8-1-1993

An Overview of the Principles of Corporate Governance

Melvin Aron Eisenberg

Berkeley Law

Follow this and additional works at: https://scholarship.law.berkeley.edu/facpubs

Part of the Law Commons

Recommended Citation


This Article is brought to you for free and open access by Berkeley Law Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Berkeley Law Scholarship Repository. For more information, please contact jcera@law.berkeley.edu.
An Overview of the Principles of Corporate Governance

By Melvin Aron Eisenberg*

INTRODUCTION

In 1978, The American Law Institute (ALI) formally initiated the Corporate Governance Project (Project), in furtherance of the ALI's mission "to promote the clarification and simplification of the law and its better adaptation to social needs." Although some commentators have connected the initiation of a corporate governance project by the ALI principally to transient social events of the late 1970s, in fact such a project had been central to the ALI's agenda since it was organized in 1923. From 1928 to 1932, three Tentative Drafts of a Restatement of the Law of Business Associations were produced. William Draper Lewis, the first Director of the ALI, served as the Reporter for that Restatement, but the project was never consummated. Nevertheless, a corporate-law project continued to remain high on the ALI's agenda both before and after the war. Indeed, given the ALI's mission, it became increasingly anomalous that by the late 1970s the ALI should have consummated projects on agency, contracts, tax, and eventually securities regulation, while its projects in the corporate-law area had aborted.¹

---

*Professor Eisenberg is Koret Professor of Law at the University of California School of Law in Berkeley, California and The Justice R. Ammi Cutter Reporter of the ALI. He also serves on the Committee on Corporate Laws of the Section of Business Law of the American Bar Association.

1. Although formally initiated in 1978, the Corporate Governance Project really did not begin in earnest until 1980, when a full complement of Reporters was in place, so that the Project took approximately 12 years to complete. By way of comparison, the Federal Securities Code took 12 years to complete, the Restatement (Second) of Contracts took 19 years, the Restatement (Second) of Conflict of Laws also took 19 years, and the Restatement (Second) of Torts took 21 years.

2. For a detailed history of the place of corporate law on the ALI's agenda from 1923 to 1978, see Roswell B. Perkins, Foreword to THE AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (forthcoming 1993). See also Roswell B. Perkins, Thanks, Myth, and Reality, infra p. 1313. For a history focusing on the intellectual (rather than social) background events of the 1970s, such as the completion of the Federal Securities Code, see Richard B. Smith, An Underview of the Principles of Corporate Governance, infra p. 1297.
Although it is not entirely clear why that happened, the reasons very well may have been connected to the ambitions of those who determined the earlier projects' scope. Most areas of American law are either dominantly common law areas, such as contracts or torts, or dominantly statutory areas, such as criminal law, tax law, or securities regulation. During the 1930s, the ALI concerned itself primarily with common law areas, which were susceptible to a pure Restatement treatment. Both the pre- and post-War corporation-law projects were cast in that format. Corporate law, however, is a mixture of common law, statutory law, procedural rules, and corporate practice. Corporate practice, in turn, involves not only customary ways of doing things, but also rules, such as certificate or bylaw provisions, that govern important aspects of corporate structure and that are adopted voluntarily through a process in which lawyers figure heavily. Accordingly, the subject of corporations could not be addressed adequately by a pure Restatement. Furthermore, by attempting to restate corporate law as a whole, the planners of the early projects took on a task that was probably too massive and complex to manage in the ALI context. Indeed, at some stages the prospectus for an ALI project contemplated the Herculean task of covering not only corporations, but all forms of business associations.

The Principles of Corporate Governance: Analysis and Recommendations (Principles) adopts different architectural strategies. First, the Principles adopts a mixed format. Most of its provisions are Restatement rules, but some are model statutory rules, recommended procedural rules, or recommendations of corporate practice. Therefore, although most of the provisions in the Principles are addressed to courts in their role as adjudicators, other provisions are addressed to legislatures, to courts in their role as framers of judicial rules of procedure, or to corporations themselves for voluntary adoption.

Second, the Principles do not cover all of corporate law—much less the entire subject of business associations—but only a limited number of selected and relatively well-defined topics in corporate law: the objective and conduct of the business corporation, the structure of the corporation, the duty of care, the duty of fair dealing, the role of directors and shareholders in transactions in control and tender offers, and remedies. The limited scope of the Project is reflected in its title, which is in part intended to convey that the Project does not cover all of corporate law. Like many other captions, the title of the Project is somewhat oversimplified, because it plausibly can be argued that every rule of corporate law, no matter how trivial, is related to corporate governance. As conceived and executed, however, the Project encompasses those areas believed by the ALI to be most central to corporate governance.

Even after the task of the Project was simplified by the architectural decisions concerning format and scope, great complexities remained. The law concerning the governance of corporations is no more intellectually difficult than most other bodies of law, but it is relatively unique in the great number of sources by which it is shaped. In the first instance, of course, corporate law is shaped by the statutes and precedents of the state of incorporation, but it also is shaped by such other sources as the Securities Exchange Act, the Williams Act, federal tax law, state takeover laws, federal constitutional principles, federal and state procedural rules, the rules of the New York Stock Exchange, the American Stock Exchange, and NASDAQ, and actual corporate practice.

Any modern Restatement must account for statutory as well as case law. For example, the Restatement (Second) of Contracts is influenced heavily by the provisions of the Uniform Commercial Code. The relationship between statute and case law in the area of corporate governance, however, is especially complex. In jurisprudential theory, statutes trump cases. In corporate law, this has not always been true. In some areas, such as the duty of care and the duty of fair dealing, the law was made almost exclusively by the courts until the 1950s. Since that time, many statutory provisions were adopted in these areas, but these provisions treat those areas in only a fragmentary way. For example, few of the statutes address such critical issues as the business judgment rule, the fiduciary obligations of controlling shareholders, or the corporate-opportunity doctrine. Where statutes do speak to an issue of fiduciary obligation, the courts tend to read the statutes against the background of the pervasive case law, and to give that case law heavy weight.

Often the result is that statutory provisions in the area of corporate governance are given a meaning that, although both sensible and consonant with the case law, is one which the statute, read on its face in isolation from the case law, bears only with great difficulty if at all. This relatively unusual treatment of statutes by the courts in some key areas of corporate governance complicates the effort to restate the law in those areas. At the same time, the coexistence of statutory and case law means that in some of these areas, a Restatement rule should account for and serve as an interpretation of statutory law as well as case law.

