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The Duty of Care and the Duty of Loyalty in the Revised Model Business Corporation Act

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I. INTRODUCTION TO THE REVISED MODEL BUSINESS CORPORATION ACT

In 1950 the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law of the American Bar Association (the Committee) adopted the Model Business Corporation Act (Model Act *or* MBCA).[1] The Committee drafted the

*This Special Project Note is cited as "*Revised Model Act* (Special Project)" throughout the Special Project.

1. The Model Act originally was published in ABA-ALI MODEL BUSINESS CORP. ACT

Model Act in order to provide a dynamic model for keeping state corporation laws updated and responsive to the current demands of the business and legal communities.[2] Because of this goal, the Model Act was in a constant state of revision.[3] This constant state of revision provided an impetus for the Committee to adopt, in 1984, the Revised Model Business Corporation Act (Revised Model Act *or* Revised MBCA).[4] The Committee intended the Revised Model Act to stand as a convenient guide to state legislatures revising their own corporation statutes.[5] This Special Project Note discusses the Revised Model Act's treatment of directors' and officers' duty of care and duty of loyalty, and the Revised Model Act's impact, if any, on this area of the law.

(1950). Tbe Model Act bas been adopted in substance in over 35 states.

2. *See* Mulder, *Introduction* to ABA-ALI MODEL BUSINESS CORP. ACT, at iii (1959). Tbe Model Act began as a federal corporation act in 1940.

3. Amendments to the Model Act are published regularly in the Business Lawyer. *See, e.g.,* Comm. on Corporate Laws, *Changes in the Model Business Corporation Act—Amendments to Financial Provisions,* 34 BUS. LAW. 1867 (1979), adopted, 35 BUS. LAW. 1365 (1980); Comm. on Corporate Laws, *Changes in the Model Business Corporation Act Affecting Dissenters' Rights,* 32 BUS. LAW. 1855 (1977), adopted, 33 BUS. LAW. 2587 (1978).

4. The official text of the Revised Model Act appears in REVISED MODEL BUSINESS CORP. ACT (1985) [hereinafter REVISED MBCA *or* Revised Model Act] and in MODEL BUSINESS CORP. ACT ANN. (3d ed. Supp. 1986). Currently, the Revised Model Act has been adopted in substance in only two states: Tennessee and Virginia.

The Exposure Draft to the Revised Model Act listed three justifications for the revision: (1) the need to publish a third edition of the MODEL BUSINESS CORP. ACT ANN.; (2) the need to react to state experimentations showing that numerous significant simplifications and innovations could be made in the Model Act; and (3) the need to consolidate all previous amendments and to determine the precise content of the Model Act. The Committee, therefore, decided to revise the entire Model Act to ensure that there would be internal consistantcy and uniformity. *See* REVISED MBCA, *supra*, at xiii-xiv (Exposure Draft 1983).

5. The Revised Model Act attempts to mix the different commercial and social interests surrounding the modern business corporation. *See* REVISED MBCA, *supra* note 4, at xvii. The Revised Model Act was written by corporate lawyers; therefore, the Revised Model Act's "appropriate mix" of the various interests may lean more toward the interests of corporate management than toward shareholders. *See generally* Branson, *Countertrends in Corporation Law: Model Business Corporation Act Revision, British Company Law Reform, and Principles of Corporate Governance & Structure,* 68 MINN. L. REV. 53, 56-72 (1983) (stating that the Model Act, through the use of "flexible statutes," is a pro-management Act); Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663, 665 (1974) (arguing that "[b]ecause the Model Act has been endorsed hy leaders of the corporate bar and is itself an American Bar Association committee product, it too accelerated the trend toward [corporate] permissiveness").

II. The Duties of Directors and Officers

Section 8.01 of the Revised Model Act[6] establishes the requirements and duties for a board of directors. It is essential to define the duties of a director before attempting to determine if there has been a breach of these duties.[7]

Section 8.01 establishes a director's duty in accordance with the realities of today's outside, and possibly inside,[8] directors and their involvement in large, publicly held corporations. Section 8.01 provides that the business and affairs of a corporation will be managed "under the direction of"[9] a board of directors rather than "by"[10] a board of directors. This formulation of a director's duty reflects that while in small corporations, and maybe even in some larger corporations, directors exercise significant control over the affairs of the corporation, a totally different situation exists in large, publicly held corporations because directors are not involved actively in the management of the corporation. Under the Revised

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6. Section 8.01 states:

> (a) Except as provided in subsection (c), each corporation must have a board of directors.
>
> (b) All corporate powers sball be exercised by or under the authority of, and the business and affairs of the corporation *managed under the direction of*, its board of directors, subject to any limitation set forth in tbe articles of incorporation.
>
> (c) A corporation having 50 or fewer shareholders may dispense with or limit the authority of a board of directors by describing in its articles of incorporation who will perform some or all of the duties of a board of directors.

Revised MBCA, *supra* note 4, § 8.01 (emphasis added).

7. Revised Model Act § 8.01(b) tracks the beginning of Model Act § 35, as amended in 1974, which concerned a director's duties and the applicable standard of care. 2 Model Business Corp. Act Ann. § 8.01 (3d ed. Supp. 1986); *see* Model Business Corp. Act § 35 (1978) [hereinafter MBCA *or* Model Act].

Basic tort law requires that a person's duties be defined before determining whether that person has negligently breached these duties. *See* Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 Bus. Law. 1477, 1493 (1984).

8. Despite the great differences between an inside director's and an outside director's potential involvement in the management of a corporation, no distinction is made between directors in the Revised Model Act.

9. Revised MBCA, *supra* note 4, § 8.01(b).

10. As originally enacted, the Model Act simply provided that "the business and affairs of a corporation be managed by a board of directors." In 1974 the Model Act was amended to read "under the direction of a board of directors." *See* 2 Model Business Corp. Act Ann. § 8.01 historical background § 2 (3d ed. Supp. 1986). The annotation specifically states that the change was made so that § 8.01 would not be "interpreted to mean that directors must become involved in the detailed administration of the corporation's affairs." *Id.* This statutory change was foreshadowed by Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963), which noted that the size of modern corporations forces directors to "confine their control to the broad policy decisions." *Id.* at 84, 188 A.2d at 130.

Model Act, therefore, a director's duty is not to provide detailed administration of the corporation, but is to establish "major management policy."[11] The Revised Model Act recognizes that directors are not expected to become involved in the day-to-day decisionmaking of a corporation,[12] activities more appropriately delegated to the corporate officers.[13]

While the Revised Model Act reflects the view that directors are not responsible for the daily operation of a corporation, it, unfortunately, does not define clearly the responsibilities of corporate directors.[14] The Revised Model Act merely lists a few of the specific tasks required of directors, such as the adoption of by-laws[15] and the election of officers.[16] This lack of a precise definition has contributed to the courts' and legislatures' continuing problems in determining whether directors have fulfilled their duties.[17]

Because of their lack of time to "call the shots," directors may delegate authority to the officers of a corporation.[18] When directors exercise this option to delegate, however, they still have a duty of

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11. REVISED MBCA, *supra* note 4, § 8.01 official comment at 194-95 (stating that in large, publicly held corporations "it is not feasible to impose a requirement that the business and affairs of the corporation be managed 'by' the board of directors . . . since the role of the board of directors consists principally of the formulation of major management policy with little or no direct involvement in day-to-day management").

12. *See, e.g.,* Barnes v. Andrews, 298 F. 614, 615 (S.D.N.Y. 1924) (explaining that directors "are not expected to interfere individually in the actual conduct" of the corporation's affairs); Lowell Hoit & Co. v. Detig, 320 Ill. App. 179, 181-82, 50 N.E.2d 602, 603 (1943) (stating that directors, by "necessity," must delegate much authority to subordinates).

13. *See* Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors,* 52 N.Y.U.L. REV. 1341 (1977); Mace, *The President and the Board of Directors,* HARV. BUS. REV., Mar.-Apr. 1972, at 37 (concluding that the role of the board is largely advisory and is not of a decisionmaking nature); *see also* Manning, *supra* note 7, at 1481 (asserting that the average director devotes only 1.5 working days a month to the corporation).

14. The Business Roundtable, however, has published its list of "core functions" for a board of directors. These "core functions" are as follows:

(1) Management, Board Selection, and Succession;
(2) Corporate Actions and Decisions with Potential for Maximum Economic Impact;
(3) Corporate Social Responsibility; and
(4) Compliance with Law.

The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation: Statement of the Business Roundtable, 33 BUS. LAW. 2083, 2096-2103 (1978).

15. *See* REVISED MBCA, *supra* note 4, § 2.06.

16. *Id.* § 8.40(a).

17. *See supra* note 7; *infra* notes 51-98 and accompanying text.

18. *See* REVISED MBCA, *supra* note 4, § 8.01 official comment at 195 (acknowledging that "it is generally recognized that the board of directors may delegate to appropriate officers those powers not required by law to be exercised by the board").

"oversight"[19] concerning the officers' actions. Section 8.25 grants directors the power to create one or more committees composed of directors unless the articles of incorporation or by-laws provide otherwise;[20] section 8.25(d) confers upon these committees the same authority granted the board under section 8.01, subject to the limitations of section 8.25(e).[21]

Section 8.41[22] details the duties of the officers of a corporation. This section empowers the officers to perform "the duties set forth in the bylaws, or . . . the duties prescribed by the board of directors."[23] Therefore, section 8.41 establishes the power by which the directors can delegate to the officers the duty to manage the daily operations of the corporation.[24] In addition to any specific duties delegated to the officers by the directors,[25] the officers also may have "implied"[26] or "apparent"[27] authority to act on behalf of the corporation.

