REALIGNING THE STANDARD OF REVIEW OF DIRECTOR DUE CARE WITH DELAWARE PUBLIC POLICY: A CRITIQUE OF VAN GORKOM AND ITS PROGENY AS A STANDARD OF REVIEW PROBLEM

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In this commentary,¹ we examine the role of Smith v. Van Gorkom² as part of a continuum of Delaware judicial decisions that, we submit, gives insufficient weight to the substantive policy judgments underlying the gross negligence standard of review that governs whether corporate directors should be found liable for breaching their duty of care. The gross negligence standard is consistent with Delaware's long-standing policy of deferring to business decisions made by well-motivated fiduciaries.

That deference furthers important public policy values and underscores the social utility of encouraging corporate directors to make decisions that may create corporate wealth but that are also risky. If law-trained judges are permitted to make after-the-fact judgments that businesspersons have made "unreasonable" or "negligent" business decisions for which they must respond in monetary damages, directors may, in the future, avoid committing their companies to potentially valuable corporate opportunities that have some risk of failure. Highly qualified directors may also avoid service if they face liability risks that are disproportionate to the benefits of service.

Therefore, as a normative matter, corporate directors are expected to act with the ordinary care expected of a reasonably prudent fiduciary. Despite that, the standard of judicial review for determining whether directors should be held financially liable (or whether their actions should be enjoined) for violating their duty of care is purposely set at the more lenient level of "gross negligence." The more lenient review standard creates a greater arena of freedom for directors, because the standard is purposefully

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² 488 A.2d 858 (Del. 1985).
designed to encourage directors to act without undue inhibition.

The gross negligence standard also limits the ability of judges to intervene in business decisions made by properly motivated directors. By intruding on the protected space that the business judgment rule accords such decisions, courts create disincentives for businesses to engage in the risk-taking that is fundamental to a capitalist economy. Such intrusiveness also prolongs litigation without offsetting social utility.

Courts therefore play a critical role in preserving the public policy values that are furthered by the divergence between (1) the standard of conduct expected of directors as a normative matter, and (2) the standard of conduct that is judicially enforceable and that is embodied in the gross negligence standard of review. In the pages that follow, we argue that Van Gorkom and two of its important progeny run counter to Delaware public policies restricting the judicial enforcement of the duty of care to cases where directors have acted in a manner that represents an extreme departure from expected normative behavior, and, if damages are sought, have not been exculpated by the firm's certificate of incorporation.

We conclude by proposing that to better align judicial decision-making with those public policies, courts should apply a true gross negligence liability standard, which would require plaintiffs to prove that a director caused quantifiable damage. We further propose that courts respect decisions by stockholders that insulate directors from liability for violating that standard.

I. THE DELAWARE CONCEPTION OF DUE CARE

Preliminarily, we note that courts deciding Delaware corporate law cases have only recently viewed the director's duty of care as being judicially enforceable. Indeed, it is arguable that the pre-Van Gorkom case law reflected a judicial aversion to reviewing director action for any purpose other than identifying (and remedying) breaches of the duty of loyalty.

The pre-1985 Delaware (and the American and English) tradition was highly deferential to decisions made by well-motivated corporate directors who acted without any conflicting self-interest. Judicial decisions that addressed director liability for non-self-dealing transactions suggested that the imposition of liability would require a showing akin to subjective bad faith. Even though the law of corporations continued to articulate the standard of conduct expected of directors in ordinary negligence terms (the "ordinarily prudent person" standard), that normative articulation was different from the standard of judicial review which required a showing of far more egre-


4 Id. at 312.
gious conduct to impose liability.\textsuperscript{5}

\textbf{A. The Divergence Between the Standard of Conduct and the Standard of Review}

This divergence reflects a distinction that legal scholars have made between a "standard of review" and a "standard of conduct"—terms that Professor Melvin Eisenberg has used in his insightful article on corporate law standards of review.\textsuperscript{6} "A standard of conduct states how an actor should conduct a given activity or play a given role. A standard of review states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief."\textsuperscript{7} Standards of conduct are sometimes referred to as "conduct rules" that are addressed to corporate directors and officers, whereas standards of review are "decision rules" that are addressed to judges.\textsuperscript{8}

In many areas of law the standard of conduct and standard of review tend to be conflated and become one and the same.\textsuperscript{9} In corporation law, however, those two standards diverge in the area of due care. That divergence was thought to serve important policy purposes. Although divergence would leave stockholders without a remedy in cases where board sloppiness resulted in financial harm, the protected space afforded properly motivated directors for beneficial risk-taking was thought to have more than countervailing social utility.\textsuperscript{10}

