CHAPTER 4

DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

Introductory Note: The Principles of Law, Corporate Governance: Analysis and Recommendations (PCG) articulated a duty of care and a duty of fair dealing for corporate officers and directors. The duty of care included both a duty to act in the best interests of the corporation and a duty of oversight. The duty of oversight captured the board's monitoring function. The duty of fair dealing focused on transactions between corporate decisionmakers and the corporation itself. The PCG's formulation differed from that found in most cases, which articulate officers' and directors' fiduciary duties as consisting of a duty of care and a duty of loyalty. See also the American Bar Association's Corporate Director's Guidebook (7th ed. 2020) at 15–16 (the "baseline legal standard for director conduct . . . generally encompasses duties of care and loyalty"); J. Travis Laster, *Fiduciary Duties in Activist Situations*, 13 VA. L. & BUS. REV. 76, 85 (2019) ("For purposes of the standard of conduct, directors of a Delaware corporation owe two fiduciary duties—care and loyalty"). This Restatement restores that approach. This Chapter addresses the duty of care. Chapter 5 addresses the duty of loyalty.

The duty of care has three distinct components: a standard of conduct; a standard of review: and a standard of liability. This Restatement treats the "standard of conduct" as articulating the standard of behavior against which officer and director conduct is to be measured. This standard of conduct is set out in § 4.01. The latter two components, the standard of liability and the standard of review, are addressed in § 4.02, the Business Judgment Rule. Although the business judgment rule has historically been applied in cases involving the duty of care, the standard of review that it articulates is also applicable in the duty-of-loyalty context when certain procedures are followed. In addition, the scope of officer and director liability is not addressed exclusively by the business judgment rule but may also be affected by exculpation provisions. See (insert cross-reference to exculpation).

Some cases conflate the duty of care with the business judgment rule and indicate, sometimes incorrectly, the extent to which the latter has been codified. It is the intent of this Section to clarify the distinction between the two. This Section also serves to clarify the different functions served by the business judgment rule, including its emerging role as a standard of review in cases beyond those involving allegations involving the duty of care.

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§ 4.01. The Duty of Care

A director or officer has a duty to the corporation to perform the director's or officer's functions with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

Comment:

a. General comparison with PCG. The Principles of Law, Corporate Governance: Analysis and Recommendations (PCG) § 4.01 sets forth a duty of care, which includes a duty to act in the best interests of the corporation, and a duty of oversight. The PCG definition of the duty of care includes a duty to act in good faith and in the best interests of the corporation, requirements that this Restatement treats as components of the duty of loyalty. The standard of conduct reflected in this Section is substantially identical to the PCG's formulation of the duty of care in § 4.01(a). Because the liability standard under the duty of care has evolved through the expansion of exculpation, and because the business-judgment-rule standard of review is also used in some situations implicating the duty of loyalty, this Restatement addresses the liability standard separately in § 4.02.

b. Duty of care versus duty of loyalty. Historically, the duty of loyalty applied to circumstances involving self-dealing. Decisional law in some states has extended the scope of the duty of loyalty. In particular, the duty of oversight (addressed in § 5.04) has evolved to include components of both the duty of care and the duty of loyalty.

c. Statutory versus common law. The American Bar Association's Model Business Corporation Act (MBCA) § 8.30 codified a general standard for director conduct that incorporates aspects of the duty of care, process-based components of the business judgment rule, and a requirement of good faith. Similarly, some non-MBCA states codify director and officer fiduciary duties in whole or in part. In Delaware, director and officer fiduciary duties are exclusively a matter of judge-made law. However, whether the standard is the product of common-law formulation or legislation, it generally combines three components: a standard of conduct; a requirement that actions be taken in the best interests of the corporation; and a requirement of good faith.

d. Standards of conduct, standards of liability, and standards of review. Corporate law distinguishes between three distinct concepts: (1) the standard of conduct that officers and directors are expected to meet; (2) the standard of review applied by courts in analyzing that

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conduct; and (3) the circumstances under which an officer or director will face liability. Section 4.01 deals only with standards of conduct—the level of performance expected of every director and officer entering into the service of a corporation and undertaking the responsibilities of that service; it does not deal with the latter two concepts, which are addressed in § 4.02. The MBCA expressly distinguishes between standards of conduct, which are addressed by MBCA § 8.30, and standards of liability, which are addressed by MBCA § 8.31.

e. Scope note. It should be noted that § 4.01 applies to both directors and officers. Most precedents and statutory provisions deal solely with directors, and the question of whether officers are held to the same duty-of-care standard as directors has received relatively limited attention. Because the factual context in which they act varies, what constitutes reasonable care in a given situation may differ for an officer versus a director, but the proposition that both are required to act with reasonable care is uncontroversial. In addition, it may be difficult to ascertain whether a person is acting in the capacity of an officer or a director. Accordingly, this Section provides a definition of the standard of care that is applicable to both officers and directors. A variety of issues implicate the extent to which officers and directors will face similar liability, including the scope of state exculpation provisions as well as the application of the business judgment rule. The application of the business judgment rule to officers is addressed in § 4.02.

f. Formulation of the standard of conduct. The standard of conduct articulated in § 4.01 is identical to the formulation in the American Bar Association's Corporate Director's Guidebook (7th ed. 2020) ("To satisfy the duty of care, directors must act with the care that a person in a like position would reasonably believe appropriate under similar circumstances."). It conveys the standard to which directors and officers are expected to adhere as a guideline for their behavior.

Illustrations:

1. A is the CEO of B corporation. B is in the process of attempting to negotiate the purchase of C corporation, a company that is critical for B to own. While dining in a crowded New York City restaurant, A loudly vents about the slow progress of the negotiations and expresses frustration over the slow progress of the mission-critical acquisition. D, the CEO of E corporation, a competitor to B, overhears the conversation. D subsequently successfully negotiates the purchase of C by E. A has not acted in accordance with the requirements of § 4.01.