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19. *See id.* (warning that "delegation does not relieve the board of directors from its responsibilities of oversight").

20. REVISED MBCA, *supra* note 4, § 8.25(a). Section 8.25(a) provides:

> Unless the articles of incorporation provide otherwise, a board of directors may create one or more committees and appoint members of the board of directors to serve on them. Each committee must have two or more members, who serve at the pleasure of the board of directors.

Id.

21. *Id.* § 8.25(d).

22. Section 8.41 provides:

> Each officer has the authority and shall perform the duties set forth in the bylaws or, to the extent consistent with the bylaws, the duties prescribed by the board of directors or by direction of an officer authorized by the board of directors to prescribe the duties of other officers.

Id. § 8.41.

23. *Id.*

24. *See supra* note 18 and accompanying text.

25. Interestingly, the Revised Model Act lists no specific duties for the president, treasurer, or any other officer of a corporation. All of an officer's power, therefore, is derived from the by-laws, from the directors, or from implied or apparent authority.

26. Officers may have implied authority by virtue of the position they hold in the corporation. For example, the mere fact that the directors appointed a president implies that this individual has sufficient authority to make ordinary business transactions for the corporation. *See* REVISED MBCA, *supra* note 4, § 8.41 official comment at 236; *see also* Yucca Mining & Petroleum Co. v. Howard C. Phillips Oil Co., 69 N.M. 281, 365 P.2d 925 (1961) (holding that a corporation is bound by contracts entered into by the president on behalf of the corporation).

27. Apparent authority results when a corporation holds out to third persons that an officer has sufficient power to bind the corporation and third persons reasonably rely on this representation. *See* REVISED MBCA, *supra* note 4, § 8.41 official comment at 236; *see also* Juergens v. Venture Capital Corp., 1 Mass. App. Ct. 274, 295 N.E.2d 398 (1973) (finding apparent authority when the president was vested with extensive corporate authority and exercised great power).

III. The Duty of Care

A. Introduction

Section 8.30[28] outlines the Revised Model Act's formulation for a director's[29] standard of conduct or "duty of care." This sec-

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28. Section 8.30 provides:

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

(b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.

Revised MBCA, *supra* note 4, § 8.30.

29. Part III of this Special Project Note will refer only to a director's duty of care. An officer's duty of care is covered by Revised MBCA § 8.42. Section 8.42 is virtually identical to § 8.30. Section 8.42 states:

(a) An officer with discretionary authority shall discharge his duties under that authority:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

(b) In discharging his duties an officer is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(1) one or more officers or employees of the corporation whom the officer reasonably believes to be reliable and competent in the matters presented; or

(2) legal counsel, public accountants, or other persons as to matters the officer reasonably believes are within the person's professional or expert competence.

(c) An officer is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (h) unwarranted.

(d) An officer is not liable for any action taken as an officer, or any failure to take any action, if he performed the duties of his office in compliance with this section.

Revised MBCA, *supra* note 4, § 8.42. The official comment to § 8.42 states that officers must meet the same standard of conduct as directors. *Id.* § 8.42 official comment at 237.

tion draws generally from the common-law formulation for a director's duty as gleaned from a number of years of judicial decisions.[30] The common law generally permitted directors to perform their duties of oversight over the management of a corporation by acting only if a "red flag"[31] of trouble arose.[32] In making business deci-

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However, because an officer usually is more intricately involved with the management of a corporation than a director, an officer is less able to rely on the reports of others when making business decisions and when monitoring the corporation's performance. *Id.* Otherwise, the analysis for a director's duty of care generally is applicable to officers. *Id.*; *see supra An Historical Perspective* (Special Project) notes 9-49 and accompanying text; *infra* note 57 and accompanying text.

30. The Revised Model Act's formulation for a director's duty of care is substantially identical to the Model Act's. *See* REVISED MBCA, *supra* note 4, § 8.30 official comment at 221.

Case law generally makes a distinction between "misfeasance" and "malfeasance." Misfeasance concerns a director's duty of oversight when he has delegated authority to the corporation's officers. The landmark case in this area is Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963). In *Allis-Chalmers* the Delaware Supreme Court held that directors are not required to seek out problems with corporate management unless they have been warned by a "red flag." The court stated:

> [D]irectors of a corporation in managing the corporate affairs are hound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances . . . .
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> If [a director] has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention ohvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.

Allis-Chalmers, 41 Del. Ch. at 84-85, 188 A.2d at 130; *see also* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (finding that liability should only be imposed in the oversight context for "obvious and prolonged failure to exercise oversight or supervision"), *cert. denied*, 460 U.S. 1051 (1983). *See generally* Kelly v. Bell, 254 A.2d 62, 72 (Del. Ch. 1969), *aff'd*, 266 A.2d 878 (Del. 1970).

By contrast, malfeasance occurs during the performance of a director's decisionmaking function. Case law protects the director in this context if the director acts with the care of an ordinarily prudent person in a like position under similar circumstances. The business judgment rule will be applied to analyze the director's decision. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (holding that the business judgment rule protects directors if they have informed themselves "prior to making a business decision, of all material information reasonably available to them" and "then act with requisite care in the discharge of their duties," and also finding that during the decisionmaking process, the business judgment rule dictates that "director liability is predicated upon concepts of gross negligence"); *cf.* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (stating that the business judgment rule will not protect directors if there was gross negligence during the decisionmaking process).

For a more complete analysis of the common-law formulation of a director's duty of care in both contexts, see *supra An Historical Perspective* (Special Project) notes 9-49 and accompanying text and *supra Recent Developments* (Special Project) notes 36-86 and accompanying text.

31. The view that directors have an active duty of inquiry in the oversight context only if there is some specific cause for concern is consistent with the reality that directors must delegate extensive decisionmaking authority to subordinates. Directors are forced to delegate because they lack the time and knowledge that is necessary to make the day-to-day

sions for the corporation, the common law demanded that a director's decisionmaking *process* show due care[33] and that the actual substantive decision be supported by some "rational business purpose."[34]

The Revised Model Act's definition of a director's duty of care is substantially identical to that found in section 35 of the Model Act,[35] as amended in 1974. The basic standard of conduct required of a director is set forth in section 8.30(a), which states:

> A director shall discharge his duties as a director, including his duties as a member of a committee:
> (1) in good faith;
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
> (3) in a manner he reasonably believes to be in the best interests of the corporation.[36]

One commentator has described this provision as "traditional and generic."[37] Indeed, the language bears the identifiable features of the traditional negligence tort doctrine[38] and is similar to the language used in *Graham v. Allis-Chalmers Corp.*,[39] the leading

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decisions concerning a corporation. Consequently, directors must rely heavily on subordinates to perform faithfully their duties. Thus, it would be nonsensical to require directors to do more than react to "red flags." *See supra* notes 13 & 30; REVISED MBCA, *supra* note 4, § 8.01 official comment at 194-95 (stating that once directors delegate authority to officers, directors can reasonably rely on the officers and are not personally responsible for the acts or omissions of the officers).

32. *See supra* note 30 (discussing "misfeasance").

33. The duty of care requires directors to show diligence during the decisionmaking process. The decision must be informed and a reasonable amount of time must be devoted to the decision. *See supra An Historical Perspective* (Special Project) notes 65-67 and accompanying text.

34. If the directors have met their duty of care during the decisionmaking process, the business judgment rule will protect the actual substantive decision if some "rational business purpose" supports the decision. For a more thorough discussion of the business judgment rule and a director's duty of care, see *supra An Historical Perspective* (Special Project) notes 50-67 and accompanying text.

35. *See supra* note 30. The only significant change from the Model Act is in Revised Model Act § 8.30(b)(3). This section permits directors to rely on a committee if the directors reasonably believe "the committee merits confidence." In Model Act § 35 this provision was limited by the phrase "as to matters within [the committee's] designated authority." The Committee deleted this phrase because it felt a director's reliance should not be limited by "technical questions as to the scope of the jurisdiction or authority of the committee." 2 MODEL BUSINESS CORP. ACT ANN. § 8.30 annotation at 933 (3d ed. Supp. 1986).

36. REVISED MBCA, *supra* note 4, § 8.30(a).

37. Subak, *Takeovers: Where Are We? Where Do We Go?*, 41 BUS. LAW. 1255, 1260 (1986). Mr. Subak was chairman of the subcommittee that "revised" § 8.30 in the Revised Model Act.

38. *See* Manning, *supra* note 7, at 1478.

39. 188 A.2d 125 (Del. 1963). The Delaware Supreme Court stated that "directors of

case in the area. In addition, while courts and the legal community in general refer to corporate directors as "fiduciaries,"[40] the Revised Model Act omits any reference to the term.[41]

B. *The "Level of Care" Required*

Although the term "ordinarily prudent person" in section 8.30(a)(2) would appear to indicate that a director must use ordinary care to avoid liability under the Revised Model Act, little importance should be placed on this formulation of the duty of care with regard to the level of care it requires. Generally, courts never place a great deal of significance on specific statutory wording;[42]

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a corporation in managing the corporate affairs are bound to use that amount of care which *ordinarily careful and prudent men would use in similar circumstances*." *Id.* at 130 (emphasis added). Two authors have stated that Model Act § 35 and, thus, by inference Revised Model Act § 8.30, "does no more than codify the existing Delaware standard as expressed by the court in *Graham*." Arsht & Hinsey, *Codified Standard—Same Harbor But Charted Channel: A Response*, 35 BUS. LAW. ix, xiii (July 1980) (originally printed at page 947 of volume 35, but later corrected and reprinted at the beginning of issue 4 in volume 35). *Contra* Veasey & Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919 (1980) (arguing that Model Act § 35 departs from the case law of Delaware because the word "reasonable" causes courts to second-guess the suhstantive decisions of directors in direct contradiction to the business judgment rule).