These special complexities of corporation law must be added to the normal complexities, faced in formulating any Restatement rule, that result from conflicts, tensions, and cross-currents among the law of fifty states and even within the law of a single state. It would not do, however, to make too much of these complexities. Cases do get decided. Lawyers do give reliable advice. Complexity in determining the law is not equivalent to intellectual difficulty in understanding the law. Corporation law is no

5. Id. § 78m-78n.
more intellectually difficult or inaccessible than most other bodies of law that the ALI has addressed. Teasing out a thread from a tangled skein is a traditional role of a lawyer, and a central function of the ALI. Nevertheless, the unusual complexity of corporate law gave added significance to the ALI's traditional mission of clarification.

The purpose of this Article is to provide an overview of the *Principles* by discussing some of its central provisions. Generally speaking, this Article considers one or two provisions in each of the substantive (as opposed to definitional and remedial) areas covered by the *Principles*. Its focus will be on Restatement rules—that is, those provisions that are addressed to the courts—which make up the bulk of the *Principles*. In this connection, it is useful to recall the principle for formulating Restatement rules set forth in 1966 by Herbert Wechsler, the Director of the ALI, and approved by the Council in 1968: Restatement rules should "give weight to all of the considerations that the courts, under a proper view of the judicial function, deem it right to weigh" in their deliberations.

Of course, a dominant consideration in reaching a judicial decision is the state of doctrine—precedents and statutes—at the time of the decision. Modern courts, however, in reaching their decisions, also deem it proper to consider nondoctrinal or social propositions, such as efficiency, fairness, and experience. These social propositions are given consideration not only as independent elements, but in determining the weight and even the reading to be given to precedents. Most precedents reflect and are congruent with social propositions. Where, however, precedents are incongruent with such elements as efficiency, fairness, and experience, the courts must make a prudential choice as to the weight the precedent should be given and whether it should be followed or distinguished.

In that regard, an important choice often must be made between following what a prior court said and following what it did. If a deciding court looked only at what prior courts did, as opposed to the rules that the prior courts stated, there would be no common law, because every case would stand only for the proposition that a given result should follow on the particular facts of a case, and the facts of every case are different. Therefore, what courts have said the law to be is extremely important. On the other hand, what courts have done is in a real sense just as much the law as what they have said, and it often happens that the results of past cases are congruent with social propositions even when the rules the courts stated are not. When that happens, a deciding court may properly give greater weight to what prior courts did than what they have said. Accordingly, some Restatement rules of the *Principles* rest heavily on what

---

6. These provisions are identified in Comment b (Implementation) to each black-letter section as a provision that can be implemented by the courts.
the courts say they do; others rest heavily on what the courts really do; and still others blend both elements. As in the case of any Restatement, a constant goal of the Principles was to make overt and explicit the rules that drive and explain the cases, so that lawyers and courts can address directly the issues raised by those rules. This goal will be hereafter referred to as transparency.

The balance of this Article briefly sketches how some of the central Restatement rules of the Principles fit with the mission of the ALI and the ALI's principle for the formulation of Restatement rules.9

**THE OBJECTIVE AND CONDUCT OF THE CORPORATION**

The objective and conduct of the corporation is the subject of Part II of the Principles, which consists of a single provision, section 2.01:

§ 2.01. The Objective and Conduct of the Corporation

(a) Subject to the provisions of Subsection (b) and section 6.02 (Action to Directors That Has the Foreseeable Effect of Blocking Unsolicited Tender Offers), a [business] corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.

(b) Even if corporate profit and shareholder gain are not thereby enhanced, the corporation, in the conduct of its business:

1. Is obliged, to the same extent as a natural person, to act within the boundaries set by law;
2. May take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business; and
3. May devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.10

The business corporation is an instrument through which capital is assembled for the activities of producing and distributing goods and services and making investments. Accordingly, a basic premise of corporation law is that a business corporation should have as its objective the conduct of such activities with a view to enhancing the corporation's profit and the gains of the corporation's owners, that is, the shareholders. This objective is embodied in subsection (a).

9. Many of the passages in the balance of this Article draw very heavily on, and sometimes paraphrase, portions of the Comments and Reporter's Notes that address the issues under consideration. I also have drawn on Melvin A. Eisenberg, *Self-Interested Transactions in Corporate Law*, 13 J. CORP. LAW 997 (1988) and Melvin A. Eisenberg, *The Duty of Care of Corporate Directors and Officers*, 51 U. PIT. L. REV. 945 (1990). Because of limitations of space, I have supplied only limited citations in this Article. More extensive citations can be found in Principles, supra note 3.

10. *Principles, supra* note 3, § 2.01. In quoting from the Principles in this Article, I will omit, without ellipses, cross references to the definitions in Part I.
A second premise of corporation law is that in pursuing the profit objective, the corporation should conduct itself with regard to the fact that it is a social as well as an economic institution. Accordingly, the pursuit of corporate profit and shareholder gain must be constrained by social imperatives and may be qualified by social needs. Section 2.01 articulates the relationship between the economic and social aspects of the corporation by stating that the objective of the corporation is economic, but the conduct of the corporation in achieving that objective is subject to social constraints and may be shaped in light of appropriate social principles and policies. The operation of these social elements is stated in section 2.01(b).

First, section 2.01(b)(1) makes clear that the corporation, like all other actors in the society, is obliged to pursue its objective within the boundaries set by law.

Next, section 2.01(b)(2) makes clear that the conduct of the corporation's business may be properly shaped by appropriate ethical considerations. Observation suggests that corporate decisions are not infrequently made on the basis of ethical considerations, even when doing so would not enhance corporate profit or shareholder gain. Such behavior is not only appropriate, but desirable. Corporate officials are not less morally obliged than any other citizens to take ethical considerations into account, and it would be unwise social policy to preclude them from doing so.

Finally, section 2.01(b)(3) allows the corporation to devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic activities. Social policy favors humane behavior by major social institutions, cooperation by corporations in furthering established public policies, and the maintenance of diversity in educational and philanthropic activity. These objectives would be difficult to achieve if corporations, which control a great share of national resources, were not allowed to devote a reasonable portion of those resources to those ends.

Although the formulation of section 2.01 is new, its elements are supported by both precedents and statutes.

The proposition that a business corporation should have as its objective the conduct of business activity with a view to enhancing corporate profit and shareholder gain was stated in *Dodge v. Ford Motor Co.*:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits, or to the non-

11. *Id.* § 2.01(b).
distribution of profits among stockholders in order to devote them to other purposes.\textsuperscript{13}

Some cases, mostly arising at or before the turn of the century, applied either the concept reflected in \textit{Dodge}, a strict notion of ultra vires, or both, to preclude the utilization of corporate resources for humanitarian, educational, philanthropic, or public welfare activities. The general thrust of the emerging case law through the first half of this century, however, was that such a utilization was permissible if it were likely to produce a direct benefit to the corporation.