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2. U, who has served on the board of X Corporation for five years, is in ill health and expects to remain in ill health for the foreseeable future. With the consent of X's board of directors, U continues to serve as an "inactive" director with the understanding that U will rarely attend board meetings or otherwise participate in the board's decisions. U's service in accord with such a limitation is not in accordance with the requirements of § 4.01. When a director recognizes, or should reasonably recognize, that because of prolonged ill health he or she can no longer perform the functions of a director with reasonable care, the director must resign. A director's failure to attend board meetings because of temporary ill health, in contrast, could be reasonable.

g. Ordinary prudent person. The requirement that one act with the care of an ordinary prudent person under similar circumstances incorporates a negligence-based standard. Some courts formulate the standard of conduct in terms of simple negligence while recognizing that the liability standard incorporates a requirement of gross negligence. The case law is complicated by the necessity for courts to distinguish the circumstances giving rise to liability from the underlying norms of conduct. Because § 4.01 articulates the standard of conduct to which officers and directors are expected to adhere, it specifies that the applicable standard of conduct is simple negligence. To do otherwise would risk sanctioning negligent conduct. Nonetheless, the application of the business judgment rule in § 4.02 has the effect of imposing a higher standard for establishing liability, thus protecting directors and officers from liability for conduct that is arguably negligent and limiting the potential for liability so as not to create undesirable aversion to taking appropriate business risks.

The formulation in the black letter is reflected in the MBCA's current standard of care for officers, but not directors. Compare MBCA §§ 8.30, 8.42(a)(2). The requirement was included in the standard for directors in a prior version of the model act. See MBCA § 35 (1978). It was removed in response to the view by some members of the Committee on Corporate Laws, a commitee of the Section of Business Law of the American Bar Association, that the formulation imposed a simple negligence standard and "gave insufficient recognition to the common law business judgment rule". John F. Olson & Aaron K. Briggs, *The Model Business Corporation Act and Corporate Governance: An Enabling Statute Moves Toward Normative Standards*, 74 LAW & CONTEMP. PROB. 31, 35–36 (2011). The vast majority of state statutes retain the requirement that a director act with the care of an ordinary prudent person. See PCG § 4.01, Reporter's Note 15.

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The use of the word "prudent" is not intended to inhibit directors or officers from encouraging, or engaging in, rational risk-taking, innovation, or other entrepreneurial activities in the interest of long-term profitability and shareholder gain. The desire to encourage directors to take rational risks also motivates the business judgment rule. See § 4.02. Nor is the word "prudent" designed to articulate the permissible scope of corporate objectives that officers and directors may pursue; those questions are addressed in § 2.01.

h. Special skills or expertise. The use of the phrase "ordinarily prudent person" is intended to convey the image of a generalist who has the capacity to perform a given corporate assignment. As the Corporate Director's Guidebook explains, "'[l]ike position' generally means that a director's actions must incorporate the basic attributes of common sense, practical wisdom, and informed judgment generally associated with the position of a corporate director." As a general rule, directors need not have any special expertise. A director's possession of such expertise may, however, affect the standard to which he or she is held. There are instances in which special skills or expertise may be a prerequisite for appointment to a particular corporate office, e.g., controller or general counsel. Similarly, federal law, stock exchange-listing requirements, or a corporation's governing documents may require that a director have specialized knowledge or expertise. In those instances, the officer undertaking the position will be held to the duty of care of an ordinarily prudent person who has the requisite knowledge or expertise.

i. Reliance on others. Officers and directors are entitled to rely on third parties, so long as such reliance is reasonable. Directors may also rely, in appropriate circumstances, on their fellow directors and officers. The circumstances under which such reliance is consistent with § 4.01 are discussed in § 4.03.

j. Additional sources of the duty of care. Regulatory regimes beyond corporate law may affect the applicable standard of conduct. For example, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 articulates a standard of conduct for officers and directors of financial institutions. 12 U.S.C.A. § 1821(k).

k. Duty of care and controlling shareholders. The duties of controlling shareholders are not included here but instead are handled separately. See § 5.10. The question of whether controlling shareholders are subject to a general fiduciary duty of care is unclear. Cases imposing liability on controlling shareholders typically implicate the duty of loyalty.

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1 *l. Application to third parties.* The duty-of-care standards set forth in § 4.01 involve duties
2 owed directly to the corporation. It should be emphasized that § 4.01 is not intended to create new
3 third-party rights (e.g., for tort claimants or government agencies) against directors or officers. The
4 standards set forth in Part IV apply only to relationships among directors, officers, shareholders,
5 and their corporations.

REPORTERS' NOTES

6 1. *Duty of oversight.* Courts initially framed the duty of oversight as part of the duty of
7 care. See, e.g., In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch.1996) ("The
8 complaint charges the director defendants with breach of their duty of attention or care in
9 connection with the on-going operation of the corporation's business."). Subsequent cases have
10 recognized that a failure to exercise sufficient oversight can constitute a breach of the duty of
11 loyalty as well. See Marchand v. Barnhill, 212 A.3d 805, 820 (Del. 2019) (failure to "make a good
12 faith effort to oversee the company's operations . . . breaches the duty of loyalty and can expose a
13 director to liability").
14 2. *Scope of MBCA adoption.* According to one commentator, the Model Business
15 Corporation Act's (MBCA) 1998 formulation of the duty of care was adopted by 42 states. See D.
16 Gordon Smith, *A Proposal to Eliminate Director Standards from the Model Business Corporation*
17 *Act*, 67 U. CIN. L. REV. 1201, 1202 (1999). However, as other commentators have observed, reports
18 vary on the degree to which states have adopted the MBCA, and the data are complicated by the
19 fact that "some states have adopted the Act in whole and some in part, some states have taken key
20 language from certain provisions of the Act but omit other portions, some states have done all of
21 the above, and others have done all of these combinations but with older versions of the Act."
22 William B. Chandler III & Anthony A. Rickey, *The Mystery of the Success of Delaware Laws:*
23 *Manufacturing Mystery: A Response to Professors Carney and Shepherd's "The Mystery of*
24 *Delaware Law's Continuing Success,"* 2009 U. ILL. L. REV. 95, 97 n.11. For an example of a non-
25 MBCA codification of director and officer fiduciary duties see CAL. CORP. CODE § 309 (West
26 2019). For an argument in favor of common-law development and against codification see Smith,
27 supra.
28 *3. MBCA treatment of duty of care.* For a description of the evolution of the MBCA's
29 treatment of the duty of care and the business judgment rule, see John F. Olson & Aaron K. Briggs,
30 *The Model Business Corporation Act and Corporate Governance: An Enabling Statute Moves*
31 *Toward Normative Standards*, 74 LAW & CONTEMP. PROB. 31 (2011); R. Franklin Balotti & Joseph
32 IV Hinsey, *Director Care, Conduct, and Liability: The Model Business Corporation Act Solution*,
33 56 BUS. LAW. 35 (2000).
34 4. *Standards of conduct.* For an explanation of the role of standards of conduct, see E.
35 Norman Veasey, *On Corporate Governance Codification: A Historical Peek at the Model Business*
36 *Corporation Act and the American Law Institute Principles Through the Delaware Lens*, 74 LAW

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& CONTEMP. PROB. 95, 98 (2011) ("standards of conduct include some conduct that is required of directors and some aspirations for what is expected of directors in carrying out best practices").

