The Corporate Governance Debate and the ALI Proposals: Reform or Restatement?

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I. INTRODUCTION

Much of the debate concerning corporate governance centers on the American Law Institute's proposed Principles of Corporate Governance [hereinafter ALI Proposals or ALI Principles].

*This Special Project Note is cited as “ALI Proposals (Special Project)” throughout the Special Project.

American Law Institute originally intended the ALI Proposals to "restate" the law of corporate governance without departing from the primary goal stated in the ALI’s charter: “to promote the clarification and simplification of the law and its better adaptation to social needs.” The ALI Proposals, however, have evolved into a "new art form" and, unlike a restatement, have proposed reforms in addition to codifying the common law. Because of the predominance of statutory corporation law, the ALI Proposals have focused

2. The American Law Institute began with the formation of the Committee on the Establishment of a Permanent Organization for the Improvement of the Law Proposing the Establishment of an American Law Institute [hereinafter the Committee]. The Committee’s members included such renowned legal scholars as Benjamin Cardozo, Arthur Corbin, Learned Hand, Harlan Stone, John Wigmore, and Samuel Williston. On February 23, 1923, the Committee published a report which asserted that American law was becoming increasingly uncertain and complex. Consequently, the Committee proposed the establishment of a “Restatement of the Law.” The American Law Institute (ALI) was founded and organized for this purpose. The ALI has produced numerous restatements of the common law in such areas as torts, property, and contracts. The ALI also joined the Commissioners on Uniform State Laws in drafting the Uniform Commercial Code. See generally The American Law Institute, The American Law Institute 50th Anniversary (1973).

3. See Eisenberg, An Introduction to The American Law Institute’s Corporate Governance Project, 52 Geo. Wash. L. Rev. 495 (1984) (quoting Perkins, The President’s Letter, ALI Rev. 1 (1982)). Traditionally, the ALI has undertaken to restate the common law. As early as 1923, William Draper Lewis, the first president of the ALI, advanced the idea of a corporation law project. His efforts spurred a debate within the ALI regarding the feasibility of restating a body of law so largely statutory. In 1977-78 the ALI-ABA Committee and the Section of Corporation, Banking and Business Law of the American Bar Association held four regional conferences, thus beginning the ALI Principles. The ALI commissioned the Principles in 1978 and appointed the late Ray Garrett, Jr. as Chief Reporter. Stanley Kaplan is the present Chief Reporter. The ALI-ABA Symposiums are documented in Commentaries on Corporate Structure and Governance (D. Schwartz ed. 1979) [hereinafter Commentaries].

4. While discussing the structure of the Corporate Governance Proposals, Professor Louis Loss stated in his final remarks to the ALI-ABA Symposium:

   I’m not sure that I would put it in terms of a creative restatement, but a new art form.
   I don’t think it could be just like the traditional restatement because, as the people in
   the American Law Institute concluded long before my time, it was not appropriate to
   try to restate the common law of corporations because so much of it has been made the
   basis of statutory law . . . . In short, the new art form that I would hope would evolve
   would be a combination of classic restatement, forward looking guidelines, and perhaps
   also model provisions—without having a model code.


5. In fact, while the first draft was entitled “Restatement and Recommendations,” the subsequent six drafts are entitled “Analysis and Recommendations.” The first draft clearly distinguished its black letter law proposals (which begin with “corporate law should provide that . . . .”) from its suggested proposals (which begin with “as a matter of good corporate practice, a corporation should . . . .”). Introductory Note, T.D. No. 1, supra note 1, at xxii. The subsequent drafts make no such separations in their text but set forth the recommendations alongside the black letter law. See Goldstein, Future Articulation of Corporation Law, 39 Bus. Law. 1541 (1984).
selectively on those areas that usually are governed by common law. The ALI Proposals have seven parts: (1) Definitions; (2) Objectives and Conduct of the Business Corporation; (3) Structure of the Corporation; (4) Duty of Care and the Business Judgment Rule; (5) Duty of Loyalty; (6) Transactions in Control; and (7) Remedies.6

II. THE CORPORATE GOVERNANCE DEBATE

Criticism of the ALI Proposals has been harsh and varied.7 In order to understand this vehement reaction, the historical corporate governance debate must be analyzed.8 This debate began in 1932 when Adolph Berle, professor of law, and Gardiner Means, professor of economics,9 suggested that the expanding shareholder constituencies of large, publicly held corporations presented managers with the opportunity to usurp control of their corporations.10

6. Eisenberg, supra note 3, at 498.
9. See A. Berle & G. Means, The Modern Corporation and Private Property (1932). This work has been widely hailed as the cause of the corporate governance debate. John Kenneth Galbraith called it “one of the two most important books of the 1930’s.” Hessen, The Modern Corporation and Private Property: A Reappraisal, 26 J.L. & Econ. 273, 273 (1983) (quoting Galbraith, Book Review, 13 Antitrust Bull. 1527 (1968)).
10. Oliver Williamson, Professor of Economics of Law and Organization at Yale University, explains the basic premise of the Berle and Means work: Plainly, many corporations have become very large: Sales and assets in some of these firms run to tens of billions of dollars, and employment numbers in the hundreds of thousands . . . . Since the large size of modern firms often resulted in diffuse ownership, management purportedly assumed effective control. Berle and Means thus inquired whether, under these circumstances, there was “any justification for assuming that those in control of a modern corporation will also choose to operate it in the interests of the owners.” The possibility that management might operate the corporation in its own interests could scarcely be dismissed. Williamson, Corporate Governance, 93 Yale L.J. 1197, 1199 (1984) (quoting A. Berle & G. Means, supra note 9, at 121); see also Brudney, Corporate Governance, Agency Costs, and
Berle and Means argued that this power made corporate managers virtually unaccountable to stockholders. Berle and Means also noted that management's goals often are diametrically opposed to those of the stockholders.

Critics of the present corporate governance system often focus on a second issue: the insensitivity of corporate managers to various social and political concerns. Ralph Nader and other consumer advocates created a controversy in the 1970s over the unbri-

*the Rhetoric of Contract, 85 COLUM. L. REV. 1403, 1403 (1985)* (arguing that “[s]cattered stockholders lack the requisite information and institutional mechanisms either to bargain over the terms of management's employment, or to monitor and control management's activities”).

11. One commentator states:

Management would be fully accountable only if it could be replaced relatively easily by stockholders, or a representative group thereof, whenever conflicts between management and stockholders arose. However, management's power to maintain itself in office through access to corporate funds for conducting proxy contests is notorious.

Christy, *Corporate Mismanagement as Malpractice: A Critical Reanalysis of Corporate Managers' Duties of Care and Loyalty*, 21 Hous. L. Rev. 105, 106 n.5 (1984). Professor Christy further argues that corporate mismanagement causes virtually all business failures and that the business judgment rule offers far too much protection. *Id.* at 107-09.

12. See A. BERLE & G. MEANS, supra note 9, at 119-35. Many modern commentators view the corporation as a mere legal vehicle for uniting the various factors of production in an efficient manner. Because the corporation consists of many agents brought together to create a product or service, conflicts of interest and agency costs are inherent in the organization. Shareholders want to minimize these agency costs, in turn maximizing their profit. While enhancement of corporate profits also is likely to benefit management by increasing job security and compensation, some managers will increase agency costs by making bad judgments and engaging in self-aggrandizing behavior. For a discussion of potential managerial abuses when corporate power becomes separated from its owners, see Christy, *supra* note 11 (citing corporate expansion to gain prestige and higher salaries for management without regard to increased profits for shareholders as examples of managerial abuse). For recent economic literature discussing the separation of ownership and control, see generally Alchian & Demsetz, *Production, Information Costs and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Fama & Jensen, *Separation of Ownership and Control*, 26 J. L. & ECON. 301 (1983); Jensen & Meckling, *The Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537 (1981). See also Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1170 n.26 (1981) (suggesting that there is nothing "undesirable in the fact that many firms are controlled by managers rather than by stockholders" and that "this 'separation of ownership and control,' criticized so harshly in . . . *The Modern Corporation* . . . is nothing but another way of describing the division of labor").

The controversy intensified dramatically because of certain egregious occurrences, such as illegal campaign contributions and the publicized bribery of foreign public officials. Corporate America's perceived lack of concern for social issues became a topic of widespread debate.

Reformists have advanced several proposals for increasing the corporate hierarchy's responsiveness to the interests of both shareholders and society. These include an increased number of outside directors on corporate boards, federal chartering of corporations, and federally imposed higher standards of managerial conduct. Because the majority of large corporations have voluntarily increased the number of outside directors on their boards, and

14. R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976) [hereinafter GIANT CORPORATION]. Nader lists industrial pollution, toxic substances affecting workers, discrimination, loss of job satisfaction at mid-levels due to non-innovative "organizational" behavior, immense political power, invasions of privacy, local community domination, deceptive advertising, decreases in product safety, corporate concentration, irresponsible multinational corporate behavior (such as bleeding local resources and exploiting workers), elite concentration of wealth, and instances of corporate crime as the major effects of the unbridled growth of large corporations in America. Nader argues that lax standards in some states virtually have eliminated the utility of state corporation law as a regulator. Consequently, he advocates federal chartering of corporations in order to make corporate America more responsive to the public at large.

15. SECURITIES & EXCHANGE COMM'N, REPORT ON QUESTIONABLE AND ILLEGAL PAYMENTS AND PRACTICES SUBMITTED TO THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMM., 94th Cong., 2d Sess. (May 12, 1976).

16. For a discussion of the distinction between inside and outside directors, see supra An Historical Perspective (Special Project) notes 93-106 and accompanying text.

17. See Schwartz, A Case for Federal Chartering of Corporations, 31 BUS. LAW. 1125 (1976). Professor Schwartz asserts that federal chartering would be a comprehensive statute, applying federal standards consistently to all facets of corporation law . . . . It would not be mired in the questionable policies of state law, and it could scrap ineffectual practices. Moreover, the proper place to engage in far-reaching changes which have uncertain economic consequences . . . is the Congress.

18. See Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 683 (1974). Professor Cary argues that the states have entered a "race to the bottom" concerning their statutory standards of conduct for directors and officers. Cary credits Justice Brandeis for the "race to the bottom" phrase. According to Justice Brandeis, "Companies were early formed to provide charters for corporations in states where the cost was lowest and laws least restrictive. The states joined in advertising their wares. The race was not one of diligence but of laxity." Liggett Co. v. Lee, 288 U.S. 517, 558-59 (1933) (Brandeis, J., dissenting); see also N. CHAMBERLAIN, SOCIAL STRATEGY AND CORPORATE STRUCTURE 125 (1982); Schwartz, Federalism and Corporate Governance, 45 OHIO ST. L.J. 545 (1984).

19. Smith, Corporate Governance: A Director's View, 37 U. MIAMI L. REV. 273, 279
because federal chartering is politically impractical, a call for national uniform standards of conduct is the most popular proposed method of reform. The ALI Proposals seek, in part, to compile the various proposals for reform into a single uniform act. As a result, critics of the present corporate governance system are optimistic about the American Law Institute's attempt to codify and reform state corporation law.

In contrast, other scholars argue that the present system of corporate governance does not need extensive reform. These scholars posit several arguments to support their assertion that the market is the best regulator of managerial conduct. First, if a firm operates profitably, its stock price will be higher than a less profitable comparable firm. Because managers generally are compensated correlatively with firm profits and because managers wish to increase their own value to other potential employers, managers naturally will seek to maximize firm profits and, hence, shareholder wealth.

Second, shareholders take little or no interest in the manage-

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23. Professor Daniel Fischel of the Northwestern University School of Law is the most prominent defender of the status quo. In his article The Corporate Governance Movement, supra note 7, Professor Fischel contends that advocates of corporate reform have not defined a true "problem" in corporate governance and that the arguments of those who advocate the need for a change in corporate governance are based on a "failure to understand the economic theory underlying the corporate form of firm organization" and are not supported by any empirical evidence. Fischel, supra note 7, at 1259.
24. See infra note 29 and accompanying text.
25. Fischel, supra note 7, at 1283. Professor Fischel further explains that because managers work cooperatively, one manager's poor performance will affect adversely the other managers' wealth and reputation. Managers, therefore, will monitor closely each other's performance.
ment of the firm's management, and, therefore, are ineffective monitors of managerial behavior. If the firm's stock price drops or continually remains low, shareholders are more likely simply to sell their shares than to attack management's policies. Furthermore, if shareholders do undertake to monitor management, the challenges involved in mounting a proxy battle might be overwhelming. Thus, prospective corporate raiders seek out corporations with unduly low stock prices. If inefficient management permits a firm's stock price to deteriorate, an outsider will have a greater incentive to launch a takeover attempt, acquire the corporation, and replace existing management with directors and officers who will adhere to higher standards.

Third, opponents of a uniform federal standard of conduct for directors and officers assert that if lower standards of required conduct for directors and officers negatively affected shareholder wealth, shareholders simply would boycott corporations chartered in states with lax standards. One empirical analysis suggests that management usually will reincorporate in a state that maximizes

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26. Easterbrook & Fischel, supra note 12, at 1169 (noting that shareholders do not realize the bulk of the gain from more efficient managerial behavior and, therefore, probably will ignore most controversies within the firm).