More modern cases have, in effect, dropped this direct-benefit test, and permitted the utilization of corporate resources for public welfare, humanitarian, educational, or philanthropic purposes without requiring a showing that a direct benefit is likely. This result was achieved through two different methods. Under the first method, the courts in effect conclusively presumed that the utilization was for a profit-maximizing purpose even where the evidence looked the other way.\textsuperscript{14} Under the second method, utilization of corporate resources for such purposes was recognized as a legitimate end in itself, either on the ground that there is an independent social policy to maintain diversified centers of such activity and full effectuation of that policy depends upon and therefore justifies corporate support, or on the ground that activity that maintains a healthy social system necessarily serves a long-run corporate purpose.\textsuperscript{15} Generally speaking, under both methods the modern cases invoked a limit of reasonableness on the utilization of corporate resources for public welfare, humanitarian, educational, or philanthropic purposes.\textsuperscript{16}

In addition to the precedents, virtually all states now have adopted statutory provisions relating to corporate contributions. Typical is the Model Business Corporation Act (Model Act) section 3.02(13), which provides that every corporation has power "to make donations for the public welfare or for charitable, scientific or educational purposes." Although these statutory provisions usually do not incorporate explicitly a limit of reasonableness, the commentators generally agree that such a limit is to be implied.\textsuperscript{17}

Provisions like Model Act section 3.02(13) give direct support to section 2.01(b)(3) of the \textit{Principles}. They also give indirect support to section 2.01(b)(2), because it would be anomalous to permit a corporation to donate money for the public welfare or for charitable purposes while prohibiting a corporation from considering ethical principles.

\textsuperscript{13} \textit{Dodge}, 170 N.W. at 684.
\textsuperscript{14} \textit{See}, \textit{e.g.}, Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968).
\textsuperscript{15} \textit{See}, \textit{e.g.}, \textit{A.P. Smith Mfg. Co. v. Barlow}, 98 A.2d 581 (N.J. 1953).
\textsuperscript{16} \textit{See}, \textit{e.g.}, \textit{Union Pac. R.R. Co. v. Trustees, Inc.}, 329 P.2d 398 (Utah 1958).
\textsuperscript{17} \textit{See}, \textit{e.g.}, Ray Garrett, \textit{Corporate Donations}, 22 Bus. Law. 297 (1967).
Sections 2.01(b)(2) and (3) are supported further by statutes that authorize the board to take into account the interests of what are sometimes called other constituencies. Most, although not all of these statutes, are comparable to that of Illinois:

In discharging the duties of their respective positions, the board of directors, committees of the board, individual directors and individual officers may, in considering the best long term and short term interests of the corporation, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors.¹⁸

Although the interpretation of these statutes has not been resolved, they can and should be interpreted to be consistent with and support the principles embodied in section 2.01.

It has been observed that taking account of ethical considerations and devoting reasonable resources to public welfare, humanitarian, educational, and philanthropic purposes usually can be defended on the ground that such activity furthers long-term profitability. Accordingly, some have urged that there is no need for provisions like sections 2.01(b)(2) and (3), which authorize such conduct within stated limits even if the conduct does not enhance corporate profit or shareholder gain, because a business reason for such conduct can always be invoked. To take that path, however, would cast a veil over both corporate and judicial decision making. If corporations should be permitted to take account of ethical considerations and to devote reasonable resources to public welfare, humanitarian, educational, and philanthropic purposes, then they should be allowed and encouraged to do so openly, on the basis of an explicit principle of law, rather than by indirection. When courts are called upon to review such activity, they should review it on the same basis. Section 2.01 is formulated to promote transparency of decisionmaking at both the judicial and the corporate levels.

THE STRUCTURE OF THE CORPORATION

Provisions concerning corporate structure are set out in Parts III and III-A of the Principles. Most sections of Parts III and III-A are made explicitly applicable only to publicly held corporations. (Indeed, throughout the Principles a careful effort was made to determine which provisions should be applicable to all corporations, which should be applicable only to publicly held corporations as a class, and which should be applicable only to very large publicly held corporations.)

Among the most important provisions of Part III and III-A are sections 3.01 and 3.02(a), which concern the functions and powers of principal senior executives and directors. Under section 3.01:

The management of the business of a publicly held corporation should be conducted by or under the supervision of such principal senior executives as are designated by the board of directors, and by those other officers and employees to whom the management function is delegated by the board or those executives, subject to the functions and powers of the board under section 3.02.

Under section 3.02(a):

Except as otherwise provided by statute:
(a) The board of directors of a publicly held corporation should perform the following functions:
(1) Select, regularly evaluate, fix the compensation of, and, where appropriate, replace the principal senior executives.
(2) Oversee the conduct of the corporation’s business to evaluate whether the business is being properly managed.
(3) Review and, where appropriate, approve the corporation's financial objectives and major corporate plans and actions.
(4) Review and, where appropriate, approve major changes in, and determinations of other major questions of choice respecting, the appropriate auditing and accounting principles and practices to be used in the preparation of the corporation's financial statements.
(5) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation.

Traditionally, the corporate statutes said little or nothing about the senior executives, and provided that the business of the corporation “shall be managed by [its] board.” Even the more modern formulations, such as section 141 of the Delaware General Corporate Laws, provides that “[t]he business and affairs of every corporation . . . shall be managed by or under the direction of” the board. 19 In the publicly held corporation, however, the board consists in significant part of outside directors, and is likely to meet only four to twelve times a year. A body so constituted cannot possibly manage the business of the corporation, nor can it direct the management of the corporation’s business in any ordinary meaning of that term. Given the complexity of the modern corporation and the composition and procedures of the modern board, it is inevitable that the business of the corporation normally will be managed not by the officers under the direction of the board, but by the principal senior executives under the direction of the chief executive officer. Therefore, the primary

functions of the board, as reflected in section 3.02(a), are to select the principal senior executives, regularly evaluate their performance, oversee the conduct of the business to evaluate whether it is being managed properly, and review and, where appropriate, approve, the corporation's financial objectives, major corporate plans and actions, and major accounting and auditing issues.

Although sections 3.01 and 3.02(a) appear to stand most statutes on their head, these sections provide an articulation of the functions and powers of the senior executives and the board that almost certainly would be applied by the courts, because the formulations reflect the reality of modern corporate practice, as the literal terms of the statute do not. For example, the Corporate Director's Guidebook\(^\text{20}\) states:

> It is generally recognized that the board of directors is not expected to operate the business. Even under statutes providing that the business and affairs shall be "managed" by the board of directors, it is recognized that actual operation is a function of management. The responsibility of the board is limited to overseeing such operation. . . .\(^\text{21}\)

Accordingly, despite the language of the statutes, it seems clear that, as provided in sections 3.01 and 3.02, the board normally can satisfy the requirements of present law without either actively managing or directing the management of the business of the corporation, although the board is obliged to oversee management and to retain the decisive voice on major corporate actions.