5. *Standards of conduct versus standards of review.* On the distinction between standards of conduct and standards of review, see Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155, 171–172 (Del. Ch. 2014) ("When determining whether directors have breached their fiduciary duties, Delaware corporate law distinguishes between the standard of conduct and the standard of review. 'The standard of conduct describes what directors are expected to do and is defined by the content of the duties of loyalty and care. The standard of review is the test that a court applies when evaluating whether directors have met the standard of conduct."). See also Melvin A. Eisenberg, *The Divergence of Standards of Conduct and Standard of Review in Corporate Law*, 62 FORD. L. REV. 437 (1993) (distinguishing corporate law from other substantive areas in which standards of conduct and standards of review converge). E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments,* 153 U. PA. L. REV. 1399, 1416–1425 (2005) (distinguishing between the standards of fiduciary conduct and standards of review). For an explanation and criticism of the conflation of the standard of conduct under the duty of care and the business judgment rule, see Fred W. Triem, *Comment, Judicial Schizophrenia in Corporate Law: Confusing the Standard of Care with the Business Judgment Rule*, 24 ALASKA L. REV. 23 (2007).

6. *Negligence versus gross negligence.* On the question of whether negligence or gross negligence is the proper formulation of the standard of care, compare Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (the "concept of gross negligence" is the "proper standard" for determining whether a business judgment is "an informed one") and Singh v. Attenborough, 137 A.3d 151 (Del. 2016) ("Absent a stockholder vote and absent an exculpatory charter provision, the damages liability standard for an independent director or other disinterested fiduciary for breach of the duty of care is gross negligence, even if the transaction was a change-of-control transaction.") with Rabkin v. Philip A. Hunt Chem. Corp., 13 DEL. J. CORP. L. 1210, 1216–1217 (Del. Ch. 1987) ("I conclude that ordinary negligence is the appropriate standard of liability in director neglect claims."). As the PCG recognized, the Delaware Supreme Court did not review *Rabkin*. Similarly, Delaware has expressly recognized that its case law applies a standard of review that is "more forgiving of directors and more onerous for stockholder plaintiffs than the standard of conduct." Chen v. Howard-Anderson, 87 A.3d 648, 667 (Del. Ch. 2014). See also In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005) (stating that duty of care requires directors to "use that amount of care which ordinarily careful and prudent men would use in similar circumstances" but noting that "deficiencies in the directors' process are actionable only if the directors' actions are grossly negligent"). Authority outside of Delaware generally reflects the language in the black letter. See, e.g., Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 720 (5th Cir. 1984) (a director "must handle his corporate duties with such care as 'an ordinarily prudent man would use under circumstances.'"); Lampe v. Lampe, 665 F.3d 506, 515 (3d Cir. 2011) (citing 15 PA. CONS. STAT. ANN. § 512(a)) ("A director's duty of care requires him to

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“discharge duties to the corporation with the same diligence, care, and skill which ordinary prudent persons exercise in their personal affairs”).

As one commentator observed, “[t]he search for cases in which directors of industrial corporations have been held liable . . . for negligence uncomplicated by self-dealing is a very small number of needles in a very large haystack[.]” Joseph Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968).

On the concern that applying simple negligence as a liability standard would induce an undesirable level of risk aversion by directors. See, e.g., Gagliardi v. Trifoods Int’l, 683 A.2d 1049, 1052 (Del. Ch. 1996) (“only a very small probability of director liability based on ‘negligence’, ‘inattention’, ‘waste’, etc., could induce a board to avoid authorizing risky investment projects to any extent”). See also Albert v. Alex Brown Mgmt. Servs., Inc., Civ. A. Nos. 762-N, 763-N, 2005 WL 2130607, at *4 (Del. Ch. Aug. 26, 2005) (“Gross negligence has a stringent meaning under Delaware corporate (and partnership) law, one which involves a devil-may-care attitude or indifference to duty amounting to recklessness.” (internal quotation marks omitted)).

7. *Standard applicable to both officers and directors*. In 2009, the Delaware Supreme Court held that “fiduciary duties of officers are the same as those of directors.” Gantler v. Stephens, 965 A.2d 695, 708–709 (Del. 2009). Some but not all states take a similar approach. See Megan Wischmeier Shaner*, Privately Ordered Fiduciaries*, 28 GEO. MASON L. REV. 345, 373 n.139 (2020) (identifying conflicting authority on this question). MBCA § 8.42 codifies a standard for officer conduct and uses language similar to § 8.30, observing that officers must meet the standards of conduct specified for directors under § 8.30. Officers and directors may operate in a different factual context, leading to different results even under the same legal standard. Cf. CAL. CORP. Code § 309 (Legislative Committee Comment) (“Although a non-director officer may have a duty of care similar to that of a director, his ability to rely on factual information, reports, or statements may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation.”). For an example of the potential challenge in ascertaining whether an individual is acting as an officer or director see In re Oracle Corp. Derivative Litig., C.A. No. 2017-0337-SG, 2021 WL 2530961 (Del. Ch. June 21, 2021).