27. Id. at 1173.

28. The idea that shareholders simply sell their stock rather than "voice" their dissatisfaction with managerial behavior has become known as the "Wall Street Rule." See Andrews, Corporate Governance Eludes the Legal Mind, 37 U. MIAMI L. REV. 213, 216 (1983); Weiss, supra note 7, at 5. But see Baysinger & Butler, Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law, 10 J. CORP. L. 431 (1984) (arguing that the exit option is not available for institutional or block shareholders, who would be more likely to exercise control over corporate managers).

29. See Baysinger & Butler, supra note 28, at 449. Baysinger and Butler explain the takeover process as follows:

If the managers of corporations do not act in their shareholders' best interests and implement an effective governance structure, the price of the corporations' stock will decline. There are two explanations for this phenomenon. First, higher costs (lower productivity) will lower expectations about the future earnings stream and this will be reflected in lower stock prices. Second, many shareholders who are dissatisfied with the firm's performance will register their dissatisfaction by either selling their shares or refusing to buy more. As a result of the increased relative supply, share prices will fall. This fall increases the probability of a hostile takeover as it simultaneously reduces the cost of purchasing control of the firm through a tender offer and increases the potential profitability (capital gains) from improving the performance of the firm.

Id.

30. Fischel, supra note 7, at 1264.

31. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 NW. U. L. REV. 913, 920 (1982) (arguing that it is in management's best interest to act in favor of shareholders and that Delaware's preeminence in corporation law is explained best by the fact that its permissive statute actually maximizes shareholder welfare).
stock price and shareholder wealth. Finally, while acknowledging that some jurisdictions may provide either too little or too much regulation for a particular corporation, advocates of the status quo argue that maintaining the present system of variation among the states provides a necessary diversity that services individual corporations with individual needs and unique stockholder compositions.

III. THE ALI PROPOSALS

This Special Project Note examines the specific proposals of the ALI in order to determine their potential impact on the common law concerning corporations. The ALI Proposals consist of six tentative drafts, each containing substantial revisions of the previous draft. No final draft exists at present; rather, each draft and its subsequent commentary is intended to help mold the ALI Proposals into a realistic approach to governing modern corporations.

A. Objectives of the Corporation — Section 2.01

In an attempt to address the two major criticisms of modern corporations—lack of managerial accountability and social irresponsibility—the ALI enacted section 2.01 to govern the objectives and conduct of a corporation. Many scholars and practitioners.
ers consider section 2.01 to be one of the least controversial provisions in the ALI Principles. Nevertheless, subsequent sections concerning directors’ and officers’ duties — including the duty of care and the duty of loyalty — all must be carried out in accordance with the objectives of section 2.01. The statement of objectives declares that a corporation should conduct its activities “with a view to enhancing corporate profit and shareholder gain.”

Section 2.01 affords wide discretion, however, by allowing, but not requiring, a reasonable amount of resources to be devoted to “public welfare, humanitarian, educational, and philanthropic purposes.” The comment to section 2.01 suggests that profit maximization is not necessarily inconsistent with public-spirited activity because, in the long run, an orientation toward lawful and ethical behavior may enhance profits.

with a view to enhancing corporate profit and shareholder gain, except that, whether or not corporate profit and shareholder gain are thereby enhanced, the corporation, in the conduct of its business

(a) is obliged, to the same extent as a natural person, to act within the boundaries set by law,

(b) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and

(c) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

Id. § 2.01.


39. Id. Comment c to § 2.01 states that § 2.01 “serves as a general guide to the conduct of the business corporation . . . [and] sets a backdrop for other, more specific provisions in subsequent Parts, and assists in the interpretation of those provisions.” T.D. No. 2, supra note 1, § 2.01 comment c.

40. Id. § 2.01 comment c.

41. Id. § 2.01(c); see also Perkins, supra note 34, at 1201. Thus, if the board of directors for the Chicago Cubs decides that it is more beneficial to the community, although less profitable to shareholders, for the Cubs to play baseball during the daytime, then § 2.01, along with the business judgment rule, would allow this discretion. See Shlensky v. Wrigley, 96 Ill. App. 2d 173, 237 N.E.2d 776 (1965).

42. T.D. No. 2, supra note 1, § 2.01 comment f. But see White, How Should We Talk About Corporations? The Languages of Economics and Citizenship, 94 Yale L.J. 1416, 1424 (1985). Professor White argues that the ALI’s supposed synthesis of economic objectives and socially responsible behavior is imperfect because it furthered the view that socially responsible behavior is valuable only because it may increase long-term profits. White would impose a loftier, but arguably less practical, standard: “The business corporation should always endeavor to act as a responsible citizen in its economic and other activities.” Id.
B. Structure of the Corporation — Sections 3.01 and 3.02

Sections 3.01 and 3.02 of the ALI Proposals outline the structure of a corporation and the various functions of corporate directors and officers. In formulating the structure for a modern corporation, the ALI Reporters sought to incorporate two “important social needs”: (1) flexibility in the corporate structure; and

43. Section 3.01 defines the powers and functions of a corporation's senior executives: The management of the business of a publicly held corporation . . . should be conducted by or under the supervision of such senior executives . . . as may be designated by the board of directors in accordance with the standards of the corporation . . . and by those other officers . . . and employees to whom the management function is delegated by those executives, subject to the powers and functions of the board under § 3.02.

T.D. No. 2, supra note 1, § 3.01.

44. Section 3.02 defines the powers and functions of the board of directors: (a) Except as otherwise provided by statute, the board of directors of a publicly held corporation should:

(1) Elect, evaluate, and, where appropriate, dismiss the principal senior executives . . .

(2) Oversee the conduct of the corporation's business with a view to evaluating, on an ongoing basis, whether the corporation's resources are being managed in a manner consistent with the principles of § 2.01 . . .

(3) Review and approve corporate plans and actions that the board or the principal senior executives consider major, and changes in accounting principles and practices that the board or the principal senior executives consider material.

(4) Perform such other functions as are prescribed by law, or assigned to the board under a standard of the corporation. . .

(b) Except as otherwise provided by statute or by a standard of the corporation, the board of directors of a publicly held corporation should also have power to:

(1) Make recommendations to shareholders.

(2) Initiate and adopt major corporate plans, commitments, and actions, and material changes in accounting principles and practices; instruct any committee, officer or other employee; and review the actions of any committee officer or other employee.

(3) Manage the business of the corporation.

(4) Act as to all other corporate matters not requiring shareholder approval.

(c) Except as otherwise specifically provided by statute or by a standard of the corporation, and subject to the board's ultimate responsibility for oversight under § 3.02(a), the board may delegate to its committees authority to perform any of its functions and exercise any of its powers.

Id. § 3.02.

45. See id., Introductory Note to Part III at 58. The Introductory Note states: For purposes of clarity, the term “function” is used in Parts III-IV in a separate sense from the term “duty.” The term “function” is used to describe the tasks to be performed by a particular corporate organ or official. The term “duty” is used to describe the obligation of all corporate organs and officials to perform their functions in the manner described in Parts IV and V.

Id.

46. Id. at 53. The Introductory Note explains that various provisions of Chapter III
(2) protection of shareholders through greater management accountability. Section 3.01 states that the corporation's senior executives shall manage the daily business operations of a public

further the goals of flexibility and accountability:

(i) Some provisions, such as those concerning the functions of the senior executives and the board, are formulated in terms of the rules that a well-instructed court would be expected to adopt, giving weight to all the considerations that courts are expected to take into account.

(ii) Some provisions, such as those concerning the nominating and compensation committees and the makeup of the board, are formulated as recommendations concerning corporate practice. These recommendations are made to corporations and their counsel, and are not intended as legal rules, noncompliance with which would impose liability. The purpose of these recommendations is to further the voluntary adoption of structures that help enhance managerial accountability. . . .

(iii) Finally, one provision, concerning the presence and composition of an audit committee in large publicly held corporations, is formulated as a recommended statutory provision.

Id. at 55-56.

47. Tentative Draft No. 1 originally required, as a matter of black-letter law, that outside directors compose a majority of the board; that these outside directors have more power than the inside directors; and that every corporation have an audit committee, a nominating committee, and a compensation committee composed entirely of outside directors. T.D. No. 1, supra note 1, §§ 3.03-3.07. Largely because of the angry reaction to Tentative Draft No. 1, Tentative Draft No. 2 omitted the requirement of a majority of outside directors, eliminated the distinction in power between inside and outside directors, and retained only the audit committee provision. See T.D. No. 2, supra note 1, Foreword at ix. These changes expand a corporation's flexibility by greatly “contract[ing] the scope of recommended legal mandates in favor of much broader opportunity for voluntary variations.” Id. For a discussion of the dangers of a highly structured corporation model, see Andrews, Rigid Rules Will Not Make Good Boards, HARV. BUS. REV., Nov.-Dec. 1982, at 34, reprinted in Roundtable Statement, supra note 7. See also Smith, Corporate Governance: A Director's View, 37 U. MIAMI L. REV. 273 (1983).

48. The Introductory Note to Chapter III acknowledges that both the product and capital markets, as well as direct review by shareholders, act as checks on managerial behavior. See supra notes 9-33 and accompanying text. The comment, however, warns that direct review by the body of shareholders . . . is seldom efficacious in publicly held corporations, because of the disparate and shifting nature of the shareholder body and the complexity of modern management issues . . . . Similarly, the discipline of the market for corporate control is limited by a number of elements, including the high transaction costs of takeover bids, the necessity to offer a premium well in excess of market price, the requirements of relevant statutes, the defensive techniques available, the incentives to take over well-run rather than poorly run companies and the time-lag often experienced by the public in ascertaining lack of managerial efficiency.

T.D. No. 2, supra note 1, Introductory Note at 54. Thus, the ALI Reporters view the board of directors as a particularly important guarantor of managerial accountability.

49. See Am. B. Ass'n, Section of Corporation, Banking and Business Law Committee on Corporate Laws, Corporate Director's Guidebook, 33 Bus. LAW. 1591 (1978).

It is generally recognized that the board of directors is not expected to operate the business. Even under statutes providing that the business and affairs shall be “managed” by the board of directors, it is recognized that actual operation is a function of management. The responsibility of the board is limited to overseeing such operation.

Id. at 1603.
corporation. Section 3.02 states that the board of directors is required to "oversee" the activities of the corporation. Section 3.02 requires the board to perform certain minimum functions, but permits it to be as active as necessary. The comment to section 3.02 acknowledges that this formulation differs from most state statutes. Nevertheless, the ALI Reporters assert that their articulation provides a summary of "basic functions and powers which almost certainly would be arrived at by the courts in light of the language of these statutes, read in the context of modern corporate practice."

The idea that corporate directors merely should "oversee" the corporation, not "manage" it, stems from the realization that corporate directors simply do not have the time to participate actively in the daily affairs of the corporation. In response to this reality,
Professor Melvin A. Eisenberg developed the monitoring model concept, which indirectly evaluates the overall performance of the senior executives rather than directly supervising their activities. While Herbert Wechsler, former director of the American Law Institute, asserts that changes were made between the first and second tentative drafts "to assure that the 'monitoring' model for the function of directors of a large, publicly held corporation is not thought to be prescribed," at least one commentator asserts

(3) at directors meetings ordinary board decisions often crowd out truly pressing issues because they are "compulsory agenda items;"
(4) directors are required to make risky decisions without complete information;
(5) the composition of the modern board is increasingly diverse and often includes directors not well-versed in business matters;
(6) the board of directors usually takes action by a consensus vote; and
(7) a typical board will only address approximately ten to fifteen major transactions a year.

*Id.* at 1481-83.

55. Professor Eisenberg is a Reporter for Parts I, II, and III of the ALI Principles.
56. See M. EISENBERG, THE STRUCTURE OF THE CORPORATION 156-69 (1976). Professor Eisenberg asserts that because the board of directors cannot "manage" the corporation effectively,

four clusters of functions remain: providing advice and counsel to the office of the chief executive; authorizing major corporate actions; providing a modality by which persons other than executives can be formally represented in corporate decisionmaking; and selecting and dismissing the members of the chief executive's office and monitoring that office's performance.

*Id.* at 157 (footnote omitted).

Professor Eisenberg, however, concludes: (1) that the advice and counsel function is not essential ("[i]f the chief executive does want outside advice, he can and frequently will obtain it from the corporation's lawyers, accountants, or bankers, rather than from the board," *id.* at 157-58); (2) that while the authorization function is important, its utility is limited ("beyond serving as an audience, and a generally agreeable one at that, the board's reviewing role is usually quite limited, since its decisions must normally turn on analysis prepared by the very executives who formulate that which is being analyzed," *id.* at 159); and (3) that other "modalities" equally can represent shareholder groups ("[t]hese [other] modalities may be more effective mechanisms than board membership for the exercise of influence by client and social groups, since they can be closely tailored to the substantive and procedural needs of each group," *id.* at 161). Thus, Eisenberg sees the monitoring function as critical. He argues that the selection of senior officers is more than a mere formality, despite the outgoing chief executive officer's influence. While board emphasis presently is placed on policymaking, the monitoring model allows the board to hold officers accountable "for adequate results (whether financial, social or both), while the role of the executives is to determine how to achieve those results." *Id.* at 165 (footnote omitted). Furthermore, Eisenberg notes that the board's independence from management is inherent in the notion that directors must monitor the performance of senior management. He cites two necessary elements in a properly functioning monitoring model: (1) an independent board; and (2) a free flow of, or at least an ability to obtain, impartial and substantial information on the executives' performance. Thus, Professor Eisenberg sees the monitoring model as a means of utilizing the board's time effectively in a capacity that assures management's accountability. *Id.* at 170.