40. *See* Veasey & Manning, *supra* note 39, at 925; *see also supra An Historical Perspective* (Special Project) note 4 and accompanying text.

41. The official comments to § 8.30 state that "fiduciary" could be confused with "the unique attributes and obligations of a fiduciary imposed by the law of trusts, some of which are not appropriate for directors of a corporation." REVISED MBCA, *supra* note 4, § 8.30 official comment at 222.

Through the years courts have used the term "fiduciary" because the modern day corporation most closely parallels the common-law trust. This characterization, however, can be misleading. *See* Nielsen, *Directors' Duties under Anglo-American Corporation Law*, 43 U. DET. L J. 605, 608 (1966). While the "beneficiaries" in hoth a trust and a corporation are entitled to undivided trust and loyalty, a shareholder accepts more risk-taking by a director than a beneficiary would accept by a trustee because a shareholder expects to earn greater profits by permitting the directors to take risks. *See* Veasey & Manning, *supra* note 39, at 925. For an excellent discussion of the shareholders' desire for their directors to take certain risks, see W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION & FINANCE: LEGAL AND ECONOMIC PRINCIPLES 188-219 (2d ed. 1986).

For a contrary view on the use of the term "fiduciary" in the corporate context, see Knauss, *Corporate Governance—A Moving Target*, 79 MICH. L. REV. 478, 496-500 (1981) (suggesting tbat the label "fiduciary" is appropriate to describe a director's position of trust to the corporation's sharebolders).

42. *See* E. BRODSKY & M. ADAMSKI, THE LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES § 2.04 (1984). The authors state that in many cases there is no evidence "that a different result would have been reached in the absence of a statute." *Id.*; *cf.* Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 224 A.2d 634 (1966). In *Selheimer* tbe Pennsylvania statute in question required a director to act with the care that an ordinarily prudent person would exercise under similar circumstances in conducting per-

rather they make their decisions on a case-by-case basis,[43] with little regard to the specific level of care required.[44] In addition, courts and commentators alike never have agreed on the level of care required by state statutes, some of which are identical to the Revised Model Act.[45]

Most courts have ruled that the required level of care is "ordinary care" and impose liability for its correlative, "ordinary negligence."[46] Some courts, however, maintain that the prevailing level of care is "gross negligence."[47] Commentators have argued that the result of a given case cannot be predicted accurately from the standard adopted[48] and that liability depends more on prevailing business practices and on the jury's perception of a director's conduct.[49] Given this confusion, the Revised Model Act, despite its general goal, is unlikely to add uniformity to future state court decisions.[50]

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sonal business affairs. The Pennsylvania Supreme Court interpreted this provision to impose a more strict standard of care than had been imposed under the common law. The Pennsylvania legislature subsequently deleted the "personal business affairs" language from its due care statute. Some states, however, such as Nebraska, still require a director to exercise the degree of care that an ordinarily prudent person would exercise in conducting personal business affairs. *See* Lewis, *The Business Judgment Rule and Corporate Directors' Liability for Mismanagement*, 22 BAYLOR L. REV. 157, 163 (1970). For a more thorough analysis of the fluctuations in Pennsylvania law on the duty of care, see *supra An Historical Perspective* (Special Project) notes 24-30 and accompanying text.

43. *See supra An Historical Perspective* (Special Project) notes 24-30 and accompanying text.

44. For a discussion of the various standards for the duty of care, see *id.* notes 11-14 and accompanying text.

45. Thirty-three states follow the general pattern of the Revised Model Act/Model Act of imposing a statutory duty of care on directors. Seven states have adopted the specific Revised Model Act/Model Act formulation. *See* 2 MODEL BUSINESS CORP. ACT ANN. § 8.30 annotation at 936 (3d ed. Supp. 1986); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 28 (Tent. Draft No. 3, Apr. 13, 1984).

46. *See, e.g.*, Francis v. United Jersey Bank, 87 N.J. 15, 34, 432 A.2d 814, 823 (1981) (establishing ordinary care as the standard in New Jersey); Fisher v. Parr, 92 Md. 245, 48 A. 621 (1901); *see also supra An Historical Perspective* (Special Project) notes 12 & 20 and accompanying text.

47. *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1101 (1968) (stating that "[a]ll in all I remain skeptical of the proposition that directors . . . run any substantial risk of liability for ordinary negligence"); *see also supra An Historical Perspective* (Special Project) note 11 and accompanying text.

48. *See* Dyson, *The Director's Liability for Negligence*, 40 IND. L.J. 341, 371 (1965) (arguing that the standard used by a court will not help in predicting how the court will rule in a given case).

49. *See* Arsht & Hinsey, *supra* note 39, at x-xiii.

50. *See* Veasey & Manning, *supra* note 39, at 927 (asserting that "[g]iven the disagreement over how much care is due under section 35 . . . one questions whether uniform

C. The Standard of Care

1. In General

The Revised Model Act describes section 8.30(a) as setting forth a "general standard of care for all directors."[51] Despite the "traditional and generic"[52] quality of section 8.30(a), special attention should be given to certain words and phrases used in the section. The "care" a director must exercise extends not only to substantive business decisions,[53] but also to the director's "duty of attention."[54] This duty includes a director's responsibility to oversee the corporation's activities[55] and to monitor those to whom authority has been delegated.[56]

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adoption will produce uniform results").

51. REVISED MBCA, *supra* note 4, § 8.30 official comment at 221. A "flexible expression of the duty of care" requires a director to "assume a duty to act carefully in fulfilling the important tasks of monitoring and directing the activities of corporate management." *Corporate Director's Guidebook*, 33 BUS. LAW. 1595, 1600-1601 (1978) [hereinafter *Guidebook*].

52. *See* Veasey & Seitz, *The Business Judgment Rule in the Revised Model Act, the* Trans Union *Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1493 (1985); Subak, *supra* note 37, at 1260.

53. It generally is recognized that directors must use due care during the decisionmaking *process*. This requires obtaining sufficient information to make an "informed" decision and devoting an appropriate amount of time to making the decision. A court's review of the decisionmaking process, however, does not extend to a review of the "correctness" of the decision. The substantive aspects of the decision are protected by the business judgment rule. *See* Veasey & Seitz, *supra* note 52, at 1486; *see also supra* notes 33-34 and accompanying text.

54. *See Guidebook*, *supra* note 51, at 1601 (stating that "care" includes "the statutory expression of the duty of attention").

55. *Id.* at 1602. This aspect of the duty of attention includes attending board meetings on a regular basis, obtaining adequate information, analyzing this information carefully, and reviewing documentation at board meetings. *Id.* A director may become involved in the daily management of the corporation to any extent the director chooses, but § 8.30 establishes the director's minimum permissible involvement. *See* REVISED MBCA, *supra* note 4, § 8.01 official comment at 195. Once a director encounters a "red flag," however, the duty of inquiry requires the director to take the necessary uffirmative steps to remedy the situation.

56. This duty to monitor stems from a director's authority, provided by § 8.01, to delegate duties to the officers. The directors have a duty to monitor management's activities and actual performance. Directors will not be held personally responsible for the actions or omissions of the officers, employees, or agents of the corporation if the directors have acted reasonably in selecting them and in relying on their actions (*i.e.*, if the directors have met the duty of care set forth in § 8.30). *See Guidebook*, *supra* note 51, at 1602-03; REVISED MBCA, *supra* note 4, § 8.01 official comment at 195; REVISED MBCA, *supra* note 4, § 8.30 official comment at 221.

Only one state—California—explicitly declares in its due care statute that the duty of care includes a duty of attention. *See* CAL. CORP. CODE § 309(a) (West 1977) (stating that directors are to act "with such care, *including reasonable inquiry*, as an ordinarily prudent person") (emphasis added).

One commentator has proposed that the duty of care provision of the Revised Model

The phrase "in a like position under similar circumstances" is the Revised Model Act's method of distinguishing between directors' different levels of skill or knowledge concerning the corporation.[57] This phrase gives courts the latitude to consider any special skill or experience a director may possess.[58] The phrase also recognizes that a director's responsibilities will vary with the size, location, and complexity of the corporation.[59]

2. The Revised Model Act's Standard of Care and the Business Judgment Rule

The standard of care enunciated in section 8.30(a) embodies within it the concept that a director, regardless of the level of care required by statute, should not be held liable for an honest mistake of business judgment;[60] this concept otherwise is known as the business judgment rule.[61] Section 8.30(a), however, does not at-

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Act be replaced by a duty of attention provision. *See* Manning, *supra* note 7.

57. A distinction can be drawn between inside and outside directors. *See supra An Historical Perspective* (Special Project) notes 93-106 and accompanying text. The Revised Model Act, however, does not draw tbis distinction. Instead, the Revised Model Act merely takes into account "the special background, qualifications, *and management responsibilities* of a particular director." REVISED MBCA, *supra* note 4, § 8.30 offical comment at 222 (emphasis added). This language also can be interpreted to distinguish between the responsibilities of a director and an officer.