8. *Specialized skills or expertise*. In Barnes v. Andrews, 298 F. 614, 617 (2d Cir. 1924) the court explained that “[d]irectors are not specialists, like lawyers or doctors. They must have good sense, perhaps they must have acquaintance with affairs; but they need not—indeed, perhaps they should not—have any technical talent.” For an example of a requirement that a director have specialized knowledge or expertise see e.g., NYSE LISTED COMPANY MANUAL § 303A.07(a) (2013) (“Each member of the audit committee shall be financially literate”). See also Karen Kane, *Help Wanted: ‘Climate Competent’ Directors*, 32 BRIEFINGS MAGAZINE 12 (Sept. 2017), https://www.kornferry.com/insights/articles/help-wanted-climate-competent-directors (identifying a growing need to identify and attract “climate-competent” directors). See, e.g., In re Emerging Commc’ns Inc. S’holders Litig., No. Civ. A. 16415, 2004 WL 1305745 (Del. Ch. June

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4, 2004) at *144. For the proposition that a director possessing specialized expertise may be held to a higher standard, see id.

9. *Additional duties imposed by other regulations*. For a discussion of additional components of the duty of care imposed by federal banking regulation see Julie Andersen Hill & Douglas K. Moll, *The Duty of Care of Bank Directors and Officers*, 68 ALA. L. REV. 965 (2017).

10. *Controlling shareholders and the duty of care*. Courts and commentators have recognized a general duty of care for controlling shareholders, See Jens Dammann, *The Controlling Shareholder's General Duty of Care: A Dogma that Should be Abandoned*, 2015 U. Ill. L. Rev. 479 (2015) (citing authority recognizing a general duty of care for controlling shareholders but arguing that they should not do so).

§ 4.02. The Business Judgment Rule

(a) A director or officer who makes a business judgment is not liable to the corporation or its shareholders if the director or officer:

(1) acts in good faith;

(2) is independent with respect to and not interested in the subject of the business judgment;

(3) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes is appropriate under the circumstances; and

(4) rationally believes that the business judgment is in the best interests of the corporation.

(b) A court shall defer to a corporation's business judgment unless the person challenging that judgment proves that the decisionmakers of the corporation have not met the requirements of subsection (a).

Comment:

a. Comparison with the PCG. Section 4.02(a) sets out the business judgment rule, which was included as a component of a director's duty of care in § 4.01(c) of the Principles of Law, Corporate Governance: Analysis and Recommendations (PCG). Section 4.02(b) is new and formalizes the judicial deference to affirmative business decisions that is a component of the business judgment rule.

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1 *b. Comparison with the Model Business Corporation Act*. Section 4.02(a) largely tracks
2 the standard of liability set out on in Model Business Corporation Act (MBCA) § 8.31. The MBCA
3 expressly states that it "does not codify the business judgment rule as a whole." Official Comment
4 to MBCA § 8.31. As the MBCA recognizes, the scope of the business judgment rule and the
5 circumstances in which it is applied have been and continue to be developed largely by the courts.
6 *c. Structure of the business judgment rule.* The business judgment rule has been the subject
7 of ongoing confusion and debate. The black letter reflects the two distinct roles played by the
8 business judgment rule in corporate law. First, § 4.02(a) limits the availability of money damages
9 against officers and directors who act in accordance with the rule. In addition to the business
10 judgment rule, corporate law provides other mechanisms for limiting officer and director personal
11 liability for money damages such as exculpation provisions and indemnification rights. [add cross-
12 references to applicable sections when drafted].
13 Second, § 4.02(b) implements a standard of review by providing that courts will not
14 substitute their judgment as to the propriety of a decision that was made in compliance with the
15 business judgment rule. The business judgment rule may be the applicable standard of review in
16 cases outside the scope of this Chapter. The black letter in this Section seeks to differentiate the
17 separate roles. The black letter also distinguishes the role played by the business judgment rule
18 from the underlying standard of conduct addressed in § 4.01.
19 **Illustrations:**
20 1. The board of Corporation A is deciding whether to expand A's existing
21 manufacturing plant in Ohio to meet increased demand for A's products. The expansion
22 will take several years and there is no guarantee that demand will continue at existing
23 levels. After considering all material information, the board votes to expand the plant.
24 Several years later, due to unforeseeable circumstances, demand for A's products has
25 declined substantially, and the expansion causes A to sustain substantial losses. If A's
26 directors have acted in accordance with the requirements of § 4.02(a), the board's decision
27 is protected by the business judgment rule.
28 2. Same facts as Illustration 1. When A announces the board's decision to expand
29 the manufacturing plan, a shareholder files suit alleging that A's board has acted
30 negligently in voting to expand and seeking to enjoin the expansion. Unless the shareholder

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can demonstrate that A's directors have not acted in accordance with the requirements of § 4.02(a), the court will defer to the board's decision.

3. Corporation A owns stock of a publicly traded corporation that has decreased in value since it was purchased. A's board of directors is deciding whether to sell the stock and recognize a loss or distribute the stock to its shareholders as a special dividend. The directors, none of whom is interested in the transaction, evaluate both options. The board concludes that distributing the stock as a dividend is in the best interests of the corporation because it will increase reported earnings per share, despite the fact that, in doing so, the company foregoes a substantial tax benefit. A shareholder sues to enjoin payment of the dividend. The board's decision is protected by § 4.02.

d. Procedural or substantive. Prior commentary has characterized the business judgment rule as both substantive and procedural. The procedural element establishes a presumption that the directors acted in accordance with the requirements of § 4.02(a). The substantive element prevents judicial review of the merits of the decision and protects the decision from challenge. The black letter replaces those concepts with the distinction between standards of liability and standards of review. By requiring that a litigant challenging a board decision prove that an officer or director has not met the requirements of § 4.02(a), § 4.02(b) has the effect of incorporating the presumption of regularity reflected by the procedural dimension of the business judgment rule as well as protecting the decision from challenge.

e. Statutory versus common law. Although a variety of decisions describe states as having codified the business judgment rule, in truth, such codifications are relatively rare. More commonly, states have incorporated some components of the business judgement rule into their formulation of the standard of care. The authors of the MBCA expressly disclaimed any intention of codifying the business judgment rule. MBCA § 8.31, Official Comment (5th ed. 2020). Delaware's formulation of the business judgment rule is entirely the product of decisional law.

f. The corporation's business judgment. Section 4.02(b) refers to the corporation's business judgment. Such a judgment can be the product of a decision by the board of directors or by an officer acting within the scope of his or her authority. The business judgment rule does not apply to transactions in which the director or officer has an interest or lacks independence. The definitions of director and officer interestedness and independence are contained in §§ 1.23 and 1.24. For decisions by the board, however, the business judgment rule requires that a majority of