The reasons for that divergence are complex, but in general, they may be attributed to considerations of fairness and public policy. More specifically: (1) directors must often make decisions in an environment of imper-
fect (that is, limited or incomplete) information; (2) the risk of liability under the applicable standard of conduct for assuming a given corporate role may dwarf the incentives for assuming the role; (3) if the risk of liability is disproportionate to the directors' incentives for service, directors may avoid making economically valuable decisions that might subject them to litigation risk; (4) courts are ill-equipped to determine after the fact whether a particular business decision was reasonable in the circumstances confronting the corporation; and (5) institutional and prudential considerations sometimes counsel judicial deference to the corporate decision maker.\(^1\)

The interplay of these considerations is best illustrated by considering how courts review board decisions under the business judgment standard. In that context an officer or director will not be held liable for a decision—even one that a court might later be inclined to view as unreasonable—that results in a loss to the corporation, so long as the business judgment rule is applicable and the decision is rational.\(^2\) In this manner, the business judgment review standard ("rationality") diverges from, and becomes more lenient than, the normative standard of conduct ("reasonableness").\(^3\)

The distinction between these concepts has a utilitarian and important functional purpose, which is that a rationality standard gives directors greater freedom to make risky decisions than a reasonableness standard.\(^4\) That result flows from the definition of an irrational decision—one that is so blatantly imprudent that it is inexplicable, in the sense that no well-motivated and minimally informed person could have made it.\(^5\) By contrast, even the best of us will occasionally make a lapse in judgment or a factual error that a judge could later second-guess as "unreasonable" or "negligent."\(^6\)

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11 Eisenberg, supra note 6, at 437-438.

12 Id. at 443. The business judgment standard, where applicable, is said to create a presumption that (1) a decision must have been made by directors who (2) were disinterested and independent, (3) acted in subjective good faith, and (4) employed a reasonable decision making process. Id. at 441; see also Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (setting forth these same elements). If those four conditions are met, the directors' decision will be reviewed not for "reasonableness," but for rationality, i.e., the existence of some basis in reason. An "irrational" decision is one that cannot be coherently explained. Eisenberg, supra note 6, at 443.

In practical terms, the business judgment standard is more of a policy expression than an actual tool for judicial decision-making. For example, if the presumption that the four preconditions to the application of the standard are not rebutted, how likely is it that the resulting decision will be irrational? In our view, the policy behind the business judgment rule actually finds its genuine expression in the judicial standards used to invoke the business judgment rule to begin with. Once invoked, the business judgment rule standard almost always results in nonliability.

13 Admittedly, the distinction between "reasonable" and "rational" actions is often subtle and elusive to grasp. Linguistically, it is odd to think of a board decision as unreasonable yet "rational," since both concepts rest in great part on whether the conduct was logical in the circumstances.

14 Allen, supra note 3, at 327; Eisenberg, supra note 6, at 443.

15 Eisenberg, supra note 6, at 443.

16 Id.
In the end, the problems of distinguishing the concepts may be more linguistic than real. If a different nomenclature, drawn from the law of torts, is employed, the reasonableness standard in corporate law is easily understood as analogous to the "reasonable person" standard in tort law, which is based on a simple negligence standard of conduct. In contrast, the corporate law concept of rationality can usefully be analogized to certain cases arising under conventional tort law (particularly, lawsuits against public officials), where, for policy reasons, the defendant official is not held liable for ordinary negligence, but only for more egregious conduct rising to the level of gross negligence.\textsuperscript{17} The selection of a gross negligence standard to govern due care cases may be viewed as synonymous with, and as a practical way to articulate a judicially useful metric to apply, the rationality test embodied in the business judgment rule.

To implement this rationality concept in the director due care context, Delaware corporate cases have adopted a gross negligence standard that requires a plaintiff to demonstrate a degree of culpability on the part of the directors that is akin to the recklessness standard employed in other contexts. "In the corporate context, gross negligence means 'reckless indifference to or a deliberate disregard of the whole body of stockholders' or actions which are 'without the bounds of reason.'"\textsuperscript{18} Thus, in corporate cases, Delaware courts have chosen a definition of gross negligence that is even more difficult for a plaintiff to establish than the gross negligence standard normally applied in American tort or criminal cases.\textsuperscript{19}

\textsuperscript{17} \textit{E.g.,} \textit{Del. Code Ann. tit. 10, § 4001} (1999) (insulating state and its officials from liability for negligence, but allowing recovery if the conduct involved "gross or wanton negligence"). Under federal law, the policy value of insulating officers from undue risk of liability is recognized, among other ways, by the qualified immunity accorded public officials subject to claims in a case involving a claim under \textit{42 U.S.C. § 1983} (1994). \textit{See Smith v. Wade}, 461 U.S. 30 (1983). \textit{Smith} held that because of [petitioner's] qualified immunity as a prison guard, . . . [respondent] could recover only if the defendants were guilty of "gross negligence" (defined as "a callous indifference or a thoughtless disregard for the consequences of one's act or failure to act") or "egregious failure to protect" [respondent] (defined as "a flagrant or remarkably bad failure to protect").

