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The Business Judgment Rule as Abstention Doctrine

Stephen M. Bainbridge*

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I. INTRODUCTION

The business judgment rule pervades every aspect of state corporate law, from the review of allegedly negligent decisions by directors, to self-dealing transactions, to board decisions to seek dismissal of shareholder litigation, and so on.¹ Countless cases invoke

* Professor, UCLA School of Law. I am grateful to Mike Dooley for comments on an earlier draft. Portions of this article are adapted from Chapter 6 of my book *CORPORATION LAW AND ECONOMICS* (2003), with permission of the publisher, Foundation Press.

1. See, e.g., *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979) (dismissal of derivative litigation); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971) (fiduciary duties of controlling

it and countless scholars have analyzed it.² Yet, despite all of the attention lavished on it, the business judgment rule remains poorly understood.³ We lack a coherent and unified theory that explains why the rule exists and where its limits should be placed.⁴ This article offers such a theory.

My analysis is grounded on the core proposition that the business judgment rule, like all of corporate law, is designed to effect a compromise—on a case-by-case basis—between two competing values: authority and accountability.⁵ These values refer, respectively, to the need to preserve the board of directors' decision-making discretion and the need to hold the board accountable for its decisions.⁶ Academic commentary on the business judgment rule strongly emphasizes accountability—i.e., the need to deter and remedy misconduct by the firm's decision makers and agents.⁷ Although the separation of

shareholder); *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968) (operational decision). So-called "business judgment rules" may also be found in the law of other forms of business organizations, where they likewise protect the "good faith business decisions" of the organizations' board of directors or comparable organ of authority "from interference by the courts." *Lee v. Interins. Exch. of the Auto. Club of S. Cal.*, 57 Cal. Rptr. 2d 798, 802 (Cal. Ct. App. 1997) (holding that business judgment rule applies to business decisions of the board of governors of a reciprocal insurance exchange); see also *Barnes v. State Farm Mut. Auto. Ins. Co.*, 20 Cal. Rptr. 2d 87 (Cal. Ct. App. 1993) (holding likewise as to board of mutual insurance company).

2. See Michael J. Kennedy, *The Business Judgment Syllogism—Premises Governing Board Activity*, in *TECHNOLOGY & EMERGING GROWTH M&AS 2002*, at 285, 327 (PLI Corp. Law & Practice Course, Handbook Series No. B01-01DE, 2002), available at WL 1316 PLI/Corp 285 (opining that "[t]here are hundreds, perhaps thousands, of cases that peel the onion of the business judgment rule's parameters.").

3. See, e.g., R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1342 (1993) (arguing that neither of the most widely "avowed bases for the business judgment rule is particularly persuasive"); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 287-88 (1994) (arguing that "the general concept behind the rule seems unassailable" but that "a problem occurs when courts and writers attempt to inject specific content into this general proposition—immediately, a lack of consensus emerges as to what the rule really is"); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270 (1967) (noting that the business judgment rule is "one of the least understood concepts in the entire corporate field").

4. See Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 573 (observing that "thousands of pages of corporate law scholarship and commentary have been devoted to" a search for the rationale underlying the business judgment rule, "yet we remain short of any broad consensus").

5. See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 208 (2002) (noting the "tension between authority and accountability").

6. See *id.* at 207 (arguing that setting the "proper mix of discretion and accountability" is "the central corporate governance question").

7. See, e.g., Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance*, 84 CORNELL L. REV. 1133, 1183 (1999) (positing a purported "lack of accountability" that "exists because of the business judgment rule and the rhetorical nature of fiduciary duty law"); Frank H. Easterbrook & Daniel R. Fischel, *The Proper*

ownership and control in modern public corporations inevitably raises important accountability concerns,⁸ accountability standing alone is an inadequate normative account of corporate law.⁹ A fully specified account of corporate law must incorporate the value of authority—i.e., the need to develop a set of corporate governance rules and standards that enable corporations to adopt efficient decision-making systems and processes.¹⁰ In this article, I argue that corporate decision-making efficiency can be ensured only by preventing the board's decision-making authority from being trumped by courts under the guise of judicial review.

Readers familiar with my recent work will recognize the themes developed herein as an application of my director primacy theory.¹¹ The director primacy model is designed to answer the two basic corporate governance questions. First, which constituency's interests will prevail when the ultimate decision maker is presented with a zero sum game? Second, in which organ of the corporation is that ultimate power of decision vested?¹² In the academic literature, the prevailing answers to these questions are provided by the shareholder primacy model.¹³ Although its precise dimensions vary from one of its advocates to another, a shareholder primacy-based

Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1202-03 (1981) (noting in the context of target management resistance to unsolicited takeover bids that "application of the usual business judgment rule would give managers free rein to carry out disguised programs of resistance"); cf. David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1021 (2000) (citing the business judgment rule as an example of how "corporate law pays lip service to shareholder primacy," but "is actually ineffective when it comes to rendering management accountable to the shareholders"); Mark J. Roe, *Corporate Law's Limits*, 31 J. LEGAL STUD. 233, 233 (noting that "the business judgment rule puts beyond direct legal inquiry most key agency costs—such as overexpansion, overinvestment, and reluctance to take on profitable but uncomfortable risks").

8. See *infra* note 143 and accompanying text.

9. See Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 (1992) (stating that "neither [authority nor accountability] could provide a sensible guide to the governance of firm-organized economic activity because each seeks to achieve a distinct and separate value that is essential to the survival of any firm").

10. See *id.* at 463-64 (noting corporate law's concern with the value of authority, which he defines as being concerned with identifying "substantive rules and procedures [that] best supports the most efficient decision-making process for the publicly held firm").

11. See, e.g., Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003) [hereinafter Bainbridge, *Director Primacy*]; Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791 (2002) [hereinafter Bainbridge, *Preliminary Reflections*]. I should acknowledge the debt director primacy owes to Professor Dooley's so-called "Authority Model," whose "heart" is said to be "the universally recognized requirement for the establishment of, and vesting of supreme authority in, the board of directors." Dooley, *supra* note 9, at 467.

12. Bainbridge, *Director Primacy*, *supra* note 11, at 549-50.

13. *Id.* at 563 (noting that "most corporate law scholars embrace some variant of shareholder primacy").

model generally posits, both as a normative and a positive matter, that corporate decision-making powers must be exercised so as to maximize shareholder wealth¹⁴ and that shareholders wield some form of ultimate decision-making power in the firm, despite the separation of ownership and control in public corporations.¹⁵ In contrast, I have argued elsewhere that shareholder primacy is neither normatively persuasive nor descriptively accurate.¹⁶

The director primacy model thus stands as an alternative to the prevailing shareholder primacy view. The director primacy model describes the corporation as a vehicle by which the board of directors hires various factors of production. The board of directors is not an agent of the shareholders; rather, the board is the embodiment of the corporate principal, serving as the nexus of the various contracts making up the corporation.¹⁷ From the descriptive perspective, director primacy claims that fiat—centralized decision making—is the essential attribute of efficient corporate governance.¹⁸ In turn, it claims that authority—i.e., the power and right to exercise decision-making fiat—is vested neither in the shareholders nor in the managers, but rather in the board of directors.¹⁹ From the normative perspective, director primacy acknowledges that vesting the power of fiat in the board of directors raises legitimate accountability concerns. In turn, director primacy thus identifies the tension between authority and accountability as the central problem of corporate law.²⁰ In this

14. To be sure, a number of commentators have argued that the business judgment rule—and, indeed, corporate law generally—is not premised on shareholder wealth maximization. See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 303 (1999) (arguing that the business judgment rule authorizes directors to make trade-offs between shareholder and nonshareholder interests); Kent Greenfield & John E. Nilsson, *Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule*, 63 BROOK. L. REV. 799, 831 (1997) (arguing that the business judgment rule reflects “an underlying distrust of the strict fiduciary duty to maximize shareholder returns”); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 286-87 (1998) (arguing that the business judgment rule precludes liability where directors fail to maximize shareholder wealth). I have addressed (and rejected) these arguments elsewhere. BAINBRIDGE, *supra* note 5, at 257-58.

15. See generally Bainbridge, *Director Primacy*, *supra* note 11, at 564-68 (describing shareholder primacy).

16. *Id.* at 563-74.

17. See generally Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002).

18. *Id.* at 20.

19. *Id.* at 25.

20. Bainbridge, *Director Primacy*, *supra* note 11, at 604.

article, I argue that the business judgment rule is the principal mechanism by which corporate law resolves that tension.²¹

The business judgment rule commonly is understood today as a standard of liability by which courts review the decisions of the board of directors.²² In this article, by contrast, I argue that the rule is better understood as a doctrine of abstention pursuant to which courts in fact refrain from reviewing board decisions unless exacting preconditions for review are satisfied.²³ Part II argues that the abstention doctrine is implicit in some cases, especially older ones. Part II focuses on two exemplar cases illustrating these competing conceptions of the business judgment rule. *Shlensky v. Wrigley* remains a classic expression of the business judgment rule as a doctrine of judicial abstention.²⁴ In *Shlensky* and similar cases, the rule creates a strong presumption against judicial review of duty-of-care claims. Courts following this approach to the rule will abstain from reviewing the substantive merits of the directors' conduct unless the plaintiff can carry the very heavy burden of rebutting that presumption. In contrast, *Cede & Co. v. Technicolor, Inc.* illustrates the modern trend towards treating the business judgment rule as a substantive doctrine, expressing the scope of director liability, and permitting courts some room to examine the substantive merits of the board's decision.²⁵ Deciding between these competing conceptions of the business judgment rule is critical. Because the two conceptions contemplate dramatically different approaches to judicial review, the choice between them can have outcome-determinative effects.

The remainder of the article develops the case for reviving—and making more explicit—the older abstention approach by exploring the tension between the business judgment rule and the duty of care. On the one hand, the duty of care requires that directors exercise reasonable care in making corporate decisions.²⁶ On the other hand, the business judgment rule mandates that courts defer to the board of

21. I anticipated some of the arguments developed more fully herein in Bainbridge, *Director Primacy*, *supra* note 11, at 600-05, where I used the business judgment rule as a case study of director primacy in action.

22. See *infra* notes 37-39 and accompanying text.

23. Although courts rarely refer to the business judgment rule as an abstention doctrine, I argue that the principle of abstention is implicit in one of the two major lines of business judgment rule cases. See *infra* Part II.B (describing that line of cases).

24. 237 N.E.2d 776 (Ill. App. Ct. 1968).

25. 634 A.2d 345 (Del. 1993).

26. Specifically, the duty of care requires corporate directors to exercise "that amount of care which ordinarily careful and prudent men would use in similar circumstances." *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

directors' judgment absent highly unusual exceptions.²⁷ Compare the liability of physicians, who are also held to a duty of care, but whose medical judgment gets no such deference.²⁸ Why are directors of an incorporated business entitled to deference that physicians are denied? After a short review of the director primacy model in Part III, Part IV of this article answers that question by interweaving the traditional explanations courts have offered for the rule with an alternative explanation premised on the director primacy model. As we shall see, the abstention doctrine conception of the rule follows logically from that model.

II. THE COMPETING CONCEPTIONS OF THE BUSINESS JUDGMENT RULE: AN ABSTENTION DOCTRINE OR A STANDARD OF LIABILITY?

Under Delaware law, corporate directors owe the corporation what the Delaware Supreme Court has taken to calling a "triad" of fiduciary duties: care; good faith; and loyalty.²⁹ Although the business judgment rule comes into play with respect to all three of the duties,³⁰ it is most intimately associated with the duty of care.³¹ As the Delaware Supreme Court has defined it, the duty of care requires directors to act with the same "amount of care which ordinarily careful and prudent men would use in similar circumstances."³² By invoking the language of reasonable care, the duty of care seemingly would be violated whenever directors act negligently.³³ At the same time, however, if the business judgment rule does anything, it insulates directors from liability for negligence.³⁴ The rule does so by providing

27. See, e.g., *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45 n.17 (Del. 1994) (stating that under the business judgment rule "the Court gives great deference to the substance of the directors' decision and will not invalidate the decision [or] examine its reasonableness").

28. See FRANKLIN A. GEVURTZ, *CORPORATION LAW* 290-91 (2000) (discussing the analogies between director and physician liability).

29. *Technicolor*, 634 A.2d at 361.

30. See BAINBRIDGE, *supra* note 5, at 283-85 (noting the numerous contexts in which the business judgment rule has relevance); see also *supra* note 1 and accompanying text (noting pervasive role of the rule in corporation law).

31. Douglas M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97, 97 (1989) (identifying the business judgment rule as a "corollary" of the duty of care); Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351, 1437 (1989) (same).

32. See, e.g., *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963); see also MODEL BUS. CORP. ACT § 8.30 (2002).

33. See GEVURTZ, *supra* note 28, at 274 (suggesting that the duty of care might "involve nothing more than an application of tort law [negligence] principles to [the corporate] context").

34. See, e.g., *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982) (holding that "[w]hile it is often stated that corporate directors and officers will be liable for negligence in carrying out their

a presumption that the directors or officers “of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”³⁵ As a result, even clear mistakes of judgment will not result in personal liability.³⁶ How can this freedom from liability be reconciled with the duty of care’s negligence-based verbiage?

Two conceptions of the business judgment rule compete in the case law. One treats the rule as a standard of liability.³⁷ Hence, for

corporate duties, all seem agreed that such a statement is misleading. . . . Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labeled the business judgment rule.”); *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 811 (Sup. Ct. 1976) (holding that the duty of care “does not mean that a director is chargeable with ordinary negligence for having made an improper decision, or having acted imprudently”), *aff’d*, 387 N.Y.S.2d 993 (App. Div. 1976); *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944) (stating that “although the concept of ‘responsibility’ is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest”).

35. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Much confusion has been engendered by the question of whether the business judgment rule is a procedural presumption, a substantive limitation of liability, or both. *See, e.g.*, S. Samuel Arshat, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 94 (1979) (arguing that the “single term” business judgment rule leads to confusion because it is “employed with reference to wholly different aspects of the rule’s application, which are governed by disparate legal principles”); Balotti & Hanks, *supra* note 3, at 1345 (contending that the business judgment rule is not a presumption “in the strict evidentiary sense of the term”). This dispute is beyond the scope of this article.