58. *See supra* note 57. A director's greater skill or experience with regard to the corporation will place a greater responsibility on that director. For example, a director who has special expertise in an area tbat touches on a particular transaction is expected to use that knowledge, or be cbarged with a breach of the duty of care. *See* Arsht & Hinsey, *supra* note 39, at xiv. This language, however, does not excuse a director who lacks business experience from exercising the common sense and informed judgment of an "ordinarily prudent person." *See* REVISED MBCA, *supra* note 4, § 8.30 official comment at 222.

59. *See* REVISED MBCA, *supra* note 4, § 8.30 official comment at 222 (advising that "the phrase 'in a like position . . . under similar circumstances' is intended to recognize that . . . the nature and extent of responsibilities will vary, depending upon such factors as the size, complexity, urgency, and location of activities carried on by the particular corporation").

60. This result is achieved by combining tbe requirement of "good faith" with the requirement that a director act "with such care as an ordinarily prudent person in a like position would use under similar circumstances." *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act*, 30 BUS. LAW. 501, 504 (1975).

61. The business judgment rule insulates corporate decisionmakers from personal liability for good faith mistakes in judgment. The Supreme Court of Delaware explained that the rule contains "a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in tbe best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Thus, directors who demonstrate that their decisionmaking process met the requisite duty of care will not be held liable for making a bad business decision.

The justifications for the rule are that courts are ill-equipped to make business judgments and that courts should not second-guess the substantive decisions of directors. *See* tempt to codify the business judgment rule.[62] Rather, the Revised

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Hinsey, *Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality*, 62 GEO. WASH. L. REV. 609, 612 n.21 (1984). The court in Joy v. North, 692 F.2d 880 (2d Cir. 1982), discussed the relationship between the duty of care and the business judgment rule as follows:

> While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed tbat such a statement is misleading. Whereas an automohile driver who makes a mistake in judgment . . . will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment . . . will rarely, if ever, be found liable for damages suffered by the corporation. Whatever the terminology, the fact is that liability is rarely imposed upon corporate directors or officers simply for bad judgment . . . .

Id. at 885. The *North* court explained this phenomenon by stating that:

> [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 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 . . . . [I]t is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions.

Id. at 886; *see also* W. KLEIN & J. COFFEE, *supra* note 41, at 141, 188-89. For a further discussion of the business judgment rule, see *supra An Historical Perspective* (Special Project) notes 50-79 and accompanying text.

62. *See* REVISED MBCA, *supra* note 4, § 8.30 official comment at 220-21. The official comment states, "Section 8.30 defines the general standard of conduct for directors . . . by *focusing on the manner in which the director performs his duties, not the correctness of his decisions.*" *Id.* (emphasis added).

Thus, the official comment restates the underlying philosophy of the business judgment rule: directors' substantive decisions should not be questioned by the courts if there was a rational business purpose for the decision. The official comment further states:

> Even before statutory formulations of directors' duty of care, courts sometimes invoked the business judgment rule in determining whether to impose liability in a particular case. In doing so, courts have sometimes used language similar to the standards set forth in section 8.30(a). The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. In view of tbat continuing judicial development, section 8.30 does not try to codify the business judgment rule or to delineate the differences, if any, between that rule and the standards of director conduct set forth in this section. That is a task left to the courts and possibly to later revision of this Model Act.

Id. at 221.

Section 8.30 of the 1983 Exposure Draft sought to integrate the business judgment rule with the duty of care. The official comment contained extensive analysis of the relatiouship between the business judgment rule and the duty of care. After receiving numerous negative comments on the Exposure Draft, however, the Committee decided to stay with the language of the Model Act. *See* 2 MODEL BUSINESS CORP. ACT ANN. § 8.30 annotation at 933-34 (3d ed. Supp. 1986).

Exposure Draft § 8.30(a)(1)-(2) was identical to the Revised Model Act. Exposure Draft § 8.30(a)(3), however, was different. It read as follows: "when exercising *his business judgment*, with the belief, premised on a rational basis, that his decision is in the best interest of the corporation." REVISED MBCA § 8.30(a)(3) (Exposure Draft 1983) (emphasis added).

One commentator stated that Exposure Draft § 8.30(a)(3) was a mix of subjective and objective elements that suffered from redundancy problems. *See* Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business*

Model Act leaves courts free to develop their own formulations of the rule.[63] The business judgment rule is applied most often to directors' substantive business decisions.[64] While a court should scrutinize a director's *decisionmaking process*,[65] the business judgment rule prohibits a court from questioning the actual substantive decision that eventually results from that process if any "rational business purpose" for the decision exists.[66]

Section 8.30 addresses the issue of due care during the decisionmaking process[67] and also creates a "safe-harbor" in section 8.30(d).[68] Section 8.30(d) provides that if a director fulfills the duty of care under section 8.30(a), the director is not liable for any action taken as a director.[69] A debate has developed concerning

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Judgment Rule, 62 TEX. L. REV. 591, 593 n.7 (1983).

63. *See* Veasey & Seitz, *supra* note 52, at 1495 (advising that "the comment to [Revised] MBCA section 8.30 makes it clear that the section is not intended to codify the business judgment rule"). For an overview of the various judicial formulations of the business judgment rule, see *supra An Historical Perspective* (Special Project) notes 52-59 and accompanying text.

64. Decisions to delegate authority, however, also can be protected by the business judgment rule if the decision to delegate is made consistent witb all elements of tbe rule. *See* Kelly v. Bell, 254 A.2d 62, 72 (Del. Ch. 1969), *aff'd*, 266 A.2d 878 (Del. Super. Ct. 1970).

65. *See* Veasey & Seitz, *supra* note 52, at 1486 (stating that "Delaware Courts have employed tbe term 'gross negligence' to describe the standard of care used in the decisionmaking *process*" and that "gross negligence should not be the touchstone of judicial review of *substantive* business decisions; rather, judicial review of substantive decisions should be limited to the search for an 'abuse of discretion'—which equates to the lack of a rational business purpose")(emphasis in original) (footnotes omitted); *see also supra An Historical Perspective* (Special Project) note 65 and accompanying text.

66. *See* Veasey & Seitz, *supra* note 52, at 1486; *see also supra An Historical Perspective* (Special Project) notes 66-67 and accompanying text.

67. The official comment to § 8.30 states:

> The process by which a director informs himself will vary but tbe duty of care requires every director to take steps to become informed about the background facts and circumstances before taking action on the matter at hand. In relying upon the performance by management of delegated or assigned duties pursuant to section 8.01 . . . the director may depend upon the presumption of regularity, absent knowledge or notice to the contrary . . . . Furthermore, a director should not be expected to anticipate the problems which the corporation may face except in those circumstances where something has occurred to make it obvious to a director that the corporation should be addressing a particular problem.

REVISED MBCA, *supra* note 4, § 8.30 official comment at 222-23.

68. Section 8.30(d) provides, "A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section." *Id.* For the full text of § 8.30, see *supra* note 28.

69. *See id.* The official comment to § 8.30 furtber explains:

> If compliance with the standard of conduct set forth in . . . section 8.30 is establisbed, there is no need to consider possible application of the business judgment rule. The possible application of the business judgment rule need only be considered if compliance with the standard of conduct set forth in . . . section 8.30 is not established.

whether the phrase "reasonably believes" contained in section 8.30(a)(3) could negate the safe-harbor created by section 8.30(d).[70] Some commentators argue that this phrase could cause courts to second-guess directors' decisions in areas in which the business judgment rule should apply to protect the decisions from judicial scrutiny.[71] These commentators suggest that courts might feel that section 8.30(a) requires them to analyze the "reasonableness" of a director's substantive business decision despite the business judgment rule's mandate that any substantive decision that was reached as a result of a director's exercise of due care and that had a "rational business purpose" be upheld automatically.[72] Other commentators, however, argue that it is unlikely that courts will blockade section 8.30(d)'s safe-harbor in this fashion.[73] These commentators assert that the "reasonable belief" language merely will force courts to inquire into the procedural aspects of a director's decision to discover whether there was a firm basis for the director's substantive decision.[74] Thus, a court will determine if the director met the section 8.30(a) duty of care standard during the *decisionmaking process*. Furthermore, there has been no indication that courts will use the "reasonably believes" language to question the judgment of directors.[75]

The debate outlined above raises another question concerning section 8.30(a). Does the business judgment rule apply if a director does not qualify for the safe-harbor of 8.30(d)? Given the courts usual lack of concern for a precise definition of "due care" and for the *level* of care this definition requires,[76] it is unlikely that courts will feel restrained by the language of section 8.30(a) if they decide

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Id. § 8.30 official comment at 224.

70. *Compare* Veasey & Manning, *supra* note 39, at 930-42 (arguing that Model Act § 35 deviates from the common law of Delaware because the term "reasonably believes" will encourage courts to substitute their own judgment for that of the defendant director) *with* Arsht & Hinsey, *supra* note 39, at xvii-xx (arguing that use of the "reasonably believes" language will have no effect on the development of the duty of care).

71. *See* Veasey & Manning, *supra* note 39, at 930-42.

72. *Id.*

73. *See* Arsht & Hinsey, *supra* note 39, at xviii-xix.

74. *Id.* Samuel Arsht, a member of the Committee from 1967 to 1977, and Joseph Hinsey, Chairman of the Committee at the time of the Revised Model Act's adoption, argue that the "reasonahly believes" language merely requires courts to determine if a director's belief that the decision was in the corporation's best interest was reasonable. Section 8.30(a) does not ask the court to determine if the substantive business decision was correct or reasonable.

75. Courts have exhibited a reluctance to "apply diligence standards against well-intentioned, non-self-enriching directors and officers." Cohn, *supra* note 62, at 593.