\textsuperscript{18} \textit{Id.} at 32-33, 55 (citations omitted).

\textsuperscript{19} \textit{PROSSER AND KEETON ON THE LAW OF TORTS} § 34, at 211-212 (W. Page Keeton ed., 5th ed. 1984).
B. The Policy Reasons for the Divergence

Sound justifications exist for employing a rationality-level gross negligence standard to evaluate claims that directors breached their duty of care. In cases involving comparatively simple decisions such as automobile accidents, there is often little difference between decisions that are bad and good decisions that turn out badly. In such cases, typically only one decision is reasonable in a given set of circumstances, so decisions that turn out badly almost invariably turn out to have been bad decisions. Thus, in the tort area, there is no unfairness in conflating the standard of conduct ("reasonableness") with the standard of review (whether the defendant acted reasonably).

But where the subject of legal challenge is a business decision, to conflate the two standards and apply a "reasonableness" standard of review risks imposing liability upon directors unfairly. Unlike automobile accident cases, it may be hard for judges to differentiate bad business decisions from good business decisions that turn out badly. Business decisions are virtually always made with less than perfect information and thus decision makers are required to assess and assume some degree of risk. Suppose, for example, that a board must decide between either investing in an expensive but untried new technology, or foregoing the investment. Each alternative involves certain risks. Given uncertainty, the only way the board can rationally decide is by weighing the benefit of each alternative against the probability that the associated negative risk will—or will not—materialize.

Thus, if the board chooses one alternative based on its assessment that a negative result is improbable, but the negative result nonetheless occurs, the decision may (in hindsight) be "wrong" but it is not "bad," because in any normal probability distribution some outcomes will inevitably fall on the "unlucky" side. If, however, the standard of review is "reasonableness," a fact finder might erroneously treat reasonable decisions that turned out badly as bad decisions, and unfairly find the directors liable for such decisions. 20 There is empirical evidence that persons who know the outcome of

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Gross Negligence. As it originally appeared, this was very great negligence, or the want of even slight or scant care. It has been described as a failure to exercise even that care which a careless person would use. Several courts, however, dissatisfied with a term so nebulous . . . have construed gross negligence as requiring willful, wanton, or reckless misconduct, or such utter lack of all care as will be evidence thereof . . . . But it is still true that most courts consider that "gross negligence" falls short of reckless disregard of the consequences, and differs from ordinary negligence only in degree, and not in kind.

Criminal negligence as defined in DEL. CODE ANN. tit. 11, § 231(d) is the functional equivalent of gross negligence as that term is applied as a basis for the recovery of damages for civil wrongs. Gross negligence, though criticized as a nebulous concept, signifies more than ordinary inadvertence or inattention. It is nevertheless a degree of negligence, while recklessness connotes a different type of conduct akin to the intentional infliction of harm.

Jardel Co. v. Hughes, 523 A.2d 518, 530 (Del. 1987).

Eisenberg, supra note 6, at 444; E. Norman Veasey & William E. Manning, Codified Standard—Safe Harbor or Unchartered Reef?, 35 Bus. LAW. 919, 932 (1980) ("Because facts differ from case to
a decision tend to exaggerate the extent to which that outcome “could have been correctly predicted beforehand.” That tendency is known as “hindsight bias.” That is one reason why the business judgment rule employs a standard of review that is more lenient than the standard of conduct: to give directors a large zone of protection to avoid an unfair imposition of liability on corporate boards when their decisions are attacked.

In addition to fairness, policy considerations may also dictate the need for divergence between a standard of review and a standard of conduct. Because the expected value of a risky business decision may be greater than that of a less risky decision, directors may be acting in the best interest of the shareholders when they choose the riskier alternative. A standard of review that imposes liability on a board of directors for making an “unreasonable” (as opposed to an “irrational”) decision could result in discouraging riskier yet socially desirable economic decisions, because an ordinary negligence standard of care will tend to make directors unduly risk averse. If a high-risk decision leads to a good outcome, only the corporation (but not the directors) would benefit, whereas a bad outcome could cause the directors to be held liable for the corporation’s entire loss.

This observation gives rise to the related policy concern that the risk of liability, at least in the case of non-management directors, could be highly disproportionate to the incentives for serving as a director. Liability for an imprudent decision could be in the millions, but outside directors rarely receive annual fees commensurate with liability risk of that magnitude. Absent a mechanism that would reduce the risk of ruinous liability, conflating the standards of conduct and of review would make it more difficult to attract qualified candidates as outside directors—a result that can only dis-

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22 Id.

23 Eisenberg, supra note 6, at 444. There is another reason for applying divergent standards of review and conduct. Decision makers forced to make decisions that are based on incomplete information and involve known risks can shield themselves from liability by showing they followed accepted protocols or practices (e.g., physicians in medical malpractice cases). Corporate directors seldom can defend themselves in that way because almost every business decision is, to some important extent, unique. Id.