57. T.D. No. 2, supra note 1, § 3.02 comment d at 69.
58. *Id.* Foreword at ix.
that the ALI formulation is consistent with Professor Eisenberg’s monitoring model.\footnote{See Karmel, The Independent Corporate Board: A Means to What End?, 52 Geo. Wash. L. Rev. 535, 549-50 (1984).}

Section 3.02(a)(1) of Tentative Draft No. 2 of the ALI Principles provides that the board of directors shall select and evaluate senior executives.\footnote{T.D. No. 2, supra note 1, § 3.02(a)(1).} Furthermore, section 3.02(a)(2) provides that the board shall “[o]versee the conduct of the corporation’s business with a view to evaluating, on an ongoing basis, whether the corporation’s resources are being managed in a manner consistent with the principles of section 2.01.”\footnote{Id. § 3.02(a)(2).} While the comment to Section III recognizes that the board should not have an adversarial relationship with senior management,\footnote{Comment d to § 3.02 states: The board’s obligation to oversee the performance of the principal senior executives does not imply an antagonistic relationship between the board and the executives. Rather, it contemplates a collegial relationship that is supportive as well as watchful. To paraphrase the Business Roundtable Statement, the relationship between the board and the executives should be challenging yet positive, arm’s length but not adversary. Id. § 3.02 comment d at 69 (citation omitted).} it also emphasizes the importance of the board’s monitoring role in fulfilling corporate objectives.\footnote{Id. § 3.02 comment d at 69 (citation omitted).} Finally, section 3.02 requires the board to review and approve all corporate plans that either the board or senior management considers material.\footnote{Id. § 3.02(a)(2).}

The monitoring model concept spurred a movement to require that corporate boards contain “outside”\footnote{Id. § 3.02(a)(3). Comment f to Part III lists examples of “major corporate actions:” the creation of significant long-term debt, programs for the reacquisition of equity or debt securities, significant capital investments, significant acquisitions of stock in other corporations, business combinations including those effected for cash, and the disposition of significant businesses.} or independent directors...
as well as inside management. Professor Eisenberg and others have argued that nonmanagement directors would provide a better check on senior executives. In fact, Tentative Draft No. 1 of the ALI Principles required a board of directors to consist of a majority of outside directors. This proposal was deleted, however, in Tentative Draft No. 2. Instead, section 3.03 requires that

which the corporation made, or from which the corporation received, during either of its two preceding fiscal years, commercial payments that, when multiplied by his percentage equity interest in the organization, exceeded $200,000;

(d) He is a principal manager of a business organization to which the corporation made, or from which the corporation received, during either of the organization's two preceding fiscal years, commercial payments that exceeded 5 percent of the organization's consolidated gross revenues for that year, or $200,000, whichever is more; or

(e) He is affiliated in a professional capacity with a law firm that was the primary legal adviser to the corporation with respect to general corporate or securities-law matters, or with an investment-banking firm that was retained by the corporation in an advisory capacity or acted as a managing underwriter in an issue of the corporation's securities, within the two preceding years, or was so affiliated with such a law or investment-banking firm when it was so retained or so acted.

(2) A director shall not be deemed to have a significant relationship with the senior executives under § 1.26(1)(c)-(e) if, on the basis of countervailing or other special circumstances, it could not reasonably be believed that the judgment of a person in the director's position would be affected by his relationship under § 1.26(1)(c)-(e).

(3) For purposes of § 1.26 (and § 1.19, to the extent it is incorporated in § 1.26 by reference) the term "the corporation" includes any corporation that controls . . . the corporation, and any subsidiary or other business organization that is controlled by the corporation, and the term "year," used without the qualifying term "fiscal," means the twelve preceding months.

Id. § 1.26 (emphasis in original) (citations omitted).

66. Karmel, supra note 59, at 543.

67. Harold M. Williams, Chairman of the SEC from 1977 to 1981, also was influential in seeking to establish boards consisting entirely of outside directors. He stated that "directors who have business links to the corporation impose a cost on the accountability process, and we need to consider carefully in each situation whether that cost is a necessary one to incur, and whether the benefits can be achieved in other ways." Williams, Corporate Accountability and Corporate Power, in The 1979 Benjamin F. Fairless Memorial Lectures: Power and Accountability: The Changing Role of the Corporate Board of Directors 18 (1979).

68. But see Note, The Propriety of Judicial Deference to Corporate Boards of Directors, 96 Harv. L. Rev. 1894, 1901 (1983) (arguing that the board of directors' "cohesiveness" and informational dependence on management will lead it to conform to management's views); Scott, supra note 7, at 934 (noting that "inside directors have much stronger reasons to monitor effectively and to strive for accurate judgments because their careers are at stake").

69. T.D. No. 1, supra note 1, § 3.03.

70. Perkins, supra note 34, at 1202 (stating that the proposal was deleted because most large, publicly held corporations already had a majority of outside directors). Section 3.04 recommends that, as "a matter of corporate practice," a majority of the board of a large, publicly held corporation have no significant relationship with the senior executives: It is recommended as a matter of corporate practice that:
large, publicly held corporations have an audit committee, composed of at least three outside directors, to oversee the corporation's audit process. The ALI Reporters assert that this requirement provides sufficient objectivity to review management performance and to encourage the exposure of "potentially troublesome issues at a relatively early stage."

(a) The board of every large publicly held corporation . . . should have a majority of directors who are free of any significant relationship . . . with the corporation's senior executives . . . unless a majority of the corporation's voting securities . . . are owned by a single person . . . a family group . . . or a control group . . .

(b) the board of a publicly held corporation . . . that does not fall within subsection (a) should have at least three directors who are free of any significant relationship with the corporation's senior executives.

T.D. No. 2, supra note 1, § 3.04.

These nonmandatory provisions are intended to encourage corporate directors and officers to take voluntary steps toward making management more accountable to shareholders. See supra note 47 and accompanying text.

71. The ALI Proposals provide that a corporation will fall into one of three categories: (1) a large, publicly held corporation, defined as a corporation having 2000 or more recordholders of its equity securities and $100 million or more in assets; (2) a publicly held corporation, defined as a corporation having 500 or more recordholders of its equity securities and $3 million in assets; or (3) anything smaller. See T.D. No. 2, supra note 1, Part III Introductory Note at 57-58. A corporation does not fall out of a particular category, however, unless it remains below that standard for two consecutive years. Id.; see also supra An Historical Perspective (Special Project) note 31 and accompanying text.

72. Section 3.03 provides:

Every large publicly held corporation . . . should have an audit committee, to oversee the audit process, consisting of at least three members, and composed of directors who are neither employed by the corporation nor persons who were so employed within the two preceding years, including at least a majority of members who have no significant relationship . . . with the corporation's senior executives.

T.D. No. 2, supra note 1, § 3.03. The Reporter proposes that this audit committee be mandatory for first-tier or large, publicly held corporations. The Reporter acknowledges that an audit committee is not required by any state except Connecticut. See Conn. Gen. Stat. § 33-318(b) (Supp. 1986). Comment a, however, states that while this provision would be a new proposal, corporations listed on the New York Stock Exchange (NYSE) already are required to have an audit committee. Because most first-tier corporations are listed on the NYSE, the Reporter believes that this provision is simply a needed codification of a widespread, current corporate practice.

Comment b to § 4.01(a) (the duty of care provision, see infra notes 86-109), in referring to a director's functions, states that "it is a matter of legislative intent in each instance as to whether or not the principles expressed in § 4.01(a) are applicable to breaches of specially imposed functions and obligations." Thus, the Reporter leaves open the question as to whether directors with special or unique obligations, such as directors serving on a board committee analyzing a proposed takeover, are exposed to greater liability. See generally T.D. No. 2, supra note 1, Reporter's Note at 80-82. But see Andrews, supra note 47, at 38 (arguing that these changes are too formal and inflexible—possibly imposing liability on directors for failure to institute the proper structure).

73. T.D. No. 2, supra note 1, § 3.03 comment c(ii).
The changes in Tentative Draft No. 2 have decreased the ALI Principles’ impact on the overall structure of corporations and the specified responsibilities of directors and officers. Nevertheless, the ALI formulation is far more explicit than the Revised Model Act’s provisions, and many commentators suggest that the inflexible approach proposed by the ALI ultimately will inhibit the effectiveness of the board of directors. While the ALI Proposals clearly depart from the present law, they are, to a certain extent, reflective of current corporate practice. Until a consensus develops over whether it is necessary or proper to restructure the majority of corporate boards in the United States, the ALI Proposals will continue to be controversial.

IV. The Duty of Care and the Business Judgment Rule — Section 4.01

Until the recent Smith v. Van Gorkom decision, few courts had found corporate directors or officers liable for breaching their duty of care absent self-dealing or truly egregious behavior. Courts often have confused the terms “agent,” “trustee,” and “fiduciary” in defining the legal relationship of directors and officers to the corporation. Furthermore, the common law has developed not one but three divergent standards governing directors’ and of-
In response to this judicial confusion, the American Law Institute has codified directors' and officers' duty of care and the business judgment rule. Neither the Revised Model Business Corporation Act nor the Delaware General Corporation Law contains a comprehensive formulation of the standards of care, although amendments to those laws in recent years have already partially fashioned them. Courts have frequently mixed up their standards in the same opinion in the most confusing manner, sometimes as if the standards were virtually interchangeable. For example, a court may articulate some impossibly rigid fiduciary standard, drawn from ancient trust law, and then, after analysis of the facts, absolve a director or officer from liability for a corporate act because he did not show bad faith, venality, intent to harm or failure to meet some other loose standard far removed from the trust-type language from whence the court commenced its analysis.

Perkins, supra note 34, at 1203; see also supra An Historical Perspective (Special Project) notes 11-14 and accompanying text. The three most common standards for the duty of care are (1) that degree of care required to avoid gross negligence, (2) that degree of care that an ordinarily prudent director or a person in a like position would exercise under similar circumstances, and (3) that degree of care that an ordinarily prudent person would exercise in conducting personal affairs.

Section 4.01 of Tentative Draft No. 4 states:

(a) A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

(1) This duty includes the obligation to make, or cause to be made, such inquiry as the director or officer reasonably believes to be appropriate under the circumstances.

(2) In performing any of his functions (including his oversight functions), a director or officer is entitled to rely on materials and persons in accordance with §§ 4.02-.03.

(b) Except as otherwise provided by statute or by a standard of the corporation and subject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate, formally or informally by course of conduct, any function (including the function of identifying matters requiring the attention of the board) to committees of the board or to directors, officers, employees, experts, or other persons; a director may rely on such committees and persons in fulfilling his duty under this Section with respect to any delegated function if his reliance is in accordance with §§ 4.02-.03.

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

(1) he is not interested . . . in the subject of his business judgment;

(2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and

(3) he rationally believes that his business judgment is in the best interests of the corporation.

(d) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of duty of care (and the inapplicability of the provisions as to the fulfillment of duty under Subsection (b) or (c)), and the burden of proving that the breach was the legal cause of damage suffered by the corporation.

T.D. No. 4, supra note 1, § 4.01 (footnotes omitted).
ration Act\textsuperscript{83} nor any state statute\textsuperscript{84} presently codifies the business judgment rule; the ALI articulation represents the first attempt at codification by a major legal organization.

A. The Duty of Care — Section 4.01(a)

Section 4.01(a) of the ALI Principles outlines corporate directors' and officers' duty of care. The ALI Reporters adopted the majority standard for the duty of care: the care that an ordinarily prudent person reasonably would be expected to exercise in a like position under similar circumstances.\textsuperscript{85} This language echoes traditional common-law negligence standards. The debate continues, however, over whether the prevailing test should be one of ordinary negligence or gross negligence.\textsuperscript{86}

Applying an ordinary negligence standard is problematic because the policy considerations in an ordinary tort case — deterrence and shifting losses — are very different from those underlying a derivative suit.\textsuperscript{87} Furthermore, if courts were to apply an
ordinary negligence standard to a director's actions, almost any business failure could constitute a breach of the duty of care. In essence, an ordinary negligence test operates on an instance-by-instance basis, potentially imposing liability on a director for any incorrect decision. Innovation in American business requires that courts not hold directors to a rigorous standard, but rather permit them to make decisions using their best business judgment without fear of liability. The purpose of the business judgment rule, therefore, is to protect directors' decisions if they act in good faith and have a rational business purpose in making the decision.

Losses caused by honest mistakes on the part of the board can amount to many times the resources of even affluent directors. Id. at 643.

88. Manning, supra note 54, at 1486. Mr. Manning asserts that because of the complex nature of corporate decisions, no director ever will acquire all possible information when investigating a decision. In retrospect, therefore, a plaintiff can present a persuasive case that the director could and should have taken into consideration a particular publication or study that would have prevented the faulty decision.