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the board act in accordance with the standard in § 4.02(b). Accordingly, most cases have concluded that an individual director's lack of independence or failure to be informed will not taint an otherwise appropriate decision. Even if a corporate decision does not comport with § 4.02(b), individual directors who act in accordance with the rule are not personally liable.

g. Best interests of the corporation. Corporate law uses the term "best interests of the corporation" in a variety of contexts. See, e.g., § 5.01, Comment *f.* Although cases rarely define the term, it is commonly understood to refer to economic value. See also § 2.01 (defining the objective of the corporation). The extent to which the interests of the corporation encompass the noneconomic interests of shareholders, or the interests of a broader range of stakeholders, such as employees, creditors and customers, is unresolved. Many states explicitly authorize, but do not require, corporate fiduciaries to consider both long- and short-term economic value as well as the interests of nonshareholder stakeholders. See, e.g., 15 PA. STAT. AND CONS. STAT. ANN. § 1715 (authorizing but not requiring the board, "in considering the best interests of the corporation" to consider, inter alia, "[t]he effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located" and "[t]he short-term and long-term interests of the corporation.").

h. Distinction between affirmative actions and failures to act. Director liability for a breach of the duty of care can arise in two contexts. The first involves an affirmative decision that results in a harm to the corporation. The second involves an unconsidered failure to act. The business judgment rule applies only to the former and requires an affirmative business decision. Thus, the business judgment rule is generally inapplicable to an allegation that the directors failed to act. A board's conscious decision not to act is an affirmative act that is covered by the business judgment rule. Director liability for failure to act has largely been incorporated into oversight liability, which is addressed in § 5.03.

Illustrations:

4. Corporation A manufactures ice cream. It turns out that a substantial quantity of the ice cream is contaminated by listeria due to unsanitary conditions in A's factories. A's board is unaware of the conditions, but it has made no effort to adopt systems to monitor factory sanitation or food safety. A's directors are sued for their failure to do so. The

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directors' inactions do not constitute affirmative acts subject to the application of the business judgment rule.

5. Corporation B is in the pharmaceutical industry and, as such, is charged with complying with the regulations of the Food and Drug Administration. The FDA has identified a wide range of flaws in B's quality-assurance procedures, leading to adulterated diagnostic-testing products. Over a period of six years, the FDA has issued multiple notices of violations. The FDA followed these notices by sending certified letters to B's board of directors indicating that B could be subject to substantial fines if the violations were not corrected. B described these regulatory issues in its federal securities filings, which were signed by B's directors. Plaintiffs allege that B's directors knew of the regulatory problems and decided that no action was required. If defendants can establish that B's directors intentionally failed to act, that failure is an affirmative action subject to analysis under § 4.02.

i. Reasonably informed. The black letter requires that officers and directors be informed to the degree that they reasonably believe is appropriate under the circumstances. Courts evaluate the reasonableness of the informational component of the board's process according to a gross-negligence standard. Gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason but is distinguished from bad faith. See Comment x [on bad faith].

The board's obligation is further limited to considering only material information, not all conceivable facts. The formulation reflects the fact that the decision regarding how much information to obtain is itself a business decision that courts should be reluctant to second-guess. It also reflects the fact that acquiring additional information imposes costs, including the potential for delay or the loss of an attractive business opportunity. In addition, directors may satisfy their duty to be informed by reasonable reliance on experts and others in accordance with [§ x.xx] [to come] (addressing reliance on third parties). Nonetheless, courts have been more willing to scrutinize the extent to which directors were adequately informed than to scrutinize their substantive business decisions.

Illustrations:

6. Plaintiffs sue the independent directors of corporation A for breach of the duty of care in connection with their decision to hire B as CEO and their approval of his

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1 employment agreement. A's board, consisting entirely of independent directors, met twice
2 to review the hiring decision. Prior to the meeting, the board was aware of the company's
3 need to hire a CEO, and there had been many discussions about potential candidates to fill
4 that role, during which A was identified as the most attractive candidate. Although the
5 board did not review a spreadsheet detailing B's anticipated compensation in all possible
6 cases, the board received a term sheet setting forth the material terms of B's compensation
7 agreement, the written advice of a compensation consultant, and the amount of downside
8 protection sought by B in consideration for the risk associated with leaving his prior
9 position. Although a board adhering to best practices might have reviewed detailed
10 spreadsheets of potential payouts to the CEO as well as requesting that the compensation
11 consultant make a formal presentation at the board meeting, the board's actions in
12 approving the hiring and compensation of B comport with the standard set out in
13 § 4.02(a)(3).

14 7. The board of corporation A is meeting to decide whether to approve a merger
15 with corporation B. Although the merger agreement, a fairness opinion, and other
16 supporting materials were distributed in advance of the meeting, director C attends the
17 meeting without having read those materials. At the meeting, management provides a
18 description of the merger terms. A's financial advisors and counsel make presentations,
19 including their conclusion that the merger price is fair to A's shareholders and the basis for
20 that conclusion. C concludes, on the basis of the material that has been presented at the
21 meeting, that he has sufficient information to determine that the merger is fair, and he votes
22 to approve the merger. B has made a decision that is informed to a degree that he reasonably
23 believes is appropriate under the circumstances and, as such, his vote is protected by § 4.02.

24 *j. Application to officers.* Section 4.02 protects the business judgments of both directors
25 *and* officers. The MBCA recognizes that the business judgment rule applies to officers' decisions
26 so long as they are acting within their discretionary authority. However, in the commentary to the
27 MBCA, the drafters make clear that "[t]he elements of the business judgment rule and the
28 circumstances for its application continue to be developed and refined by courts."

29 A variety of cases describe the business judgment rule as applying to both officers and
30 directors, but statements as to the scope of the rule are generally dicta. Different considerations
31 apply to the scope of personal liability of officers than those applicable to directors. These include

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1 that officers are typically compensated more highly than outside directors, they have greater access
2 to corporate information, and they are able to devote their efforts to the corporation on a full-time
3 basis. These considerations may affect both the decision whether to apply the business judgment
4 rule to officers and, if so, the standards to which officers should be held in applying § 4.02(a). The
5 differences are also reflected in the fact that some statutory exculpation provisions apply to
6 directors but not officers. See DEL. CODE ANN. tit. 8, § 102(b)(7).