24 Veasey & Manning, supra note 20, at 931-32.

[To equate the analyses in common negligence cases with those involving corporate decision-making overlooks the different values society assigns to the behavior under review. There seems to be no discernible bias, in common negligence cases, to encourage our perambulating friend to risk crossing the street. On the other hand, courts have traditionally favored freedom in corporate decision-making in response to society’s encouragement of risk-taking enterprises. While that spirit of encouragement is not without limitation, corporate decision makers have, nevertheless, been given less cause to fear their honest mistakes than has the errant pedestrian. The substitution of a judge’s or jury’s notion of what is reasonable (after the fact) for that of a corporate director (before the fact) runs counter to society’s traditional encouragement offered to the creative entrepreneur.

Id.
serve the stockholders’ best interests.25

A third policy consideration is that intracorporate remedies may be socially preferable. Directors are elected, and can be removed, by shareholders. Where stockholders are able to change the board because of inadequate performance, there is less reason for courts to intervene and police whether the directors are behaving reasonably. And, if stockholders believe that their well-intentioned directors have acted unreasonably, their ex post regret that they should have elected a different board ex ante is not a worthy justification for holding a director liable in damages.26 Arguably, court intervention is more properly reserved for cases of policing disloyal board conduct, a function stockholders are ill-equipped to perform adequately by the periodic exercise of their voting franchise.

These justifications for deferential review of due care cases were collectively voiced by the Court of Chancery in Gagliardi v. Trifoods, Int’l, Inc.: [Where there is a large, well-developed stock market] shareholders can [cheaply] diversify the risks of their corporate investments. Thus, it is in their economic interest for the corporation to accept, in rank order, all positive net present value investment projects available to the corporation, starting with the highest risk-adjusted rate of return first. Shareholders don’t want (or shouldn’t rationally want) directors to be risk averse. Shareholders’ investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk-adjusted returns available that are above the firm’s cost of capital.

But directors will tend to deviate from this rational acceptance of corporate risk if, in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to ex post facto claims of derivative liability for any resulting corporate loss.

Corporate directors of public companies typically have a very small propor-

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25 Eisenberg, supra note 6, at 445.
26 Allen, supra note 3, at 327-28, cites Judge Learned Hand’s excellent articulation of this rationale in Barnes v. Andrews:

True, he was not very suited by experience for the job he had undertaken, but I cannot hold him on that account. After all, it is the same corporation that chose him which now seeks to charge him. . . . Directors are not specialists like lawyers or doctors . . . . They are the general advisors of the business, and if they faithfully give such ability as they have to their charge, it would not be lawful to hold them liable. Must a director guarantee that his judgment is good? Can shareholders call him to account for deficiencies which their votes assured him did not disqualify him for his office? While he may not have been the Cromwell for that Civil War, Andrews did not engage to play any such role.

298 F. 614, 618 (S.D.N.Y. 1924).

[T]rust law seems particularly inapposite to situations in which no self-dealing or other act of bad faith is alleged. . . . [T]he stockholder, in return for his expectation of greater profit, [than the beneficiary of a trust] accepts the risk that a directors’ judgments, honestly formed but not vindicated by subsequent events, may result in financial loss.

Veasey & Manning, supra note 20, at 925.
Realigning the Standard of Review

ionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any “upside” gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation and modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on “negligence,” “inattention,” “waste,” etc., could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders’ economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimal proceduralist standards of attention, they can face liability as a result of a business loss.27

For these reasons where the substance of the directors’ decision is challenged on due care grounds, the business judgment standard applies and the result, as a practical matter, is that the decision is not reviewed.28 The Delaware Supreme Court’s recent Brehm v. Eisner decision clearly suggests that Delaware law preserves the divergence between the standards of conduct and of review in all aspects of the duty of care.29 Observing that the concept of “‘substantive due care’ . . . is foreign to the business judgment rule,” the court stated unambiguously that “[d]ue care in the decisionmaking context is process due care only,” and reviewable only for “irrationality.”30 That is, Brehm explicitly recognizes that the gross negligence standard applicable in due care cases is, functionally speaking, a proxy for the rationality standard of the business judgment rule.31

Having set forth the public policies that animate the standard of review in due care cases, we now discuss a series of cases that appear to give less than appropriate weight to those policies. The discussion begins with Van

29 Brehm v. Eisner, 746 A.2d 244 (Del. 2000).
30 Id. at 264.
31 Arguably, there is even more divergence where the aspect of due care being reviewed is the director's duty to monitor. In that context it has been held that corporate directors will not be held liable unless their dereliction of duty is in bad faith. In re Caremark Ins. Derivative Litig., 698 A.2d 959, 967-68 (Del. Ch. 1996). “Bad faith” is an element of the duty of loyalty, not the duty of care, which suggests that “duty to monitor” cases may be remediable only if the board’s conduct violates the duty of loyalty, as distinguished from the duty of care.