36. *See, e.g.*, *FDIC v. Casterter*, 184 F.3d 1040, 1044 (9th Cir. 1999) (noting that “[t]he California business judgment rule is intended to protect a director from liability for a mistake in business judgment which is made in good faith and in what he or she believes to be the best interest of the corporation, where no conflict of interest exists.” (internal quotation marks and citation omitted)); *Strassburger v. Earley*, 752 A.2d 557, 582 (Del. 2000) (holding that “[t]he business judgment rule shields directors from liability for good faith business decisions, even those that turn out to be mistaken.”).

37. Professor Melvin Eisenberg, for example, views the duty of care as a standard of conduct and the business judgment rule as a standard of review. Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 444-45 (1993). The former specifies how directors should conduct themselves, while the latter sets forth the test courts will use in determining whether the directors’ conduct gives rise to liability. MELVIN ARON EISENBERG, *CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES AND MATERIALS* 544-49 (8th ed. 2000). Unlike typical negligence cases, in which the two standards are identical, in corporate law they diverge. *Id.* at 547. The function of the business judgment rule thus is to create a less demanding standard of review than the (largely aspirational) standard of conduct created by the duty of care. *Id.*; *see also* William T. Allen et al., *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*, 96 NW. U. L. REV. 449 (2002) (embracing the standard of conduct/review dichotomy and contending it helps explain Delaware law).

A version of this distinction is now embodied in the Model Business Corporation Act (MBCA). MBCA § 8.30 sets forth the standards of conduct for directors, requiring a director to act in good faith and in a manner the director reasonably believes to be in the corporation’s best interest. MODEL BUS. CORP. ACT § 8.30(a) (2002). Conduct that satisfies the requirements of § 8.30 cannot result in liability. *Id.* § 8.31 cmt. Conduct falling short of those aspirational goals can only result

example, some courts and commentators argue that the business judgment rule shields directors from liability so long as they act in good faith.³⁸ Others contend that the rule simply raises the liability bar from mere negligence to, say, gross negligence or recklessness.³⁹

Alternatively, however, the business judgment rule can be seen as an abstention doctrine. In this conception, the rule's presumption of good faith does not state a standard of liability but rather establishes a presumption against judicial review of duty of care claims.⁴⁰ The court therefore abstains from reviewing the substantive merits of the directors' conduct unless the plaintiff can rebut the business judgment rule's presumption of good faith.⁴¹

A. Technicolor: *The Business Judgment Rule as a Standard of Liability*

The modern trend is to treat the business judgment rule as a substantive standard of liability.⁴² There is some disagreement, even

in liability if it violates the standards of director liability set forth in MBCA § 8.31. *Id.* Specifically, liability can be imposed where the director acted in bad faith, did not reasonably believe the action to be in the corporation's best interest, was not informed to the extent the director reasonably believed appropriate under the circumstances, was interested in the transaction, was not independent, engaged in self dealing, or failed to exercise oversight over a sustained period. *Id.* § 8.31(a)(2). For a critique of Eisenberg's position, as well as the new MBCA provisions, see D. Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation Act*, 67 U. CIN. L. REV. 1201 (1999).

38. See GEVURTZ, *supra* note 28, at 282-84 (describing this position).

39. See *id.* at 284-86 (discussing this view).

40. Cf. Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 632 (2000) (opining that "[u]nder a proper understanding of the business judgment rule as a policy of non-review, the 'substantive' force of the business judgment rule always applies in a duty of care case, immunizing the quality of the business decision from judicial review whether or not care was exercised.").

41. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) (stating that "directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available"); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989) (stating that if plaintiff "fails to meet her burden of establishing facts rebutting the presumption, the business judgment rule, as a substantive rule of law, will attach to protect the directors and the decisions they make").

42. See, e.g., *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 927 (Del. 2003) ("The business judgment rule, as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors." (footnote and internal quotation marks omitted)); Wayne O. Hanewicz, *When Silence Is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Merger Agreements*, 28 J. CORP. L. 205, 217 (2003) (asserting that "the standard of conduct for directors is to act reasonably. But the business judgment rule's standard of review is much more limited and diverges sharply from this standard of conduct."); Report, *Corporate Director's Guidebook: Third Edition*, 56 BUS. LAW. 1571, 1586 (2001) (asserting that "[u]nlike the standards of conduct

among its proponents, as to the standard of review applied under this approach. It may be mere subjective good faith, it may be a requirement of rationality, or it may be gross negligence.⁴³ The key point, however, is that the business judgment rule, so conceived, entails “some objective review of the quality of the [board’s] decision, however limited.”⁴⁴

A good judicial example of this approach to the business judgment rule is *Cede & Co. v. Technicolor, Inc.*⁴⁵ The stage was set for this remarkably convoluted litigation in late 1982 when Technicolor’s board of directors approved merging Technicolor into a subsidiary of MacAndrews and Forbes Group, Inc. (MAF).⁴⁶ In the merger, Technicolor shareholders received \$23 cash per share.⁴⁷ Plaintiff Cinerama, Inc., which owned 4.4 percent of Technicolor’s outstanding stock, dissented from the merger and filed an appraisal proceeding.⁴⁸ As the litigation dragged on, Cinerama brought a separate suit for damages alleging that Technicolor’s board violated its duty of care when it approved the merger.⁴⁹

encompassed in the duties of care and loyalty, the business judgment rule is not a description of a duty or standard used to determine whether a breach of duty has occurred; rather, it is a standard of judicial review”); see also *infra* text accompanying notes 43-44.

43. WILLIAM L. CARY & MELVIN ARON EISENBERG, CORPORATIONS: CASES AND MATERIALS 603 (7th ed. 1995) (discussing these alternatives).

44. *Id.*; see also GEVURTZ, *supra* note 28, at 284 (arguing that few cases “unequivocally rule out any review of objective reasonableness”).

45. 634 A.2d 345 (Del. 1993). No claim is made that *Technicolor* represents the last word on Delaware’s business judgment rule jurisprudence. Professor David Skeel persuasively argues that Delaware corporate decisional law tends to cycle between competing doctrinal approaches to the same problem, which he attributes to the Delaware Supreme Court’s norm of unanimous decision making. See generally David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127 (1997). As I have demonstrated elsewhere by case analysis, Delaware’s business judgment rule jurisprudence demonstrates just such a pattern of cycling. See BAINBRIDGE, *supra* note 5, at 249-51 (discussing relevant precedents). Indeed, as discussed below, some years after *Technicolor* the Delaware Supreme Court articulated a strongly abstention-oriented version of the business judgment rule in *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). See *infra* notes 103-105 and accompanying text (discussing *Brehm*). Yet, just a few years later, in *McMullin v. Beran* the Delaware Supreme Court reaffirmed the *Technicolor* approach. 765 A.2d 910, 916-17 (Del. 2000). And so, the cycle goes on.

46. *Cede & Co. v. Technicolor, Inc.*, 13 DEL. J. CORP. L. 225, 231 (Del. Ch. Jan. 13, 1987), available at 1987 WL 4768, *rev’d*, 542 A.2d 1182 (Del. 1987).

47. *Id.*

48. *Cede & Co. v. Technicolor, Inc.*, Civ. A. No. 7129, 1990 WL 161084, at *21 (Del. Ch. Oct. 19, 1990). For discussions of the appraisal proceeding, see generally BAINBRIDGE, *supra* note 5, at 632-45; GEVURTZ, *supra* note 28, at 648-54.

49. See *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1190-91 (Del. 1988) (holding that Cinerama did not have to elect between the appraisal remedy and an action for equitable or legal relief, but could instead pursue both simultaneously).

Cinerama's claim was premised on the Delaware Supreme Court's earlier decision in *Smith v. Van Gorkom*.⁵⁰ As with *Technicolor*, the *Van Gorkom* litigation arose out of a shareholder's duty-of-care-based challenge to a board of directors' decision to approve a merger.⁵¹ In concluding that the business judgment rule did not entitle the directors to protection on the facts before it, the *Van Gorkom* court focused on the process by which the board made its decision, exhaustively detailing the board's many procedural errors and irregularities.⁵² *Van Gorkom* thus established a requirement of what might be called procedural or process due care as a prerequisite for invoking the business judgment rule.⁵³ Put another way, directors who fail "to act in an informed and deliberate manner" may not assert the business judgment rule as a defense to care claims.⁵⁴

In assessing Cinerama's claim that Technicolor's board had violated its duty of care when it approved the merger with MAF, the lower court expressed "grave doubts" that Technicolor's board had complied with its *Van Gorkom* obligations.⁵⁵ Chancellor Allen nevertheless found for the defendant directors on causation grounds.⁵⁶ In Allen's view, Cinerama could not prove damages. In the appraisal proceeding, Allen had already determined the fair value of Technicolor at the time of the merger to be \$21.60 per share, while the shareholders had been offered \$23.⁵⁷ On appeal, the Supreme Court of Delaware reversed.⁵⁸

50. 488 A.2d 858 (Del. 1985). For a more detailed treatment of *Van Gorkom*, see BAINBRIDGE, *supra* note 5, at 276-83. For a particularly trenchant contemporary critique of *Van Gorkom*, which demonstrates the majority's misuse of precedent, see William T. Quillen, *Trans Union, Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465 (1985).

51. *Van Gorkom*, 488 A.2d at 871-72.

52. *Id.* at 874-88; see BAINBRIDGE, *supra* note 5, at 277 (suggesting that "one can plausibly read *Van Gorkom* as providing a procedural roadmap by which corporate decisions, at least of this magnitude, ought to be made").

53. *Cf. Brehm v. Eisner*, 746 A.2d 244, 262-64 (Del. 2000) (rejecting plaintiff shareholder's contention that the business judgment rule includes an element of "substantive due care" and holding that the business judgment rule requires only "process due care").

54. *Van Gorkom*, 488 A.2d at 873.

55. *Cinerama, Inc. v. Technicolor, Inc.*, 17 DEL. J. CORP. L. 551, 560 (Del. Ch. June 24, 1991), available at 1991 WL 111134, *rev'd*, 634 A.2d 345 (Del. 1993).

56. *Id.* at 581-84.

57. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 369 (Del. 1993).

58. *Id.* The causation issue is relatively unimportant for our purposes, but the Supreme Court's mistreatment of that issue is such an egregious example of its mangling of the business judgment rule that one cannot resist treating the question briefly. Chancellor Allen's conclusion that Cinerama could not prevail in light of its failure to prove financial injury relied principally on the classic case of *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924). See *Technicolor*, 17 DEL. J. CORP. L. at 582 (quoting from *Barnes*). On appeal, the Supreme Court found it to be "a 'mystery' how the [Chancery] court discovered the *Barnes* case and then based its decision on *Barnes*." *Technicolor*, 634 A.2d at 370 n.38. Perhaps Chancellor Allen found the *Barnes* case by glancing

In so doing, the Supreme Court morphed Allen's "grave doubts" into "presumed findings" of gross negligence by the board of directors.⁵⁹ Specifically, the court identified five process failures, collectively amounting to a breach of the duty of care: (1) the board had failed to make a "prudent search for alternatives" before approving the agreement; (2) once the merger agreement was signed, the board had no reasonable basis for believing that competing bids might be made; (3) most directors had little information about the merger and its terms before the meeting at which they approved it; (4) MAF locked up the transaction through stock options granted by the corporation and the two principal shareholders; and (5) the board was not "adequately informed" before approving the agreement.⁶⁰ In sum, the court concluded, "Cinerama clearly met its burden of proof for the purpose of rebutting the rule's presumption by showing that the defendant directors of Technicolor failed to inform themselves fully concerning all material information reasonably available prior to approving the merger agreement."⁶¹

In so holding, the Supreme Court effectively rejected any conception of the business judgment rule as a doctrine of judicial abstention. The analysis began innocuously enough, with a fairly standard statement of the board of directors' authority to manage the business and affairs of the corporation.⁶² The court immediately went

at virtually any major corporate law text. If so, such a glance would have demonstrated that *Barnes* is routinely cited as the leading authority for the well-accepted proposition that "the undoubted negligence of directors may not result in liability if the plaintiff cannot show that the negligence proximately caused damages to the corporation." ROBERT C. CLARK, CORPORATE LAW 126 (1986). The corporation law nutshell in print at the time *Technicolor* was decided likewise cited *Barnes* as "the leading case" for this proposition. ROBERT W. HAMILTON, THE LAW OF CORPORATIONS (3d ed. 1991). Even the Emanuel's law outline cited *Barnes* for the proposition that "the traditional tort notions of cause in fact and proximate cause apply in [the duty of care] context." STEVEN EMANUEL, CORPORATIONS 128 (1989) (emphasis omitted). The true mystery thus is how the Delaware Supreme Court failed to discover *Barnes*'s well-established status in corporate law jurisprudence. To be sure, the *Barnes* issue does not come up very often. But that is because duty-of-care cases that reach the damages phase of litigation are so few and far between as to amount to sports. See generally BAINBRIDGE, *supra* note 5, at 287-90 (discussing role of causation in duty of care litigation); MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 249-54 (1995) (explaining that the *Technicolor* court's analysis of the causation issue, when coupled with its approach to calculating damages, improperly incorporates the fairness analysis appropriate in duty of loyalty litigation into the care context).

59. *Technicolor*, 634 A.2d at 369; see DOOLEY, *supra* note 58, at 253 (criticizing the Supreme Court for doing so).

60. *Technicolor*, 634 A.2d at 369.

61. *Id.* at 371.

62. The court stated:

Our starting point is the fundamental principle of Delaware law that the business and affairs of a corporation are managed by or under the direction of its board of directors. In exercising these powers, directors are charged with an unyielding fiduciary duty to

off the rails, however, by describing the business judgment rule as being intended "to preclude a court from imposing itself *unreasonably* on the business and affairs of a corporation."⁶³ Contrast that formulation to *Van Gorkom's* statement that the rule is intended to "protect and promote the full and free exercise of the managerial power granted to Delaware directors."⁶⁴ The contrast between these formulations is quite striking, with more than semantic implications. *Technicolor's* formulation suggests far less judicial deference to the board that does that of *Van Gorkom*.

To be sure, the *Technicolor* court described the business judgment rule as "a powerful presumption" against judicial interference with board decision making.⁶⁵ Immediately thereafter, however, the court proceeded to eviscerate that presumption:

Thus, a shareholder plaintiff challenging a board decision has the burden at the outset to rebut the rule's presumption. To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments. If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the "entire fairness" of the transaction to the shareholder plaintiff.⁶⁶

Notice how the court puts the cart before the horse. Directors who violate their duty of care do not get the protections of the business judgment rule; indeed, the rule is rebutted by a showing that the

protect the interests of the corporation and to act in the best interests of its shareholders. The business judgment rule is an extension of these basic principles.