7 There are nonetheless sound policy arguments in favor of applying the business judgment
8 rule to decisions by corporate officers. Officers and directors are held to the same legal standard
9 in § 4.01 and, absent the application of the business judgment rule, this standard would subject
10 officers to liability for simple negligence, a standard that is difficult to apply in the context of ex
11 post judicial review. Like directors, officers make risky business decisions, and the prospect of
12 negligence-based liability will chill appropriate risk-taking. The same considerations in terms of
13 the courts' ability to second-guess business decisions apply to decisions made by corporate
14 officers. In addition, an individual may hold positions as both an officer and a director, and it may
15 be difficult to determine the role in which an individual is acting, in a situation in which different
16 liability standards will apply based on that determination.

17 In addition to the business judgment rule, differences in the role of officers and directors
18 can be addressed through the scope of exculpation provisions. Notably, in some states those
19 exculpation provisions apply to directors but not officers. See DEL. CODE ANN. tit. 8, § 102(b)(7).
20 Exculpation is addressed in § [x.xx].

21 *k. Rational risk-taking.* The purpose of the business judgment rule is to encourage rational
22 risk-taking. A director or officer who makes a risky business decision on an informed basis and
23 after consideration of the relevant risks should not face liability on the basis that the decision turned
24 out, with the benefit of hindsight, to result in a loss to the corporation.

25 **Illustration:**

26 8. M is a director of T Corporation, an investment company that invests in debt
27 securities. T's president brings to the board an opportunity to invest in derivatives based on
28 mortgages tied to shopping malls, office buildings, and hotels. Because of current market
29 conditions, the derivatives have a high potential return but are extremely risky. After
30 carefully reviewing the derivatives and other potential investment opportunities for T, M
31 decides that the return potential of the investment is better than any alternative and that the

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mortgages, although risky, are likely to be paid, particularly since the mortgagees are likely to receive federal bailout money that will support their ability to continue to make payments.

M votes to approve the investment strategy. Unfortunately, when the bailout money runs out, a substantial number of the mortgages default, and T loses millions of dollars. M has acted in accordance with § 4.02.

l. Distinction from waste. Truly egregious decisions can also be addressed through the doctrine of waste. See [add cross-reference to Section on waste]. The common-law doctrine of waste evolved as an alternative basis for challenging director conduct that failed to meet the rationality requirement. This standard is rarely met.

m. Demonstrating noncompliance with § 4.02. Section 4.02 provides that it is the plaintiff's burden to demonstrate that the requirements of § 4.02(a) have not been met. A plaintiff typically rebuts the presumption by demonstrating the absence of an adequate decisionmaking process, a conflict of interest, or bad faith.

o. Bad faith. The black letter requires that officers and directors act in good faith to receive the protection of the business judgment rule. The term "bad faith" is used extensively in corporate law, and the extent to which its meaning varies depending on the context in which it is used is unclear. The Restatement addresses the concept of bad faith in § [x.xx]. Illegal conduct may constitute bad faith, and courts have generally stated that the business judgment rule does not apply to knowingly illegal conduct.

p. Consequences of noncompliance with § 4.02. Rebutting the application of the business judgment rule does not establish per se liability. In a case alleging breach of the duty of care, the plaintiff must then establish a causal link between the alleged acts and harm. An exculpation provision, if applicable, may also limit the defendants' liability for money damages. See [add cross-reference to exculpation]. In a duty-of-loyalty case, if the business judgment rule has been rebutted, the defendant must establish entire fairness.

q. Pleading requirement. Most courts require particularized pleading by the plaintiff to get past a motion to dismiss. When the actions of an officer or director are within the scope of an exculpation provision, the plaintiff faces a heightened pleading requirement. A few states have held that analysis of the application of the business judgment rule can occur at trial or on motion for summary judgment. Analysis of the pleading requirement is closely related to the demand

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1 requirement in derivative litigation. See, e.g., Fed. R. Civ. P. 23.1; Del. Ch. Rule 23.1. See § [x.xx]
2 on the demand requirement.

REPORTERS' NOTES

3 1. *Formulation of the business judgment rule*. Courts have varied in the precise language
4 they use to describe the business judgment rule. See, e.g., R. Franklin Balotti & James J. Hanks,
5 Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1342 (1993) (describing the three
6 versions of the business judgment rule in Delaware corporate law, the Principles of Corporate
7 Governance (PCG)), and the Model Business Corporation Act (MBCA)). Section 4.02 (a) adopts
8 the language of the PCG § 4.01(c). A number of cases have adopted the "rationally believes"
9 standard from the PCG. See, e.g., Moulton v. Stewart Enters., 321 So. 3d 1038, 1053 (2021)
10 (quoting Louisiana statute); Cuker v. Mikalauskas, 547 Pa. 600, 612 (1997); Seidman v. Clifton
11 Sav. Bank, S.L.A., 205 N.J. 150, 176 (2011) (citing PCG); Omnibank of Mantee v. United S. Bank,
12 607 So. 2d 76, 85 (Miss. 1992) (citing PCG).
13 Other cases use similar language. For example, the Delaware courts have stated that the
14 business judgment rule requires that directors act "on an informed basis, in good faith and in the
15 honest belief that the action taken was in the best interests of the company." Aronson v. Lewis,
16 473 A.2d 805, 812 (Del. 1984). Delaware incorporates the fourth component of the black letter by
17 explaining: "where the business judgment presumptions are applicable, the board's decision will
18 be upheld unless it cannot be attributed to any rational purpose." In re Walt Disney Co. Derivative
19 Litig., 906 A.2d 27, 74 (Del. 2006) (en banc) (internal quotation marks omitted) (quoting Sinclair
20 Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)). A line of cases decided under Delaware law
21 support the test that under the business judgment rule, a corporate decision will be upheld unless
22 it cannot be attributed to any rational business purpose. See, e.g., Panter v. Marshall Field & Co.,
23 646 F.2d 271, 293 (7th Cir. 1981) (courts will not disturb a business judgment if "any rational
24 business purpose can be attributed" to a director's decision); Unocal Corp. v. Mesa Petroleum Co.,
25 493 A.2d 946, 954 (Del. 1985) ("any rational business purpose" test). For an example of conduct
26 that, in the view of the court, failed to meet the rationality requirement, see Selheimer v.
27 Manganese Corp. of America, 224 A.2d 634, 646 (Pa. 1966) ("With the knowledge which
28 defendants had of the unsuitability of the Paterson plant for profitable production, the pouring of
29 Manganese' funds into this plant defies explanation; in fact, the defendants have failed to give any
30 satisfactory explanation or advance any justification for such expenditures.").
31 A few courts characterize the business judgment rule as requiring "reasonable" rather than
32 "rational" belief. See, e.g., Deep Photonics Corp. v. LaChapelle, 368 Ore. 274, 292 (2021);
33 McDonnell v. Am. Leduc Petroleums, Ltd., 491 F.2d 380, 384 (2d Cir.1974) (the court, applying
34 California law, concluded that the "business judgment rule protects only reasonable acts of a
35 director or officer"). The black letter rejects the reasonableness standard as affording lesser
36 deference to a director's business judgment. See In re RJR Nabisco, Inc. Shareholders Litig., CIV.
37 A. No. 10389, 1989 WL 7036, at *22 n.13 (Del. Ch. Jan. 31, 1989) (such an approach would "make
38 of courts super-directors"). As the drafters of the PCG explained, "The 'rationally believes'