76. *See supra* note 42 and accompanying text.

that the business judgment rule should apply.[77] Thus, even if courts interpret the "reasonably believes" language to allow judicial scrutiny of a director's judgment, and even if the director has not met the requirements of section 8.30(a), a court still could apply the business judgment rule and find the director not liable.[78] This conclusion is supported by the Committee's decision not to codify the business judgment rule, but rather to let the courts define the rule's boundaries.[79]

Unlike the American Law Institute's Principles of Corporate Governance,[80] which soon will include a draft on "Transactions and Control,"[81] the Revised Model Act does not specifically consider a director's duty of care in the context of takeover battles or derivative actions. In the context of a takeover battle or a derivative action, a director's decisionmaking role changes significantly.[82] In the takeover context, a director, because of a self-interest in remaining employed, may not make a totally disinterested decision. The decision, therefore, may lack the element of good faith that is necessary for the business judgment rule to apply.[83] Some recent

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77. *See* Veasey & Seitz, *supra* note 52, at 1496 (stating that "rightly or wrongly, the Committee concluded that there were too many imponderables that might arise in future cases to say that the business judgment rule would never protect one who had flunked the standard . . . in section 8.30"); *see also supra* note 69; Cohn, *supra* note 62, at 594. Professor Cohn argues that the business judgment rule often is invoked to protect a director's decision without the court even entering into an analysis of the director's due care during the decisionmaking process. For an analysis of whether the business judgment rule has supplanted the duty of care, see *supra An Historical Perspective* (Special Project) notes 60-67 and accompanying text.

78. *See* Veasey & Seitz, *supra* note 52, at 1496. The Revised Model Act's official comment states:

> If compliance with the standard of conduct set forth in former section 35 or section 8.30 is established, there is no need to consider possible application of the business judgment rule. The possible application of the business judgment rule need only he considered if compliance with the standard of conduct set forth in former section 35 or section 8.30 is not established.

REVISED MBCA, *supra* note 4, § 8.30(d) official comment at 224. The Revised Model Act does not establish specific limits on the application of the business judgment rule in situations in which a director has not met the requirements of § 8.30(a).

79. *See supra* note 63 and accompanying text.

80. For a discussion of the American Law Institute's Principles of Corporate Governance, see *infra ALI Proposals* (Special Project).

81. *Id.*

82. In both of these situations a director has some self-interest in the outcome of the decision: maintaining employment in the takeover context and avoiding a potential lawsuit in the derivative suit context. Because a lack of self-interest in the transaction is a prerequisite for application of the business judgment rule, special consideration must be given to its application in these situations.

83. For a discussion of self-interest transactions, see *infra* notes 99-155 and accompanying text.

court decisions have placed the initial burden on the director to prove that the defensive measures taken were reasonable. Once this burden is satisfied, the business judgment rule applies.[84] The derivative action, with its inherent conflict of interest problems,[85] also calls for special treatment *vis a vis* the business judgment rule.[86]

D. Reasonable Reliance on Opinions of Others

Section 8.30(b)—(c) provides that directors, in discharging their duties, are entitled to rely on information, opinions, and reports prepared by the corporation's officers, employees, legal counsel, public accountants, and board of directors committees.[87] In addition, directors may rely on other persons with professional or expert competence.[88] Directors, however, must fulfill their duty of care under section 8.30(a) by determining whether reliance on the

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84. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985). The *Moran* court placed the burden on the defendant-directors to show (1) that they believed in good faith that there was a threat to the corporation, (2) that they met their duty of due care, and (3) that the steps taken were *reasonable* in relation to the threat posed. *Id.* at 1356. For an excellent discussion of the law in this area, see Note, *Target Directors' Fiduciary Duties: An Initial Reasonableness Burden*, 61 NOTRE DAME L. REV. 722 (1986). *See also supra Recent Developments* (Special Project) notes 100-102. *But see* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 120 (1979) (arguing that the business judgment rule should apply in a takeover situation); Hanson Trust PLC v. ML SCM Acquisitions, Inc., 781 F.2d 264 (2d Cir. 1986) (applying the business judgment rule to a corporate control situation).

85. *See supra* note 82; *supra Recent Developments* (Special Project) note 22.

86. Some courts have held, in the context of a derivative suit, that because of the possibility for directors to make less than good faith decisions, a court should second-guess a director's (or special litigation committee's) decision not to go forward with a derivative suit. *See, e.g.*, Joy v. North, 692 F.2d 880 (2d Cir. 1982); Zapata Corp. v. Maldonado, 430 A.2d 797 (Del. 1981); *see also supra Recent Developments* (Special Project) notes 22-47. *But see* Auerbach v. Bennett, 393 N.E.2d 994 (1979) (applying the business judgment rule in a derivative suit situation).

The Revised Model Act contains a section on the procedural requirements for pursuing a derivative action. *See* REVISED MBCA, *supra* note 4, § 7.40. A full discussion of that section and its relation to the duty of care, however, is beyond the scope of this Special Project Note. According to the official comment to § 7.40, the issue of whether the board of directors' decision to terminate a derivative suit should bar the derivative suit is left unresolved by the Revised Model Act. *Id.* official comment at 189.

87. *See* REVISED MBCA, *supra* note 4, § 8.30(b)-(c); *see also supra* note 28 (providing full text of § 8.30(b)-(c)).

A director's ability to rely on the guidance of others in discharging the director's duties follows directly from the limited nature of a director's duties and the necessity for a director to delegate authority in the manner outlined in § 8.30(c). *See supra* note 13 and accompanying text.

88. REVISED MBCA, *supra* note 4, § 8.30(b)-(c).

person's information, report, or opinion is warranted.[89] Indeed, directors should complement the information received from an expert, officer, or professional with questions and a discussion[90] to determine whether reliance on their report or opinion is justified.

In addition, section 8.30(c)[91] prevents a director from "hiding his head in the sand."[92] A director, therefore, cannot rely on information that the director knows is unreliable. Section 8.30(c) expressly provides that reliance by a director on information known to be unreliable is unreasonable and in bad faith.[93] Reliance on information known to be unreliable would subject a director to liability for breach of the duty of care under section 8.30(a). Section 8.30(c), however, only declares that a director acts in bad faith when the director has *actual* knowledge[94] that makes reliance on the information unreasonable. Thus, section 8.30(c) provides a more lenient standard than the common law, which held a director accountable for any *inputed or actual* knowledge that made reliance unwarranted.[95] Section 8.30(b) also may be more lenient than some other statutory standards[96] because it allows directors to rely on the opinions of "other persons . . . [with] professional or expert competence"[97] even if these persons are not certified by state

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89. *See id.* § 8.30 official comment at 223 (advising that "the director must comply with the general standard of care of section 8.30(a) in making a judgment as to the reliability and competence of the source of information").

90. *See Guidebook, supra* note 51, at 1603. A director cannot rely mechanistically on another's report or opinion. The director must question the reliability of the report or opinion in order to make an informed judgment. *Id.* The business judgment rule will not shield a director's judgment if it is uninformed or irrational. *See supra* notes 61-63 and accompanying text.

91. REVISED MBCA, *supra* note 4, § 8.30(c). For the full text of § 8.30(c), see *supra* note 28.

92. REVISED MBCA, *supra* note 4, § 8.30 official comment at 224.

93. *See id.* § 8.30(c).

94. Section 8.30(c) only refers to "knowledge;" the official comment, however, states that a director must have "actual knowledge." *Id.* official comment at 224.

95. *See* Veasey, *Director's Standard of Care Under Section 35 of the Model Business Corporation Act*, 3 DEL. J. CORP. L. 257, 262-63 (1978). In Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963), the court required the plaintiffs to prove that the directors had actual or imputed notice of wrongdoing that would have made reliance on the officers' performance unwarranted. It is unclear what would have constituted "imputed notice" to the *Allis-Chalmers* court. *See* Veasey, *supra*, at 261. The *Allis-Chalmers* court merely stated that "directors are entitled to rely on the honesty and integrity of their subordinates until *something occurs* to put them on suspicion that something is wrong." *Allis-Chalmers*, 41 Del. Ch. at 85, 188 A.2d at 130 (emphasis added).

96. Section 8.30(b)(2) allows reliance on *all* "other persons . . . [with] professional or expert competence." "Experts" need not be certified by the state. The Securities Act of 1933 and some state statutes, however, require that "experts" be certified by state authorities.

97. REVISED MBCA, *supra* note 4, § 8.30(b)(2) official comment at 224. The official

authorities.[98]

IV. THE DUTY OF LOYALTY

Corporate directors and officers owe a duty of undivided and unqualified loyalty to the corporation.[99] This duty of loyalty requires directors and officers to act in the best interests of the corporation and its stockholders and not in their own self-interest.[100] While the duty of loyalty has been applied to both directors and officers[101] in a variety of contexts,[102] Revised Model Act section 8.31[103] limits its discussion to "conflict of interest" and "self-deal-

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comment makes a distinction between the words "competence" with regard to experts and "confidence" with regard to a board committee. "Competence" recognizes technical skill and experience in the expert's chosen field. "Confidence" infers no specific technical skill. *Id.*

98. *Id.* at 223. Experts that are not typically certified by state authorities include investment bankers, geologists, and actuaries. *Id.*

99. *See, e.g.,* Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939) (stating that "corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests . . . [and that] a rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest"). For a thorough analysis of the duty of loyalty, see *supra An Historical Perspective* (Special Project) notes 115-40 and accompanying text.