Id. at 360 (citations omitted).

63. *Id.* (emphasis added).

64. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

65. *Technicolor, Inc.*, 634 A.2d at 361.

66. *Id.* (citations omitted). *Technicolor's* author, Justice Henry Horsey, asserts that *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940), articulates a *Technicolor*-like formulation of the business judgment rule under which, "for the rule of judicial deference to be invoked, directors of a board must be found to have met not only their duty of loyalty but also their duty of care." Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 976 (1994). One problem with this analysis is that *Litwin* involved the directors of a bank, who are typically held to a higher standard of accountability than directors of other corporations. See *Litwin*, 25 N.Y.S.2d at 678. Another is that *Litwin* is a sport—a case that falls well outside the norm. The court found the transaction in question to be "so improvident, so risky, so unusual, and unnecessary as to be contrary to fundamental conceptions of prudent banking practice." *Id.* at 699. Although the court expressly declined to find a violation of the duty of loyalty in *Litwin*, it seems fair to ask whether "we have reason to disbelieve the protestations of good faith by directors who reach 'irrational' conclusions?" DOOLEY, *supra* note 58, at 263. Indeed, on the facts of *Litwin*, there is good reason to suspect that the defendant and directors did have a serious conflict of interest. CLARK, *supra* note 58, at 127-28.

directors violated their fiduciary duty of “due care.”⁶⁷ This is exactly backwards. As we shall see, the abstention doctrine approach to the rule prevents plaintiff from litigating that very issue.⁶⁸ Put another way, the whole point of the business judgment rule is to prevent courts from even asking the question: did the board breach its duty of care?

B. *Shlensky v. Wrigley: Abstention in Action*

Competing with the standard of liability conception is an alternative view that treats the business judgment rule—albeit implicitly—as a doctrine of abstention. One of the best examples is also one of corporate law’s hoariest chestnuts, *Shlensky v. Wrigley*.⁶⁹ Plaintiff Shlensky challenged Philip Wrigley’s famous refusal to install lights in Chicago’s Wrigley Field baseball stadium.⁷⁰ At that time, Wrigley was the majority stockholder and president of the Chicago National League Ball Club, Inc., a Delaware corporation that owned the Chicago Cubs and operated Wrigley Field.⁷¹ Shlensky was a minority shareholder in the company.⁷² Between 1961 and 1965, the period about which Shlensky complained, the Cubs had consistently operated at a loss.⁷³ Shlensky’s complaint attributed the losses to the Cubs’ poor home attendance.⁷⁴ In turn, Shlensky alleged that the low attendance was attributable to Wrigley’s refusal to install lights at Wrigley Field and, concomitantly, to schedule games at night.⁷⁵

67. In *McMullin v. Beran*, the Delaware Supreme Court likewise opined that:

The business judgment rule “operates as both a procedural guide for litigants and a substantive rule of law.” Procedurally, the initial burden is on the shareholder plaintiff to rebut the presumption of the business judgment rule. To meet that burden, the shareholder plaintiff must effectively provide evidence that the defendant board of directors, in reaching its challenged decision, breached any one of its “triad of fiduciary duties, loyalty, good faith or due care.” Substantively, “if the shareholder plaintiff fails to meet that evidentiary burden, the business judgment rule attaches” and operates to protect the individual director defendants from personal liability for making the board decision at issue.

765 A.2d 910, 916-17 (Del. 2000) (footnotes omitted); see also *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 (Del. 1999) (opining that “a breach of any one of the board of directors’ triad of fiduciary duties, loyalty, good faith, or due care, sufficiently rebuts the business judgment rule and permits a challenge to the board’s action under the entire fairness standard”).

68. See *infra* text accompanying note 90.

69. 237 N.E.2d 776 (Ill. App. Ct. 1968) (applying Delaware law).

70. *Id.* at 777-78.

71. *Id.* at 777 (noting that Wrigley owned approximately 80 percent of the stock).

72. *Id.*

73. *Id.*

74. *Id.* at 778.

75. *Id.* at 777-78 (summarizing Shlensky’s factual allegations).

Shlensky alleged that Wrigley's refusal to install lights was motivated by two factors, neither of which related to the maximization of shareholder wealth.⁷⁶ First, he alleged, Wrigley refused to institute night baseball because Wrigley believed that baseball was a daytime sport.⁷⁷ Second, he alleged that Wrigley feared night baseball might have a negative impact on the neighborhood surrounding Wrigley Field.⁷⁸ Shlensky focused on Wrigley's motivation because the other defendant directors, he alleged, were so dominated by Wrigley that they improperly acquiesced in his business decisions.⁷⁹

Wrigley and the other defendant directors moved to dismiss Shlensky's complaint for failure to state a claim. In doing so, they asserted a strong version of the abstention conception of the business judgment rule, arguing "that the courts will not step in and interfere with honest business judgment of the directors unless there is a showing of fraud, illegality or conflict of interest."⁸⁰ In analyzing the defendants' argument, the court began by setting out "certain ground rules" it extracted from prior precedents. First, "courts of equity will not undertake to control the policy or business methods of a corporation although it may be seen that a wiser policy might be adopted and the business more successful if other methods were pursued."⁸¹ Second, the court observed that the case presented "a conflict in view between the responsible managers of a corporation and an overwhelming majority of its stockholders on the one hand and a dissenting minority on the other" that touched on "matters of business policy."⁸² According to the *Shlensky* court: "The response which courts make to such applications is that it is not their function to resolve for corporations questions of policy and business management. The directors are chosen to pass upon such questions and their judgment unless shown to be tainted with fraud is accepted as final."⁸³

Finally, the court opined that "[i]n a purely business corporation . . . the authority of the directors in the conduct of the

76. *Id.* at 778 (noting Shlensky's allegation that Wrigley was "not interested in whether the Cubs would benefit financially from" night baseball).

77. *Id.*

78. *Id.*

79. *Id.* (noting Shlensky's allegation that that "the other defendant directors . . . have acquiesced in the policy laid down by Wrigley and have permitted him to dominate the board of directors in matters involving the installation of lights and scheduling of night games, even though they knew he was not motivated by a good faith concern as to the best interests of defendant corporation, but solely by his personal views . . .").

80. *Id.*

81. *Id.* (quoting *Wheeler v. Pullman Iron and Steel Co.*, 32 N.E. 420, 423 (Ill. 1892)).

82. *Id.* at 779 (quoting *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654 (Del. Ch. 1928)).

83. *Id.* (quoting *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654 (Del. Ch. 1928)).

business of the corporation must be regarded as absolute when they act within the law, and the court is without authority to substitute its judgment for that of the directors.”⁸⁴

Each of these three “ground rules” supported the defendants’ claim that, absent colorable allegations of fraud, illegality, or conflict of interest, the court must abstain from reviewing the directors’ decision.⁸⁵ Because Shlensky’s complaint lacked any such allegations,⁸⁶ the court could have dismissed Shlensky’s claim without addressing either the substantive merits of Wrigley’s refusal or his motives. Curiously, however, the court in fact posited several legitimate business reasons for Wrigley’s conduct. The court opined, for example, that “the effect on the surrounding neighborhood might well be considered by a director.”⁸⁷ Likewise, the court hypothesized that “the long run interest” of the firm “might demand” attention to the impact of night baseball on the neighborhood.⁸⁸ Note that neither motivation was based on evidence presented by Wrigley; to the contrary, both were invented by the court.

The key point is that the court did not require Wrigley and the other defendants to show either that such considerations motivated their decisions or that the decision otherwise redounded to the corporation’s benefit. Indeed, the court emphasized that its speculations in this regard were mere dicta:

By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.⁸⁹

At the risk of being excessively cute, we might emphasize that the court did not even permit Shlensky to come to bat.⁹⁰

84. *Id.* (quoting *Toebelman v. Mo.-Kan. Pipe Line Co.*, 41 F. Supp. 334, 339 (D. Del. 1941)).

85. Note that mere allegations of director impropriety do not entitle plaintiff to discovery. *Stoner v. Walsh*, 772 F. Supp. 790, 800 (S.D.N.Y. 1991). Accordingly, business judgment rule claims should be determined as a motion to dismiss on the pleadings rather than at the summary judgment stage.

86. *Shlensky*, 237 N.E.2d at 780 (holding that “unless the conduct of the defendants at least borders on one of the elements, the courts should not interfere. The trial court in the instant case acted properly in dismissing plaintiff’s amended complaint.”).

87. *Id.*

88. *Id.*

89. *Id.*

90. The court also found Shlensky’s claim defective for failure to allege damages. *Id.* This discussion went mainly to causation. To be sure, the Cubs’ poor attendance probably contributed to the firm’s losses, but was poor home attendance attributable to the lack of night baseball or to the Cubs’ performance? During the relevant time period, the Cubs were pretty consistent losers.

The doctrine thus articulated by *Shlensky* has a long pedigree in American law. In 1888, for example, New York's highest court explained that "courts will not interfere unless the [directors'] powers have been illegally or unconscientiously executed; or unless it be made to appear that the acts were fraudulent or collusive, and destructive of the rights of the stockholders. Mere errors of judgment are not sufficient . . ." ⁹¹ In 1917, the Michigan Supreme Court famously refused to interfere with Henry Ford's decision to expand Ford Motor Company's manufacturing facilities, explaining that "judges are not business experts." ⁹²

More recent examples also can be cited, perhaps most notably *Kamin v. American Express Co.* ⁹³ In *Kamin*, plaintiff challenged the decision by American Express' board of directors to declare a dividend of property, specifically shares of stock American Express owned in a second corporation. ⁹⁴ According to plaintiff, by deciding to distribute the shares rather than selling them, the board lost a potential tax savings of over \$8 million. ⁹⁵ Even though it seems indisputable that American Express' board made the wrong decision, the court dismissed for failure to state a claim. ⁹⁶ In doing so, the court set out an even stronger statement of the abstention conception of the business judgment rule than had the *Shlensky* court: "[t]he directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact of on profits, market prices, competitive situations, or tax advantages." ⁹⁷

The claim is not that courts rubberstamp the board's decision. Conceptualizing the business judgment rule as a principle of judicial abstention means that the rule is not a standard of liability; it does

In any event, this portion of the court's opinion is dicta. Once the court decided the business judgment rule was applicable, the inquiry could have (and should have) ended.

91. *Leslie v. Lorillard*, 18 N.E. 363, 365 (N.Y. 1888).

92. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

93. 383 N.Y.S.2d 807 (Sup. Ct. 1976), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976).

94. *Id.* at 809-10.

95. *Id.*

96. *Id.* at 815; cf. Ellen Taylor, *New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL. J. CORP. L. 837, 877 (1996) (citing *Kamin*, among other precedents, for the proposition that "directors are not liable for simply making mistakes, even if those mistakes result in substantial costs to the corporation and its shareholders").

97. *Kamin*, 383 N.Y.S.2d at 810-11. Hence, absent "fraud, dishonesty, or nonfeasance," courts will not substitute their judgment for that of the directors. *Id.* at 811; see also *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) (holding that New York's business judgment rule "bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes"); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984) (holding that under Texas law only fraud, self dealing, or ultra vires conduct rebuts the presumption of good faith provided by the business judgment rule).

not preclude the rule from having some aspects of a standard of review. As the quoted passages from both *Shlensky* and *Kamin* make clear, the business judgment rule does not prevent judicial review of director conduct involving fraud or self-dealing. In addition, before the rule comes into play, various prerequisites must be satisfied. It is well established, for example, that directors may only invoke the business judgment rule when they have made a conscious decision.⁹⁸ Hence, the business judgment rule does not prevent judicial review of a board's failure to exercise proper oversight of the corporation's management.⁹⁹ The good faith and disinterested independence of the directors are also often identified as conditions on which the rule is predicated.¹⁰⁰ Finally, some courts and commentators contend that the business judgment rule does not protect an irrational decision.¹⁰¹ Instead, what the abstention conception contemplates is that, if the requisite preconditions are satisfied, there is no remaining scope for judicial review of the substantive merits of the board's decision.¹⁰²

The Delaware Supreme Court expressed this point well in *Brehm v. Eisner*, in which the court explicitly rejected, as "foreign to the business judgment rule," the plaintiffs' argument that the rule could be rebutted by a showing that the directors failed to exercise "substantive due care":¹⁰³

98. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984) (stating that the business judgment rule is inapplicable "where directors have either abdicated their functions, or absent a conscious decision, failed to act").

99. See, e.g., *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996) (reviewing settlement of derivative litigation in which lack of oversight was alleged). For more detailed discussion of oversight cases, see BAINBRIDGE, *supra* note 5, at 270, 291-96.

100. See, e.g., *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979) (so long as directors were disinterested and acted in good faith, the business judgment rule required court to defer to board committee's recommendation to dismiss a shareholder derivative suit). See generally BAINBRIDGE, *supra* note 5, at 270-71 (discussing precondition of disinterested and independent decision makers).

101. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (stating that "[i]rrationality is the outer limit of the business judgment rule."); cf. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c)(3) (1994) [hereinafter ALI PRINCIPLES] (asserting that director must rationally believe action to be in corporation's best interest). Professor Dooley has grappled at some length with the problems inherent in positing rationality as a predicate for invoking the business judgment rule, concluding that a rationality requirement should not have teeth. See Dooley, *supra* note 9, at 478-81 (criticizing use of term rational as a precondition for the business judgment rule's invocation); see also *infra* note 105 (discussing this issue in more detail). See generally BAINBRIDGE, *supra* note 5, at 274-75 (same).

102. BAINBRIDGE, *supra* note 5, at 246 (arguing that under the abstention version of the rule the inquiry ends when the requisite preconditions are satisfied and that "[t]here will be no judicial review of the substantive merits of the board's decision—whether those merits are measured in terms of fairness, reasonableness, wisdom, care, or what have you").

103. 746 A.2d 244, 264 (Del. 2000).

Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decisionmaking context is *process* due care only. . . .

Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.¹⁰⁴

Perhaps *Brehm* was not as pure an abstention decision as was *Shlensky*, but note that none of the preconditions set forth by *Brehm* contemplate substantive review of the merits of the board's decision. Even the reference to a rational business purpose requires only the possibility that the decision was actuated by a legitimate business reason, not that directors must prove the existence of such a reason.¹⁰⁵ Absent self dealing or other conflicted interests, or truly egregious process failures, the court will abstain.

C. *Why It Matters Doctrinally*

When we compare *Technicolor* and *Shlensky*, it becomes apparent that the former gets things exactly backwards. One does not rebut the business judgment rule by showing a breach of the duty of care; if the business judgment rule applies, the court will not review the directors' conduct to see if that duty was violated. This criticism is not merely semantic; it goes to the core of the business judgment rule.

104. *Id.* at 264 & n.66.

105. See Dooley, *supra* note 9, at 478-79 n.58 (arguing that the term "rational is to be equated with conceivable or imaginable and means only that the court will not even look at the board's judgment if there is any possibility that it was actuated by a legitimate business reason. It clearly does not mean, and cannot legitimately be cited for the proposition, that individual directors must have, and be prepared to put forth, proof of rational reasons for their decisions."). Put another way, the reference to a "rational business purpose" does not contemplate substantive review of the decision's merits. As former Delaware Chancellor Allen explained, "such limited substantive review as the rule contemplates (i.e., is the judgment under review 'egregious' or 'irrational' or 'so beyond reason,' etc.) really is a way of inferring bad faith." *In re RJR Nabisco, Inc. Shareholders Litig.*, 1989 WL 7036, at *13 n.13 (Del. Ch. Jan. 31, 1989). Hence, a purported inquiry into the rationality of a decision is better viewed as a proxy for an inquiry into whether the decision was tainted by self-interest. In *Parnes v. Bally Entertainment Corp.*, for example, the Delaware Supreme Court adopted a formulation similar to Chancellor Allen's: "The presumptive validity of a business judgment is rebutted in those rare cases where the decision under attack is 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'" 722 A.2d 1243, 1246 (Del. 1999) (quoting *In re J. P. Stevens & Co.*, 542 A.2d 770, 780-81 (Del. Ch. 1988)). In that case, Bally's CEO allegedly demanded bribes from prospective takeover bidders and, moreover, allegedly received such a bribe from the successful bidder. *Id.* In holding that the plaintiff shareholder had stated a cause of action, the court observed that "it is inexplicable that independent directors, acting in good faith, could approve the deal" when it was so tainted. *Id.*

As articulated by *Shlensky* and its ilk, the business judgment rule's function is to preclude courts from deciding whether the directors violated their duty of care. Yet, it is that very task to which *Technicolor* directs the trial court. The court's statement of the doctrine thus threatens to render the business judgment rule nugatory, which raises several important concerns.

First, *Technicolor* trivializes the business judgment rule. Under *Technicolor*, the business judgment rule's primary function is the procedural task of assigning burdens of proof. In that limited guise, moreover, the rule merely assigns to the plaintiff the burden of establishing a prima facie case—the same burden the plaintiff bears in all civil litigation.¹⁰⁶ If the plaintiff fails to carry that burden, the business judgment rule requires the court to dismiss the lawsuit without inquiry into the merits of the decision. But so what? Under this conception, the business judgment rule is nothing more than a restatement of the basic principle that the defendant is entitled to summary judgment whenever the plaintiff fails to state a prima facie case.

Second, the *Technicolor* approach has significant settlement implications. Unlike poor old *Shlensky*, who was not even allowed up to bat, litigants suing under *Technicolor's* cart-before-the-horse formulation logically should be allowed to present evidence that the board failed to exercise due care.¹⁰⁷ This distinction has important procedural consequences. In *Shlensky*, plaintiff could not survive a motion to dismiss, while plaintiff in *McMullin* was able to do so.¹⁰⁸ Does that matter? Of course. As the probability increases that a cause of action will survive a motion to dismiss, both the probability that more such actions will be brought and the settlement value of such actions increase.

106. Granted, *Technicolor* does not mandate liability in the event that plaintiff carries its burden of showing a breach of fiduciary duty. Instead, per *Technicolor*, that showing merely shifts the burden to the defendant to show the entire fairness of the challenged transaction. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). Yet, the court's importation of the entire fairness standard into duty of care litigation is itself a highly problematic feature of the opinion. See DOOLEY, *supra* note 58, at 249-54 (criticizing the court for doing so). For a careful demonstration that *Technicolor's* importation of entire fairness into the duty of care was a doctrinal novelty, see Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787, 799-801 (1999). In my view, Johnson correctly concludes there is "no clear and reasoned prior authority" supporting *Technicolor* in this respect. *Id.* at 801.

107. *But see McMullin v. Beran*, 765 A.2d 910, 918 (Del. 2000) (holding that the directors are entitled to the protection of the business judgment rule unless the "effectively pled factual allegations" in the plaintiff's complaint "successfully rebut the procedural presumption" inherent in the rule).

108. Compare *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968), with *McMullin*, 765 A.2d at 915.

Finally, and most disturbingly, by opening the courthouse door to care questions at the outset of the litigation, *Technicolor* appeared to broaden the scope of judicial review of board decision making to reach not just the process by which the decision was made but also the substance of the directors' decision. *Technicolor* can be reconciled with the mainstream of business judgment rule analysis only by interpreting the duty of "due care" as being limited to the adequacy of the decision-making process. At several points in the opinion, the court in fact so characterized that duty.¹⁰⁹ Yet, this is a cramped and narrow definition of the duty of due care, which is more usually deemed to require some degree of substantive prudence.¹¹⁰ Asking whether a decision was made with reasonable care implicates not only the process by which the decision was reached but also whether the decision itself was the one the hypothetical reasonable person would have made.

III. FIRST PRINCIPLES: DIRECTOR PRIMACY AND THE TENSION BETWEEN AUTHORITY AND ACCOUNTABILITY

Shlensky and *Technicolor* offer radically different conceptions of the business judgment rule. Deciding between these competing conceptions requires us to go back to first principles. My thesis is that the corporation's governance system is properly characterized as a regime of director primacy.¹¹¹ In this model, the corporation is conceived as a vehicle by which the board of directors hires various factors of production. Consequently, directors are not mere agents of the shareholders. To the contrary, "the directors in the performance of their duty possess [the corporation's property], and act in every way as if they owned it."¹¹² It thus makes no sense to speak of the directors' powers as being delegated from the shareholders. Instead, as an old New York decision put it, the board's powers are "original and undelegated."¹¹³ The directors thus are Platonic guardians of a *sui*

109. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993) (holding that the duty of care requires that directors "act on an informed basis").

110. See *supra* text accompanying note 32.

111. This thesis was more fully developed in an earlier article. See Bainbridge, *Director Primacy*, *supra* note 11. For a critique of my director primacy model, see Wayne O. Hanewicz, *Director Primacy and Omnicare*, available at <http://www.law.ufl.edu/faculty/pdf/9-4-03hanew.pdf> (last visited Jan. 7, 2004). In my view, Professor Hanewicz provides a useful corrective in the following sense: The tension between authority and accountability that lies at the heart of corporate law is resolved on a case-by-case basis through a judicial (or, in some cases, legislative) determination as to whether the "locus of authority" should be shifted from the board to courts or shareholders and, if so, to what extent the board's authority should be circumscribed.

112. *Manson v. Curtis*, 119 N.E. 559, 562 (N.Y. 1918).

113. *Id.*

generis entity in which shareholders are but one of many contracting inputs.¹¹⁴

Yet, while directors are vested with wide powers to exercise their discretion by fiat, those powers are limited by their contractual obligations—both explicit and implied in law—to the factors of production with whom they contract.¹¹⁵ In American business law, one of these implied terms is the directors' obligation to maximize the wealth of its shareholders.¹¹⁶ A tension between authority and accountability thus arises. On the one hand, as developed below, the modern public corporation simply could not exist if directors lacked authority to exercise fiat.¹¹⁷ On the other hand, possession of that power by directors enables them to divert corporate profits from shareholders to themselves. A complete theory of the firm thus requires that the law balance the virtues of discretion against the need to require that discretion be used responsibly.¹¹⁸

The difficulty is that authority and accountability are ultimately antithetical: one cannot have more of one without also having less of the other.¹¹⁹ As Nobel laureate economist Kenneth Arrow explained, the power to hold to account is ultimately the power to decide.¹²⁰ Consequently, efforts to hold the board accountable

114. See PLATO, THE REPUBLIC 289-90 (Benjamin Jowett trans., 1991) (describing the education of philosopher-kings who rule "for the public good, not as though they were performing some heroic action, but simply as a matter of duty"). In *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988), former Delaware Chancellor William Allen opined: "The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters." Director primacy squarely rejects this claim. Bainbridge, *Director Primacy*, *supra* note 11, at 550-51.

115. Cf. FRANK H. EASTERBROOK & DANIEL R. FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 90-93 (1991) (explaining that corporate law fiduciary duties should be understood as gap-fillers designed to plug holes in the inherently incomplete contract between the corporation and shareholders).

116. The classic statement is the Michigan Supreme Court's famous remark that a "corporation is organized and carried on primarily for the profit of the stockholders." *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919). For a defense of the shareholder wealth maximization norm against critics who argue it is both normatively and descriptively inadequate, see Bainbridge, *Director Primacy*, *supra* note 11, at 574-92.

117. To be sure, some scholars have argued that with the corporation there exists "no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people." Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777 (1972); see also G. Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887, 947 (2000) (arguing that within a corporation "there is no primacy, no core, no hierarchy, no prominent participant, no firm, no fiduciary duty," but only a set of contracts among the enterprise's factors of production). I have explained elsewhere that this argument is erroneous. See Bainbridge, *supra* note 17, at 16-25 (discussing the role of fiat in corporate governance).

118. Dooley, *supra* note 9, at 464-71.

119. *Id.* at 470.

120. KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 78 (1974).

necessarily shift some of the board's decision-making authority to shareholders or judges. As we shall see in the next Part, the business judgment rule follows inexorably from this foundational principle. In this Part, we set the stage by developing the tension between authority and accountability in more detail.

A. *The Centrality of Fiat: Authority-Based Governance*

It is conventional in the law and economics literature to describe the corporation as a nexus of contracts between factors of production.¹²¹ Yet, public corporations function neither by the price mechanism of a market nor by participatory democracy. Instead, they are bureaucratic hierarchies in which decisions are made on a more-or-less authoritarian basis.¹²² Why? What survival advantages does a large corporation gain by being structured as a bureaucratic hierarchy? As I have explained elsewhere in more detail,¹²³ an answer is suggested by Ronald Coase's fundamental insight that corporate employees move from one department to another not in response to a change in relative prices, but because they are directed to do so.¹²⁴ Put another way, while markets allocate resources via the price mechanism, corporations do so via fiat—i.e., authoritative direction.¹²⁵ Accordingly, Coase explained, economic activity typically will occur within a firm when bargaining across a market is more costly than command-and-control.

At the top of the corporate hierarchy sits the board of directors. As the Delaware General Corporation Law puts it, the corporation's business and affairs "shall be managed by or under the direction of a

121. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1426-28 (1989); Thomas S. Ulen, *The Coasean Firm in Law and Economics*, 18 J. CORP. L. 301, 318-28 (1993). As no less an authority than former Delaware Chancellor William Allen has acknowledged, contractarianism is now the "dominant legal academic view." William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1400 (1993). For an argument that the corporation is better understood not as being a nexus but as having a nexus (i.e., the board of directors), see Bainbridge, *supra* note 17, at 16-24.

122. See ALFRED D. CHANDLER, JR., *THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS* 8 (1977) (observing that corporate hierarchies have proven to possess "a permanence beyond that of any individual or group of individuals who worked in them").

123. Bainbridge, *supra* note 17, at 18-20.

124. R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 35 (1988).

125. Drawing a distinction between across-market transactions and intra-firm transactions serves a useful pedagogic purpose, but is not a wholly accurate description of the real world, in which there is a wide array of choices falling between purely contractual relationships and the classical economic firm. See William A. Klein, *The Modern Business Organization: Bargaining Under Constraints*, 91 YALE L.J. 1521, 1523 (1982).

board of directors.”¹²⁶ Pursuant to this grant of authority, the vast majority of corporate decisions are made by the board of directors or by managers acting under delegated authority.¹²⁷ In practice, of course, many boards of directors are captured by the firm’s senior management and simply rubberstamp management decisions. This problem of management-captured boards is beyond the scope of this article, but is one I have addressed elsewhere.¹²⁸ As I explained there, modern boards tend to be considerably more independent of management than was the case several decades ago.¹²⁹ In addition, if push comes to shove, the board holds the legal trump card in its power to hire and fire management.¹³⁰

In any event, the key point is that a corporation’s constituencies—its human factors of production—have essentially no voice in corporate decision making. The chief distinguishing characteristic of the modern public corporation is the separation of ownership and control.¹³¹ Shareholders, who are said to “own” the firm,¹³² have virtually no power to control either its day-to-day operation or its long-term policies. Shareholders essentially have no power to initiate corporate action, for example, and are entitled to approve or disapprove only a very few board actions.¹³³ The statutory

126. DEL. CODE ANN. tit. 8, § 141(a) (2001). For a discussion of why the corporate hierarchy is topped by a committee rather than a single autocrat, see Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002).

127. Of course, operational decisions are normally delegated by the board to subordinate employees. The board, however, retains the power to hire and fire firm employees and to define the limits of their authority. Moreover, certain extraordinary acts may not be delegated, but are instead reserved for the board’s exclusive determination. See *Lee v. Jenkins Bros.*, 268 F.2d 357, 370 (2d Cir. 1959); *Lucey v. Hero Int’l Corp.*, 281 N.E.2d 266, 269 (Mass. 1972). Because of the delegation phenomenon, however, the term “decision” is used here as a semantic shorthand for a process that “does not consist of taking affirmative action on individual matters” but rather of “a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision.” Bayless Manning, *The Business Judgment Rule and the Director’s Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1494 (1984).

128. See BAINBRIDGE, *supra* note 5, at 205-06.

129. *Id.* at 206.

130. *Id.*

131. ALFOLD A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 84-89 (1932).

132. The corporation in fact is not a thing capable of being owned. Instead, per the most widely accepted theory of the corporation, the nexus of contracts model, the firm is a legal fiction representing a complex set of contractual relationships. Because shareholders are simply one of the inputs bound together by this web of voluntary agreements, ownership is not a meaningful concept under this model. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980).