In short, sections 3.01 and 3.02 bring clarity and transparency to the law by codifying in a clear and concise manner what principal senior executives and directors can and realistically should be expected to do. In accordance with the principle for the formulation of Restatement rules, sections 3.01 and 3.02 state the rules that the courts would be expected to follow, giving weight to all of the considerations that the courts deem it right to weigh.

**THE DUTY OF CARE**

The duty of care is the subject of Part IV of the *Principles*. The central provision of Part IV is section 4.01, which provides:

> (a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably


\(^{21}\) Id. at 1603.
be expected to exercise in a like position and under similar circumstances. This Subsection (a) is subject to the provisions of Subsection (c) (the business judgment rule) where applicable.

(1) The duty in Subsection (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary. . . .

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

(1) is not interested in the subject of the business judgment;
(2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
(3) rationally believes that the business judgment is in the best interests of the corporation. . . .

The duty of care provides a striking illustration of the unusual role of statutes in corporate law. Most corporate statutes provide that a director or officer must act with "the care an ordinarily prudent person in a like position would exercise under similar circumstances" and "in a manner he reasonably believes to be in the best interests of the corporation."22 Under a straightforward reading of such a statute, a director would be liable for damages as a result of an imprudent decision. In fact, however, no court imposes such liability. Instead, the courts read such statutes against the background of the business judgment rule, established by case law, which precludes the imposition of liability on a director simply because his conduct was imprudent, provided the elements of the rule are satisfied. Section 4.01 brings clarity to the duty of care by openly and explicitly recognizing that the business judgment rule is a carve-out from the basic standard of care, by clarifying the implications of the basic standard and its relation to the business judgment rule, and by clarifying the business judgment rule itself.

The introductory paragraph of section 4.01(a) embodies the basic standard of care. Subsection 4.01(a)(1) spells out the implications of that basic standard with regard to the duty of inquiry. The inquiry concept embodied in this subsection is reflected explicitly in several statutes and is recognized generally in the case law and by commentators.

Section 4.01(c) clarifies the business judgment rule. Although this rule is a critical aspect of the duty of care in the corporate context, there are no full statutory formulations of the rule, and judicial formulations of it have varied. The numerous formulations of the rule, and the fact that courts often have stated the rule incompletely or with elliptical shorthand

22. See Model Act §§ 8.30, 8.41.
references, have created a degree of confusion and uncertainty. Section 4.01(c) and the accompanying Commentary make clear that the business judgment rule effectively consists of four conditions and a special standard of liability that will be utilized in reviewing the substance or quality of a director's or officer's decision if the conditions are satisfied. The conditions are as follows: (i) a decision (judgment) must have been made; (ii) the decision must have been made in good faith—a condition that is not met if the director or officer knowingly violated the law; (iii) the director or officer must not have been self-interested in the decision; and (iv) the director or officer must have been informed with respect to the decision to the extent he or she actually and reasonably believed to be appropriate under the circumstances.

If these four conditions are not met because the director or officer is interested, the basic standards of Part V (Duty of Fair Dealing) apply. If the conditions are not met but the director or officer is disinterested, the basic standard of section 4.01(a) applies. If the conditions are met, then the quality of the director's or officer's decision will be substantively reviewed, not under the basic standard of section 4.01(a), but only under the limited standard of section 4.01(c)(3) to determine whether the director or officer did not actually and rationally believe the decision to be in the corporation's best interests. This rationality standard of review is and is intended to be very easy for a director or officer to satisfy, and, in particular, much easier to satisfy than a reasonability standard. Perhaps the most obvious type of a decision that lacks rationality is one that cannot be explained coherently. For example, in Selheimer v. Manganese Corp. of America23 the managers poured the corporation's funds into a single plant even though they knew the plant could not be operated profitably because of a lack of railroad siding, a lack of proper storage areas, and other factors. The court imposed liability on the ground that the defendants' conduct "defies explanation; in fact, the defendants have failed to give any satisfactory explanation or advance any justification for [the] expenditures."24

Each of the conditions in section 4.01(c) is supported by substantial precedential authority, as is the rationality standard of review that applies if the conditions are satisfied.25 Some courts have stated that good faith is the only standard of review under the business judgment rule.26 It often is obscure, however, whether a good-faith test is strictly subjective or has an objective component as well. For example, U.C.C. section 2-103 provides that in the case of a merchant, good faith is defined to include "the observance of reasonable commercial standards of fair dealing in the trade." Similarly, in Sam Wong & Son, Inc. v. New York Mercantile Exchange27

24. Id. at 646.
25. See Principles, supra note 3, § 4.01 Reporters' Notes.
26. See, e.g., In re RJR Nabisco Shareholders Litig., 556 A.2d 1070 (Del. 1989).
27. 735 F.2d 653 (2d Cir. 1984).
Judge Friendly held that the rationality of a decision by the Board of Governors of the Mercantile Exchange was relevant in determining whether the Board had acted in good faith. 28 "By this," he added, "we mean only a minimal requirement of some basis in reason. Absent some basis in reason, action could hardly be in good faith even apart from ulterior motive." 29 Even courts that seem to use the term good faith in a relatively subjective way characteristically go on to review decisions for quality under the guise of a rule that if a decision is irrational, egregious, or the like, this shows bad faith. 30

For the most part, the courts have not employed a good faith standard of review in applying the business judgment rule, but instead have employed a standard that involves some substantive review of the quality of the decision, however limited. As William T. Quillen, formerly a Delaware Chancellor and Supreme Court Justice, stated: "[T]here can be no question that for years the courts have in fact reviewed directors' business decisions to some extent from a quality of judgment point of view. Businessmen do not like it, but courts do it and are likely to continue to do it because directors are fiduciaries." 31

Certainly, serious problems would arise if an objectively irrational business decision was protected solely because it was made in subjective good faith. Unlike a purely subjective good faith standard, a rationality standard of review represents an appropriate balance of the relevant considerations of fairness and policy. A purely subjective good faith standard would depart too far, and unjustifiably, from the general principles of law applicable to private actors in general, and fiduciaries in particular. A rationality standard of review gives enormous scope to the decisions of directors and officers, so as not to discourage them from making bold decisions, and not to subject them to liability simply because their decisions turn out badly. At the same time, however, a rationality standard preserves a minimum and necessary degree of accountability on the part of corporate directors and officers, and allows the courts to enjoin actions of directors and officers that threaten to waste the assets of the shareholders by dealing with those assets in a manner that lacks a rational basis.