100. *See, e.g.,* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) (stating that "the duty of loyalty derives from the prohibition against self-dealing that inheres in a fiduciary relationship"); *see also supra An Historical Perspective* (Special Project) notes 115-16 and accompanying text. *See generally* Ruder, *Duty of Loyalty—A Law Professor's Status Report,* 40 BUS. LAW. 1383 (1985).

101. *See* E. BRODSKY & M. ADAMSKY, *supra* note 42, at § 3.01.

102. The duty of loyalty applies in many contexts. Situations other than transactions arising out of confiict of interest or self-dealing that require a duty of loyalty inquiry are the corporate opportunity doctrine, insider trading, and transactions between corporations with interlocking directorates. *See* Ruder, *supra* note 100, at 1386, 1389-1402; *see also supra An Historical Perspective* (Special Project) notes 125-29 and accompanying text.

103. Section 8.31 provides:

> (a) A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest transaction is not voidable by the corporation solely because of the director's interest in the transaction if any one of the following is true:
>
> (1) The material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction;
>
> (2) the material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction; or
>
> (3) the transaction was fair to the corporation.
>
> (b) For purposes of this section, a director of the corporation has an indirect interest in a transaction if (1) another entity in which he has a material financial interest or in which he is a general partner is a party to the transaction or (2) another entity of which he is a director, officer, or trustee is a party to the transaction and the transaction is or should be considered by the board of directors of the corporation.

ing" transactions[104] involving directors.[105]

A. *The Voidability of Conflict of Interest Transactions*

1. In General

Revised Model Act section 8.31(a) follows the substance and overall effect of Model Act section 41, but simplifies it with stylistic changes.[106] Section 8.31(a) rejects the traditional common-law view that all conflict of interest transactions are voidable at the

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(c) For purposes of subsection (a)(1), a conflict of interest transaction is authorized, approved, or ratified if it receives the affirmative vote of a majority of the directors on the board of directors (or on the committee) who have no direct or indirect interest in the transaction, but a transaction may not he authorized, approved, or ratified under this section hy a single director. If a majority of the directors who have no direct or indirect interest in the transaction vote to authorize, approve, or ratify the transaction, a quorum is present for the purpose of taking action under this section. The presence of, or a vote cast by, a director with a direct or indirect interest in the transaction does not affect the validity of any action taken under suhsection (a)(1) if the transaction is otherwise authorized, approved, or ratified as provided in that subsection.

(d) For purposes of subsection (a)(2), a conflict of interest transaction is authorized, approved, or ratified if it receives the vote of a majority of the shares entitled to be counted under this subsection. Shares owned by or voted under the control of a director who has a direct or indirect interest in the transaction, and shares owned by or voted under the control of an entity described in subsection (b)(1), may not be counted in a vote of shareholders to determine whether to authorize, approve, or ratify a conflict of interest transaction under subsection (a)(2). The vote of those shares, however, is counted in determining whether the transaction is approved under other sections of this Act. A majority of the shares, whether or not present, that are entitled to be counted in a vote on the transaction under this subsection constitutes a quorum for the purpose of taking action under this section.

REVISED MBCA, *supra* note 4, § 8.31.

104. The official comment states that "[s]ection 8.31 deals *only* with 'conflict of interest' transactions by a *director* with the corporation, that is, transactions in which the director has an interest either (1) directly, or (2) indirectly through an entity in which the director has a financial or managerial interest covered by section 8.31(b)." *Id.* § 8.31 official comment at 227 (emphasis added). In addition, the official comment makes it clear that the Revised Model Act does not attempt to define completely a director's duty of loyalty. *Id.*

105. The Exposure Draft to the Revised Model Act included directors and officers within the scope of § 8.31. *See* REVISED MBCA, *supra* note 4, § 8.31 (Exposure Draft 1983). Officers, however, were not included in the Revised Model Act because the Committee felt that the tests of § 8.31(a)(1)-(2) were not appropriate for officers. *See* 2 MODEL BUSINESS CORP. ACT ANN. § 8.31 annotation at 966 (3d ed. Supp. 1986). Presumably, treatment of officers and the duty of loyalty is left to the common law.

106. *See* 2 MODEL BUSINESS CORP. ACT ANN. § 8.31 annotation at 966 (3d ed. Supp. 1986). Section 8.31(a) contains many stylistic changes. For example, the revised test for a fair transaction is whether the transaction is "fair," instead of "fair and reasonable." The Revised Model Act's drafters felt that "reasonable" added nothing of substance to the test. *Id.*

will of the corporation regardless of whether the transaction was fair to the corporation or was approved by the board of directors or shareholders.[107] Instead, the Revised Model Act sets forth the following three-pronged "or" test:

> A conflict of interest transaction is a transaction with the corporation in which a director of the corporation has a direct or indirect interest. A conflict of interest transaction is not voidable by the corporation solely because of the director's interest in the transaction if any one of the following is true:
>
> (1) the material facts of the transaction and the director's interests were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved, or ratified the transaction; *or*
>
> (2) the material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved, or ratified the transaction; *or*
>
> (3) the transaction was fair to the corporation.[108]

Read literally, section 8.31(a) would appear to provide that a transaction cannot be invalidated by the corporation on conflict of interest grounds[109] if any one of the three criteria of section 8.31(a) is satisfied. Courts, however, generally have interpreted this provision to be consistent with the common law, which requires that conflict of interest transactions be fair to the corporation before they will be validated.[110] Approval of the transaction by a disinter-

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107. REVISED MBCA, *supra* note 4, § 8.31 official comment at 227. Historically, all conflict of interest transactions were voidable at the election of the corporation. A few jurisdictions, however, took a more rigid position and held that conflict of interest transactions were void automatically. Most jurisdictions eventually adopted a more lenient stance and permitted conflict of interest transactions to stand if they met a test of "intrinsic fairness to the corporation" and if the director fully disclosed any interest in the transaction. For further discussion, see *supra An Historical Perspective* (Special Project) notes 117-20 and accompanying text.

108. REVISED MBCA, *supra* note 4, § 8.31(a)(emphasis added). Section 8.31 is patterned after "interested director" statutes in California, Delaware, New Jersey, and New York. These state statutes were in existence at the time Model Act § 41 was drafted. *See* CAL. CORP. LAW § 820 (West 1955); DEL. CODE ANN. tit. 8, § 144 (1974); N.J. STAT. ANN. § 14A: 6-8 (West 1969) (amended 1972); N.Y. BUSINESS CORP. LAW § 713 (McKinney 1963) (amended 1971). The California statute was amended in 1975. *See* CAL. CORP. LAW § 310 (West 1977).

109. Section 8.31 does not validate transactions. Instead, it provides that if the criteria of § 8.31(a) are met, a directer's conflict of interest is not a ground for invalidating the transaction. A transaction still can he attacked on other grounds, such as fraud, breach of the director's duty of care when approving the transaction, or waste. *See* REVISED MBCA, *supra* note 4, § 8.31 official comment at 228. The sole purpose of § 8.31 is to make sure that the common-law rule of automatic voidability no longer is followed. *Id.*

110. *See, e.g.*, Rivercity v. American Can Co., 600 F. Supp. 908, 919-22 (E.D. La. 1984), *aff'd*, 753 F.2d 1300 (5th Cir. 1985) (holding that a director cannot validate an unfair transaction by mere disclosure to and approval by a disinterested board of directors); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 417, 241 P.2d 66, 73 (1952) (stating that to allow mere disclosure to and consent by the board to validato unfair

ested and fully informed board or by the shareholders will be significant, if at all, only to shift the burden of proving the fairness of the transaction from the director trying to uphold the transaction to the person attacking it.[111] One court has justified this position by pointing out that the Delaware conflict of interest statute, which is almost identical to section 8.31, merely meant to provide that self-dealing transactions are not voidable automatically.[112] Section 8.31(a), therefore, probably will not prevent judicial scru-

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transactions would he a "shocking reflection on the law of California" and would allow conniving directors to get around the law).

Giving effect to the "or" language would be a major departure from the common-law rule, which requires that the transaction be fair to the corporation. *See* Note, *Section 21-2040.01: Interested Director Transactions and Considerations of Fairness*, 58 NEB. L. REV. 909, 912-13 (1979).

111. For a discussion of the burden of proof, see *infra* notes 126-36 and accompanying text.

The Revised Model Act's Exposure Draft established this very scheme of shifting the burden from director to plaintiff to handle conflict of interest transactions. In fact, the Exposure Draft was intended to reflect the current judicial interpretation of Model Act § 41. Section 8.31 of the Exposure Draft provided:

> (a) If a transaction is fair to a corporation at the time it is authorized, approved, or ratified, the fact that a director or officer of the corporation has a direct or indirect interest in the transaction is not a ground for invalidating the transaction or for imposing liability on that director or officer.
>
> (b) In a proceeding contesting the validity of a transaction in which a director or officer has an interest, the person asserting validity has the burden of proving fairness unless:
>
> (1) the material facts of the transaction and the director's or officer's interests were disclosed or known to the board of directors or a committee of the board and the board or committee authorized, approved, or ratified the transaction by the vote of a requisite quorum of directors who had no interest in the transaction; or
>
> (2) the material facts of the transaction and the director's or officer's interests were disclosed to the shareholders entitled to vote and they authorized, approved, or ratified the transaction by the vote of a requisite quorum of shareholders who had no interest in the transaction.
>
> (c) The presence of, or votes entitled to be cast by, the director or officer who has a direct or indirect interest in the transaction may be counted in determining whether a quorum is present but may not be counted when the board of directors, a committee of the board, or the shareholders vote on the transaction.
>
> (d) For purposes of this section, a director or officer has an indirect interest in a transaction if an entity in which he has a material financial interest or in which he is an officer, director, or general partner is a party to the transaction. A vote or consent of that entity is deemed to be a vote or consent of the director or officer for purposes of subsection (c).