133. Under the Delaware Code, shareholder voting rights are essentially limited to the election of directors and approval of charter or by-law amendments, mergers, sales of substantially all of the corporation’s assets, and voluntary dissolution. As a formal matter, only electing directors and amending the by-laws do not require board approval before shareholder

decision-making model thus is one in which the board acts and shareholders, at most, react.

The decision-making processes of modern public corporations thus bear a striking resemblance to the paradigm Kenneth Arrow called "authority." Arrow distinguishes authority from consensus, defining the latter as "any reasonable and acceptable means of aggregating [the] individual interests" of the organization's constituents.¹³⁴ American partnership law is a good example of a consensus-based decision-making structure.¹³⁵ In contrast, Arrow defines authority-based governance by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions that are binding on the whole.¹³⁶

According to Arrow, consensus-based governance systems work best when each decision maker has the same information and comparable interests.¹³⁷ In contrast, authority-based decision-making structures tend to arise where there are information asymmetries among potential decision makers and the decision makers have different interests.¹³⁸ With these criteria being specified, it should be self-evident that efficient corporate governance requires an authority-based decision-making structure.¹³⁹ At the very least, the obvious mechanical difficulties of achieving consensus amongst thousands of decision makers impede shareholders from taking an active role. Yet, even if those collective action problems could be overcome, active shareholder participation in corporate decision making would still be precluded by the intractable information asymmetries between the firm and its shareholders (and those among shareholders themselves), as well as by the shareholders' widely divergent interests.¹⁴⁰

action is possible. DEL. CODE ANN. tit. 8, §§ 109, 211 (2001). In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year's board. See generally Bayless Manning, Book Review, 67 YALE L.J. 1477, 1485-89 (1958) (describing incumbent control of the proxy voting machinery).

134. ARROW, *supra* note 120, at 69.

135. Dooley, *supra* note 9, at 466-67.

136. ARROW, *supra* note 120, at 68.

137. *Id.* at 69.

138. *Id.* at 70.

139. In case it is not, see Bainbridge, *Director Primacy*, *supra* note 11, at 554-59; Bainbridge, *supra* note 17, at 20-24.

140. Bainbridge, *supra* note 17, at 20-22.

B. *The Trade-Off Between Authority and Accountability*

Although authority is essential for organizational efficiency, it must be exercised responsibly.¹⁴¹ Because human cognitive powers are limited and subject to being overwhelmed by information flows, unaccountable authority is likely to make unnecessary errors.¹⁴² More pertinent for our purposes, unaccountable authority may be exercised opportunistically. The central decision maker may divert organizational resources to its own benefit rather than the good of the organization and its constituents.

In the corporate setting, the potential for opportunism arises because of the very separation of ownership and control that makes the corporate form feasible.¹⁴³ When the directors hire equity capital from shareholders, the directors undertake a contractual obligation to maximize the value of the shareholders' residual claim on the corporation's assets.¹⁴⁴ Like most of corporate law, this obligation is implied in law, rather than expressed in formal contracts, of course, but as I have argued elsewhere in more detail, there seems little doubt that shareholder wealth maximization is the majoritarian default that emerges when one brings the hypothetical bargain methodology to bear on the question.¹⁴⁵ Because shareholders exercise so little direct control over the board of directors, however, shareholders have

141. ARROW, *supra* note 120, at 73.

142. *Id.* at 74-75.

143. See BERLE & MEANS, *supra* note 131, at 6 ("The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge and where many of the checks which formerly operated to limit the use of power disappear.").

144. See *supra* note 116 and accompanying text (discussing the shareholder wealth maximization norm).

145. See *supra* note 116. See generally Bainbridge, *Director Primacy*, *supra* note 11, at 577-84 (explaining the hypothetical bargain methodology used in contractarian law and economics and applying it to the corporate context). As I have summarized the methodology elsewhere:

If corporate law consists mainly of default rules, corporate statutes and decisions can be viewed as a standard form contract voluntarily adopted—perhaps with modifications—by the corporation's various constituencies. The point of a standard form contract, of course, is to reduce bargaining costs. Parties for whom the default rules are a good fit can take the default rules off the rack, without having to bargain over them. Parties for whom the default rules are inappropriate are free to bargain out of the default rules.

In selecting the appropriate default rule, we therefore perform a thought experiment: "If the parties could costlessly bargain over the question, which rule would they adopt?" To answer that question we draw on both experience and economic analysis. Once we figure out a plausible majoritarian default, we adopt that hypothetical bargain as the corporate law default rule. Doing so reduces transaction costs and therefore makes firms more efficient.

BAINBRIDGE, *supra* note 5, at 420. See generally *id.* at 29-31 (providing a more extensive explanation).

minimal ability to prevent directors from appropriating corporate assets that should have gone into the residue against which the shareholders have their claim.

Director opportunism is not limited to instances of intentional self-dealing. Instead, it can extend to such other forms of "shirking" as negligence, oversight, incapacity, and even honest mistakes.¹⁴⁶ But while the business judgment rule does not protect directors who have engaged in self-dealing,¹⁴⁷ it does protect those who make errors of judgment, even when those errors rise to the level of negligence.¹⁴⁸

Why does the business judgment rule create this obstacle to director accountability? If tort liability for negligence encourages people to be careful,¹⁴⁹ after all, judicial review of board decisions presumably would likewise encourage directors to be careful. That we do not expose director decisions to judicial scrutiny absent self-dealing suggests that the law finds a value in the board's authority that might be lost if director decisions were routinely subject to review.

The source of that value is found in Arrow's observation that the power to hold to account is ultimately the power to decide.¹⁵⁰ Arrow explains:

[Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.¹⁵¹

As a result, the board cannot be made more accountable without shifting some of its decision-making authority to shareholders or judges.

Does this analysis mean that the board should have unfettered authority? No. In some cases, accountability concerns become so pronounced that they trump the general need for deference to the

146. Dooley, *supra* note 9, at 465.

147. See *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944) (holding that "[t]he 'business judgment rule,' however, yields to the rule of undivided loyalty. This great rule of law is designed 'to avoid the possibility of fraud and to avoid the temptation of self-interest.' " (citations omitted)).

148. See *supra* note 34 and accompanying text.

149. The rhetorical power of the analogy to tort liability fails, of course, if the threat of tort liability does not in fact encourage optimal care taking. Given cognitive biases in how actors assess the risk of liability and juries determine liability, plus the availability of both first- and third-person insurance, the assumption that tort liability encourages due care seems quite heroic. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 296-98 (2d ed. 1997) (discussing implications of cognitive biases and insurance for efficiency of tort system and tentatively concluding that tort system nevertheless may be efficient).

150. ARROW, *supra* note 120, at 78.

151. *Id.*

board's authority. Once again, I turn to Arrow: "To maintain the value of authority, it would appear that [accountability] must be intermittent. This could be periodic; it could take the form of 'management by exception,' in which authority and its decisions are reviewed only when performance is sufficiently degraded from expectations" ¹⁵²

Establishing the proper mix of deference and accountability thus emerges as the central problem in applying the business judgment rule to particular situations. Given the significant virtues of discretion, however, one must not lightly interfere with management or the board's decision-making authority in the name of accountability. Preservation of managerial discretion should always be the null hypothesis.

IV. JUSTIFYING ABSTENTION: WHY *SHLENSKY* GOT IT RIGHT AND *TECHNICOLOR* DIDN'T

In the director primacy model, as sketched out in the prior Part, the business judgment rule is justified precisely because judicial review threatens the board's authority. ¹⁵³ This understanding of the rule's role is consistent with a passage from the Delaware Supreme Court's famed *Van Gorkom* decision that has received less attention than it deserves:

Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in [Delaware General Corporation Law] § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors. . . . The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. ¹⁵⁴

In other words, the rule ensures that the null hypothesis is deference to the board's authority as the corporation's central and final decision maker.

Critics of the foregoing analysis likely would concede that judicial review shifts some power to decide to judges, but contend that that observation is normatively insufficient. To be sure, they might posit, centralized decision making is an essential feature of the corporation. Judicial review could serve as a redundant control on board decision making, however, without displacing the board as the primary decision maker.

152. *Id.*

153. See Dooley, *supra* note 9, at 469-76 (analyzing the business judgment rule in an Arrow-based model).

154. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

An analogy to engineering concepts may be useful. If a mechanical system is likely to fail, and its failure is likely to entail high costs, basic engineering theory calls for redundant controls to prevent failure. It would be naive to assume that markets fully constrain director behavior.¹⁵⁵ Why then is judicial review not an appropriate redundant control? If we assume that corporate law is generally efficient, the losses tolerated by judicial abstention must be outweighed by benefits elsewhere in the system. In this Part, I identify the likely sources of those benefits.

A. Encouraging Risk Taking

In the American Law Institute's *Principles of Corporate Governance*, a quasi-Restatement of corporate law,¹⁵⁶ the drafters justify the business judgment rule as being necessary to protect "directors and officers from the risks inherent in hindsight reviews of their business decisions" and to avoid "the risk of stifling innovation and venturesome business activity."¹⁵⁷ This claim cannot be a complete explanation of the business judgment rule. Duty of care litigation, after all, probably does far less to stifle innovation and business risk taking than does product liability and securities fraud litigation, but no equivalent of the business judgment rule exists in the latter contexts.¹⁵⁸ Even so, however, encouraging optimal risk taking is part of the story.

As the firm's residual claimants, shareholders do not get a return on their investment until all other claims on the corporation

155. Professor Ronald Gilson argues that where markets constrain management's behavior one would not expect courts "to provide redundant controls." Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 839 (1981). The business judgment rule thus "operates to har courts from providing additional, and unnecessary, constraints on management discretion through judicial review of operating decisions." *Id.*

156. See William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 898 (1993) (opining that "[t]he final approval of the American Law Institute's (ALI) *Principles of Corporate Governance: Analysis and Recommendations* . . . represents the culmination of the most controversial event in the history of American corporate law.").

157. ALI PRINCIPLES, *supra* note 101, § 4.01 cmt. d. Professor Dooley persuasively argues that the ALI Principles' version of the business judgment rule on grounds is flawed, inter alia, because it in fact encourages intrusive substantive review of business decisions. Dooley, *supra* note 9, at 471-86.

158. The latter types of litigation may be desirable to force corporations to internalize certain costs imposed on outsiders by negative externalities associated with corporate conduct, of course, while we shall see that shareholders would not wish to force directors to internalize all costs borne by shareholders. See BAINBRIDGE, *supra* note 5, at 257-58 (developing this externalities argument in comparing these shareholder litigation to other causes of action).

have been satisfied.¹⁵⁹ All else equal, shareholders therefore prefer high return projects.¹⁶⁰ Because risk and return are directly proportional, however, implementing that preference necessarily entails choosing risky projects.¹⁶¹

Even though conventional finance theory assumes shareholders are risk averse,¹⁶² rational shareholders still will have a high tolerance for risky corporate projects. First, the basic corporate law principle of limited liability substantially insulates shareholders from the downside risks of corporate activity.¹⁶³ The limited liability principle, of course, holds that shareholders of a corporation may not be held personally liable for debts incurred or torts committed by the firm.¹⁶⁴ Because shareholders thus do not put their personal assets at jeopardy, other than the amount initially invested, they effectively externalize some portion of the business' total risk exposure to creditors.¹⁶⁵

159. DOOLEY, *supra* note 58, at 33.

160. See WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE* 258-60 (8th ed. 2002) (comparing creditor and shareholder risk preferences).

161. See *id.* at 259 (explaining why "common shareholders might be better off with the riskier investment").

162. *Id.* at 236.

163. Indeed, it is this very insulation that motivates most critics of corporate limited liability. See, e.g., Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1414-15 (1993) (arguing that "[t]hanks to limited liability, shareholders can fund the activities of large corporations, receive dividends and capital gains on their investments, and yet remain immune to some of the costs of misconduct or misjudgment by their corporate agents."); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1882 (1991) (arguing that limited liability, *inter alia*, creates an "incentive . . . for the shareholder to direct the corporation to spend too little on precautions to avoid accidents"). For a defense of limited liability against such critiques, see BAINBRIDGE, *supra* note 5, at 132-51.

164. See, e.g., MODEL BUS. CORP. ACT ANN. § 6.22 (2002) (stating that "[u]nless otherwise provided in the articles of incorporation, a shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct."). The limited liability rule, of course, is subject to the equitable exception most commonly known as "piercing the corporate veil." See generally BAINBRIDGE, *supra* note 5, at 151-71 (discussing veil piercing and related doctrines); CLARK, *supra* note 58, at 71-85 (same); GEVURTZ, *supra* note 28, at 69-111 (same).

165. To be sure, creditors could protect themselves *ex ante* either by negotiating contractual limitations on corporate behavior, such as restrictions on the types of projects in which the firm may invest, or by negotiating for a share of the up-side, such as through the use of convertible debt securities. See KLEIN & COFFEE, *supra* note 160, at 257 (noting that in risky debt transactions "substantial constraints on the firm's freedom of action are likely to be imposed by the terms of the loan agreement or by the covenants" in a bond indenture). The utility of such devices, however, is vitiated by the inherently incomplete nature of such contractual provisions and the resulting room for *ex post* opportunism by the shareholders. See *id.* at 258 (explaining why drafting workable contractual protections is "not feasible"). Alternatively, creditors can force shareholders to internalize those risks by charging a higher interest rate that compensates the creditor for the higher risk of default. Cf. *id.* at 235-36 (discussing why borrowers must

Second, shareholders can largely eliminate firm-specific risk by holding a diversified portfolio.¹⁶⁶ Accordingly, although investors are risk averse and therefore demand a risk premium when investing,¹⁶⁷ that premium will only reflect certain risks.¹⁶⁸ Modern portfolio theory distinguishes systematic risks from unsystematic risks.¹⁶⁹ Unsystematic risks are those specific to a particular firm, such as the risk that the CEO will have a heart attack, the firm's workers will go out on strike, or the plant will burn down.¹⁷⁰ Systematic risks are those that are general to the market as a whole and thus affect all firms to one degree or another, such as changes in market interest rates or the prevailing economic climate.¹⁷¹ Investors can eliminate unsystematic risk by diversifying their portfolio, because things tend to come out in the wash.¹⁷² If one firm's plant burns down, another will hit oil, and so on.¹⁷³ In contrast, no matter how well investors diversify their portfolios, they cannot eliminate systematic risk, because it affects all stocks.¹⁷⁴ Consequently, according to modern portfolio theory, while investors must be compensated for bearing systematic risk, they need not be compensated for bearing unsystematic risk.¹⁷⁵ Returns on specific investments therefore differ not because the

compensate creditors for bearing risk). Indeed, the distinguishing characteristic of voluntary creditors (as opposed to involuntary creditors) is that they can allow for the risk of default in the initial contract with the corporation. BAINBRIDGE, *supra* note 5, at 146 (noting that "contract creditors can protect themselves by bargaining with the controlling shareholder and obtaining a modification of the default rule"). Lenders, for example, factor in the risk of default in calculating the interest rate. *See id.* at 148 (noting that "[t]rade creditors concerned about limited liability should simply raise their interest rates or refuse to transact except on a cash basis."). Thus, it matters little to the lender if an individual corporation goes bankrupt (assuming diversification of risk). While the lender will sustain a loss as a result of the transaction with the bankrupt corporation, it will recoup that loss through the interest rate it receives from other borrowers. In this way, voluntary creditors pass on the risk of default to the shareholders, even in a system of limited liability. *See id.* at 146 (concluding that limited liability is based on "an efficient general presumption about the allocation of risks between shareholders and creditors").