The Caremark standard can be viewed as consistent with the traditional approach in due care cases decided before Van Gorkom. Allen, supra note 3, passim. While the authors may or may not agree with each other regarding whether this traditional approach should be resumed, all concur that at the very least the gross negligence standard must be applied in a rigorously faithful manner in accordance with the stringent definitional standard set forth in Tomczak. See supra note 18.
II. VAN GORKOM AND THE STANDARD OF REVIEW IN DUTY OF CARE CASES

In Aronson v. Lewis, the Delaware Supreme Court announced that the standard of review in cases involving claimed breaches of the duty of care is gross negligence. Because that standard is facially more lenient than the simple negligence standard of conduct, it appeared that as a result of Aronson the standard of review and the standard of conduct in due care cases would continue to diverge as a matter of Delaware public policy, so that in director liability cases the court's function would be to decide whether the board's conduct constituted gross negligence.

Unfortunately, that expectation was not fully realized. Instead, in later decisions the Delaware Supreme Court, while purporting to apply the gross negligence standard of review, in reality (but not explicitly) applied an ordinary negligence standard.

Van Gorkom was the first case where that occurred. There, the Delaware Supreme Court held outside directors liable in damages for approving a sale of the corporation at a fifty percent premium over the stock market price. The gross negligence consisted of the board having failed (1) to require an independent valuation of the corporation or, alternatively, a reliable post-signing “market check;” (2) to obtain an adequate “no shop” clause that enabled the board to consider a higher offer and gave the board a reasonable basis to terminate the agreement; and (c) to employ a monitoring and decision-making process that was not controlled by the corporation's CEO. These failures of process may well have constituted ordinary negligence (though some observers dispute even that), but it is difficult to argue that those failures constituted true gross negligence, which requires a "devil-may-care" attitude or indifference to duty amounting to recklessness.

By abandoning the gross negligence review standard in deed albeit not in word, the Delaware Supreme Court eliminated the comfort implicit in, and promised by, Aronson.

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32 473 A.2d 805, 812 (Del. 1984) ("[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.").
33 Smith v. Van Gorkom, 488 A.2d 858, 869 n.9 (Del. 1985).
34 Id. at 873-88.
36 No one was misled by the court's application of the simple negligence review standard dressed up as "gross negligence," evidenced by the fact that shortly after Van Gorkom, the D & O insurance industry sharply increased their premiums and in some cases, threatened to stop writing D & O insurance policies. This crisis required a legislative solution, which took the form of the adoption of DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).
That this result was not inadvertent was confirmed eight years later in *Cede v. Technicolor, Inc.* ("*Cede II,*")37 There, the Delaware Supreme Court ruled that outside directors who approved an arm's-length-negotiated sale of their company to an unrelated third party, upon the advice of independent counsel and investment bankers, were (based upon presumed findings of the Chancellor) grossly negligent for not having "shopped" the company in advance of agreeing to the sale, and by not affording some of the directors adequate time to prepare for the meeting at which the sale would be considered and voted upon. The court held that as a consequence of not having made an informed decision, the directors would be required to prove (on remand) that the merger transaction was entirely fair as to both price and process.

Although again the court purported to apply gross negligence as the standard of conduct and review, its own description of the due care required of directors approving a sale of the corporation suggests that, in fact, the review standard being applied was far less lenient. Emphasizing that it had consistently "given equal weight to [the business judgment] rule's requirements of duty of care and duty of loyalty," the court stated that "a director's duty of care requires a director to take an active and direct role in the context of the sale of a company from beginning to end," and that "the directors individually and the board collectively [must] inform themselves fully and in a deliberate manner before voting as a board upon a transaction as significant as a proposed merger or sale of the company."38 While we do not quarrel with (and indeed applaud) that standard as a description of the board's duty in the precise context of selling the company,39 our point is that the quoted language does not describe gross negligence. If anything, the *Cede II* court's language is suggestive of a "higher-than-ordinary-care" standard in cases involving a sale of the company, but in all events *Cede II* does not articulate a gross negligence standard of review, which by definition is far less exacting than "ordinary negligence."