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standard set forth in § 4.01(c)(3) is intended to afford directors and officers wide latitude when making business decisions that meet the other prerequisites of [the business judgment rule]." Comment to § 4.01(c).

2. *Purpose and scope*. Commentators have articulated the purpose of the business judgment rule as to encourage rational risk-taking. See Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) (holding that purpose of the business judgment rule is to encourage rational risk-taking); David Rosenberg, *Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule*, 6 BERKELEY BUS. L.J. 216 (2009) (discussing the relationship between the business judgment rule and risk-taking). For an argument that the business judgment rule should not apply in the close-corporation context see Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456 (1985).

3. *State codification of business judgment rule.* A small number of states have codified components of the business judgment rule. See generally ALA. CODE 1975 § 10A-2A-8.31 (Effective Jan. 1, 2020); CAL. CORP. Code § 309 (West 2019); MD. CODE ANN. CORPS. & ASSN'S § 2-405.1 (West 2019); NEB. REV. ST. ANN. § 21-2,103 (West 2019); NEV. REV. STAT. ANN. § 78.138 (West 2019); OHIO REV. CODE ANN. § 1701.59 (West 2019). Most commonly, those statutes address the applicable standard of liability against individual directors and/or officers for monetary damages. See, e.g., IDAHO CODE ANN. § 30-29-831 (West 2019); IOWA CODE ANN. § 490.831 (West 2014); MISS. CODE ANN. § 79-4-8.31 (West 2013).

4. *Standards of conduct versus standards of liability.* On the distinction between standards of conduct and standards of liability, see In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 697 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006) (en banc) ("Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices"). For a thoughtful effort to untangle the standard of conduct in the duty of care from the business judgment rule, see Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625 (2000).

5. *The business judgment rule as a standard of review.* The business judgment rule operates as a standard of review, requiring courts to defer to business decisions that are made in accordance with its requirements. Alternatively, the business judgment rule may be described a judicial policy of nonreview. William T. Allen, et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 874–878 (2001) ("The 'business judgment rule' . . . is an expression of a policy of non-review of a board of directors' decision"); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 109 (2004) (characterizing the business judgment rule as an "abstention doctrine" that prevents courts from overriding the board's decisionmaking authority).

In Delaware, the business judgment rule is one of three standards of review. Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011) ("Delaware has three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness."). But see Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) (adopting a fourth standard of review for cases involving interference with the shareholder

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franchise). Not all states have adopted Delaware's enhanced-scrutiny standard. See, e.g., Lewis v. Celina Fin. Corp., 655 N.E.2d 1333, 1340 (Ohio Ct. App. 1995) (rejecting *Revlon* duties under Ohio law); Willard ex rel. v. Moneta Bldg. Supply, 515 S.E.2d 277, 283-85 (Va. 1999) (rejecting *Revlon* duties under Virginia law).

6. *Broader application of the business judgment rule.* For examples of cases purporting to apply the business judgment rule standard of review outside the context of the duty of care see Kahn v. M&F Worldwide Corp., 88 A.3d 635, 652 (Del. 2014) (MFW) (applying business judgment rule to controlling stockholder buyout); Flood v. Synutra Int'l, Inc., 195 A.3d 754, 769 (Del. 2018) (explaining that business judgment rule standard of review applies to conflicted transactions that are conditioned, ab initio, on the approval of an independent empowered Special Committee and the uncoerced informed vote of a minority of disinterested shareholders); In re USG Corp. Stockholder Litig., C.A. No. 2018-0602-SG, 2020 WL 5126671 (Del. Ch. Aug. 31, 2020) (holding that acquisition would be reviewed under the business judgment rule standard "if it was approved by a 'fully informed, uncoerced majority of the disinterested stockholders.'"), citing Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304, 306 (Del. 2015). The extent to which these cases involve an application of the business judgment rule as opposed to a determination that the transaction does not violate the duty of loyalty is unclear. See also In re Dell Techs. Inc. Class V Stockholders Litig., C.A. No. 2018-0816, 2020 WL 3096748 (Del. Ch. June 11, 2020) (terming the *MFW* standard "the irrebuttable version of the business judgment rule.").

7. *Substantive versus procedural.* Some courts have described the procedural component of the business judgment rule as a presumption that the directors have acted in compliance with their duties, such that a party challenging a board decision must "establish facts rebutting the presumption." See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."). See also Data Key Partners v. Permira Advisers LLC, 849 N.W.2d 693, 696 (Wis. 2014) (describing the business judgment rule as both substantive and procedural). See also R. Franklin Balotti & Joseph Hinsey IV, *Director Care, Conduct, and Liability: The Model Business Corporation Act Solution*, 56 BUS. LAW. 35, 37 (2000).