166. RONALD J. GILSON & BERNARD S. BLACK, (SOME OF THE) ESSENTIALS OF FINANCE AND INVESTMENT 95-97 (1993).

167. *See* KLEIN & COFFEE, *supra* note 160, at 233-35 (describing the risk premium as the difference in the rate of return paid on a risky investment and the rate of return on a risk-free investment).

168. *See generally* DOOLEY, *supra* note 58, at 88-97 (discussing portfolio theory).

169. *See generally* GILSON & BLACK, *supra* note 166, at 96-97 (discussing and defining these categories of risk).

170. *Id.* at 97.

171. *Id.* at 96.

172. *Id.* at 97.

173. *Id.*

174. *Cf. id.* at 96 (defining systematic risk as the risk that "remains after full diversification").

175. DOOLEY, *supra* note 58, at 90; GILSON & BLACK, *supra* note 166, at 95-97.

corporations involved have differing levels of firm-specific risk, but rather because firms differ insofar as their sensitivity to systematic risk is concerned.¹⁷⁶ The Capital Asset Pricing Model (CAPM) uses the well-known beta coefficient to measure that relative sensitivity to systematic risk.¹⁷⁷

Given limited liability and diversification, rational shareholders should be indifferent to changes in corporate policies that merely alter exposure to unsystematic risks. Instead, they should focus on (and prefer) policies that portend a higher rate of return by increasing the firm's beta. In contrast, rational corporate managers—and, to a lesser extent, directors—should be risk averse with respect to such policies. Corporate managers typically have substantial firm-specific human capital.¹⁷⁸ Unfortunately for such managers, however, the risks inherent in firm-specific capital investments cannot be reduced by diversification; managers obviously cannot diversify their human capital among a number of different firms.¹⁷⁹ As a result, managers will be averse to risks shareholders are perfectly happy to tolerate.¹⁸⁰

The diversion of interests as between shareholders and managers will be compounded if managers face the risk of legal liability, on top of economic loss, in the event a risky decision turns out badly. Business decisions rarely involve black-and-white issues; instead, they typically involve prudential judgments among a number

176. GILSON & BLACK, *supra* note 166, at 97 (asserting that the value of stock or any other asset “should depend only on systematic risk”).

177. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 195 (7th ed. 2003). CAPM is somewhat controversial in the finance literature. *See id.* at 198-203 (discussing critiques of CAPM). It remains more-or-less the state of the art in the legal community, however, being especially widely used in valuation proceedings. *See, e.g.,* Hintmann v. Fred Weber, Inc., No. 12839, 1998 WL 83052 (Del. Ch. Feb. 17, 1998) (using CAPM to determine cost of equity capital); Le Beau v. M.G. Bancorp., Inc., 1998 WL 44993 (Del. Ch. Jan. 29, 1998) (using CAPM to determine the discount rate), *aff'd*, 737 A.2d 513 (Del. 1999); Gilbert v. MPM Enters., Inc., 709 A.2d 663 (Del. Ch. 1997) (using CAPM to determine cost of equity capital), *aff'd*, 731 A.2d 790 (Del. 1999); Ryan v. Tad's Enters., Inc., 709 A.2d 682 (Del. Ch. 1996) (using CAPM to determine discount rate), *aff'd*, 693 A.2d 1082 (Del. 1997).

178. Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L.Q. 403, 414 (2001) (explaining that “employees and managers often make large investments in firm-specific human capital”); Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1245 (2002) (explaining that “[m]anagers generally make large firm-specific human capital investments in their firms and thus are risk-averse”).

179. Sanford M. Jacoby, *Employee Representation and Corporate Governance: A Missing Link*, 3 U. PA. J. LAB. & EMP. L. 449, 452 (2001) (observing that “institutional investors have large, diversified portfolios whereas managers' assets are less diversified due to a heavy investment in firm-specific human capital and in the stock of the company that employs them”).

180. Gordon, *supra* note 178, at 1245; Jacoby, *supra* note 179, at 452.

of plausible alternatives.¹⁸¹ Given the vagaries of business, moreover, even carefully made choices among such alternatives may turn out badly.¹⁸²

At this point, the well-known hindsight bias comes into play.¹⁸³ Decision makers tend to assign an erroneously high probability of occurrence to a probabilistic event simply because it ended up occurring.¹⁸⁴ If a jury knows that the plaintiff was injured, the jury will be biased in favor of imposing negligence liability even if, viewed *ex ante*, there was a very low probability that such an injury would occur and taking precautions against such an injury was not cost effective.¹⁸⁵ Even where duty of care cases are tried without a jury, as in Delaware,¹⁸⁶ judges who know with the benefit of hindsight that a business decision turned out badly likewise could be biased towards finding a breach of the duty of care.¹⁸⁷

Hence, there is a substantial risk that suing shareholders and reviewing judges will be unable to distinguish between competent and negligent management because bad outcomes often will be regarded, *ex post*, as having been foreseeable and, therefore, preventable *ex ante*.¹⁸⁸ If liability results from bad outcomes, without regard to the *ex*

181. James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1232 (1988).

182. *Cf. In re Limited, Inc.*, Civ. A. No. 17148-NC, 2002 WL 537692, at *9 (Del. Ch. Mar. 27, 2002) (explaining that the fact that plaintiff "identifies viable alternatives to the Board's decision here is not enough—it is precisely this kind of judicial after-the-fact evaluation that the business judgment rule seeks to prevent").

183. In a valuation proceeding, Delaware's Vice Chancellor Leo Strine explained:

The possibility of hindsight bias and other cognitive distortions seems untenably high. Consider this analogy. Suppose there was an interview with Sir George Martin from 1962 in which he opined as to how many number one songs he thought would be released by his new proteges, the Beatles. Could one fast-forward to 1971, interview Martin, and revise Martin's earlier projection in some reliable way, recognizing that Martin would have known the correct answer as of that date? How could Martin provide information that would not be possibly influenced in some way by his knowledge of the actual success enjoyed by the Beatles and his recollection of his earlier projection?

Agranoff v. Miller, 791 A.2d 880, 892 (Del. Ch. 2001).

184. Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1523 (1998).

185. *Id.* at 1523-27. For a useful analysis relating the hindsight bias to the business judgment rule, see Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 OR. L. REV. 587 (1994).

186. See DEL. CONST. art. IV, § 10 (providing that the Chancery court sits without a jury).

187. *Cf. Chris Guthrie et al., Inside the Judicial Mind*, 86 CORNELL L. REV. 777, 799-805 (2001) (discussing empirical evidence that judicial decision making is tainted by the hindsight bias). See generally *infra* Part IV.B (discussing judicial decision-making errors and biases).

188. In *Joy v. North*, 692 F.2d 880, 885-86 (2d Cir. 1982), Judge Ralph Winter explained: [C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are

ante quality of the decision or the decision-making process, however, managers will be discouraged from taking risks.¹⁸⁹ If it is true that “lack of gumption is the single largest source of agency costs,”¹⁹⁰ rational shareholders will disfavor liability rules discouraging risk taking.

This analysis suggests that rational shareholders would be willing to precommit by contract to refrain from challenging the reasonableness of managerial business decisions. Obviously, however, the practicalities of running a large corporation with fluid stock ownership preclude effecting such a policy by contract.¹⁹¹ The business judgment rule thus may be seen as providing a default off-the-rack rule that both shareholders and managers would prefer, as Judge Ralph Winter opined in *Joy v. North*:

Although the rule has suffered under academic criticism, it is not without rational basis. . . . [B]ecause potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. . . . Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. . . . A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.¹⁹²

not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

See also Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 574 (1998) (arguing that “in corporate law, the business judgment rule protects corporate officers and directors from liability for negligent business decisions because, in part, of the tendency for adverse outcomes to seem inevitable”).

189. Cf. Arkes & Schipani, *supra* note 185, at 624 (suggesting that “retrospective evaluation of business decisions might discourage highly qualified people from serving on boards of directors”).

190. EASTERBROOK & FISCHER, *supra* note 115, at 99.

191. See *supra* note 145 (discussing the hypothetical bargain methodology). The contractual nature of the business judgment rule is implied by Judge Winter's argument that:

Investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers. Nor need investors buy stock in particular corporations. In the exercise of what is genuinely a free choice, the quality of a firm's management is often decisive and information is available from professional advisors. Since shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.

Joy, 692 F.2d at 885.

192. *Id.* at 885-86 (footnotes omitted). Or, as Chancellor Allen similarly observed in *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (emphasis omitted):

Shareholders can 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

Hence, judges should abstain from reviewing the substantive merits of business decisions. When courts review the objective merits of a board decision, as some variants of the standard of review conception allow,¹⁹³ they effectively penalize “the choice of seemingly riskier alternatives.”

Although Winter’s analysis is compelling, it nevertheless is incomplete in several important respects. First, Winter’s argument cannot be a complete explanation for the business judgment rule because it assumes that negligence by corporate directors must be a form of unsystematic risk. It must be so, because such negligence could not be diversified away otherwise. If so, however, why is neither fraud nor illegality on the part of such directors also a form of unsystematic risk? Just as a shareholder could protect herself against bad decisions, so could a shareholder protect herself against fraudulent decisions. Yet, the business judgment rule has never protected directors who commit fraud or self-dealing.¹⁹⁴

Second, the analysis thus far has fudged the distinction between directors and managers. To be sure, some commentators contend that directors have the same incentives for risk aversion as managers. As Chancellor Allen explained in *Gagliardi v. Trifoods International, Inc.*:

Corporate directors of public companies typically have a very small proportionate 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 . . . , their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of 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.¹⁹⁵

Allen likely is correct, but it is doubtful whether outside directors make substantial investments in firm-specific human capital. At the

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.

193. See *supra* notes 43-44 and accompanying text.

194. See *supra* note 80 and accompanying text.

195. 683 A.2d 1049, 1052 (Del. Ch. 1996).

same time, it has become very common for public corporations to require that newly appointed directors purchase substantial blocks of the corporation's shares or compensate directors in the corporation's stock, which practice has been empirically linked to improved corporate performance, probably by aligning director and shareholder interests.¹⁹⁶ Hence, outside directors may not be quite as risk averse as inside directors and other managers. Indeed, to the contrary, the incentives of outside directors may well be somewhat closer to shareholder preferences than to those of managers.

Finally, encouraging risk taking must be deemed an incomplete explanation because it fails to account for many of the rule's applications. Consider, for example, the business decision made in *Shlensky*. Was Wrigley an innovator making a venturesome business decision or an eccentric coot who was just behind the times? How can we know when the business judgment rule precluded Shlensky from even getting up to bat?¹⁹⁷ In sum, encouraging risk taking is part of the story, but only part. Something else is going on as well.

B. Judges Are Not Business Experts

In *Dodge v. Ford Motor Co.*, the Michigan Supreme Court famously invoked the business judgment rule in refusing to enjoin Henry Ford's plans to expand production.¹⁹⁸ As justification for its decision, the court modestly observed that "*The judges are not business experts.*"¹⁹⁹ Although we shall see that this too is an incomplete explanation for the business judgment rule at best, it has somewhat more plausibility than it is usually given in the literature.²⁰⁰

196. See generally Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999) (discussing trends in director stock ownership); Charles M. Elson, *Director Compensation and the Management-Captured Board: The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996) (same).

197. Alternatively, consider the business judgment rule's role in precluding shareholder derivative litigation. Although some scholars regard decisions about pursuing specific litigation as being more appropriate for judicial review than ordinary business decisions, the business judgment rule substantially insulates such decisions from judicial review. See, e.g., John C. Coffee & Donald Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261, 280-84 (1981).

198. 170 N.W. 668, 684 (Mich. 1919) (noting that "[w]e are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company.").

199. *Id.* (emphasis added).

200. For criticism of this explanation of the rule, see Davis, *supra* note 4, at 581 (arguing that "judges should find it far easier to overcome the barrier of expertise and stand in the shoes of outside directors than in those of almost any of the other professionals whose actions courts are routinely called upon to review"); Greenfield & Nilsson, *supra* note 14, at 825-26 (suggesting that "[t]his rationale . . . seems more than a little disingenuous."); and Dale A. Oesterle & Alan

A modern version of this rationale can be constructed by building on the burgeoning insights for legal analysis of cognitive psychology and behavioral economics.²⁰¹ The rational choice model of neoclassical economics not only assumes that individuals act so as to maximize their expected utility, but also acknowledges no limits on their cognitive power so to do.²⁰² In contrast, behavioral economics contends that the limitations of human cognition often result in decisions that fail to maximize utility.²⁰³ These limitations are bundled in the concept of “bounded rationality,” which describes the inherent limits on the ability of decision makers to gather and process information.²⁰⁴ All humans have inherently limited memories, computational skills, and other mental tools, for example.²⁰⁵

Under conditions of uncertainty and complexity, boundedly rational decision makers are unable to devise either a fully specified solution to the problem at hand or fully assess the probable outcomes of their action.²⁰⁶ In effect, cognitive power is a scarce resource, which the inexorable laws of economics tell us decision makers will (to the best of their ability) seek to allocate efficiently. Consistent with that prediction, there is evidence that actors attempt to minimize effort in the face of complexity and ambiguity.²⁰⁷

As applied to judicial decision making, the inherent cognitive limitations implied by bounded rationality are reinforced both by the incentive structures familiar from agency cost economics and the well-known institutional constraints on adjudication (such as the necessity in many courts of general jurisdiction to provide speedy trials for criminal defendants).²⁰⁸ In addition, of course, there is the problem of

R. Palmiter, *Judicial Schizophrenia in Shareholder Voting Cases*, 79 IOWA L. REV. 485, 572 (1994) (dismissing this rationale as an “old adage”). For a defense, see Manning, *supra* note 127, at 1491 (arguing that lawyers and judges favor a mode of linear thinking inapplicable to business decision making).