This de facto departure from the gross negligence review standard in *Van Gorkom* and *Cede* prompts us to suggest that the time has come to re-

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37 634 A.2d 345 (Del. 1994).
38 *Cede II*, 634 A.2d at 367, 368.
39 That is, *Van Gorkom* and *Cede II* must also be viewed as part of the Delaware courts' effort to grapple with the huge increase in mergers and acquisition activity in 1980s and the new problems that posed for judicial review of director conduct. See Allen, supra note 3, at 325 ("In retrospect, *Van Gorkom* can be best rationalized not as a standard duty of care case, but as the first case in which the Delaware Supreme Court began to work out its new takeover jurisprudence."). Indeed, if decided consistent with the "enhanced scrutiny" analysis mandated by *Revlon*, with its emphasis upon immediate value maximization, rather than as a "due care" case, *Van Gorkom* would not be viewed as remarkable. It would, however, still be problematic to square with later *Revlon* jurisprudence such as *Barkan v. Amsted Indus.*, 567 A.2d 1279, 1286-1287 (Del. 1989), under which the broad market check conducted by the board in *Van Gorkom* would have satisfied its *Revlon* duties. By focusing on the impact of these cases on the standard of review applied in due care cases, we, of course, do not diminish the other beneficial influences these decisions have had on corporation law.
examine the appropriate standard of review in due care cases. The standards, both of conduct and of review, and whether they should be identical or different, should be clearly articulated, and then candidly and consistently applied. If simple negligence is to be the standard of care and gross negligence the standard of review, that would further the fairness and policy goals discussed above. But in that event the Delaware Supreme Court should announce in clear terms that the two standards are divergent, state why, and then apply the standard of review in a consistent manner. The same holds true if gross negligence were to become both the standard of conduct and the standard of review. In that case, the court would have to confront the problem that that congruent formulation creates a lower aspirational due care norm for board conduct. Similarly, if both the standard of review and the standard of conduct are to be "ordinary negligence," that would avoid the problem of imposing too low a standard on corporate boards, but would introduce the same policy and fairness problems that caused the standards of conduct and review in the business judgment context to become divergent in the first place.

Whatever it is to be, the standard of review, once announced, should be adhered to in fact as well as in rhetoric. If the gross negligence standard of review persists—as we think it should—the courts must apply that standard consistently and in a manner that implements the important public policies it is intended to serve.

III. **CEDE II AND ITS LINKAGE OF DUE CARE AND ENTIRE FAIRNESS**

*Van Gorkom*’s failure to effectuate the policies advanced by the gross negligence duty of care review standard was later compounded by the unprecedented linkage of the duty of care and the duty of loyalty in *Cede II*. For reasons we discuss next, that linkage further erodes the objectives supposedly served by a nonstringent standard for enforcing the duty of care.

Before *Cede II*, claimed breaches of the fiduciary duty of care and of the duty of loyalty were reviewed under different standards. Claimed breaches of the duty of care were reviewed under traditional tort analysis, that is, whether the duty was violated and, if so, whether the violation caused harm to the corporation or the shareholders. The burden of proof...
fell upon the plaintiff. If a violation of duty and resulting harm were shown, the directors would be found liable.

Claimed breaches of the duty of loyalty were reviewed under a far more exacting standard—entire fairness. In cases where the board is not conflicted, the directors are motivated to achieve the highest transaction price that the market will permit, and thus the interests of the board and the shareholders are aligned. In such cases there is no reason for a court to engage in substantive review of the board’s decision. But where a majority of the board is conflicted—has a personal interest in the transaction that is adverse to the interest of the shareholders—it cannot be presumed that the board was motivated to achieve the highest transaction price the market will permit. Because it is difficult to ascertain at what higher price the transaction could have been effected in the market, in such cases the law imposes upon the directors the burden of showing that the transaction is entirely fair, both as to the decision-making process and the transaction price. That is why in “conflict” transactions implicating the directors’ duty of loyalty, the court engages in the most searching review of the substance of the board’s decision and, in close cases, will resolve the doubt against the directors.

*Cede II* changed this clear demarcation of the standards by which duty of care and duty of loyalty claims are reviewed. It did so by holding (at least in the context of a merger or sale of the company) that if the acquired corporation’s directors breach their duty of care in approving the terms of the transaction—even if there is no resulting financial harm—they will be required to prove the transaction’s entire fairness. In that manner, an adjudicated breach of the duty of care became transformed from an independent basis for imposing liability to a mechanism for changing the standard of review and shifting the burden of proof. Functionally speaking, a demonstrated breach of the duty of care will now cause the directors’ conduct to be reviewed as if the directors stood accused of a breach of the duty of loyalty.

The *Cede II* court cited no precedent nor offered any explanation for why, on policy grounds, duty of care claims should receive the same searching substantive review traditionally reserved for duty of loyalty claims. We submit that no reason in law or policy justifies that result.

First, the basic rationale for entire fairness review—the difficulty in ascertaining, in non-arms-length transactions, the price at which the deal would have been effected in the market—is not applicable in due care cases. “Care cases, unlike loyalty cases, do not deprive corporations of ‘neutral decisionmakers.’”42 In the due care context the plaintiff should be able to identify whatever harm flowed from the neutral decision-makers’ alleged breach of care, which obviates any need for a court to assess the substantive fairness of the board’s business decision.

