so does not enhance corporate profits or shareholder gains. Such behavior is not only appropriate, but desirable." ALI Draft No. 2, *supra* note 1, § 2.01 comment h.

¹⁵⁸ See Weiss, *supra* note 9, at 363-77, for a discussion of the factors that deter many corporate managers from responding constructively to social pressures and ethical considerations.

¹⁵⁹ See *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968); *Kelly v. Bell*, 266 A.2d 878 (Del. 1970).

¹⁶⁰ The Institute tentatively approved § 2.01 at its 1984 meeting. See *supra* note 4. The principal danger posed by § 2.01 is that managers threatened with hostile takeover bids may suddenly become acutely sensitive to their "social obligations" to employees or communities and attempt to justify opposition to threats to control on ethical grounds. See Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 105-06 (1979) (arguing that target company management can appropriately cite social concerns as basis for opposing tender offers). The ALI Project seems alert to this possibility. See ALI Draft No. 2, *supra* note 1, § 2.01 comment h (stating special rules may limit role of ethical considerations in control transaction).

holders in a fashion that maximizes their combined wealth.¹⁶¹ The ALI's recommendation that corporations be authorized to take account of ethical considerations serves as a reminder that more than economic values are at stake.

Societal well-being would be increased if corporations were to forego profits to the extent necessary to reflect the external costs and benefits associated with their activities.¹⁶² Questions concerning whether, and to what extent, corporations should be required to deviate from the pursuit of profits are political, however, and should be resolved by appropriate governmental bodies.¹⁶³ The ALI is more a technocratic than a political entity—better suited to designing a system to regulate the relationships of participants within corporations than to deciding whether the traditional objective of corporate activity should be modified. But the ALI also appreciates that law—even corporate law, which deals with essentially economic entities and issues—requires more than economic analysis.¹⁶⁴ When courts decide corporate law disputes, they must remain sensitive to the social and political environment.

Publicly held corporations are the most important nongovernmental institutions in American society. The private quasi-contractual arrangements made by participants in those corporations have broad social implications. This potential should inform the courts when they decide corporate law disputes. For example, a court might credit *The New York Times's* recent report that a “‘me-first, grab-what-you-can’ extravagance appears to be cropping up among the nation’s top executives.”¹⁶⁵ The court also might believe that continuation of this trend is likely to breed similar attitudes among other groups in society—workers, professionals, or public officials, for instance. In that event, when deciding a case challenging multi-million dollar “golden parachute” payments to executives who, after years of mediocre performance, had been ousted by a hostile takeover bid, the court might view with particular skepticism the executives’ arguments in support of those payments.¹⁶⁶

Specifying exactly how social or political or “ethical” concerns

¹⁶¹ See, e.g., Scott, *supra* note 6; Winter, *supra* note 2; and sources cited *supra* note 126. The bulk of this Article, too, analyzes the ALI Project largely with reference to economic values.

¹⁶² See Weiss, *supra* note 9, at 418-26.

¹⁶³ *Id.* at 436-37.

¹⁶⁴ See, e.g., Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 U. VA. L. REV. 451 (1974) (arguing that economic analysis is a useful, but distinctly limited, technique for dealing with legal disputes).

¹⁶⁵ N.Y. Times, Aug. 19, 1984, § 3, at 1, col. 3. The *Times* prefaced this statement with the observation: “It doesn’t take a revolutionary to figure out that something is amiss in American business today.” *Id.*

¹⁶⁶ Cf. *Fradkin v. Ernst*, 571 F. Supp. 829 (N.D. Ohio 1983) (enjoining golden parachute plan because proxy statement soliciting shareholder approval was misleading). *But cf. Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984) (denying shareholder of acquired corporation standing to challenge golden parachute payments).

should shape the courts' corporate law decisions is not a task the ALI Project should undertake, however. To attempt such specification would plunge the Project, which already has proven to be quite controversial, into a morass of unnecessary controversy. The Project's assertion that ethical considerations are relevant to the conduct of corporate activities serves as a sufficient reminder of corporations' and corporate law's broader purposes.