201. For an anthology of essays on behavioral economics that provides a good introduction to the field, see generally CASS R. SUNSTEIN, *BEHAVIORAL LAW AND ECONOMICS* (2000).

202. Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1075 (2000).

203. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 45-46 (1985) (quoting Herbert Simon to the effect that economic actors are “intendedly rational, but only limitedly so”).

204. See generally PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 127-29 (1992) (defining the concept mostly by examples).

205. Jolls et al., *supra* note 184, at 1477.

206. See OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 23 (1975) (under conditions of uncertainty and complexity, it becomes “very costly, perhaps impossible, to describe the complete decision tree”).

207. See Korobkin & Ulen, *supra* note 202, at 1078 (citing studies).

208. See generally Stephen M. Bainbridge & Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51

hindsight bias discussed above.²⁰⁹ Under such conditions, judges will shirk—i.e., look for ways of deciding cases with minimal effort.²¹⁰

An actor can economize limited cognitive resources in two ways. First, he may adopt institutional governance structures designed to promote more efficient decision making.²¹¹ Second, he may invoke shortcuts; i.e., heuristic problem-solving decision-making processes.²¹² Is the business judgment rule an example of the latter tactic? When one considers the ease with which the *Shlensky* court disposed of the plaintiff's claims, the idea seems not wholly implausible.

Business decisions are frequently complex and made under conditions of uncertainty. Accordingly, bounded rationality and information asymmetries counsel judicial abstention from reviewing board decisions. Judges likely have less general business expertise than directors. They also have less information about the specifics of the particular firm in question. Consider the *Shlensky* court's discussion of possible effects of putting lights in Wrigley Field.²¹³ The court seems to be acknowledging the limits of its knowledge. Finally, most judges only rarely face business judgment issues. Most judges likely arrive on the bench with little expertise in corporate law and, equally likely, have little incentive to develop substantial institutional expertise in this area after they arrive. Because the legal and business issues are complex, and because judges are as subject as anyone to the cognitive limitations implied by bounded rationality, they have an incentive to duck these cases. In Eric Posner's useful phrase, many judges are "radically incompetent":²¹⁴

[C]ourts have trouble understanding the simplest of business relationships. This is not surprising. Judges must be generalists, but they usually have narrow backgrounds in a particular field of the law. Moreover, they often owe their positions to political

EMORY L.J. 83 (2002) (discussing constraints and incentives that impact judicial decision making).

209. See *supra* notes 183-189 and accompanying text.

210. The claim is not that judges do not work hard. Bainbridge & Gulati, *supra* note 208, at 106. The claim is only that judges have incentives to "delegate opinions to the clerks and focus their own attention on making sure that the opinions are 'good enough' so as to avoid negative attention." *Id.* at 109.

211. WILLIAMSON, *supra* note 203, at 46.

212. *Id.* For claims that judges make use of decision-making heuristics, see Bainbridge & Gulati, *supra* note 208, at 112 (arguing that "the use of shortcuts by the courts is neither a new phenomenon nor one unique to securities doctrine"); and Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 905 (2002) (arguing that "judges find ways to meet the demands of their jobs" by using "shortcuts, or heuristics").

213. See *supra* notes 86-89 and accompanying text.

214. Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 754 (2000).

connections, not to merit. Their frequent failure to understand transactions is well-documented. One survey of cases involving consumer credit, for example, showed that the judges did not even understand the concept of present value. . . . Skepticism about the quality of judicial decisionmaking is reflected in many legal doctrines, including the business judgment rule in corporate law, which restrains courts from second-guessing managers and directors²¹⁵

Although this line of analysis has considerable traction, it too cannot be a complete explanation for the business judgment rule. In the first instance, business is not the only context in which judges are called upon to review complex issues arising under conditions of uncertainty. Reviewing Wrigley's refusal to install lights strikes many as no more onerous than reviewing medical or product design decisions.²¹⁶ Yet, no "medical judgment" or "design judgment" rule precludes judicial review of malpractice or product liability cases.²¹⁷ Something else must be going on.

In the second instance, Posner overlooks both the pervasive role Delaware plays in business judgment rule jurisprudence and the unique incentive structure in which Delaware courts function.²¹⁸ The rationality of Delaware chancellors is bounded—just like that of everyone else.²¹⁹ Like all judges, moreover, Delaware chancellors face significant resource constraints, especially with respect to the time available for decision making.²²⁰ In contrast to judges in other states, however, Delaware chancellors frequently have considerable prior corporate experience as practitioners.²²¹ Once on the bench, there is a

215. *Id.* at 758 (footnote omitted).

216. See, e.g., EASTERBROOK & FISCHER, *supra* note 115, at 94 (asking why "the same judges who decide whether engineers have designed the compressors on jet engines properly . . . cannot decide whether a manager negligently failed to sack a subordinate who made improvident loans").

217. See Arkes & Schipani, *supra* note 185, at 613-17 (noting the disparity of treatment of business and medical decisions).

218. On Delaware's dominance, see BAINBRIDGE, *supra* note 5, at 16; GEVURTZ, *supra* note 28, at 42-43. For a good analysis of the contribution the Delaware Chancery Court makes to Delaware's dominance, see Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000). See also William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 BUS. LAW. 351 (1992) (providing an appreciation of the chancery court's prominence); E. Norman Veasey, *The National Court of Excellence*, 48 BUS. LAW. 357 (1992) (same).

219. See Bainbridge & Gulati, *supra* note 208, at 149, on which the following discussion draws.

220. Time constraints are particularly significant for the chancery court's members due to the longstanding norm in that court of deciding corporate law cases on an expedited basis. See Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683, 704-05 (1992) (describing chancery court's goal of responsiveness).

221. See William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery—1792-1992*, 18 DEL. J. CORP. L. 819, 841-65 (1993) (describing in exhaustive detail the backgrounds of Delaware's 20th Century chancellors).

substantial pay-off for Delaware chancellors who continue to master corporate law. Delaware chancellors sit at “the center of the corporate law universe.”²²² Unlike other courts, which face corporate cases only episodically, such cases make up a very high percentage of the Delaware chancellors’ docket. The frequency with which they face such cases provides a strong incentive for Delaware’s chancellors to master both doctrine and the business environment in which the doctrine works.²²³ In particular, there is a strong reputational incentive to do so. Sitting without juries in a court of equity, Delaware chancellors put their reputation on the line whenever they make a decision.²²⁴ Because so many major corporations are incorporated in Delaware,²²⁵ chancery court cases are often high profile and the court’s decisions therefore are subject to close scrutiny by the media, academics, and practitioners. The reputation of a Delaware chancellor thus depends on his or her ability to decide corporate law disputes quickly and carefully.

For these reasons, the adage that “judges are not business experts” cannot be a complete explanation for the business judgment rule. Yet, many old adages have more than a grain of truth. So too does this one. Justice Jackson famously observed of the Supreme Court: “We are not final because we are infallible, but we are infallible only because we are final.”²²⁶ Neither courts nor boards are infallible, but someone must be final. Otherwise, we end up with a never-ending process of appellate review. The question then is simply who is better suited to be vested with the mantle of infallibility that comes by virtue of being final—directors or judges?

222. D. Gordon Smith, *Chancellor Allen and the Fundamental Question*, 21 SEATTLE U. L. REV. 577, 578 (1998).

223. Cf. Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 BROOK. L. REV. 1, 37 (1995) (arguing that “[c]ases cannot be adjudicated any more efficiently than Delaware is currently adjudicating them.”); Fisch, *supra* note 218, at 1078 (opining that “Delaware chancery judges are known for their expertise in business matters, and the court has developed a reputation for its sophistication in corporate law”); Greenfield & Nilsson, *supra* note 14, at 825 (arguing that “the Delaware Supreme Court displays a marked ability to address business decisions in a very detailed way. This ability undermines the notion . . . that courts are incapable of such analysis.”).

224. See Rehnquist, *supra* note 218, at 352-53 (observing that “because no juries exist in equity, a chancellor is even more personally responsible for the quality of justice than a traditional ‘law judge’”).

225. See Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 737 (2001) (noting that “[f]or many years, Delaware has been chosen as the state of incorporation by more than half of all Fortune 500 companies and more than 45 percent of New York Stock Exchange listed companies.”).

226. *Brown v. Allen*, 344 U.S. 443, 540 (1953) (Jackson, J., concurring).

Corporate directors operate within a pervasive web of accountability mechanisms. A very important set of constraints are provided by competition in a number of markets.²²⁷ The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by directors and managers.²²⁸ Granted, only the most naïve would assume that these markets perfectly constrain director decision making.²²⁹ It would be equally naïve, however, to ignore the lack of comparable market constraints on judicial decision making. Market forces work an imperfect Darwinian selection on corporate decision makers, but no such forces constrain erring judges.²³⁰ As such, rational shareholders will prefer the risk of director error to that of judicial error. Hence, shareholders will want judges to abstain from reviewing board decisions.²³¹

The shareholders' preference for abstention, however, extends only to board decisions motivated by a desire to maximize shareholder wealth. Where the directors' decision is motivated by considerations other than shareholder wealth, as where the directors engage in self-dealing or seek to defraud the shareholders, however, the question is no

227. See *supra* note 155 (noting potential for market constraints).

228. See Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 303-06, 315 (1988) (arguing that "[c]ompetition in capital markets, product markets, and the market for corporate control all induce managers and directors of public corporations to act in ways consonant with shareholder welfare."); Mark J. Roe, *German Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167, 181 (identifying the "principal monitoring mechanisms" as "market competition (in capital and product markets), takeovers, a good board of directors, and a concentrated shareholder").

229. A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 21 (2003) (opining that although "market restraints" should "induce directors to make decisions . . . that are in the best interests of the business," markets "generally will not curb directorial misconduct—especially when firms face financial crises").

230. EASTERBROOK & FISCHEL, *supra* note 115, at 100. This is not to say, of course, that judicial review is entirely unconstrained. To the contrary, judges are subject to a variety of formal and informal constraints. See Stephen M. Bainbridge, *Social Propositions and Common Law Adjudication*, 1990 U. ILL. L. REV. 231, 237 (listing several constraints on the adjudicatory process). In my view, however, Easterbrook and Fischel correctly argue that Darwinian selection works far more effectively in the business setting, where markets operate, than with respect to adjudication.

231. Another way of looking at the problem invokes the principle of subsidiarity, which posits the social primacy of the smallest units in society. In turn, subsidiarity provides both moral and instrumental justification for the business judgment rule:

[Subsidiarity] suggests that people closest to the problem at hand are the ones with the strongest moral claim to finding a solution. To empower higher authorities as anything but second-best solutions or even last resorts endangers the rights and liberties of those who are most affected. The subsidiarity principle also embodies the practical point that those closest to the problem have the strongest interest in seeing that the problem is solved most competently.

Robert A. Sirico, *Subsidiarity, Society, and Entitlements: Understanding and Application*, 11 NOTRE DAME J.L. ETHICS & PUB. POL'Y 549, 552 (1997). Because boards are closer to the problem than courts, subsidiarity posits that they should have decision-making primacy.

longer one of honest error but of intentional misconduct. Despite the limitations of judicial review, rational shareholders would prefer judicial intervention with respect to board decisions so tainted.²³² The affirmative case for disregarding honest errors simply does not apply to intentional misconduct. To the contrary, given the potential for self-dealing in an organization characterized by a separation of ownership and control, the risk of legal liability may be a necessary deterrent against such misconduct.

Note the resulting link between this justification of the business judgment rule—i.e., the likelihood of judicial error—and the preceding justification—i.e., encouraging optimal risk taking. In theory, if judicial decision making could flawlessly sort out sound decisions with unfortunate outcomes from poor decisions, and directors were confident that there was no risk of hindsight-based liability, the case for the business judgment rule would be substantially weaker.²³³ As long as there is some non-zero probability of erroneous second-guessing by judges, however, the threat of liability will skew director decision making away from optimal risk taking. That this result will occur even if the risk of judicial error is quite small is suggested by the work of behavioral economists on loss aversion and regret avoidance.

Behavioral economists have demonstrated that people evaluate the utility of a decision by measuring the change effected by the decision relative to a neutral reference point.²³⁴ Changes framed in a way that makes things worse (losses) loom larger in the decision-making process than changes framed as making things better (gains) even if the expected value of the two decisions is the same.²³⁵ Hence, a loss averse person (as are most people) will be more perturbed by the prospect of losing \$100 than pleased by that of gaining \$100. A bias against risk taking is a natural result of loss aversion, because the decision maker will give the disadvantages of a change greater weight than its potential advantages.²³⁶ Hence, the so-called status quo bias.

Closely related to the loss aversion phenomenon, and a possible explanation for it, is the psychological concept of regret avoidance. Decision makers experience greater regret when undesirable

232. As Delaware Chief Justice Veasey observes, "investors do not want self-dealing directors or those bent on entrenchment in office. . . . Trust of directors is the key because of the self-governing nature of corporate law. Yet the law is strong enough to rein in directors who would flirt with an abuse of that trust." E. Norman Veasey, *An Economic Rationale for Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681, 694 (1998).

233. Davis, *supra* note 4, at 574.

234. RICHARD H. THALER, *THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE* 70 (1992).

235. *Id.*

236. *Id.* at 72.

consequences follow from action than from inaction.²³⁷ Hence, decision makers tend towards inertia. Because the effect of these cognitive biases is considerably greater than traditional rational choice theory predicts, even a small risk of liability can be expected to have a large deterrent effect on managers who are already risk averse by virtue of their non-diversifiable investment in firm-specific human capital. Accordingly, shareholders will prefer judicial abstention to judicial review.