89. The imposition of liability on an instance-by-instance basis is inappropriate and unrealistic because it is impossible to make an exhaustive, all-encompassing investigation for each decision. See Kennedy, supra note 87, at 630. The United States Court of Appeals for the Second Circuit has stated:

While it is often stated that corporate directors and officers will be liable for negligence in carrying out their corporate duties, all seem agreed that such a statement is misleading . . . . Whereas an automobile driver who makes a mistake in judgment as to speed or distance injuring a pedestrian will likely be called upon to respond in damages, a corporate officer who makes a mistake in judgment as to economic conditions, consumer tastes or production line efficiency 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 and this reluctance to impose liability for unsuccessful business decisions has been doctrinally labelled the business judgment rule.

Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982).

90. Hansen, supra note 7, at 1241; see also Demsetz, The Monitoring of Management in Roundtable Statement, supra note 7, at Exhibit B. Professor Demsetz, a professor of economics, discusses the problem of the decrease in innovative risk-taking that results when a director's exposure to liability is increased:

Board members prepared to tolerate frequent poor performance in order to increase the probability of an occasional big profit payoff to the firm are put at greater risk of being sued successfully than are members who seek to guide their firms into policies that are very typical of those being adopted by other firms . . . . This bias in the board's decisions would work to the disadvantage of stockholders over the long run because the risk of being second guessed about business decisions in a court of law inevitably creates a tendency to avoid strategies that seek an occasional big profit payoff from a policy different than that being followed by "the crowd." Such a policy will be avoided to some extent even when it is expected to yield large enough profits in a few years to more than offset the more frequent losses that are a necessary prelude to such a payoff.

Demsetz, supra, at B-1.

91. The "rational business purpose" element of the business judgment rule is controversial. See infra notes 127-32 and accompanying text.
Thus, despite the "ordinarily prudent director" standard articulated in many statutes and opinions, most courts have held directors personally liable only if they were grossly negligent.

Critics of the ALI Proposals argue that section 4.01 does not accurately reflect present corporation law. Charles Hansen, general counsel for Emerson Electric, asserts that while courts have often espoused the "ordinarily prudent person in similar circumstances" language in dicta, their holdings reflect that a director will not be held liable absent egregious behavior. Mr. Hansen, therefore, argues that the ALI standard for the duty of care should reflect the courts' actual holdings, not their dicta. In contrast, Ros-

92. The business judgment rule has been codified by the ALI in § 4.01(c) of Tentative Draft No. 4. See infra notes 110-32 and accompanying text. For a discussion of various common-law formulations of the business judgment rule, see supra An Historical Perspective (Special Project) notes 52-57 and accompanying text. For a discussion of the various elements of the business judgment rule as articulated in recent court decisions, see Veasey & Seitz, supra note 86, at 1484-93.

93. See supra An Historical Perspective (Special Project) notes 15 and accompanying text.

94. See id. note 20 and accompanying text.

95. See id. note 53 and accompanying text.

96. Hansen, supra note 7, at 1237.

97. According to Mr. Hansen:

Two primary problems exist [with the ALI formulation]. The first is that a torts-derived results-oriented standard has been used for formulating the duty of due care. The second is the Reporters' failure to distinguish sharply between case holdings and dicta. These problems together make the duty of care and business judgment provisions, as drafted, difficult to understand and apply consistently with current law.

Id. at 1237-38 (footnote omitted); see also Phillips, Principles of Corporate Governance, A Critique of Part IV, 52 Geo. Wash. L. Rev. 653, 662 (1984) (stating that "[t]he Reporter's choice of dictum over holding represents a preference for formalistic statement of doctrine over contextual focus").

98. But see Steinberg, supra note 86, at 304. Professor Steinberg interprets § 7.06(d) of Tentative Draft No. 1, which proposes a ceiling on damages for negligence, to indicate that the Reporter endorses a "negligence" standard. He asserts that "[t]he Draft Restatement seeks to overcome this judicial reluctance [to find directors liable] by making it explicitly clear that negligent behavior by corporate fiduciaries is actionable." Id. According to William Kennedy, the ceiling's purpose is "to enhance directors' due-care obligations by increasing the likelihood of judgments adverse to defendants. The whole thrust of the ceiling is to invite courts to 'sting' but not 'bust' directors." Kennedy, supra note 87, at 642 (footnote omitted). Mr. Kennedy notes that the most likely effect of the ceiling will be to encourage settlements between shareholder-plaintiffs and director-defendants because potential liability for an honest mistake will be increased, while the likelihood of receiving an unlimited judgment against a director remains fairly low. Faced with this situation, directors would be more likely to settle and avoid a costly legal defense. Id.

The new ceiling provision, § 7.17(a) of Tentative Draft No. 6, states:

(a) If a failure by a director . . . or an officer . . . to meet the standard of conduct specified in § 4.01 did not

(1) involve a knowing and culpable violation of law; or
well Perkins, president of the American Law Institute, argues that because the word “negligence” does not appear in the ALI’s articulation, courts will continue to analyze specific fact situations “under a time-honored and generalized articulation of the concept.”

Some commentators assert that the ALI standard will make directors more cautious and less willing to take risks, thereby inhibiting business innovation. Furthermore, these commentators argue, the phrase “in a like position, and under similar circumstances” assumes that judges interpreting this standard will have an informed perception of corporate directors’ responsibilities and pressures. In reality, however, there is no universal list of direc-

(2) enable the defendant, or an associate, . . . to receive an improper benefit to which the defendant, or such associate, was not entitled under Part V; or
(3) show a conscious disregard for the defendant’s duty to the corporation under circumstances that threatened serious injury to the corporation; or
(4) constitute a sustained and unexcused pattern of inattention that amounted to an abdication of the defendant’s duty to the corporation, damages for the violation should be limited to an amount that is not disproportionate to the economic benefits to the defendant for serving the corporation.

T.D. No. 6, supra note 1, § 7.17(a).

Comment c to this provision provides that “[a]lthough the business judgment rule should serve as the primary bulwark of protection for the board, even the diligent and prudent director who complies fully with the requisite standard of care may fear that the factfinder will misperceive the actual facts.” T.D. No. 6, supra note 1, § 7.17(a) comment c. Thus, § 7.17 does not covert § 4.01(a) into a negligence standard as Professor Steinberg proposes. Section 7.17 applies after the determination of a breach of the duty of care. Comment a to § 4.01(a) states that “the black letter set forth in the first paragraph of Subsection (a) is consistent with the duty of care standards articulated in most jurisdictions today.” T.D. No. 4, supra note 1, at 8. The current standard is one of gross negligence and was not intended to be changed by the § 7.17 ceiling on damages.

99. Perkins, supra note 34, at 1205.
101. Cf. T.D. No. 4, supra note 1, § 4.01(a) comment h. Comment h states that: Courts should, of course, apply § 4.01(a)’s reasonable care standards with balance, fairness, and a realistic sense of what may reasonably be expected, in given circumstances, from a corporation’s directors and officers. . . . Any judgment as to whether a given director has exercised the requisite care with respect to the board’s oversight obligations should take into account all relevant circumstances. These may include:
(i) the foreseeability of the problem that allegedly developed because of the claimed failure of oversight;
(ii) the foreseeability of the magnitude of the problem that developed;
(iii) the state of the corporation’s business during the period in question (e.g., was it a period of stable profitability or of financial crisis and corporate change);
(iv) the complexity and scale of the corporation;
(v) the reliability of, and confidence to be placed in, other directors, officers, employees, experts, other persons, and committees of the board . . . and
tors' functions nor an authoritative source delineating directors' common experiences.  

B. The Duty of Inquiry — Section 4.01(a)(1)(a)

Encompassed within section 4.01's duty of care standard is the requirement that a director make "such inquiry as the director or officer reasonably believes to be appropriate under the circumstances." At present only one state statute contains a similar "reasonable inquiry" provision; the ALI Reporters, however, assert that a director's or officer's duty to inquire is "generally recognized in the case law and by commentators."

(vi) the precise role the director played within the corporation during the period in question. For example, the length of time that a director has served on the board and whether a director assumed special obligations (e.g., as a member of the audit committee) or was attentive and diligent in general with respect to corporate affairs during the period may be relevant in evaluating whether he had exercised reasonable care.

102. Manning, supra note 54, at 1493. Mr. Manning points out that it is difficult for nondirectors to comprehend a director's experience and also that individual boards of directors vary widely in their mode of operation, thus making each experience unique. Id. at 1482-83. The ALI responds to this problem in § 4.01(a) comment e:

There is an increasing body of literature . . . which will undoubtedly continue to expand, [which] should help to illuminate for courts the meaning of "in a like position and under similar circumstances." The comments made in the Introductory Note to Part IV are pertinent here. These pertain to the practical limitation on what can be expected of a director or officer by virtue of such factors as the complexity of the modern corporation, the need for reliance, and the group dynamics of the board room.

T.D. No. 4, supra note 1, § 4.01(a) comment e; see also supra note 101 and accompanying text.

103. T. D. No. 4, supra note 1, § 4.01(a)(1).

104. California Corporation Code § 3.09(a) provides:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

CAL. CORP. CODE § 3.09 (West 1977) (emphasis added).

The legislative committee comment, however, explains that a director is not required to inquire "regardless of the circumstances," but only if the director is put on notice by the presence of "suspicious circumstances." Id. commentary at 188; see Stern, The General Standard of Care Imposed On Directors Under the New California General Corporation Law, 23 U.C.L.A. L. Rev. 1269, 1279 (1976) (cited by the ALI Reporters in comment a to § 4.01(a)(1)-(2)).

105. T.D. No. 4, supra note 1, § 4.01(a)(1)-(2) comment a at 43. In support of this proposition, the Reporters cite Barnes v. Andrews, 298 F. 614, 615-16 (S.D.N.Y. 1924) (stating that "[d]irectors have an individual duty to keep themselves informed in some detail"), and Frances v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814 (1981), which states:

Directors are under a continuing obligation to keep informed about the activities of the corporation . . . . Directors may not shut their eyes to corporate misconduct and then
In contrast, existing corporation law requires a director or officer to inquire only if circumstances would place a reasonable director or officer on notice.\(^{106}\) Thus, the Business Roundtable, when commenting on Tentative Draft No. 1, argued that the ALI Principles’ provision went “beyond current law.”\(^{107}\) Perhaps because of the Roundtable’s criticism, section 4.01(a)(1) of Tentative Draft No. 4 was changed to read as follows:

This duty includes the obligation to make, or cause to be made, an inquiry claim that because they did not see the misconduct, they did not have a duty to look. The sentinel asleep at his post contributes nothing to the enterprise he is charged to protect. . . . Directorial management does not require a detailed inspection of day-to-day activities, but rather a general monitoring of corporate affairs and policies. \textit{Frances}, 87 N.J. at 31-32, 432 A.2d at 822. The Reporters assert that the “inquiry” obligation is an inherent element of the duty of care; therefore, § 4.01(a)(1) merely provides clarity and “does not expand the obligation that already exists under current law.” \textit{T.D. No. 4, supra} note 1, § 4.01(a)(1) comment a at 44-45.

106. A director must investigate when suspicious circumstances trigger an inquiry. This “red flag” test was first articulated by the Delaware Supreme Court in Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963). The Graham court found that the directors had no duty to “ferret out wrongdoing which they have no reason to suspect exists.” \textit{Id.} at 85, 188 A.2d at 130.

107. \textit{Roundtable Statement, supra} note 7, at 46. The Business Roundtable points out that California is the only state to adopt a “reasonable inquiry” provision. Nevertheless, even the legislative comment to the California statute, see \textit{supra} note 104, adopts a “notice-inquiry” standard that is “perfectly consistent” with current case law. \textit{Roundtable Statement, supra} note 7, at 47.

Citing the commentary to § 4.01(b) of Tentative Draft No. 1, which requires reasonable inquiry from directors “in most instances” concerning major corporate changes and commitments, the Roundtable argues that § 4.01(b) of Tentative Draft No. 1 could be interpreted as eliminating the “notice” requirement and endorsing a general duty of inquiry within the duty of care. \textit{Id.} The Roundtable also reviewed Advisory Group Draft No. 3, which contained language resembling the Tentative Draft No. 4 § 4.01(a)(1) formulation, and stated that it was a “step in the right direction.” \textit{Id.} The Roundtable specifically endorsed the “notice-inquiry” standard. \textit{Id.} at 47. The comment to Tentative Draft No. 4 is considerably more subdued than the comment to Tentative Draft No. 1 that was criticized by the Roundtable. Comment b to § 4.01(a)(1) in Tentative Draft No. 4 provides:

In many instances, the documentation and presentations related to the board’s review and approval of a major action will not raise significant questions and the board will be able to act on the officers’ recommendations without further inquiry. The board’s actions would be entirely proper in these circumstances. Nothing in Subsection (a)(1) is intended to encourage needless inquiries or the creation of burdensome paper records. In other instances, an obligation to make inquiry might arise, but could be satisfied by questions to officers about the ramifications of a major commitment. In still other instances, discussions with inside or outside attorneys, auditors, or other experts, as well as presentations by corporate officers, might be necessary. \textit{T.D. No. 4, supra} note 1, § 4.01(a)(1) comment b at 46.