It is sometimes stated that under the business judgment rule there is a presumption that directors or officers acted properly. The term presumption is frequently ambiguous, unless elaborated, because it can refer to an allocation of the burden of production, an allocation of the burden of persuasion, or a change in the standard of proof. The meaning of the term is especially obscure in the context of the business judgment rule,

28. Id. at 678.
29. Id. at 678 n.32.
30. See, e.g., In re RJR Nabisco Shareholders Litig., 556 A.2d 1070 (Del. 1989).
because courts sometimes say that "[t]he business judgment rule... is a presumption." Of course, if the rule itself is a presumption then the concept of presumption adds nothing to whatever the rule does. Subsection 4.01(d) reaches a functional result that is equivalent to a presumption, while avoiding the ambiguity that term often entails, by providing that in a duty of care action the burden of proof is on the plaintiff, and this burden includes the burden of proving that the business judgment rule is inapplicable.

THE DUTY OF FAIR DEALING

Directors, senior executives, and controlling shareholders are under a duty to deal fairly with the corporation when their pecuniary self-interest is involved. This duty is addressed in Part V of the Principles. The duty of fair dealing is a special case—but by far the most important case—of the more general duty of loyalty.

A central provision of Part V is section 5.02, which concerns transactions between a director or senior executive and the corporation. Section 5.02 provides rules for four types of cases involving self-interested transactions between the corporation and a director or senior executive: (i) cases in which the transaction was neither authorized in advance nor ratified by disinterested directors or disinterested shareholders nor authorized in advance by a disinterested superior; (ii) cases in which the transaction was authorized in advance by disinterested directors or a disinterested superior; (iii) cases in which the transaction was ratified by disinterested directors; and (iv) cases in which the transaction was authorized in advance or ratified by disinterested shareholders.

If self-dealing occurs without advance authorization or ratification by disinterested directors or shareholders or advance authorization by a disinterested superior, sections 5.02(a)(1) and (2)(A) set out a conjunctive, full fairness test: there must be fairness of terms—substantive fairness—and full disclosure. The requirement of substantive fairness is a longstanding one in corporate law. Even if the substantive terms of a self-interested transaction are fair, however, a director or senior executive who fails to make full disclosure has failed to fulfill the duty of fair dealing. A contract price might be fair in the sense that it corresponds to the market price, and yet the corporation might have refused to make the contract if a given material fact was disclosed, because the fact would have shown that the transaction was not in the corporation's best interests. Furthermore, fairness is often a range, rather than a point, and disclosure of a

material fact might have induced and allowed the corporation to bargain the price down lower in the range. Accordingly, an interested director or senior executive owes a duty to the corporation not only to avoid misleading the corporation by misstatements, but affirmatively to disclose the material facts known to him or her.

Although some cases have held that failure to make full disclosure of material facts is only a factor to be considered in determining fairness, others have taken the position, embodied in section 5.02, that failure to make full disclosure affords an independent basis for the corporation to rescind the transaction. This position also is supported by the Restatements of Agency, Contracts, Torts, and Restitution to the extent that the relationship between a director or senior executive and the corporation is viewed as a relationship of trust and confidence.

Suppose now that an interested transaction was authorized in advance by disinterested directors. Again, full disclosure is required, because without full disclosure the authorization is meaningless. There are several reasons why the transaction also should be subject to some review for substantive fairness, although a more limited review than would be applied in the absence of advance authorization.

For one thing, it is difficult, if not impossible, to use a definition of disinterested in corporate law that corresponds with factual objectivity. A director is factually objective in regard to a self-interested transaction if he or she has no significant relationship of any kind with either the interested party or the subject matter of the transaction that would be likely to affect his or her judgment. Factual objectivity is, in short, the disinterestedness we expect from a judge, and a proper test for factual objectivity would be the test applied to recusal of judges, that is, whether the director's "impartiality might reasonably be questioned." A corporate-law definition that turned on factual objectivity or impartiality, however, would seriously diminish the protection afforded by the business judgment rule. That rule protects only directors who are disinterested. If the corporate law definition of disinterestedness corresponded to factual impartiality or objectivity, the protection of the business judgment rule would be undesirably withheld from a director who had no financial or close familial ties to a party to a transaction, but nevertheless had extra-corporate relationships with the party of a sort that would be likely to affect his or her objectivity. For example, if a judge was the long-time friend of a party, the maid of honor at her wedding, and the godmother of her child, the judge should recuse herself, because her impartiality might reasonably be questioned. If a director had such a relationship, however, we would not

34. See, e.g., Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186, 195 (6th Cir. 1974).
want to label her "interested" for corporate-law purposes and thereby remove the protection of the business judgment rule.

Therefore, for corporate-law purposes, **interestedness** is not defined to mean that the director's objectivity or impartiality might reasonably be questioned, but is defined in a bounded manner to include only certain kinds of interestedness. For example, under section 1.23 of the *Principles* a director or officer normally is treated as interested in a transaction only if he or she has a material pecuniary interest in the transaction or certain financial or familial relationships to a party to the transaction, and certain other tests are met. Thus the corporate-law definition of **interestedness** does not include all types of interestedness, and is far from equivalent to lack of objectivity or questionable impartiality. Accordingly, the law should require a fairness review of a self-interested transaction, even if the transaction was approved by "disinterested" directors, because directors who are disinterested under the bounded corporate-law definition may not be impartial or objective in fact, as a result of extra-corporate relationships that are not within that bounded definition.

Furthermore, directors, by virtue of their collegial relationships, may not treat one of their own with the degree of wariness with which they would approach a transaction with a third party.

There is another way in which all this can be put: A review of the fairness of the price of a self-interested transaction may be thought of as a surrogate for a review of the fairness of the process by which the transaction was approved. If we lived in a world of perfect information, a court could always determine, by direct means, whether directors who approved a self-interested transaction were objective and impartial, and whether they approached the transaction with that degree of wariness with which they would approach transactions with third parties. Because we do not live in such a world, the courts may need to make these determinations by indirect means. If a self-interested transaction that was approved by disinterested directors is substantively unfair, it normally can be inferred that either the approving directors were not objective and impartial in fact, or that they were not as wary as they should have been because they were dealing with a colleague.