C. *Impact on the Board's Internal Dynamics*

As the discussion in the preceding sections acknowledges, variants of the encouraging risk taking and judicial expertise rationales for the business judgment rule are well accepted in the literature, if not in the precise form offered here. In recent scholarship, I have suggested a third rationale for the rule, which is based on the potential implications of judicial review for the internal governance of boards.²³⁸ As with the preceding explanations, the group dynamics rationale helps justify not only the business judgment rule itself but also the abstention doctrine version thereof championed herein.

Recall that the corporate governance is a superb exemplar of Kenneth Arrow's authority model.²³⁹ Information flows up a branching hierarchy to a central office and binding decisions flow back down.²⁴⁰ At the apex of that decision-making pyramid is not a single hierarch, however, but a multi-member committee—the board—that usually functions by consensus.²⁴¹ Curiously, however, corporate law scholarship rarely treats questions about the board as team production problems.²⁴²

237. See Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 657-59 (1998) (positing regret avoidance as an explanation of the status quo bias); Russell Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583, 1619-20 (1998) (same).

238. See Bainbridge, *supra* note 126, at 35-38, 48-54 (using research on effective group decision making to support the business judgment rule).

239. See *supra* Part III.B.

240. See generally CLARK, *supra* note 58, at 801-16 (explaining why corporations are structured hierarchically).

241. Bainbridge, *supra* note 126, at 35-36.

242. Production teams are defined conventionally as "a collection of individuals who are interdependent in their tasks, who share responsibility for outcomes, [and] who see themselves and who are seen by others as an intact social entity embedded in one or more larger social systems . . ." Susan G. Cohen & Diane E. Bailey, *What Makes Teams Work: Group Effectiveness Research from the Shop Floor to the Executive Suite*, 23 J. MGMT. 239, 241 (1997).

The board of directors is a good example of what Oliver Williamson refers to as a “relational team.”²⁴³ Relational teams arise within organizations when two conditions are satisfied: (1) team members make large investments in firm-specific human capital; and (2) their productivity is costly to measure because of task nonseparability.²⁴⁴ Members of such a team often develop idiosyncratic working relationships with one another.²⁴⁵ In fact, one might say that members of a relational team develop not only firm-specific human capital but also team-specific human capital.

Such teams may well make decisions that are superior to those made by individuals acting alone.²⁴⁶ Individuals are subject to the constraints of bounded rationality and the temptations to shirk or self-deal.²⁴⁷ Group decision making responds to bounded rationality by creating a system for aggregating the inputs of multiple individuals with differing knowledge, interests, and skills.²⁴⁸

Although teams can be a highly effective decision-making mechanism, they are difficult to monitor. Recall that relational teams arise when the production process results in nonseparable outputs.²⁴⁹ By definition, therefore, the productivity of individual team members cannot be measured on an output basis.²⁵⁰ Yet, at the same time, individual productivity also may be quite costly to measure from an input perspective.²⁵¹ How does one measure how well a board member cooperates in responding to changed circumstances or emergencies, for example?²⁵² Because neither input nor output can be measured effectively, judicial review of board decision making cannot be an effective monitoring mechanism.

The key problem for present purposes, and the one that differentiates this line of argument from that of the preceding section, however, is that judicial review could interfere with—or even destroy—the internal team governance structures that regulate board behavior. Research on relational teams shows that they are not only hard to

243. WILLIAMSON, *supra* note 203, at 246-47.

244. *Id.*

245. *Id.* at 244.

246. Bainbridge, *supra* note 126, at 12-19 (reviewing empirical evidence on group versus individual decision making).

247. *Id.* at 20-21.

248. *Id.* at 19-27.

249. See *supra* text accompanying note 244.

250. WILLIAMSON, *supra* note 203, at 244.

251. See *id.* (observing that “the assessment of inputs is much more subtle than effort-accounting”).

252. Bainbridge, *supra* note 126, at 48.

monitor, but that they also are hard to discipline.²⁵³ As they develop team-specific human capital, members of a production team develop idiosyncratic ways of working with one another that generate a form of synergy.²⁵⁴ Under such circumstances, dismissal becomes a highly undesirable sanction, because no team member can be replaced without disrupting the entire team. Because relational teams often become insular,²⁵⁵ moreover, even external sanctions falling short of dismissal may have ripple effects throughout the team.²⁵⁶ Insular workplace teams often fail to deal effectively with outsiders.²⁵⁷ In particular, relational teams often respond to external monitoring efforts by “circling the wagons” around the intended target of sanctions.²⁵⁸ Instead of external review, relational teams are best monitored by a combination of mutual motivation, peer pressure, and internal monitoring.²⁵⁹ As I have explained elsewhere in more detail, however, judicial review might well destroy the interpersonal relationships that foster these forms of internal board governance.²⁶⁰ Again, shareholders will therefore prefer a rule under which judges abstain from reviewing board decisions.

This line of analysis justifies several aspects of the business judgment rule unexplained by alternative theories. Under this analysis, for example, the inapplicability of the business judgment rule to fraud or self-dealing is readily explicable. Duty-of-care litigation is typically concerned with collective actions taken by the board of directors as a whole. In taking such actions, we have seen, the board is constrained to exercise reasonable care by a combination of external market forces and internal team governance structures.

253. *Id.* at 49.

254. *Id.*

255. See Charles Hecksher, *The Failure of Participatory Management*, ACROSS THE BOARD, Nov. 1995, at 16, 18 (citing empirical studies).

256. Cf. RAGHURAM G. RAJAN & LUIGI ZINGALES, THE TYRANNY OF THE INEFFICIENT: AN ENQUIRY INTO THE ADVERSE CONSEQUENCES OF POWER STRUGGLES (Nat'l Bureau Econ. Research, Working Paper No. 5396, 1995) (demonstrating the inefficiency of power struggles by sub-units of an organization).

257. Hecksher, *supra* note 255, at 16 (citing studies).

258. Cf. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981) (opining that directors tasked with deciding whether the corporation should sue one or more of their fellow directors might be affected by “a ‘there but for the grace of God go I’ empathy”).

259. WILLIAMSON, *supra* note 203, at 245.

260. Bainbridge, *supra* note 126, at 49-50. A related concern is that external review of board decisions could have multiplicative effects throughout the firm as a whole. Because “the efficiency of organization is affected by the degree to which individuals assent to orders, denying the authority of an organization communication is a threat to the interests of all individuals who derive a net advantage from their connection with the organization” CHESTER I. BARNARD, THE FUNCTIONS OF THE EXECUTIVE 169 (2d ed. 1962). By calling into question the legitimacy of the board’s authority within the corporation, judicial review could reduce the incentive for subordinates to assent to the board’s decisions and thereby undermine the efficient functioning of the entire firm.

When an individual director decides to pursue a course of self-dealing, however, he or she usually acts alone and, moreover, betrays his or her fellow directors' trust.²⁶¹ It makes sense for courts to be less concerned with damage to internal team governance when the defendant director's misconduct has already harmed that governance structure through betrayal. Instead, by providing a set of external sanctions against self-dealing, the law encourages directors to refrain from such betrayals.²⁶²

D. Why Judges Must Abstain

Proponents of treating the business judgment rule as a standard of liability rather than as an abstention doctrine might well concede the arguments developed in the preceding sections. They might argue, however, that the benefits attributed to the rule in those sections can be obtained while treating the rule as a standard of liability, so long as the standard is sufficiently lenient.²⁶³ But this is error.

The argument herein has not been one for judicial abnegation of its role, but rather one for judicial abstention. The distinction is a significant one. Abstention contemplates judicial reticence, but leaves open the possibility of intervention in appropriate circumstances. The problem is to identify the circumstances in which intervention is necessary. Put another way, when do accountability concerns trump preservation of the board's authority?

If the business judgment rule is treated as a standard of liability, rather than as an abstention doctrine, judicial intervention readily could become the norm rather than the exception. This is why *Technicolor* is so problematic. *Technicolor's* cart before the horse formulation implies that the business judgment rule does not preclude judicial review of cases in which the board failed to exercise reasonable care.²⁶⁴ Yet, if the business judgment rule is to have teeth,

261. Cf. Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1062-63 (1982) (describing the deleterious effects on board effectiveness of director self-dealing).

262. See William W. Bratton, *Game Theory and the Restoration of Honor to Corporate Law's Duty of Loyalty*, in PROGRESSIVE CORPORATE LAW 139, 154 (Lawrence E. Mitchell ed., 1995) (arguing for a "coercive [legal] backstop" to prevent self-dealing).

263. Cf. Denise Ping Lee, Note, *The Business Judgment Rule: Should It Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925, 939 (2003) (observing that "[i]t is worth noting that the 'business judgment rule is a standard of judicial review for director conduct, not a standard of conduct.' Because the standard of review is more relaxed than the standard of conduct set out for directors, the corporate duty of care has been characterized as 'more aspirational than consequential.'" (footnotes and citations omitted)).

264. See *supra* notes 67-68 and accompanying text.

it is precisely those cases in which it is especially important for courts to abstain.²⁶⁵ No matter how gingerly courts apply the standard of liability, trying to measure the "quantity" of negligence is a task best left untried.²⁶⁶ As we have seen, courts will be tempted constantly to apply the standard in ways that sanction honest decisions that, with the benefit of hindsight, have proved unfortunate or appear inept.²⁶⁷ All of the adverse effects of judicial review outlined in the preceding sections are thus implicated whether or not the board exercised reasonable care. Unfortunately, as we have seen, *Technicolor* can be read as having nullified this essential aspect of the rule.²⁶⁸

If the business judgment rule is framed as an abstention doctrine, however, judicial review is more likely to be the exception rather than the rule. The court begins with a presumption against review. It then reviews the facts to determine not the quality of the decision, but rather whether the decision-making process was tainted by self-dealing and the like. The requisite questions to be asked are more objective and straightforward: Did the board commit fraud? Did the board commit an illegal act? Did the board self-deal? Whether or not the board exercised reasonable care is irrelevant, as well it should be. The business judgment rule thus builds a prophylactic barrier by which courts pre-commit to resisting the temptation to review the merits of the board's decision.

To say that the abstention conception of the business judgment rule is objective, of course, does not mean that it admits of bright-line solutions. To the contrary, once we recognize that reconciling the competing claims of authority and accountability is the central problem for business judgment rule jurisprudence—indeed, for all of corporate governance—the misnomer inherent in the law's nomenclature becomes apparent. It has become conventional to distinguish between standards and rules. Rules say, "Drive 55 mph," while standards say, "drive reasonably." Within that dichotomy, the business judgment rule clearly is misnamed; it is a standard, not a rule. The question is not whether the directors violated some bright-line precept, but whether their conduct satisfied some standard for judicial abstention. The greater flexibility inherent in standards frequently comes into play in business judgment rule jurisprudence as courts fine tune the doctrine's application to the facts at bar.²⁶⁹ Much

265. Johnson, *supra* note 40, at 633.

266. Manne, *supra* note 3, at 271.

267. See *supra* Part IV.A.

268. See *supra* Part II.A.

269. Cf. *Stahl v. Apple Bancorp, Inc.*, 579 A.2d 1115, 1125 (Del. Ch. 1990) (observing that "inquiries concerning fiduciary duties are inherently particularized and contextual").

of that 'fine tuning can be explained as an unconscious attempt to strike an appropriate balance between authority and accountability under specific factual circumstances. The principal law reform implication of this analysis thus may be that courts ought to be more explicit both about the fact that they are balancing competing concerns and about why they believe the balance struck in a particular case is the appropriate one.

V. CONCLUSION

Authority and accountability are in constant tension. Seeking to hold directors accountable for their decisions necessarily reduces the efficiency of corporate decision making. Conversely, deference to the board's authority necessarily entails a risk of opportunism and even plain carelessness. Choosing the appropriate balance between authority and accountability is the central problem of business judgment jurisprudence.

Although the partition admittedly is somewhat artificial, a useful first cut at striking that balance is provided by the distinction between operational issues, such as whether to install lighting in a baseball park, and structural choices, especially those creating a final period situation, such as takeovers.²⁷⁰ The former appropriately receives much less probing review than does the latter.²⁷¹ The thesis of this article is that, except to verify that the relevant preconditions for review are not met, courts should simply abstain from reviewing operational decisions.

Abstention in operational decisions is appropriate because most such decisions do not pose much of a conflict between the interests of directors and shareholders. Granting, for example, that Wrigley appears to have preferred the neighborhood's interests to those of his shareholders, what selfish interests was he advancing? Perhaps he was simply trying to comply with what he saw as appropriate business ethics. Or, maybe he had eccentric ideas about how baseball was to be played. At most, however, he might have reaped some psychological benefits from implementing his attitudes. Even assuming *arguendo* that these sort of psychological benefits implicate the kinds of self-dealing concerns that justify setting aside the business judgment rule,

270. See E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 394 (1997) (drawing a similar distinction between "enterprise" and "ownership" decisions). As Chief Justice Veasey points out, a third class of cases involves judicial review of board oversight. Such cases typically involve no exercise of business judgment and, hence, the business judgment rule does not apply. *Id.* Such cases fall outside the scope of this article.

271. See *id.* (noting that "[t]here is little or no court interference in enterprise issues.").

it is not clear that Wrigley's "self-interest" conflicted with the interests of their shareholders. With their theoretically perpetual duration, corporations must plan for the long-term.²⁷² As the *Shlensky* court's dictum suggested, it is plausible that Wrigley's opposition to lights was in the shareholders' best long-term interest.²⁷³

Wrigley probably made the wrong decision. But so what? Operational decisions are a species of what economists refer to as repeat transactions. Where parties expect to have repeated transactions, the risk of self-dealing by one party is constrained by the threat that the other party will punish the cheating party in future transactions. To be sure, shareholder discipline is not a very important check on directorial self-dealing. Yet, as we have seen, it is just one of an array of extrajudicial constraints that, in totality, give directors to exercise reasonable care in decision making. True, these constraining forces do not eliminate the possibility of director error. The directors will still err from time to time. It is precisely this sort of error, however, that this Article has argued courts traditionally—and appropriately—abstain from reviewing.

272. Accordingly, directors may pursue plans that are in the corporation's "best interests without regard to a fixed investment horizon." *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1989); see also *In re Reading Co.*, 711 F.2d 509, 520 (3d Cir. 1983) (corporate pricing and dividend policies that failed to maximize short-term profits nevertheless could rationally be seen as in corporation's long-term interest).

273. See *supra* text accompanying notes 87-88.