Thus, the commentary to Tentative Draft No. 4, in contrast to the commentary to Tentative Draft No. 1, allows the board to make many decisions without inquiry. According to Tentative Draft No. 4, certain instances, but not “most instances,” require inquiry as set forth in Tentative Draft No. 1.
when, but only when, the circumstances would alert a reasonable director or
officer to the need therefore. The extent of such inquiry shall be such as the
director or officer reasonably believes to be necessary.108

This change reduces the impact of the ALI Principles’ original
duty of inquiry and is not intended to expand current corporation
law.109

C. The Business Judgment Rule — Section 4.01(c)

Section 4.01(c) of the ALI Principles endeavors to codify the business judgment

108. See Perkins, supra note 34, at 1206. The members of the ALI proposed this for-
mulation at their May 1985 meeting. This change has not been translated into a draft yet,
but, according to Perkins, is in essence a codification of the “red flag” test. Id.; see also
Vessey & Seitz, supra note 86, at 1504 (stating that “[t]here is no doubt that the 1963
Graham court could have construed this [latest] provision as a ‘red flag’ test”).

The ALI Reporters, however, specifically reject the Graham test, see supra note 106,
because Graham concerns a board of directors’ failure to monitor the law compliance poli-
cies of the corporation. The Reporters interpret the Graham test to permit a “passive” role
for the board with respect to this dimension of oversight. In comment c the Reporters assert
that “[t]oday, an ordinarily prudent person serving as the director of a corporation of any
significant scale or complexity should recognize the need to be reasonably concerned with
the existence and effectiveness of programs or procedures . . . to assist the board in its
oversight role.” T.D. No. 4, supra note 1, § 4.01(a)(1) comment c at 48.

In fact, § 4.01(b) of Tentative Draft No. 1 explicitly codified the duty “to be reasonably
concerned with the existence and effectiveness of monitoring programs, including law com-
pliance programs.” Although not incorporated in black-letter text, Tentative Draft No. 4
maintains the position that it is necessary for the board of directors to institute law compli-
ance procedures. See Vessey & Manning, Codified Standard — Safe Harbor or Uncharted
Law. 919, 930 (1980) (asserting that “the expected role of a director has grown to include
the installation of legal compliance systems” and that this growth merely is an evolution of
the “ordinary prudent director’s duties”) (cited in comment c). But see Arsh & Hinsey,
Codified Standard — Safe Harbor But Charted Channel: A Response, 35 Bus. Law. ix, xv
(1980) (arguing that in the law compliance context “[a]bsent known facts which should have
alerted [the director] to a condition which warranted his investigation, he had no duty of
inquiry”) (endorsed by the Business Roundtable, see Roundtable Statement, supra note 7, at
46); Brudney, The Role of the Board of Directors: The ALI and Its Critics, 37 U. MIAMI
L. Rev. 223, 241 (1983) (arguing that law compliance obligations do not increase a director’s
duties under existing law).

Thus, even though the May 1985 codification is closer to the “red flag” test, it still
imposes an affirmative duty to inquire. The duty, however, arises in much more limited
circumstances. In contrast, the Graham test requires no duty to “ferret out wrongdoing.”
Despite the May 1985 codification’s apparent consistency with current case law, its imposi-
tion of an affirmative duty may demand greater inquiry by directors than present law
requires.

109. See T.D. No. 4, supra note 1, § 4.01(a)(1) comment a at 45 (stating that “subsec-
tion (a)(1) adds no substantive principles to the first paragraph of subsection (a) and does
not expand the obligation that already exists under current law”); see also Perkins, supra
note 34, at 1206-07.

110. Section 4.01(c) provides:
rule encompassed a number of concepts, including:

(a) the absence of personal interest or self-dealing,
(b) an informed decision, which reflects a reasonable effort (subject to permitted reliance upon the advice and efforts of others) to become familiar with the relevant and available facts, as well as an actual decision,
(c) a reasonable belief that the decision serves the interests of the corporation, and
(d) good faith. 111

While section 4.01(c) includes each of these elements, some commentators maintain that the ALI formulation is not an accurate restatement of the common-law business judgment rule. 112 Because the ALI Principles focus on a deliberative decision, the Business Roundtable asserts that the “deliberative” requirement 113 narrows the scope of the business judgment rule’s protection. 114 Moreover,

A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:

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

T.D. No. 4, supra note 1, § 4.01(c).


112. See Roundtable Statement, supra note 7, at 48 (arguing that although each provision of the rule is based on the common law, because of the commentary and the separation of the business judgment rule from the duty of care, “the sum is greater than the parts”).

113. See Fischel, supra note 7, at 1289 (arguing that shareholders do not benefit from increased decisionmaking requirements because directors will be forced to incur substantial costs in gathering information and documenting their decisions even though an unduly deliberative process may not be warranted).

114. The Business Roundtable asserts that the “informed decision” requirement assumes that an affirmative decision in fact has been made. Roundtable Statement, supra note 7, at 48. It is important to note, however, that most current commentary is focused on either Tentative Draft No. 1 or Tentative Draft No. 2. Regarding the business judgment rule, the actual codification of Tentative Draft No. 4 is not substantially different from that of Tentative Draft No. 1 or Tentative Draft No. 3, but the rewording of the reliance provisions in Tentative Draft No. 4 and its relation to the business judgment rule has helped to alleviate directors’ exposure to liability in non-decisionmaking contexts. See infra notes 133-40. In fact, Geoffrey Hazard, Director of the ALI, states in the Foreword to Tentative Draft No. 4 that:

Since sound business practice on the part of directors and executives entails abstention
the requirement that directors have a “rational basis” for their decision also has received a great deal of comment.\textsuperscript{116} Finally, some critics assert that the business judgment rule simply should not be codified.\textsuperscript{116}

The ALI Principles’ business judgment rule, as codified in section 4.01(c), contains four distinct elements. First, a director must act in good faith.\textsuperscript{117} This concept, however, remains murky because “good faith” means an absence of self-interest to some, while others consider it the equivalent of due diligence.\textsuperscript{118} The ALI Principles do not specify the extent to which good faith requires due diligence. Rather, section 4.01(c) simply cites good faith as a pre-

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T.D. No. 4, \textit{supra} note 1, Foreword at x. The Roundtable’s comments on Tentative Draft No. 1 specifically chastise the ALI formulation for not protecting a director’s discretion to decide “what is important and what is not—including what needs to be ‘monitored’ and what does not, what needs ‘further inquiry’ and what does not.” \textit{Roundtable Statement, supra} note 7, at 48. Tentative Draft No. 4 addresses this concern.

The “deliberative decision” also might encourage shareholder strike suits because it is relatively easy to state a cause of action against directors for failing to inform themselves of material information, while dismissing such a claim is much more difficult without a trial on the merits. Weiss, \textit{supra} note 7, at 15.

\textsuperscript{115} See infra notes 127-32. One commentator notes a discrepancy between the requirement of §§ 4.01(a) and 4.01(c) of Tentative Draft No. 2 that a director “reasonably” believe the decision is in the best interests of the corporation, and § 4.01(c)(3)’s requirement of a “rational” basis for the decision. Tentative Draft No. 4 contains a similar dichotomy: § 4.01(a) requires a “reasonable” belief, while § 4.01(c)(3) adopts the “rationality” test. As Veasey and Seitz put it, “[e]ntire porridge, indeed!” Veasey & Seitz, \textit{supra} note 86, at 1497.

\textsuperscript{116} Veasey and Seitz conclude in their article:

Codification is not necessarily an improvement over decisional law . . . . Although clarification and certainty are noble goals of codification, such goals may be elusive because courts need to use elastic phrases to permit them to hold what they are result-driven to hold in a given case. Mischief may be created by the use of new terms and concepts.

Veasey & Seitz, \textit{supra} note 86, at 1605.

\textsuperscript{117} T.D. No. 4, \textit{supra} note 1, § 4.01(c).

\textsuperscript{118} See Manning, \textit{The Business Judgment Rule in Overview}, 45 Osso Sr. L.J. 615, 620 (1984) (noting that good faith to some means simply that the director’s heart was “pure;” to others, good faith would not be found if a director failed to attend board meetings, inquire into suspicious circumstances, and do the necessary work associated with the job).
requirement for application of the business judgment rule.\textsuperscript{119}

Second, section 4.01(c)(1) requires that a director to be “disinterested.”\textsuperscript{120} Section 1.15 states that a director or officer is “interested” if the director or officer is a party to the transaction, or if any associate or family member has a pecuniary interest in the transaction.\textsuperscript{121} Section 4.01(c)(1) is particularly important in takeover situations because a director or officer might be a party to the transaction and have a pecuniary interest in the transaction.\textsuperscript{122}

The third and most important requirement is set forth in section 4.01(c)(2), which demands an informed, deliberative decision.

\textsuperscript{119} The Proposals do provide that there is a “good faith” limitation on a director’s ability to cause a corporation to violate the law. T.D. No. 4, \textit{supra} note 1, § 4.01(c) comment d at 64. Furthermore, “good faith” includes the duty to perform the functions within the purview of § 2.01, which allows a corporation sometimes to forego immediate pecuniary gains in order to enhance long-term profits. T.D. No. 4, \textit{supra} note 1, § 4.01(a) comment d at 20-23; see also Hansen, \textit{supra} note 7, at 1248-50. Mr. Hansen asserts that besides the subjective “good faith” component, there are three additional elements of good faith: (1) a director’s disinterested; (2) absence of egregious conduct; (3) and independence. Mr. Hansen argues that a director does not act in good faith if any of these elements are not fulfilled.

\textsuperscript{120} T.D. No. 4, \textit{supra} note 1, § 4.01(c)(1). The rationale behind this requirement is that the business judgment rule should not be applied to violations of the duty of loyalty. Once a plaintiff shows that a director or officer was interested in the transaction, the burden shifts to the director or officer to prove that the transaction was “fair and reasonable to the corporation.” Id. § 4.01(c)(1) comment d at 63; see also infra notes 188-92 and accompanying text.

\textsuperscript{121} Section 1.15 provides:

(1) A director . . . or officer . . . is “interested” in a transaction if:

(a) the director or officer is party to the transaction, or

(b) the director or officer or an associate . . . of the director or officer has a pecuniary interest in the transaction, or the director or officer has a financial or familial relationship to a party to the transaction, that is sufficiently substantial that it would reasonably be expected to affect the director’s or officer’s judgment with respect to the transaction in a manner adverse to the corporation.

T.D. No. 2, \textit{supra} note 1, § 1.15.

\textsuperscript{122} See Easterbrook & Fischel, \textit{supra} note 12, at 1197-99. Easterbrook and Fischel note that one objective of the acquiring corporation usually is to replace existing management. This creates an inherent conflict of interest. Easterbrook and Fischel conclude that the business judgment rule should not protect the target management’s defensive tactics, even if such tactics indirectly benefit shareholders by driving up share prices. Id. at 1198-99; see also Note, \textit{Target Directors’ Fiduciary Duties: An Initial Reasonableness Burden}, 61 Notre Dame L. Rev. 722, 727 (1986) (acknowledging that most courts do not examine target management’s substantive decisions in confronting a takeover, but arguing that the board should have to show that it responded reasonably and in the shareholders’ best interest); Subak, \textit{Takeovers: Where Are We? Where Do We Go?}, 41 Bus. Law. 1255, 1261 (1989) (stating that “the decision-making role of directors changes substantially when the issue goes to the ownership of the corporation rather than its ongoing business” and that this dichotomy is not addressed in the ALI).

The ALI will discuss the relationship between the business judgment rule and hostile takeovers in \textit{Part VI: Transactions in Control}, which should be released in the near future. Perkins, \textit{supra} note 34, at 1220-21.
This provision requires a director to become informed "to the extent he reasonably believes to be appropriate under the circumstances." Thus, section 4.01(c)(2) holds directors' and officers' decisionmaking process to a due care standard. This purely subjective standard differs from the objective test articulated by the Delaware Supreme Court in Smith v. Van Gorkom. Roswell Perkins and the ALI Reporters favor the ALI's formulation for precisely this reason.

The fourth component of the ALI Principles' business judgment rule is the "rationality" test set forth in section 4.01(c)(3). By using the word "rational" instead of "reasonable," the ALI Reporters intended to create an easier standard of validity for the decision. The Business Roundtable, however, argues that a "rational basis" test will create problems by allowing courts to examine the merits of the business decision. The ALI Reporters

123. T.D. No. 4, supra note 1, § 4.01(c)(2).

124. Id. comment e at 64 (stating that "an informed decision is a prerequisite to the legal insulation afforded by the business judgment rule"). But see Scott, supra note 7, at 993-95 (discussing the ALI's "active" model of monitoring and arguing that the requirement of outside directors is likely to result in less informed corporate decisions).

125. See supra Recent Developments (Special Project) notes 48-86 and accompanying text; see also Hansen, supra note 7, at 1249-50 & n.57. Hansen asserts that in Smith v. Van Gorkom the Trans Union directors were found liable not because they were not informed to the extent they "reasonably believed to be appropriate under the circumstances" under the language of § 4.01(c)(2), but because they did not meet the objective standards of the court. While Hansen does not endorse either standard, he asserts that it is not the province of the ALI to "advance a recommended change in the law in the guise of codification." Id. at 1250 & n.57.