REVISED MBCA, *supra* note 4, § 8.31 (Exposure Draft 1983).

112. *See* Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976). The *Fliegler* court stated:

> We do not read the statute as providing the broad immunity for which defendants contend. It merely removes an 'interested director' cloud when its terms are met and provides against invalidation of an agreement 'solely' because such a director or officer is involved. Nothing in the statute sanctions unfairness . . . or removes the transaction from judicial scrutiny.

tiny of fairness even if there has been approval by a fully informed and disinterested board or by the shareholders.[113] The Revised Model Act's Exposure Draft structured this section to be consistent with judicial interpretations of the Model Act.[114] This structuring, coupled with the Revised Model Act's official comments,[115] appears to indicate that the Revised Model Act was not intended to change present judicial interpretations of the law concerning conflict of interest transactions.[116]

2. Determining What is "Fair" to the Corporation

Assuming that courts are unlikely to approve conflict of interest transactions if they are not fair to the corporation, the question of how to determine fairness arises. No single precise formula has been developed;[117] the most pervasive test, and the one apparently adopted by the Revised Model Act,[118] is the "arm's length bargain" test that the United States Supreme Court established in *Pepper v. Litton*.[119] Under this test, a court must determine, given all the

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113. *Id.* at 222; *see supra* note 110. However, a literal interpretation of a statute similar to § 8.31 was adopted in a Tennessee lower court decision. *See* Tennessee Dressed Beef Co. v. Hall, 519 S.W.2d 805, 808 (Tenn. Ct. App. 1974). This interpretation was criticized in Recent Development, *Corporations—Duty of Loyalty and Corporate Opportunity—Transactions Between Corporations with Common Directors*, 43 TENN. L. REV. 155 (1975).

114. *See supra* note 111.

115. *See supra* notes 109 & 112 and accompanying text.

116. This view is bolstered by the comments of Henry Ballantine, a drafter of former CAL. CORP. CODE § 820 (conflict of interest), one of the statutes upon which the Model Act was based. According to Mr. Ballantine, the drafters of the former California statute did not intend to affect the entire common law dealing with transactions that were unfair, but intended only to overcome the procedural problems surrounding interested directors. Ballantine, *Questions of Policy in Drafting a Modern Corporation Law*, 19 CALIF. L. REV. 465, 475-76 (1931).

117. *See* Note, *supra* note 110, at 920. The determination of fairness is a question of fact that must be made on a case-by-case basis. *See, e.g.*, Harris Trust & Sav. Bank v. Joanna-Western Mills Co., 53 Ill. App. 3d 542, 555, 368 N.E.2d 629, 639 (1977) (stating that "[i]n our view, the fairness of an agreement is a question of fact").

118. The official comment to § 8.31 states:

> The fairness of a transaction for purposes of section 8.31 should be evaluated on the basis of the facts and circumstances as they were known or should have been known at the time the transaction was entered into. For example, the terms of a transaction subject to section 8.31 should normally be deemed "fair" if they are within the range that might have been entered into *at arms length* by disinterested persons.

REVISED MBCA, *supra* note 4, § 8.31 official comment at 230 (emphasis added).

119. 308 U.S. 295 (1939). In *Pepper* the Supreme Court stated, "The essence of the test is whether or not under all the circumstances the transaction carries the earmark's of an arm's length bargain." *Id.* at 306-07.

An alternative test is whether the proposition submitted would have commended itself to a wholly independent board of directors. Johnston v. Greene, 35 Del. Ch. 479, 490, 121 facts and circumstances, whether a disinterested board of directors would have accepted the transaction in an arm's length bargain.[120] The official comment to section 8.31 states that fairness should be determined "on the basis of the facts and circumstances as they were known or should have been known at the time the transaction was entered into."[121] Under the Revised Model Act's arm's length bargain test, a court will consider whether the transaction was in the best interests of the corporation.[122] It is unclear from section 8.31, however, whether the fairness consideration should include a determination of whether the board was advised about the director's interest in the transaction and about the material facts concerning that interest.[123] These factors, however, appear to go beyond the facial requirements of the "arm's length bargain" test and effectively force the interested director to meet two prongs[124] of the three-prong "or" test.[125]

A.2d 919, 925 (1956).

120. *See* Webber, *Arkansas Corporate Fiduciary Standards—Interested Directors' Contracts and the Doctrine of Corporate Opportunity,* 5 U. ARK. LITTLE ROCK L. REV. 39, 47 (1982).

121. REVISED MBCA, *supra* note 4, § 8.31 official comment at 230. For the full text of § 8.31, see *supra* note 118. Fairness, therefore, should be determined at the time of the transaction, not at the time of the challenge. In addition, courts should take into account all facts and circumstances.

122. For example, even if the price was fair, a disinterested board surely would consider whether the corporation needed the commodity in question. *See, e.g.,* Fill Bldgs., Inc. v. Alexander Hamilton Life, 396 Mich. 453, 461, 241 N.W.2d 466, 469 (1976) (concluding that there was no legitimate reason why a corporation would buy something it did not need). Thus, even if the price for a particular good was reasonable, the transaction would not be in the corporation's best interests if the corporation did not need that particular good. *Cf.* Webber, *supra* note 120, at 47. Professor Webber argues that a transaction may be fair under the arm's length bargain test, yet still not be in the corporation's best interests.

123. There is definitely the appearance of impropriety if a director's interest is not disclosed. The issue, however, is whether nondisclosure makes the transaction "unfair." Professor Webber argues that full disclosure of the director's interest and full disclosure of all relevant facts that might affect a board's judgment should have a bearing on fairness. Webber, *supra* note 120, at 48. *But cf. Harris Trust,* 53 Ill. App. 3d at 554, 368 N.E.2d at 638 (stating that "[i]n our view . . . [the fairness test] is meant to be effective . . . when the agreement is known, but the director's interest is not disclosed"); American Timber & Trading Co. v. Niedermeyer, 276 Or. 1135, 1146, 558 P.2d 1211, 1218-19 (1976) (holding that the Oregon statute, which is identical to Model Act § 41, allowed the enforcement of contracts even if the contracts had "not been approved by a disinterested board or ratified by the shareholders").

124. Requiring full disclosure to the board before it approves the transaction is the substantial equivalent of requiring that the first "prong" of § 8.31(a) be met. *See* REVISED MBCA, *supra* note 4, § 8.31(a); *supra* note 103.

125. *Compare* the American Law Institute's Principles of Corporate Governance, which would strike down a transaction omitting disclosure of a director's interest and the

3. Burden of Proving Fairness

Neither section 8.31 nor the official comments address the issue of which party must carry the burden of proving the fairness of a transaction. Nevertheless, the burden of proof is of critical importance[126] because courts have had difficulty evaluating "fairness"[127] and because this fairness evaluation often is outcome determinative.[128] It appears certain that courts will place the burden of proof on the interested director in cases in which the director's interest was not fully disclosed to the board or shareholders prior to ratification. Courts have interpreted the state statutes patterned after Model Act section 41[129] in this manner.[130] Revised Model Act section 8.31 does not require courts to change this interpretation.

A more difficult question arises, however, if a disinterested board or the shareholders have ratified, approved, or authorized

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material facts concerning that interest even if the transaction was "fair" to the corporation *with* REVISED MBCA, *supra* note 4, § 8.31. *See generally infra ALI Proposals* (Special Project) notes 164-72.

126. *See* Bulbulia & Pinto, *Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards*, 53 NOTRE DAME L. REV. 201, 225-26 (1977) (noting that "[b]ecause of the conceptual problems posed by the fairness test, the burden of proof is of critical importance").

127. *See supra* notes 117-25 and accompanying text.

128. *See supra* notes 111-16 and accompanying text.

129. Similar to Revised Model Act § 8.31, Model Act § 41 also does not discuss the burden of proof. Section 41 provides:

> No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if:
>
> (a) the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or
>
> (b) the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or
>
> (c) the contract or transaction is fair and reasonable to the corporation.
>
> Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contact or transaction.

MBCA, *supra* note 7, § 41.

130. *See, e.g.*, Ohio Drill & Tool Co. v. Johnston, 498 F.2d 186 (6th Cir. 1974) (holding that, under an Ohio statute similar to Model Act § 41, the burden of proof is on the interested director if there was not full disclosure).

the transaction after a full disclosure of the director's interest.[131] Some courts still place the burden on the interested director,[132] while others shift the burden to the party attacking the transaction.[133] Courts interpreting the Revised Model Act should reach the latter result and shift the burden. If the interested director still bears the burden of proof, the first two prongs of section 8.31's "or" test would be complete surplusage.[134] It is unlikely that the drafters of the Revised Model Act intended the statute to be read in this manner. In addition, the Revised Model Act's Exposure Draft specifically shifted the burden of proof to the party attacking the transaction if full disclosure was made to the board or shareholders and the transaction was thereafter authorized, approved, or ratified.[135] The drafters of the Exposure Draft changed the language of Model Act section 41 to reflect more accurately present judicial interpretations of section 41.[136] Revised Model Act section 8.31 does not attempt to change these interpretations of Model Act section 41.

B. Determining Who is an "Interested" Director

Section 8.31 clearly applies if a director has a direct, material financial interest in any of the corporation's transactions.[137] However, it also applies if a director has an "indirect interest" in a transaction.[138] Therefore, section 8.31 applies to a transaction in

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131. *See* Webber, *supra* note 120, at 53.