Most states have adopted statutes that address the effect of approval by disinterested directors. Most of these statutes, however, were adopted only since 1970, and there is not yet a substantial body of case law construing them. Many of the statutes are susceptible to the interpretation that approval by disinterested directors precludes a judicial inquiry into fairness, but most or all of the statutes can be interpreted not to preclude such an inquiry. Some of the statutes expressly require some form of fairness test even if transactions were approved by disinterested directors.37 Many of the statutes explicitly require that approval by disinterested directors be

in good faith, and such a requirement can be implied even where it is not explicit. Because of the uncertain meaning of *good faith*, this requirement opens the door to judicial scrutiny of fairness.

Finally, many of the statutes can be interpreted merely to change the common law rule that self-interested transactions are voidable without regard to fairness, rather than to preclude review for fairness. For example, in adopting section 41 of the prior version of the Model Act, on which many of the statutes are based, the Committee on Corporate Laws of the Section of Business Law of the ABA stated that "[t]he function of Section 41 is not to provide a basis for validating for all purposes a contract or transaction between an interested director and his corporation, but simply to establish that such contract or transaction is not automatically void or voidable solely by reason of the director's interest," and that "[i]n all other respects equitable principles will continue to be applicable." 38

Some courts have stated that a statute of the type in question does not preclude judicial review of the fairness of transactions that have been approved by disinterested shareholders; 39 others have stated the contrary. 40 It is widely understood that regardless of the form of the statute and the statements in some cases, approval by disinterested directors will not prevent a court from applying what is sometimes called a "smell test" to self-interested transactions. Section 5.02(a)(2)(B) makes explicit the implicit rule of decision in such cases, by adopting, in cases involving advance authorization by disinterested directors, an intermediate test between the business judgment rule and the full fairness test.

Two significant effects are accorded to such authorization under section 5.02(a)(2)(B). First, the authorization shifts the burden of proof. If a self-interested transaction was not authorized or ratified by disinterested directors or shareholders, or authorized by a disinterested superior, the burden of proof is on the self-interested director or senior executive to show that the transaction was fair. In contrast, if the transaction was authorized in advance by disinterested directors, the burden of proof is on the complainant.

Second, advance authorization by disinterested directors changes the standard of fairness under which the self-interested transaction is reviewed: The test is whether disinterested directors "could have concluded that the transaction is fair to the corporation." 41 This test is intended to be easier for the director or senior executive to satisfy than a full fairness test, although harder to satisfy than the business judgment standard.

The explicit articulation of an intermediate standard to govern self-interested transactions that were authorized in advance by disinterested

---

directors accommodates both the need to review self-interested transactions for fairness to at least some degree—a need grounded in preserving the real and perceived public integrity of the corporate system and capital markets—and the deference due to an informed decision by directors who are at least economically and familially disinterested. The articulation of this intermediate standard promotes transparency of decision making by making explicit the processes and analyses that all agree the courts will undertake in any event.

Under section 5.02(a)(2)(C), the same shift in burden of proof and change in standard of review results where the transaction was approved in advance by a disinterested superior or, under specified conditions, ratified by disinterested directors.

Finally, if a self-interested transaction is authorized in advance or ratified by disinterested shareholders, under section 5.02(a)(2)(D) it can be attacked only on the ground of waste. This rule effectively provides a safe harbor that especially is useful in small corporations, where it is easy and inexpensive to obtain disinterested shareholder approval of a fair self-interested transaction that benefits the corporation.

**TENDER OFFERS**

Part VI of the Principles concerns the role of directors and shareholders in transactions in control and tender offers. Tender offers are covered by section 6.02:

(a) The board of directors may take an action that has the foreseeable effect of blocking an unsolicited tender offer, if the action is a reasonable response to the offer.

(b) In considering whether its action is a reasonable response to the offer:

(1) the board may take into account all factors relevant to the best interests of the corporation and shareholders including, among other things, questions of legality and whether the offer, if successful, would threaten the corporation’s essential economic prospects; and

(2) the board may, in addition to the analysis under section 6.02(b)(1), have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders. . . .

(d) An action that does not meet the standards of Subsection (a) may be enjoined or set aside, but directors who authorize such an action are not subject to liability for damages if their conduct meets the standard of the business judgment rule.

Determination of the appropriate standard of review of actions by the board in response to a tender offer to the shareholders is complicated by
the fact that tender offers present at least two very different faces. On the one hand, a tender offer typically is a highly complex business transaction. Shareholders therefore often will need management’s expertise to be employed on their behalf in the evaluation of such offers. When this face is presented, a response to a tender offer may resemble a business decision, review of which is normally controlled by the business judgment rule. On the other hand, a tender offer represents a conflict of interest for principal senior executives, who normally will lose their positions or find their authority significantly diminished if the offer succeeds. These executives either may be directors themselves or be in a position to strongly influence the directors’ assessment of the tender offer. If the principal senior executives recommend action to block a tender offer, that recommendation may reflect their preference for retaining their positions. When this face is presented, a response to a tender offer resembles a self-interested transaction, review of which is normally controlled by a fairness standard.

Furthermore, shareholders normally have the right to sell their shares, free of any restrictions, to any person who wishes to purchase them. An action taken by the board that interferes with that right, such as an action blocking a tender offer, goes well beyond the usual board function of conducting the corporation’s business, and therefore needs special justification.

For these reasons, the validity of actions taken by the board to block tender offers cannot be reviewed appropriately by either the business judgment standard or a full fairness standard. Accordingly, in proceedings against directors to enjoin an action blocking a tender offer, section 6.02(a) embodies another intermediate standard of review: whether the action was a reasonable response to the offer.

This intermediate standard, however, is not applied in a damages setting. To apply this standard in a damages setting might unduly discourage directors from taking a blocking action that was in the best interests of the corporation and shareholders. Section 6.02 therefore draws a distinction between the standards of review in suits to enjoin blocking actions and in suits to impose personal liability for blocking actions. Under section 6.01(c), the standard of review in the latter case is the business judgment rule. By applying different standards of review in determining whether to grant equitable relief and whether to impose personal liability on directors, courts can avoid being overly lenient in permitting a blocking action to stand because of a concern that invalidating the blocking action automatically would expose the directors to huge personal liability.

Section 6.02(b) sets out factors that may be considered in determining whether a response to a tender offer is reasonable. Subsection (b)(1) identifies factors as to which the corporation and shareholders share a common interest in promoting corporate profit and shareholder gain. Subsection (b)(2) identifies circumstances in which the board may give weight to interests or groups, other than the shareholders, that may be affected neg-
atively by a tender offer. Such interests would include, for example, environmental and other community concerns, and such groups would include employees, suppliers, and customers. These interests or groups may be considered under section 6.02(b)(2) even if that consideration would disfavor the long-term interests of shareholders, so long as it would not significantly disfavor those interests. Section 6.02(b)(2) is therefore a counterpart, in the tender offer context, of sections 2.01(b)(2) and (3), which permit the board to take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and to devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes, in the context of the ongoing conduct of the corporation’s business.