126. See Perkins, supra note 34, at 1212. The objective test, as articulated in Van Gorkom, fails to consider that directors frequently work under extreme time pressure and may not need extensive investigation to familiarize themselves with a subject. Furthermore, the "all material information reasonably available to them" standard provides no clear guideline for determining when a director is reasonably informed. For a discussion of the time constraints on directors, see infra note 136 (T.D. No. 4 comment e).

127. See T.D. No. 4, supra note 1, § 4.01(c)(3).

128. Comment d to Tentative Draft No. 4 § 4.01 states that:

This standard is intended to provide directors and officers with a wide ambit of discretion. It is recognized that the word "rational," which is widely used by courts, has a close etymological tie to the word "reasonable" and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable," and to give a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonable" but are not so removed from the realm of reason when made that liability should be incurred.

Id. § 4.01 comment d at 10-11.

129. Although some courts have stated that the business judgment rule will apply only if the decision has a "rational basis," the Business Roundtable notes that other courts have
justify the rational basis test by arguing that a “good faith only” test would provide too safe a harbor. The Reporters assert that there is no reason to protect “an objectively irrational business decision”—one so removed from the realm of reason that it should not be sustained solely on the basis that it was made in subjective good faith.” Others argue that despite the ALI’s intention to exclude only “off-the-wall” or “wildly irresponsible” decisions, innovation in American business often thrives on “off-the-wall” proposals.

Scholars and practitioners have debated whether section 4.01(c) protects a decision not to act. Roswell Perkins finds the answer in section 4.01(b), which governs directors’ right to delegate their functions. Section 4.01(b) of Tentative Draft No. 4 states that “the board may delegate, formally or informally by course of conduct, any function . . . to committees of the board or to directors, officers, employees, experts, or other persons.” A director arguably could satisfy the duty of care by delegating specific functions to an executive who the director reasonably believed was trustworthy. Section 4.01(b) interacts with sections 4.02 and

precluded any review whatsoever of the decision’s merits. Roundtable Statement, supra note 7, at 49. Courts generally presume that directors and officers have acted in good faith and with due diligence if a business decision in fact has been made. See supra An Historical Perspective (Special Project) note 61 and accompanying text. The Roundtable asserts that § 4.01(c)(3) requires inquiry into the substantive decision in every case. Furthermore, the Roundtable feels it is unnecessary to incorporate the “rational basis” test into the business judgment rule in order to impose liability when a director or officer has made “an objectively irrational business decision.” The Roundtable asserts that if a director has acted so egregiously, the decision could not have been one reasonably believed to be in the best interests of the corporation. Thus, any inquiry as to a decision’s rational basis is unnecessary. Roundtable Statement, supra note 7, at 49.

130. T.D. No. 4, supra note 1, § 4.02(c) comment f at 69 (stating that “courts that have articulated only a ‘good faith’ test provide too much legal insulation for directors and officers”).
131. Id.
132. Manning, supra note 118, at 622 (noting that “[m]any inventions, industrial innovations, and discoveries, whether ultimately successful or unsuccessful, have been considered ‘off-the-wall’ when first proposed”).
133. Manning, supra note 54, at 1484. Mr. Manning argues that the most important decisions concern choosing the issues to put on the board’s agenda:

From among an infinite number of useful things that a board of directors might reasonably have done or looked into in a given time period, the number that will not have been done by the most qualified, best-run, and most diligent board in the world will always be far greater than the number that were done.

Id. at 1485 (emphasis in original).
134. Perkins, supra note 34, at 1208.
135. T.D. No. 4, supra note 1, § 4.01(b).
136. Comment b to Tentative Draft No. 4 § 4.01(b) provides:
The board (or a committee) may also generally instruct a senior executive . . . to report to it major "trouble spots" related to his area of responsibility. In the absence of suspicious circumstances or other unusual facts indicating that reliance is unwarranted . . . the board would be reasonable in assuming that silence indicated that everything was progressing satisfactorily . . . . When a director acts in "good faith" and "reasonably believes" that reliance is warranted, the director is entitled to rely on the senior executive . . . Of course, directors cannot simply delegate away all of their oversight obligations. Under § 4.01, which is consistent with section 42 of the Model Act and the common law on the subject, the board must retain ultimate responsibility for overseeing the conduct of the corporation's business.

T.D. No. 4, supra note 1, § 4.01(b) comment b at 56. Comment e to Tentative Draft No. 4 § 4.01(b) provides:

Some business decisions must, for example, he made under severe time pressure while others afford time for the orderly marshalling of material information. Section 4.01(c)(2) permits the director or officer to take into account the time that is realistically available in deciding the extent to which he should be informed. The time realistically available may involve risk taking, which includes the risk of not having all relevant facts concerning a proposed transaction as well as the risks related to the economic consequences of the transaction itself. A decision to accept the risk of incomplete information, so long as the director reasonably believes such informational risk taking to be appropriate under the circumstances, will be fully consistent with the application of the business judgment rule to decisions made with respect to the principal transaction.

Id. comment e.

In comment c to Tentative Draft No. 4 § 4.02, the ALI Reporters address whether a director is "entitled to rely" on other people and reports. The comment states that reliance is simply one element to consider in analyzing the defendants' good faith or exercise of due care. If the only issue is reliance and the director fulfills the requirements of § 4.01(b), the director will have a complete defense. Tentative Draft No. 4, supra note 1, § 4.02 comment c at 78-79. Comment f to Tentative Draft No. 4 § 4.02 explains that the "reasonably believes merit confidence" formulation requires only that the director or officer have a reasonable belief that the delegatee "has the ability to do a satisfactory job with respect to the matter in question." Id. § 4.02 comment f at 82.

137. Tentative Draft No. 4 § 4.02 states:

In performing his duty and functions, a director or officer who acts in good faith, and reasonably believes that his reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other financial data), and decisions, judgments, or performance (including decisions, judgments, or performance within the scope of § 4.01(b)), in each case prepared, presented, made or performed by:

(a) One or more directors, officers, or employees of the corporation, or of a business organization . . . under joint control or common control . . . whom the director or officer reasonably believes merit confidence; or

(b) Legal Counsel, public accountants, engineers, or other persons whom the director or officer reasonably believes merit confidence.

Id. § 4.02.

Tentative Draft No. 4 § 4.03 states:

In performing his duty and functions, a director who acts in good faith, and reasonably believes that his reliance is warranted, is entitled to rely on:
for the protection provided by sections 4.02 and 4.03, a director or officer must be reasonably confident that any individual on whom the director or officer relies is competent to handle the job. Furthermore, a director's lapse in oversight might constitute "informal" delegation and reliance.

In sum, the ALI's codification of the duty of care and the business judgment rule remains controversial even though Tentative Draft No. 4 marks its third publication. First, codification of the duty of care in section 4.01 provides for an ordinary negligence standard even though many scholars and practitioners argue that a gross negligence standard represents the true majority common-law view. Second, section 4.01(a)(1)'s duty of inquiry provision has been changed to resemble a red flag test; nevertheless, the ALI Reporters reject Graham v. Allis-Chalmers, which imposes no duty except in suspicious circumstances. Instead, the ALI Reporters impose a duty of inquiry "when . . . circumstances would alert a reasonable director or officer." This formulation will shift the burden of inquiry to the director in all borderline situations. Finally, the ALI Principles' codification of the business

(a) The decisions, judgments, or performance (including decisions, judgments, or performance within the scope of § 4.01(b)), of a duly authorized committee of the board upon which the director does not serve, with respect to matters properly delegated to that committee, provided that the director reasonably believes the committee merits confidence.

(b) Information, opinions, reports, or statements (including financial statements and other financial data), in each case prepared or presented by a duly authorized committee of the board upon which the director does not serve, provided that the director reasonably believes the committee merits confidence.

Id. § 4.03.

138. Under the ALI Principles, officers, as well as directors, are entitled to the protection of §§ 4.01(b), 4.02, and 4.03. Because an officer is expected to be more familiar with the internal affairs of the corporation, the Revised Model Act is more restrictive in the extent to which it allows officers to rely on information, reports, or statements. The ALI Reporters, however, assert that the use of the "reasonable belief" language provides enough flexibility to decide whether the officer's reliance was indeed warranted and that the complexities of the large, modern corporation require that an officer be allowed to rely on other people and information. See id. § 4.02 comment d at 79-80.

139. Perkins, supra note 34, at 1207-09.

140. See id. at 1207-09 (arguing that § 4.01(b) might classify a mild lapse in oversight as an "informal" delegation); see also Hansen, supra note 7, at 1247 (noting that current case law imposes liability in the non-decisionmaking context only upon a showing of egregious facts).

141. See supra notes 85-95 and accompanying text.

142. See supra notes 96-99 and accompanying text.

143. See supra note 106 and accompanying text.

144. See supra notes 107-09 and accompanying text.

145. See supra note 108 and accompanying text.
judgment rule remains controversial even though the four require-
ments in section 4.01(c) all are based, in part, in the common
law. Commentators argue that the specific language of each re-
quirement potentially could decrease protection for directors and
officers. In certain instances, such as the required structuring of
the corporation as outlined in Chapter III and the subjective test
for the "reasonably informed" requirement in section 4.01(c)(2),
the ALI has proposed blatant changes to the common law. Other
provisions, such as the duty of inquiry in section 4.01(a)(1) and the
qualifications for protection by the business judgment rule in sec-
tion 4.01(c), do not blatantly change the common law, but arguably
decrease protection for directors and officers. These changes high-
light a controversy surrounding the ALI Proposals—whether it is
proper for an institution of such power and prestige, whose prior
restatements generally carry the force of law, to codify corporation
law in a manner inconsistent with present interpretations of the
common law. Courts already have begun to cite the ALI Propos-
als despite their nonrestatement character. Arguably, the ALI
should limit its efforts to codification of established case law and
allow the natural evolution of judicial authority to resolve the
multi-faceted corporate governance debate.

V. The Duty of Loyalty

At its April 1986 meeting the ALI adopted a new draft concern-
ing directors' and officers' duty of loyalty to the corporation.

146. See supra notes 112-16 and accompanying text.
147. See supra notes 117-40 and accompanying text.
148. See Roundtable Statement, supra note 7, at 3 (stating that "[m]ost troublesome,
in these circumstances, is the fact that the Reporters have presented their proposals in a
document which carries the hallmark of a traditional Restatement").
149. See Hansen Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274 (2d Cir.
150. For a discussion of the duty of loyalty at common law and in the Revised Model
Act, see supra An Historical Perspective (Special Project) notes 115-40 and accompanying
text, and Revised Model Act (Special Project) notes 99-158 and accompanying text. In the
ALI Proposals, the duty of loyalty is addressed primarily in §§ 5.01 and 5.02, which state:
§ 5.01 Duty of Loyalty of Directors, Senior Executives, and Dominating Shareholders
Directors, senior executives, and dominating shareholders have a duty of loyalty
that requires each of them, when personally interested in a matter affecting the corpo-
ration, to deal fairly with the corporation, as provided in Chapters 2 and 3 of Part V.
This duty includes the obligation to make appropriate disclosure as provided in such
chapters.
§ 5.02 Transactions with the Corporation
(a) General Rule. A director or senior executive who enters into a transaction with
the corporation (other than a transaction involving the payment of compensation) ful-
The ALI typically issues a statement that is far more specific than existing statutory law. Part V of the ALI Principles is no exception. While most states statutes are silent on issues such as burden of proof, compensation to senior executives and directors, transactions between corporations with common directorates, the corporate opportunity doctrine, use of corporate information, and competition between directors and officers and the corporation, the ALI Principles address each of these issues.

Of the provisions addressing the duty of loyalty, section 5.02 has received the most discussion. Unlike most state statutes, the ALI's codification begins with an attempt to define the duty of loyalty. Under section 5.02 the duty of loyalty applies to a "director fills his duty of loyalty to the corporation with respect to the transaction if:

(1) disclosure concerning the conflict of interest . . . and the transaction . . . is made to the corporate decisionmaker . . . who authorizes or ratifies the transaction; and

(2) (A) the transaction is fair to the corporation when entered into; or
(B) the transaction is authorized, following such disclosure, by disinterested directors . . . and could reasonably be believed to be fair to the corporation at the time of such authorization; or
(C) the transaction is authorized or ratified, following such disclosure, by disinterested shareholders . . . and does not constitute a waste of corporate assets . . . at the time of the shareholder action.

(b) Burden of Proof; Ratification of Defective Disclosure. A party who challenges a transaction between a director or senior executive and the corporation has the burden of proof, except that the director or the senior executive has the burden of proving that the transaction is fair to the corporation if the transaction was not authorized by disinterested directors, or authorized or ratified by disinterested shareholders, following disclosure concerning the conflict of interest and the transaction. The disclosure requirements of § 5.02(a)(1) will be deemed to be satisfied if at any time (but no later than a reasonable time after suit is filed challenging the transaction) the transaction is ratified, following such disclosure, by the board, the shareholders, or the corporate decisionmaker who initially approved the transaction or his successor.