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Second, in care cases not involving a specific transaction, an entire fairness analysis would have little or no utility. The reason is that due care cases in nontransactional settings (for example, uninformed or otherwise careless decisions on corporate distributions, or decisions to expand or contract a business by means other than by acquiring or divesting an entire corporation) do not involve discrete market-based events that lend themselves to a fairness analysis. That is also true of nontransactional director conduct such as a failure to monitor the conduct of corporate employees. Thus, the Cede II analytical framework could not be used as a uniform review standard applicable in all due care cases, which raises fundamental questions of what are the outer limits and contours of the Cede II doctrine.

Third, the Cede II standard-changing treatment of the duty of care is procedurally unfair to directors accused of breaching that duty, and may diminish the incentive for directors to engage in risk-taking transactions that could serve the best interests of stockholders. Under traditional duty of care analysis, the plaintiff had the burden of proving that the director(s) breached the duty and that the breach proximately caused harm to the corporation or the shareholders. Any claim that the duty was breached would be reviewed under the lenient gross negligence standard, and if a breach of duty and resulting harm were found, then liability would be imposed.

Under Cede II, all a plaintiff need show is a breach of the duty of care, irrespective of any resulting harm, to trigger the far more liability-threatening procedural consequences of changing the review standard to the more exacting entire fairness scrutiny, with the directors having the burden to negative the presumption of unfairness. Nothing in Cede II explains or justifies subjecting directors accused of due care violations to that greater liability risk. A predictable result will be to make directors more risk averse, and cause them to avoid risky wealth-creating transactions that corporate boards should be encouraged to undertake.

IV. Emerald Partners v. Berlin: Are the Protections of Title 8, Section 102(b)(7) of the Delaware Code Now in Doubt?

The Van Gorkom and Cede II intrusions on the public policies that underlie the gross negligence review standard have been limited to some extent by title 8, section 102(b)(7) of the Delaware Code. That statute, which

43 Id. at 817.

44 A learned commentator, Professor Lyman Johnson, argues another reason why the Cede II approach is flawed, namely, that blurring the duty of care and the duty of loyalty and subsuming the duty of care within the business judgment rule standard of review weakens the significance of the duty of care, which the Delaware Supreme Court has stated merits the same weight on the jurisprudential scale as the duty of loyalty. A purposeful breach of the duty of loyalty will almost always result in the imposition of liability and a remedy. After Cede II, however, the consequence of a determination that the duty of care was violated is to shift the standard of review and to require the careless director(s) to establish the entire fairness of the transaction. The arguable effect is to downgrade the significance of the duty of care and, functionally speaking, subsume it within the duty of loyalty. Id. at 802-803.
was enacted in direct response to Van Gorkom, permits certificates of incorporation to contain a provision that exculpates directors from damages liability for breaches of the duty of care. That statute thus restored most of the liability protections afforded by a consistently applied gross negligence standard. Because most corporations quickly took advantage of section 102(b)(7), the liability-enhancing feature of Van Gorkom and Cede II, was marginalized.  

Equally important, the statute gave directors a tool that potentially would facilitate the termination of lawsuits at the earliest possible stage. By insulating directors from monetary liability for gross negligence, an exculpatory charter provision requires plaintiffs to plead a breach of the duty of loyalty if they wish to state a claim. As a result, directors can obtain prompt dismissals if they can demonstrate that the complaint did not plead facts supporting an inference that the directors acted in a manner not exculpated by the statute.

But the Cede II doctrine—that a director found to have breached his duty of care must demonstrate the entire fairness of the challenged transaction—has resulted in another unintended (and, we suggest, unfortunate) consequence: the rule, announced in Emerald Partners v. Berlin, that an exculpation defense based on a charter provision authorized by section 102(b)(7) is an affirmative defense that the directors must bear the burden of establishing. Presumably that burden includes the obligation to negate the statutory categories of excepted-out conduct—specifically, breaches of the duty of loyalty to the corporation or its stockholders, acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, and transactions from which the director derived an improper personal benefit. The Emerald Partners approach can be read as exacting a high price for invoking immunity from damages liability for due care violations, because under that approach the directors must bear the burden to demonstrate that they did not act disloyally. That is, the defendants must now show nonbreach of the duty of loyalty as the cost of receiving immunity from liability for alleged carelessness.

A section 102(b)(7) defense is more properly viewed—and should be treated—as a statutory immunity rather than as an affirmative defense. But however the section 102(b)(7) defense may be viewed, it is (we venture) unsound policy to impose this method of establishing the defense on the directors. There are several reasons.

First, requiring the directors to disprove all of the duty of loyalty—

45 Although Cede II was decided after the enactment of section 102(b)(7), the transaction it addressed predated the statute.

46 The statutory examples of conduct that cannot be exculpated under § 102(b)(7) are all, in our opinion, examples of loyalty violations.