The particular formulation of the intermediate standard of review adopted in section 6.02 is new, but an intermediate standard is well established in the case law. Some cases essentially applied an intermediate standard of review by analyzing the legality of a blocking action in terms of the duty of loyalty, through an inquiry into whether the blocking action was motivated by the directors’ desire to entrench themselves in office. Alternatively, under the test developed in *Unocal v. Mesa Petroleum Co.*, if directors take action to block a tender offer they have the burden of showing that there were reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and that the blocking action was reasonable in relation to the threat posed by the tender offer. If the directors satisfy this burden, they are protected by the business judgment rule. Because the business judgment rule comes into play under *Unocal* only if a reasonability test first is satisfied, the *Unocal* rule is in effect an intermediate test.

Section 6.02 does not adopt the duty of loyalty test because as that test is formulated in the tender offer context, the application of that test depends on subjective factors. Section 6.02 does not adopt the *Unocal* test because that test is beside the mark in focusing on a “threat,” and is convoluted to an unnecessary degree. Although the precise formulation of section 6.02 differs from the duty of loyalty and *Unocal* tests, the thrust of section 6.02, in adopting a test that is intermediate between the business judgment rule and the full fairness standard of review, is comparable to the results of the *Unocal* and duty of loyalty tests and therefore to the existing case law. Section 6.02 also is consistent with and supported by the statutes, discussed earlier, that authorize directors to consider the interests of such groups as employees, suppliers, customers, and the local community.

42. *See, e.g., Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980).
43. 493 A.2d 946 (Del. 1985).
44. *Id.* at 955.
45. *Id.*
46. *See supra* text accompanying note 23.
REMEDIES

Part VII of the Principles concerns remedies. As conceived traditionally and in Part VII, the subject of remedies in corporate law includes derivative actions and damages, as well as topics that might be conceived of as substantive, such as appraisal, insurance, and indemnification. One of the most important topics addressed in Part VII is the role and power of the board in derivative actions. The central question within that topic is the standard of judicial review that should be applied to a negative board determination concerning a derivative action. The central theme of Part VII is that the standard of review of such a determination should be comparable in its nature and intensity to the standard of review applicable to the conduct or transaction on which the derivative action is based.

The approach of Part VII must be set against its historical background. Until about the 1970s, it was well settled that before bringing a derivative action a shareholder was required to make a demand on the board, unless demand was excused. Two related issues, however, were much less well settled. The first issue was, when was demand excused? The general rule was that demand was excused if it was futile.47 The scope of that exception, however, was unclear. The most important application of the exception was that demand was excused if a majority of the directors were interested. It was not clear, however, what constituted interest for these matters. For example, it was not clear whether a director was interested merely because he or she was named as a defendant, and if not, how much more had to be shown.

The second unsettled issue was the consequence of not making demand. In most of the reported cases, demand had not been made and the corporation moved to dismiss the action on the ground that demand was required. The courts in such cases often simply held that demand was or was not required, without getting into what consequences would follow if a required demand was made and rejected—although some courts did say or hold that if demand was required and rejected, and the rejection was by disinterested directors who constituted a majority of the board, a derivative action could not proceed unless in rejecting demand the board violated the business judgment rule.

The picture was complicated further in the 1970s, when a series of cases held that even when a majority of directors were interested, so that demand was not required, the board could appoint a committee to consider whether the derivative action was in the best interests of the corporation. If the committee concluded that the action was not in the corporation’s best interests, and the committee had engaged in an adequate investigation, the court could dismiss the action on the committee’s motion, subject to a designated standard of review. (If the board was disinterested, the board itself could conduct the investigation and make the motion.)

47. See Principles, supra note 3, § 7.03 cmt. a.
In short, as of the 1970s a cluster of related issues were raised concerning the role and power of the board in derivative actions. When was demand on the board excused? What were the consequences if demand was required, made, and denied? What, if anything, could a board do if demand was excused?

The first question—when is demand excused—is addressed by section 7.03 of the Principles. This section adopts a rule that has come to be known as "universal demand." Under this rule, demand is required in all cases, even where the board is interested. The theory is that a board always should be given a chance to consider the subject matter of a prospective derivative action. However, the corollary of universal demand is that whether demand is required has no impact on what standard of review governs a board's determination in response to a demand, or in response to the filing of a derivative action. Instead, the standard of review of such a determination depends on the standard of review applicable to the underlying transaction or conduct on which the demand or derivative action is based.

A second level of issues is addressed by section 7.04(a). Section 7.04(a)(1) requires that:

The complaint shall plead with particularity facts that, if true, raise a significant prospect that the transaction or conduct complained of did not meet the applicable requirements of Parts [IV, V, or VI] . . . in light of any approvals of the transaction or conduct communicated to the plaintiff by the corporation.

Section 7.04(a)(2) then addresses the effect of a rejection of a demand. The effect to be given to a rejection under section 7.04(a)(2) depends in large part on whether the underlying transaction or conduct that is the subject of the demand would be reviewed under the business judgment rule or some other standard, such as a standard of fairness or the intermediate standard applicable under section 6.02 to injunctive proceedings against actions to block tender offers.

If the underlying transaction would be reviewed under the business judgment rule, then under section 7.02(a)(2)(B) the derivative action can be dismissed on a motion by the corporation unless the complaint pleads with particularity facts that, if true, raise a significant prospect either that the demand was not rejected by a majority of the entire board who were disinterested and capable of objective judgment in the circumstances, or that the rejection did not satisfy the requirements of the business judgment rule.

On the other hand, if the underlying transaction would be reviewed under a standard other than the business judgment rule, such as the full fairness standard or an intermediate standard, then under section 7.02(a)(2)(C) the derivative action cannot be dismissed on a motion by the corporation if the plaintiff pleads with particularity facts that, if true, raise a significant prospect (i) that the demand was not rejected by a majority
of the entire board who were disinterested and capable of objective judgment in the circumstances, (ii) that the directors who rejected the demand did not satisfy the good faith and informational requirements of the business judgment rule, or (iii) that disinterested directors could not reasonably have determined that rejection of the demand was in the best interests of the corporation.