T.D. No. 5, supra note 1, §§ 5.01-5.02.

Many of the terms in these sections are defined within the ALI Principles. See, e.g., § 1.09(a) (defining "conflict of interest"); § 1.09(b) (defining "transaction"); § 1.11 (defining "disinterested shareholder"); § 1.34 (defining "waste of corporate assets").

152. See supra An Historical Perspective (Special Project) notes 121-29 and accompanying text.
153. See Perkins, supra note 34, at 1218 (stating that "[s]ection 5.02, the section of Part V which has been the focus of most discussion . . . governs generally the situation of a director or senior executive entering into a transaction . . . with the corporation").
154. See Sommer, supra note 152, at 726 (commenting on Tentative Draft No. 3's articulation of the duty of loyalty). The section parallel to § 5.02 in Tentative Draft No. 3 is § 5.08. Section 5.08 of Tentative Draft No. 3 states what would be considered a violation of the duty of loyalty. Conversely, the Tentative Draft No. 5 formulation states what would not be considered a violation. The basic proposals of the provision, however, remain the
or senior executive who enters into a transaction with the corporation. The definition of an "interested" director for purposes of Part V has been revised in section 1.18. While the new definition is essentially the same as the definition in section 1.15 of Tentative Draft No. 1, a director now is "interested" if the director is "subject to a controlling influence by" a party to the transaction. Section 5.02 encompasses most types of transactions between directors and officers and the corporation. It does not apply, how-

same. Mr. Sommer, a former Chairman of the SEC, notes that most state statutes simply provide which types of transactions might be voidable. See also Revised Model Business Corp. Act § 8.31; supra Revised Model Act (Special Project) note 103.

T.D. No. 4, supra note 1, § 5.02(a). Section 5.02(a) does not apply to a disinterested director who approved a transaction between an interested director and the corporation. The Introductory Note to Part V provides:

Part V is not concerned with the standard of conduct or liability of directors, senior executives, and shareholders who are not personally interested in a matter affecting the corporation. Part V is therefore inapplicable to disinterested directors who authorize a transaction involving interested directors. The conduct of the disinterested directors in such a case is governed by the standards set forth in Part IV.

Section 1.18 provides:

(a) A director . . . or officer is "interested" in a transaction if:

(1) The director or officer is a party to the transaction, or

(2) The director or officer or an associate . . . of the director or officer has a pecuniary interest in the transaction, or the director or officer has a financial or familial relationship with, or is subject to a controlling influence by, a party to the transaction, that in each instance is sufficiently substantial that it would reasonably be expected to affect the director's or officer's judgment with respect to the transaction in a manner adverse to the corporation.

(b) A shareholder is interested in a transaction if either the shareholder or, to his knowledge, an associate of the shareholder is a party to the transaction or the shareholder is also an interested director with respect to the same transaction.

T.D. No. 5, supra note 1, § 1.18.

See supra note 121.

T.D. No. 5, supra note 1, § 1.18. According to the comment to § 1.18, the concept of "interested" should be distinguished from the "significant relationship" and "associate concepts." "Interested" applies when a director is involved in a particular transaction or is related to an involved party, while the "significant relationship" provision defines who is an inside or outside director. An officer who is also a director, but who is subordinate to a senior executive interested in the transaction, is presumed to be interested in the transaction. A corporation is not required to determine whether shareholders are "interested" in a transaction. If, however, the corporation endeavors to determine the "interest" of shareholders, the test is more narrow than that for directors and officers. The comment also provides that a court may determine that in certain circumstances a constructive "familial relationship" exists even though the parties are not related by blood or marriage. Finally, the comment provides that a court may set aside a transaction that appears to have had disinterested board approval if the transaction was "controlled" in fact by an interested director.

T.D. No. 5, supra note 1, § 1.18 comment a at 8-9.

Comment c to § 5.02 provides:

[S]uch dealing would include supplying property to the corporation or acquiring property from the corporation, by sale, lease or otherwise, furnishing services to the corporation in some capacity other than as a director or senior executive (such as an invest-
ever, to a director's usurpation of a corporate opportunity\textsuperscript{160} or to

tment advisor, investment banker, or attorney), supplying or acquiring services from the
corporation, or making loans to or receiving loans from the corporation.

T.D. No. 5, supra note 1, § 5.02 comment c at 28.

\textsuperscript{160} Section 5.05 specifically addresses the corporate opportunity doctrine. Section
5.05 provides:

(a) General Rule. A director . . . or senior executive . . . may not take advantage
of a corporate opportunity unless:

1. he first offers the corporate opportunity to the corporation and makes dis-

closure concerning the conflict of interest . . . and the facts concerning the corpo-
rate opportunity . . .

2. the corporate opportunity is rejected by the corporation; and

3. (A) the rejection of the opportunity is fair to the corporation; or

   (B) the rejection is authorized, following such disclosure, by disinter-
   rested directors . . . in a manner that satisfies the standards of the business
judgment rule . . . or

   (C) the rejection is authorized or ratified by disinterested shareholders
   . . . following such disclosure, and the shareholders' action is not
equivalent to a waste of corporate assets . . .

(b) Definition of a Corporate Opportunity. For purposes of this section, a corpo-
rate opportunity means:

1. any opportunity to engage in a business activity of which a director or
senior executive becomes aware either:

   (A) in connection with the performance of his functions as a director or
senior executive, or under circumstances that should reasonably lead him to
believe that the person offering the opportunity expects him to offer it to
the corporation; or

   (B) through the use of corporate information or property, if the result-
ling opportunity is one that the director or senior executive should reasona-
ably be expected to believe would be of interest to the corporation; or

2. any opportunity to engage in a business activity of which a senior execu-
tive becomes aware, if he knows or reasonably should know that the activity is
closely related to the business in which the corporation is engaged or may reasona-
ably be expected to engage.

A "business activity" includes the acquisition or use of any contract right or other
tangible or intangible property.

Id. § 5.05.

Section 5.05(c), not reprinted here, provides that the burden of proof shall be much the
same as under § 5.02(b), which provides that the burden of proof shifts from the challenger
to the director or officer in the absence of director or shareholder authorization.

The common law has adopted a number of positions. \textit{See supra An Historical Perspec-
tive (Special Project) note 126.} According to comment a to § 5.05, some courts have consid-
ered only whether the opportunity fell in the corporation's line of business. Other courts
have evaluated the director's seizure of the opportunity under a general standard of fairness.
Still other courts have combined these elements using a "two-step" test — first applying a
"line of business" test and, if the opportunity is in the corporation's business, then deciding
whether it is fair to require the director or officer to give up the opportunity in favor of the
corporation. Section 5.04 encompasses any opportunity that is advantageous to the corpora-
tion and requires a senior executive to offer it first to the corporation. Outside directors will
be governed by a less stringent test. \textit{See generally T.D. No. 5, supra note 1, § 5.06 comment
at 107; id. § 5.06(a)-(d) comments.}

The ALI has codified separately in § 5.04 a director's or officer's duties concerning use
of corporate position, nonpublic information about the corporation, and corporate property.
transactions involving compensation. Likewise, section 5.02 does

These concepts generally are discussed in cases concerning
misuse of position for a variety of purposes, including securing an undisclosed commis-
sion, obtaining a tax benefit at the expense of the corporation, manipulating the corpo-
ration's dividend policy for personal objectives, precluding the corporation from engaging in a profitable business activity so that the director or senior executive may do so, and securing a benefit in connection with a director's resigning from office. Some cases involve harm to the corporation or misuse of inside information in connection with transactions in the corporation's stock. Some cases involve use of corporate property for personal benefit.

T.D. No. 5, supra note 1, § 5.04 commentary at 69-70.

Section 5.04 attempts to incorporate the holdings of each of these cases. This section provides that a director or senior executive, unless the director or senior executive pays the fair market value for any benefit received, must provide full disclosure and obtain proper approval before using corporate property, information, or position to obtain a pecuniary benefit. Id. at 67-104.

Finally, in § 5.06 the ALI Proposals address the circumstances under which a director or senior executive may compete with the corporation. Section 5.06 generally provides that a director or senior executive may not compete with the corporation in order to advance personal wealth unless: (1) any "reasonably foreseeable harm" to the corporation is outweighed by the benefits of the competition; (2) no harm comes to the corporation; or (3) the competition is ratified by disinterested directors in a manner that satisfies the business judgment rule or by shareholders if the shareholders actions do not constitute waste. See id. § 5.06 commentary at 125-35.

161. Transactions involving compensation are dealt with in § 5.03, which provides:

(a) General Rule. A director . . . or senior executive . . . who receives compensation from the corporation for services in that capacity fulfills his duty of loyalty to the corporation with respect to the compensation if:

(1) disclosure concerning the transaction . . . is made to the corporate decisionmaker . . . who authorizes or ratifies the compensation; and

(2) (A) the compensation is fair to the corporation when approved; or

(B) the compensation is authorized, following disclosure concerning the transaction, by disinterested directors . . . in a manner that satisfies the standards of the business judgment rule . . . or

(C) the compensation is authorized or ratified, following such disclo-
sure, by disinterested shareholders . . . and does not constitute a waste of corporate assets . . . at the time of the shareholder action.

(b) Burden of Proof: Ratifications of Defective Disclosure. A party who challenges a transaction involving the payment of compensation to a director or senior executive has the burden of proof, except that the director or the senior executive has the burden of proving that the transaction is fair to the corporation if the transaction was not authorized by disinterested directors, or authorized or ratified by disinterested shareholders, following such disclosure. The disclosure requirements of § 5.03(a)(1) will be deemed to be satisfied if at any time (but no later than a reasonable time after suit is filed challenging the transaction) the transaction is ratified, following such disclosure, by the board, the shareholders, or the corporate decision-maker who initially approved the transaction or his successor.

T.D. No. 5, supra note 1, § 5.03.

The Reporters felt that a less stringent test was necessary for compensation payments because compensation for directors and senior executives must be determined in all cases. In most conflict of interest transactions, however, the deal can be avoided. Compensation generally is well publicized, and the process for determining compensation is widely institutionalized. Thus, any disadvantage to the corporation is unlikely. T.D. No. 5, supra note 1,
not apply\textsuperscript{162} if the transaction involves goods or services that generally are offered to the public on fixed terms, or if the transaction was determined by competitive\textsuperscript{163} bids.

Once a senior executive, director, or shareholder meets section 1.18’s definition of “interested,” certain information\textsuperscript{164} must be disclosed to the corporate decisionmaker concerning the transaction and the conflict of interest.\textsuperscript{165} The duty to make adequate disclosure is much the same as in state statutes.\textsuperscript{166} Under the ALI approach, however, a failure to disclose is in itself a breach of the duty of loyalty.\textsuperscript{167}

At common law the minority approach was to void transactions in which the interested director or officer did not fully disclose the conflict of interest to the corporation.\textsuperscript{168} The common law’s main concern, however, was whether the transaction was fair

\textsuperscript{162} T.D. No. 5, supra note 1, § 5.02 comment c at 29.

\textsuperscript{163} A valid competition, free of sharp dealing or other devices, must have occurred before awarding of the bid. Id. at 28-29.

\textsuperscript{164} “Disclosure Concerning a Conflict of Interest” is satisfied under § 1.09 if there is disclosure to the corporate decisionmaker of “the material facts known to him concerning the conflict of interest, or if at the time the transaction is approved, the corporate decisionmaker knows of those facts.” “Disclosure Concerning a Transaction” is defined as a disclosure to the corporate decisionmaker of “the material facts known to him concerning the transaction.” T.D. No. 5, supra note 1, § 1.09 at 3.

\textsuperscript{165} Section 5.02(a) provides:

(a) General rule. A director or senior executive who enters into a transaction with the corporation (other than a transaction involving a payment of compensation) fulfills his duty of loyalty to the corporation with respect to the transaction if:

(1) disclosure concerning the conflict of interest and the transaction is made to the corporate decisionmaker who authorizes or ratifies the transaction. . . .

T.D. No. 5, supra note 1, § 5.02(a).

\textsuperscript{166} See supra An Historical Perspective (Special Project) notes 121-24 and accompanying text.

\textsuperscript{167} T.D. No. 5, supra note 1, § 5.02(a)(1) comment a at 27. The comment states that when faced with a reasonably fair transaction but inadequate disclosure, some courts have stated that failure to make full disclosure is but one factor to consider in determining the fairness of the transaction. Other courts, however, have found that a corporation may void a transaction on the basis of inadequate disclosure alone. The Reporters adopt the latter view, finding provisions in the Restatements of Agency, Contracts, Torts, and Restitution to the effect that a director or officer is in a confidential relationship with the corporation and must make full disclosure. Id. Furthermore, the comment to § 5.02(a)(1) (the disclosure provision) states that a senior executive may not deal with the corporation as if at arm’s length. The senior executive has the duty to avoid misleading omissions and to reveal material facts. This provision differs from the New York statute, which requires disclosure only of the conflict, not of all material information regarding the transaction. See W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 150 (1986).