132. *See, e.g.,* Mueller v. MacBan, 62 Cal. App. 3d 258, 277, 132 Cal. Rptr. 222, 232 (1976) (placing the burden on the defendant-director to prove the fairness of the transaction even in situations in which the shareholders approved the transaction).

133. *See, e.g.,* Cohen v. Ayers, 596 F.2d 733, 739 (7th Cir. 1979) (shifting the burden of proof back to the party challenging the transaction if, after full disclosure, the transaction was approved by a disinterested vote of the hoard or by the shareholders).

134. The first two prongs of § 8.31 will be rendered surplusage if a court refuses to give effect to these two prongs to validate a transaction for conflict of interest purposes, *see supra* notes 109-16, or to shift the burden of proof. Therefore, § 8.31(a)(1)-(2) would play no role in conflict of interest situations.

135. REVISED MBCA, *supra* note 4, § 8.31 (Exposure Draft 1983). For the full text of the Exposure Draft, see *supra* note 111.

136. *See* REVISED MBCA, *supra* note 4, § 8.31 official comment 4 (Exposure Draft 1983).

137. *See* REVISED MBCA, *supra* note 4, § 8.31(a).

138. *Id.* Section 8.31(b) defines "indirect interest" for purposes of § 8.31(a) as follows:

> (1) Another entity in which he has a material financial interest or in which he is a general partner is a party to the transaction, or
>
> (2) Another entity of which he is a director, officer or trustee is a party to the transaction and the transaction is or should be considered by the board of directors of the corporation.

Id. § 8.31(b).

which the corporations involved have common directors[139] if the transaction is of such importance to either corporation that its board should approve the transaction, even if the common directors do not have a material financial interest in the transaction.[140] Section 8.31(b)(2), however, permits "normal" business activities between corporations with common directors.[141]

C. Ratification, Approval, or Authorization by the Board or Shareholders

Section 8.31(c)—(d), which addresses board and shareholder approval of conflict of interest transactions, is an elaboration on and clarification of the concepts contained in Model Act section 41.[142] The requirements for approval of conflict of interest transactions are more strenuous than normal voting requirements.[143] In section 8.31(c) a conflict of interest transaction is approved, authorized, or ratified for purposes of section 8.31(a)(1) if a majority of disinterested[144] directors of the corporation vote in favor of the transaction.[145] A quorum for such a vote also is defined as a majority of the disinterested directors; however, at least two directors must be eligible to vote.[146]

Section 8.31(d), which governs shareholder approval, is similar to section 8.31(c). A majority of the shares "entitled to vote" is needed both for a quorum and for approval of the transaction.[147] Shares that are not entitled to vote include those shares "owned or

139. *Id.* § 8.31 official comment at 230.

140. *Id.*

141. *Id.* § 8.31(b)(2).

142. 2 MODEL BUSINESS CORP. ACT. ANN. § 8.31 annotation at 966 (3d ed. Supp. 1986). *Compare* REVISED MBCA, *supra* note 4, § 8.31(c)-(d) (reprinted *supra* note 103) *with* MBCA, *supra* note 7, § 41 (reprinted *supra* note 129).

143. *See* REVISED MBCA, *supra* note 4, § 8.31 official comment at 230. *Compare* REVISED MBCA, *supra* note 4, § 8.31(c)-(d) *with* REVISED MBCA, *supra* note 4, § 8.24 (voting and quorum requirements for directors) *and* REVISED MBCA, *supra* note 4, §§ 7.25-7.27 (voting and quorum requirements for shareholders).

144. The Revised Model Act does not define "disinterested director" for purposes of § 8.31(c)-(d). The official comment, however, states that a director normally should be considered "interested" if the director or immediate members of the director's family "have a financial interest in the transaction or a relationship with the other parties to the transaction such that the relationship might reasonably be expected to affect his judgment in the particular matter in a manner adverse to the corporation." REVISED MBCA, *supra* note 4, § 8.31 official comment at 231.

145. *Id.* § 8.31(c). A committee of the hoard of directors also may approve a transaction. *Id.*

146. *Id.*

147. *Id.* § 8.31(d).

voted under the control of a director who has a direct or indirect interest in the transaction, and shares owned by or voted under the control of an entity described in [section 8.31 (a)(1)]."[148] All unentitled shares, however, are permitted to vote to determine if the transaction is approved under other provisions of the Revised Model Act.[149]

D. Loans to Directors

Revised Model Act section 8.32 addresses a specific type of conflict of interest transaction: loans to directors by the corporation.[150] Section 8.32 declares that these transactions are forbidden;[151] however, it also lists two exceptions to this general rule. Loans may be made to a director if: (1) the loan is approved by a majority of the outstanding shares of the corporation, except those shares held by or controlled by the benefitted director;[152] or (2) the board determines that the loan benefits the corporation and, consequently, approves the loan or a general plan authorizing loans.[153] Revised Model Act section 8.32 deviates from the Model Act in two ways. First, section 8.32(c) specifically excludes those loans

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148. *Id.*

149. *Id.* The official comment gives as an example a situation in which a parent corporation merges with its 60% owned subsidiary and the majority shareholder in the parent is a director of the subsidiary. The director's shares should be counted to determine whether the corporation approved the merger under chapter 11 of the Revised Model Act. The director's shares, however, should not be counted to determine the conflict of interest issue because the shares are owned by an entity that the director controls and that is a party to the transaction. Instead, the parent must rely on the "fairness" test of § 8.31(a)(3) to approve the conflict of interest transaction. *Id.* official comment at 229-30.

150. *See id.* § 8.32. This section also applies to guarantees of directors' obligations by the corporation. Section 8.32 provides as follows:

> (a) Except as provided by subsection (c), a corporation may not lend money to or guarantee the obligation of a director of the corporation unless:
>
> (1) the particular loan or guarantee is approved by a majority of the votes represented by the outstanding voting shares of all classes, voting as a single voting group, except the votes of shares owned by or voted under the control of the benefited director; or
>
> (2) the corporation's hoard of directors determines that the loan or guarantee benefits the corporation and either approves the specific loan or guarantee or a general plan authorizing loans and guarantees.
>
> (b) The fact that a loan or guarantee is made in violation of this section does not affect the borrower's liability on the loan.
>
> (c) This section does not apply to loans and guarantees authorized by statute regulating any special class of corporation.

Id.

151. *Id.* § 8.32(a).

152. *Id.* § 8.32(a)(1).

153. *Id.* § 8.32(a)(2).

"authorized by statute regulating any special class of corporations" from its definition of "prohibited loans."[154] Second, section 8.32(b) provides that any loan made in violation of section 8.32 will not affect the director's liability for the loan.[155]

By permitting the board of directors to approve loans to board members, section 8.32(a)(2) reflects the Committee's belief that the potential for abuse is minimal, or at least is counterbalanced by the potential benefits. In fact, section 8.32 allows the benefitted director to participate in the vote.[156] One commentator has suggested that section 8.32 should be eliminated, or at least re-written to (1) exclude the benefitted director from the vote, or (2) allow the corporation's shareholders to decide in the articles of incorporation or the by-laws whether to grant the board the power to approve loans to directors.[157] This commentator argues that the modern day board of directors lacks the "independence and objectivity" to vote in good faith on corporate loans to a colleague.[158]

V. Conclusion

This Special Project Note is intended as a primer for analysis of the duty of care and the duty of loyalty under the Revised Model Act. The Revised Model Act's treatment of the duty of care is no different than the Model Act's treatment; therefore, the Re-

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154. *Id.* § 8.32(c). The official comment explains that because statutes regulating loans by banks, savings and loans, and other financial institutions provide sufficient protection for the shareholders, the protections of § 8.32 are unnecessary. *Id.* official comment at 232.

155. *Id.* § 8.32(b). This provision protects the shareholders from possible loss on the loan. *See* Elfin, *A Critique of Portions of the 1983 Revised Model Business Corporation Act*, 28 St. Louis U.L.J. 865, 872 (1984). *Compare* Revised MBCA, *supra* note 4, § 8.32 *with* MBCA, *supra* note 7, § 47, which provides:

> A corporation shall not lend money to or use its credit to assist its directors without authorization in the particular case by its shareholders, but may lend money to and use credit to assist any employee of the corporation or of a subsidiary, including any such employee who is a director of the corporation, if the board of directors decides that such loan or assistance may benefit the corporation.

MBCA, *supra* note 7, § 47.

156. Revised MBCA, *supra* note 4, § 8.32(a)(2). Section 8.32(a)(2) makes no provision for the exclusion of the benefitted director. Loans to directors still might be struck down, however, if the loans were not made pursuant to § 8.32(a)(2) because the loan could not possibly "benefit" the corporation. *See* Oberhelman v. Barnes Inv. Corp., 236 Kan. 335, 690 P.2d 1343 (1984).

157. *See* Elfin, *supra* note 155, at 873-76.

158. *Id.* at 874. Professor Elfin lists New York and North Carolina as two states with statutes that are consistent with his reasoning. *See* N.Y. Business Corp. Law § 714 (McKinney 1963); N.C. Gen. Stat. § 55-22 (1982).

vised Model Act should have little, if any, impact on this area of the law. In fact, the Model Act itself was essentially a restatement of the common-law approach existing at the time of the Model Act's adoption. Likewise, the duty of loyalty under the Revised Model Act and the Model Act, although radically different from the common-law duty on their face, will not affect courts' continued application of the common-law approach. Thus, the Revised Model Act will not materially alter the common law surrounding directors' and officers' duties of care and loyalty.

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