The Commentary to section 7.04(a)(2) elaborates on the application of that section by pointing out that there is an important relationship between sections 7.04(a)(1) and 7.04(a)(2):

Section 7.04(a)(1) and 7.04(a)(2) state separate tests, so both are required to be met. There is nevertheless an interrelationship between the two tests. In applying § 7.04(a), a court should balance the strength and seriousness of the case set out by the particularized pleading of the plaintiff, as tested under § 7.04(a)(1), with that required under § 7.04(a)(2). The stronger and more serious the case set out by the plaintiff’s particularized pleading, as tested under § 7.04(a)(1), the less the complaint must allege with particularity to establish under § 7.04(a)(2) that there is a significant prospect the directors could not have satisfied the business judgment rule under § 7.04(a)(2)(B), or could not reasonably have determined that rejection of the demand was in the best interests of the corporation under § 7.04(a)(2)(C).

Although the law on the issues addressed by section 7.04(a) was confused and not well articulated, this section probably reflects what the courts actually did. Like other provisions of the Principles, section 7.04(a) makes the implicit legal standard explicit, and brings needed transparency to this area.

Suppose now that the board does not reject a demand; or that the board cannot effectively reject a demand because there is not a majority of disinterested directors capable of objective judgment in the circumstances; or that the board, acting through a majority of disinterested directors, does reject a demand, but the rejection does not meet the relevant standard of section 7.04(a)(2). In that case, the board can investigate the complaint and, if it concludes that the action is contrary to the best interests of the corporation, can move that the complaint be dismissed on that ground. (The board can do this if there is a majority of disinterested directors, or can act through a disinterested committee if there is not such a majority.)

Under section 7.07, in the case of derivative actions against anyone other than controlling shareholders, directors, senior executives, and their associates, a determination of the board or a committee that the action should be dismissed as contrary to the best interests of the corporation is subject to review only under the business judgment rule. In contrast, special rules govern derivative actions against controlling shareholders, directors, senior executives, or their associates. Section 7.09 sets out cer-
tain procedures to be employed by a board or committee that moves to dismiss a derivative action against such persons on the ground that the action is contrary to the best interests of the corporation. Section 7.10(a) sets out the basic standards of review of the determination on which such a motion is based. In setting these standards of review, section 7.10(a), like section 7.04(a)(2) and other provisions of the Principles, distinguishes between cases based on transactions or conduct that are governed by the business judgment rule and cases based on transactions or conduct that are governed by some other standard, such as the fairness standard or an intermediate standard. In the former type of case, the standard of review is the business judgment rule. In the latter type of case, the standard of review is an intermediate standard—that the board or committee was adequately informed under the circumstances and reasonably determined that dismissal was in the best interests of the corporation, based on grounds that the court deems to warrant reliance.48

The articulations in the case law of the standard of review that governs motions by the board to dismiss a derivative action as contrary to the best interests of the corporation are varied and inconsistent. Some formulations are comparable to section 7.10;49 others are not.50 Delaware, like section 7.10, employs a bifurcated standard of review, but the stated bifurcation is along different lines. If either a majority of the board is interested, or the plaintiff has alleged with particularity facts that, taken as true, would support a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment, then the standard of review is whether the board's conclusions are soundly based, with discretion in the court to substitute its own business judgment even if the board's conclusions are soundly based.51 If, however, a majority of the board is disinterested and the plaintiff has not alleged such facts, the standard of review is the business judgment rule.52 The meaning of the second test, that the plaintiff has alleged facts that, taken as true, would support a reasonable doubt that the transaction was the product of a valid business judgment, is obscure, but this test clearly opens the door to, and indeed virtually invites, a smell test even when a majority of the directors are disinterested. Although the formulation in section 7.10 differs from the Delaware formulation, in any given case it is likely that Delaware (or courts applying still other formulations) would come to the same result as would a court that applied section 7.10. That section is justified, therefore, not

48. In addition, § 7.10(b) singles out for special treatment certain particularly severe violations of the duty of fair dealing involving the retention of a significant improper benefit.
only on the grounds of policy and case law support, but more importantly on the ground that, like other provisions of the Principles, it "promote[s] the clarification and simplification of the law," makes the implicit rule of decision explicit, and brings transparency to the difficult problem of dismissal of derivative actions.

CONCLUSION

The Principles of Corporate Governance: Analysis and Recommendations, as completed, consists of just under fifty pages of black-letter text (apart from definitions) together with another 775 pages of definitions, Comments, and Reporters' Notes. In addressing the task of preparing the Principles, the Corporate Governance Project was highly fortunate in the resources upon which it could draw. Within the ALI's framework, these resources included a small group of Consultants, a larger group of Advisers, a group of Advisers to the ALI Council, the Council itself, and the members of the ALI. Outside the ALI's framework, the Project's drafts received intensive, skillful, and constructive review by an ad hoc committee of the ABA's Section on Business Law, The Business Roundtable, and other committees. All of these bodies, inside and outside the ALI's framework, included distinguished corporate practitioners; many of these bodies included distinguished judges and academics as well. Furthermore, in addition to extensive interchanges concerning both substance and drafting in meetings with most of these bodies over a period of years, many individual members of these bodies and of the ALI prepared detailed written comments that reflected the highest level of scrutiny, skill, and care. As a result of these internal and external processes, it is fair to say that the successive drafts of the Principles received more intensive review, by a greater number and a wider variety of persons and over a longer period of time, than any other project in the history of corporate law.

This Article has focused on the Restatement rules of the Principles. As mentioned in the Introduction, the Principles also include recommendations of corporate practice and recommended statutory provisions. Like the Restatement provisions, the practice and statutory provisions are grounded substantially in precedent, although of different types. The recommendations of corporate practice are located in Part III-A, which con-

53. Some have criticized the Principles as too long. Perhaps they are, although the admonition reminds me of the Emperor's criticism of one of Mozart's operas in Amadeus—"Too many notes." Two kinds of comparisons came to mind. First, the Principles is 822 pages long. By comparison, the Restatement (Second) of Contracts is 1,218 pages long and the Restatement (Second) of Torts is 1,750 pages long. Second, §§ 5.02-5.05 of the Principles, which concern self-interested transactions with the corporation, consist of 46 pages of black letter, Comment, and related definitions, not including Reporters' Notes. By comparison, the counterpart material in the Model Act, Subchapter F of Chapter 8, consists of 31 pages of text and Official Comment.

cerns the composition of the board and the composition and functions of the central oversight committees. The provisions that require implementation by statute are relatively few in number, and take various forms. For example, section 3.05 is a model statutory provision for a mandatory audit committee; section 7.20 recommends standards for the formulation and interpretation of indemnification statutes; and certain aspects of some sections scattered through the *Principles* would require legislative action for full implementation. The great bulk of the provisions of the *Principles*, however, are Restatement rules, and can be implemented by the courts like any other Restatement rules, both in areas that have been developed basically through case law and in areas that involve the interpretation of statutes.