\textsuperscript{168} See supra An Historical Perspective (Special Project) notes 118, 134, and accompanying text; see also supra note 167.
to the corporation. If the transaction was fair, the majority of jurisdictions would not void the transaction. Thus, the ALI Principles' proposal that a director's or officer's inadequate disclosure is itself a breach of the duty of loyalty apparently departs from the majority common-law view. The ALI approach also is more restrictive than the Revised Model Act, which would uphold a transaction that was fair to the corporation and had been approved by shareholders or disinterested directors. This heightened exposure of directors and officers to liability for a breach of the duty of loyalty is mitigated, however, by the last sentence of section 5.02(b), which allows a transaction to be ratified following a belated disclosure by the interested party.

Section 5.02(a)(2) provides that a transaction will be valid under section 5.02 only if one of the enumerated standards is met and if the disclosure requirement of section 5.02(a)(1) has been fulfilled. In simple terms, the transaction must be (1) fair to the corporation, (2) authorized by disinterested directors and reasonably believed to be fair to the corporation, or (3) ratified by disinterested shareholders and determined not to constitute a waste of


170. See supra Revised Model Act (Special Project) notes 107-13 and accompanying text. The Revised Model Act now requires a director to disclose all material facts concerning the transaction, not just that a conflict of interest exists. This conforms with the ALI approach. See supra Revised Model Act (Special Project) note 108 (discussing § 8.31(a) of the Revised Model Act).

171. Professor Weiss asserts that allowing shareholders to challenge the sufficiency of management's disclosure was an effort by the ALI to "increase shareholder's opportunities to challenge conflict-of-interest transactions." Weiss, supra note 7, at 19-20.

172. The relevant part of § 5.02(b) provides:

The disclosure requirements of § 5.02(a)(1) will be deemed to be satisfied if at any time (but no later than a reasonable time after suit is filed challenging the transaction) the transaction is ratified, following such disclosure, by the board, the shareholders, or the corporate decisionmaker who initially approved the transaction or his successor.

T.D. No. 5, supra note 1, § 5.02(h).

According to Roswell Perkins, this belated disclosure will not have the further effect of shifting the burden of proof back to the plaintiff, which would have been the case with prior disclosure. This belated disclosure can occur even after a complaint challenging the transaction has been filed, although it must be within a reasonable time thereafter. The Reporters do not say what constitutes a "reasonable" time. Mr. Perkins also notes that if a good faith attempt to disclose occurred at the beginning, a subsequent remedying of the disclosure probably will shift the burden of proof back to the plaintiff and narrow the scope of review. See Perkins, supra note 34, at 1218-19; see also T.D. No. 5, supra note 1, § 5.02(b) comment at 43.

173. These standards essentially determine the level of judicial scrutiny and placement of the burden of proof. T.D. No. 5, supra note 1, § 5.02(a)(2) comment at 33.
corporate assets. The requirement that the transaction be fair to the corporation is consistent with current case law. Section 8.31(a) of the Revised Model Business Corporation Act provides that the transaction will stand if it is fair or if it has been ratified by either disinterested directors or disinterested shareholders. This language appears to provide that the transaction will be valid if any of the three requirements is met; however, most jurisdictions interpreting statutes based on the Revised Model Business Corporation Act have required fairness in all circumstances. In determining fairness, the ALI Reporters state that the test is an objective one in which the transaction must come within a “range of reasonableness.” Fairness will be judged at the time of the transaction, not in light of subsequent events.

The second prong of section 5.02(a)(2) provides that the transaction will be upheld if it was authorized by disinterested direc-

174. Id. § 5.02(a)(2)(A)-(C).
175. See supra note 169 and accompanying text; see also Note, Section 21-2040.01: Interested Director Transactions and Considerations of Fairness, 58 Neb. L. Rev. 909, 912-17 (1979).
176. See supra Revised Model Act (Special Project) note 108 and accompanying text.
177. See supra Revised Model Act (Special Project) notes 109-10 and accompanying text. The leading case in this area is Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 406, 241 P.2d 66 (1952), which did not preclude judicial review into the fairness of the transaction despite disinterested director approval that fulfilled one element of California’s statutory test. The California statute was based on the Revised Model Act. While some commentators argue that the Revised Model Act requires that only one of these statutory tests be met, the majority view allows further judicial scrutiny into the fairness of the transaction. See Note, supra note 175, at 914.
178. The Reporters cite Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49, 54 (5th Cir. 1980), cert. denied, 450 U.S. 1029 (1981), in support of the “range of reasonableness” test. The comment to § 5.02(a)(2)(A) states that:

[1]In determining fairness, the court may take into account the process by which the transaction was shaped and approved (such as whether there was pressure on the corporate decisionmaker who approved the transaction) and any objective indicators of fairness of price (such as comparable transactions between parties dealing at arm’s length).

T.D. No. 5, supra note 1, § 5.02(a)(2)(A) comment at 34.

For a discussion of the “arm’s length bargain test,” see supra Revised Model Act (Special Project) notes 119-125 and accompanying text. The comment to § 5.02(a)(2)(A) points out that the decisionmaker should consider not only the transaction as if it had been at arm’s length, but also whether the transaction is in the best interests of the corporation. The comment further asserts that if a disinterested director initiated the transaction, it is more likely to be fair to the corporation. T.D. No. 5, supra note 1, § 5.02(a)(2)(A) comment at 34.

179. See supra note 178.
180. The Reporters omitted the word “ratified” from this prong because they believed that once the transaction had been entered into, the corporation was not likely to strike a
tors and if the transaction “could reasonably be believed to be fair to the corporation at the time of such authorization.” The Business Roundtable asserts that if disinterested directors authorized the transaction, most state statutes would preclude judicial inquiry into its fairness and would protect the directors’ decision under the business judgment rule. The ALI approach, however, requires a higher standard than the business judgment rule because a “reasonably believed” test is more rigorous than the “rationality” test of section 4.01(c). The “reasonably believed” test is not as stringent as a determination of fairness under section 5.02(a)(2)(A), however, because even if a court believes the transaction was unfair, if reasonable minds could differ as to the fairness of the transaction, the transaction still will be valid.

The third prong of section 5.02(a)(2) provides that the transaction will be upheld if there was authorization or ratification by disinterested shareholders and the transaction does not constitute a waste of corporate assets. Section 1.34 of Part V defines a waste of corporate assets as a transaction in which “no person of ordinary sound business judgment would say that the consideration was a fair exchange for what was given by the corporation.”

favorable bargain. In essence, director “permission” is required. See T.D. No. 5, supra note 1, § 5.02(a)(2)(B) comment at 39.

181. T.D. No. 5, supra note 1, § 5.02(a)(2)(B).

182. STATEMENT OF THE BUSINESS ROUNDTABLE CONCERNING COUNCIL DRAFT NO. 2 (Dec. 1983) [hereinafter December 1983 Roundtable Statement]. For the proposition that all transactions will be reviewed for fairness in spite of statutory language, see supra note 177 and accompanying text

183. Perkins, supra note 34, at 1219. Mr. Perkins explains:

We know that courts will generally consider in a different light the board’s (1) decision to authorize a business transaction with a complete “outsider,” and (2) decision to authorize a business transaction with one of the board members. Thus, § 5.02 in effect takes the view that, so long as the threshold for potential liability of the disinterested directors who approve the transaction is not lowered (which it is not, under § 5.02), it is preferable to recognize the difference in the treatment a court will give to the two situations and to reserve the very wide protection of the business judgment doctrine for transactions wherein courts will be willing truly to give minimal scrutiny to the merits of the transaction.

Id. at 1219; see also Scott, supra note 7, at 940 (stating that “[i]n loyalty analysis, there is no proper place for the business judgment rule . . . [t]he court has much less reason to defer to management determinations when their interests directly conflict with shareholder interests”).

184. Sommer, supra note 151, at 730.

185. T.D. No. 5, supra note 1, § 5.02(a)(2)(C).

186. This provision adopts the Supreme Court of Delaware’s test in Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979). This test is to be applied at the time of ratification, not at the time of trial. T.D. No. 5, supra note 1, § 1.34 comment at 13.
This provision does not depart from the common law.\textsuperscript{187}

The burden of proving fairness historically has fallen on the interested director.\textsuperscript{188} This is especially true if there was not disinterested director approval or disinterested shareholder ratification.\textsuperscript{189} The ALI formulation adopts this traditional approach, but shifts the burden of proof to the challenging party if there has been authorization by disinterested directors or ratification or authorization by disinterested shareholders.\textsuperscript{190} While this issue remains unsettled,\textsuperscript{191} the Revised Model Act has been interpreted to be consistent with the ALI approach.\textsuperscript{192}

While some critics complain that the ALI codification departs from current case law and statutes,\textsuperscript{193} other commentators assail Part V for different reasons. Professor Weiss argues that the ALI's dependence on independent director approval in conflict-of-interest transactions is improvident because of the popular belief that independent directors—especially when "independent" means only a lack of pecuniary interest—are incapable of substantive objectivity.\textsuperscript{194} Professor Weiss also notes that shareholders are equally unlikely to provide a substantive check on management be-

\textsuperscript{187} Sommer, supra note 151, at 721 (citing Gottlieb v. Heyden Chem. Corp., 33 Del. Ch. 82, 90-92, 90 A.2d 660, 665 (1952)); see also Marsh, supra note 169, at 48 (stating that shareholder ratification will validate a transaction absent fraud or unfairness and that a "waste of corporate assets" would surely be "unfair"); T.D. No. 5, supra note 1, Reporter's Note 6 at 54-55.

\textsuperscript{188} Pepper v. Litton, 308 U.S. 295, 306 (1939).

\textsuperscript{189} See Note, supra note 175, at 917-18.

\textsuperscript{190} T.D. No. 5, supra note 1, § 5.02(b).

\textsuperscript{191} See Note, supra note 175, at 917-20 (discussing conflicting developments in New York, Iowa, Delaware, and New Jersey); see also Marsh, supra note 169, at 49-50 (asserting that shareholder approval may shift the burden of proof to the one attacking the fairness of the transaction). But see Weiss, supra note 7, at 24-25 (arguing that director approval should not shift the burden of proof because an absence of pecuniary interest is not necessarily indicative of complete objectivity).

\textsuperscript{192} See supra Revised Model Act (Special Project) notes 129-36 and accompanying text.

\textsuperscript{193} Roundtable Comments, supra note 7, at 23 (stating that "[w]ith respect to Part V (Duty of Loyalty), we believe that it represents a significant departure from existing law — by requiring a fairness inquiry rather than a business judgment determination by the board — which would unnecessarily complicate many important corporate transactions by overemphasizing procedural aspects and increasing judicial involvement").

\textsuperscript{194} The effectiveness of independent directors has been the subject of intensive debate. See Brudney, The Independent Director - Heavenly City or Potemkin Village, 96 HARV. L. REV. 597 (1982); Note, supra note 68.

\textsuperscript{195} Weiss, supra note 7, at 20-21 (arguing that objectivity is better determined by an ability to make decisions absent influence by social and professional relationships, not by an absence of pecuniary interest).
cause shareholders generally acquiesce to management's desires.\textsuperscript{196} In short, Professor Weiss asserts that the ALI test is too relaxed and that courts should be allowed a much freer reign to inquire into the substantive fairness of a conflict-of-interest transaction. Similarly, Professor Scott states that standards for the duty of loyalty should be higher than current standards because the corporate marketplace cannot adequately police duty of loyalty violations.\textsuperscript{197}

Thus, Part V of the ALI Principles has received criticism from all sides. The Roundtable advocates less inquiry into the fairness of the transaction,\textsuperscript{198} while Professors Scott and Weiss argue that heightened review is required.\textsuperscript{199} Except for the proposal that inadequate disclosure by the interested director or officer should be a breach of the duty of loyalty in itself,\textsuperscript{200} however, Part V generally is consistent with current judicial interpretations of most statutes.

VI. CONCLUSION

The American Law Institute has drafted a set of proposals surrounded by controversy. While many of the proposals have a basis in common law, the provisions that depart from current judicial interpretations are particularly obtrusive. A major criticism of the ALI Proposals is their failure to elicit input from experts in other disciplines, such as business and economics.\textsuperscript{201} Arguably, the ALI should strive for the accuracy that distinguishes its restatements and leave the evolution of corporate law to the judicial process. The ALI's goals of clarification and presentation of the law in a cohesive manner are commendable. The ALI Proposals, however, will not be accepted universally as long as they propose a virtual overhaul of the corporate structure with a systematic slant toward increased liability for corporate directors and officers. Recent case law clarifies, but does not markedly change, directors' and officers'

\begin{footnotesize}
\begin{enumerate}
\item[196.] Id. Professor Weiss further suggests that the ALI Principles' disclosure provisions will allow courts to manipulate facts in order to determine whether a director made "material" disclosure.
\item[197.] Scott, supra note 7, at 938-39 (arguing that the derivative suit is the most effective means to prevent management from engaging in self-enriching transactions).
\item[198.] See supra note 193 and accompanying text.
\item[199.] See supra notes 195-97 and accompanying text.
\item[200.] See supra notes 167-72 and accompanying text.
\item[201.] See Roundtable Comments, supra note 7, at 5.
\end{enumerate}
\end{footnotesize}
duty of care and duty of loyalty. Arguably the ALI should engage in the same endeavor.

Kathryn N. Fine

202. See supra Recent Developments (Special Project).