47 726 A.2d 1215, 1223-24 (Del. 1999).

related "exceptions" to the defense dysfunctionally undercuts the purpose of section 102(b)(7), which is to exculpate directors for duty of care claims for money damages. The unintended result is to leave directors who interpose the exculpation defense worse off procedurally than those who do not, which creates disincentives to invoking that statutory defense, and increases the likelihood that meritless cases will survive motions to dismiss. That perpetuates costly litigation without creating any countervailing social utility, and is not how the exculpation defense should work. To the extent the directors are subject to duty of care claims for damages, those claims should be automatically deemed exculpated. Any other claims will by definition be duty of loyalty claims that the plaintiff traditionally has had—and should have—the burden of establishing.

As an analytical matter, the defendant directors should have to do nothing to establish the section 102(b)(7) defense other than to point to the existence of the exculpatory charter provision. This would establish that the defendants may not be held liable for damages on account of any breaches of the duty of care. The logical procedural consequence would seem to be that the plaintiff who seeks a monetary recovery against the directors has the burden to plead facts supporting the inference, and the burden ultimately to prove at trial, that the directors engaged in nonexculpated conduct that caused damage.

Requiring directors accused of a due care violation to prove that they did not act disloyally imports to yet another context the fairness and policy concerns previously discussed in connection with Cede II. That is, the Emerald Partners doctrine undercuts the policies sought to be achieved by the gross negligence standard of review applicable in due care cases.

V. BREHM V. EISNER: A RETURN TO TRADITIONALISM?

A recent decision suggests the de facto misapplication of the gross negligence standard of review in Van Gorkom and Cede II may be coming to

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49 We use the term "disloyally" in the broad sense of encompassing breaches of the duty of loyalty, including conduct that is in bad faith, or that constitutes intentional misconduct or results in the director receiving an improper benefit. Id.

Although corporate directors are unquestionably obligated to act in good faith, doctrinally that obligation does not exist separate and apart from the fiduciary duty of loyalty. Rather, it is a subset or "subsidiary requirement" that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care.


50 As this Article was on the verge of publication, the Delaware Supreme Court issued a new opinion in Emerald Partners v. Berlin. 2001 WL 1568741 (Del. Nov. 28, 2001). We do not comment upon that decision at this time, other than to note its consistency with the court's prior decision in the case. See 726 A.2d 1215 (1999).
an end. In *Brehm v. Eisner*, the Delaware Supreme Court evaluated whether plaintiffs had pled a claim that the Disney board of directors was grossly negligent in approving the employment contract of Michael Ovitz. Within a short period of time after Ovitz’s hiring, he was permitted to terminate his employment on a “no-fault” basis and received hundreds of millions of dollars in severance benefits.

Without elaborating on the facts pled in the lengthy amended complaint, it is fair to say that the plaintiffs had made strong allegations that the Disney board had been sloppy in its approval of Ovitz’s contract. Indeed, the complaint alleged that neither the board nor the board’s compensation consultant had calculated the potential costs of Ovitz’s departure. Nevertheless, the Delaware Supreme Court, adhering to a rigorous gross negligence standard, held that the complaint did not plead facts supporting an inference of carelessness of that severity. Although it was confronted with a case where there was substantial judicial temptation to second-guess Disney’s directors, the Delaware Supreme Court fully respected the policy judgment reflected in the gross negligence standard and affirmed the Court of Chancery’s dismissal of the complaint.

VI. CONCLUSION: DUE CARE ANALYSIS MUST REFLECT THE POLICY VALUES EMBODIED IN THE GROSS NEGLIGENCE STANDARD

The preceding analysis highlights the distortion of incentives that can arise when standards of review are not applied with a sufficient focus on the policies that underlie those standards. In the corporate community, the selection of the level of behavior that will subject a corporate director to liability is a highly sensitive and important matter. When courts do not consciously align their decisions with the policy judgment inherent in the standard of review, they affect director behavior in ways that are unintended and undesirable.

*Van Gorkom, Cede II*, and *Emerald Partners* illustrate this proposition in different ways. Each encroached on the protected space the gross negligence standard and section 102(b)(7) provide to directors. To align judicial decision-making with the traditional values embodied in the business judgment rule, the Delaware courts should reassess these decisions and, as the Delaware Supreme Court did in *Brehm v. Eisner*, adhere to a regime more deferential to well-motivated director action. That approach would: (1) apply a genuine gross negligence standard of review in determining whether directors should be liable for having breached their duty of care; (2) impose on plaintiffs the burden to demonstrate that a breach of the duty of care caused quantifiable damage; and (3) dismiss damage claims in cases where an exculpatory charter provision is in force and the plaintiffs have not pled facts supporting an inference that the directors breached their duty of loyalty.

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51 *Brehm v. Eisner*, 746 A.2d 244, 260-61 (Del. 2000).
alty. The court's recent opinion in *Brehm* is a commendable start in that direction.