> The procedural element establishes a presumption that the directors 'acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.' The substantive element prevents judicial review of the merits of the decision and protects the decision from challenge.

(footnotes omitted); R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1342 (1993) ("In its substantive aspect, the rule prohibits a court, absent an abuse of discretion, from substituting its judgment for that of the directors.").

For a formulation of the substantive approach, see Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (observing that the concept that the directors failed to exercise substantive due care "is foreign to the business judgment rule."). For the procedural approach, see Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993) ("The rule posits a powerful presumption in favor of

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actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose.'"), quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

8. *Requirement of disinterestedness.* The business judgment rule is not applicable if the plaintiff can prove that the directors have a conflict of interest. Lewis v. S.L. & E., Inc., 629 F.2d 764, 769 (2d Cir. 1980). See In re RJR Nabisco, Inc. S'holders Litig., CIV. A. No. 103891989 WL 7036, *1157 (Del. Ch. Jan. 31, 1989) ("the sort of "interest" that qualifies to disarm a board at the outset of the benefits of a business judgment approach is a financial interest in the transaction adverse to that of the corporation or its shareholders.").

9. *Individual vs. collective analysis.* Cases have generally afforded deference to decisions in which a majority of the board acted in compliance with the business judgment rule. See, e.g., Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (to rebut the business judgment rule the plaintiff must show that at least half the directors who approved the decision were not disinterested or independent). But see In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 779 n. 373 (Del. Ch. 2005) (noting testimony of expert witness that "individualized one-on-one discussions between management and directors can lead to directors who are 'unequally or unevenly informed with regard to significant matters' and 'have the effect of vitiating, sapping the board's ability as an institution to function together collectively and collegially and deliberatively'"). Courts analyze the personal-liability exposure of officers and directors on an individualized basis. See In re Emerging Commc'ns Inc. S'holders Litig., Civ.A. No. 16415, 2004 WL 1305745, at *38 (Del. Ch. Jun. 4, 2004) ("liability of the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are exculpated from liability for that breach, can vary for each director.").

10. *Business judgment only applicable to affirmative business decisions.* For the proposition that the business judgment rule applies only to affirmative business decisions, see *Aronson*, 473 A.2d at 813 ("the business judgment rule operates only in the context of director action. . . . It has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 112 (1979); Dennis J. Block & H. Adam Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, 33 (1981) ("The [business judgment] rule does not apply where the director has in fact made no decision"). A board's conscious decision not to act, in contrast, is an affirmative act and thereby covered by the business judgment rule. See Aronson, 473 A.2d at 813 ("a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment.").

11. *Liability for failure to act.* In Stone v. Ritter, 911 A.2d 363, 370 (Del. 2006) the Delaware Supreme Court referred to oversight liability as the failure to act in the face of a known duty to act and termed such a failure a violation of the duty of loyalty.

12. *Burden of rebutting business judgment rule.* It is the plaintiff's burden to rebut the application of the business judgment rule by showing that one or more of the conditions set forth in the black letter has not been met. See, e.g., Angelo, Gordon, Co., L.P. v. Allied Riser Commc'ns

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Corp., 805 A.2d 221, 229 (Del. Ch. 2002) (stating that "to overcome the presumption of regularity attending the application of the business judgment rule plaintiffs must carry an initial burden of showing circumstances supporting an inference that the directors did not act in good faith after a reasonable investigation"). If the plaintiff meets that burden, the decision will not be subject to the black letter's deferential standard of review. See, e.g., Bomarko, Inc. v. Int'l Telecharge, Inc., 794 A.2d 1161, 1178 (Del. Ch. 1999) ("if the Court finds facts evidencing disloyalty by the defendant, the business judgment rule is rebutted, and the Court reviews the transaction to determine whether, despite the disloyal act, the transaction is nevertheless entirely fair to the Company's shareholders."); Smith v. Van Gorkom, 488 A.2d 858, 888 (Del. 1985) (holding that because the board's decision to approve a merger was not fully informed, "the Trial Court erred in according to the defendants the benefits of the business judgment rule."); Krasner v. Moffett, 826 A.2d 277, 287 (Del. 2003) ("when the presumption of the business judgment rule has been rebutted, the entire fairness rule is implicated and defendants bear the burden of proof"). On the requirement that the plaintiff establish a causal link between the acts and the harm, see Frost v. Adiletta (In re Teleservices Group, Inc.), 2009 Bankr. LEXIS 5533 (N.J. Bankr. 2009), aff'd, 2009 WL 4250055 (D.N.J. 2009).

13. *Informed decision.* A variety of cases address the extent to which directors have a duty to become informed. See, e.g., *Aronson*, 473 A.2d at 812 ("to invoke the [business judgment] rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them."); *Brehm*, 746 A.2d at 259 (The Board is responsible for considering only *material* facts that are *reasonably available*, not those that are immaterial or out of the Board's reasonable reach") (italics in original). See generally In re Walt Disney Co. Derivative Litig., 906 A.2d at 56 (Del. 2006) (en banc) (concluding that compensation committee was adequately informed despite its failure to adhere to best practices).

Courts have articulated some objective criteria in determining whether a challenged action has been made on a sufficiently informed basis. See, e.g., Grobow v. Perot, 593 A.2d 180, 191 (Del. 1988) (noting that allegation that directors failed to consult with financial advisors would support claim of lack of due care); Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985) (concluding board was not sufficiently informed when it relied entirely on a 20-minute oral presentation by the chief executive). The standard for determining when an officer or director was not properly informed is gross negligence. Davis v. Gutierrez, Civil No. 17–cv–147–JL, 2018 WL 1514869 at *11 (D.N.H. 2018). See also Solash v. Telex Corp., 1988 WL 3587, at *9 (Del. Ch. 1988) ("a reasonable investigation is one that is not grossly negligent"). On the board's decision on what information to consider, see Citron v. Fairchild Camera & Instrument Corp., Civ. A. No. 6085, 1988 WL 53322, *304 (Del. Ch. 1988), aff'd, 569 A.2d 53 (Del. 1989) ("just how much information prudence requires before a decision is made is itself a question that calls for informed judgment of the kind courts are not well-equipped to make").

14. *Application of the business judgment rule to officers*. For case law stating that the application of the business judgment rule to officers is unclear see Chen v. Howard-Anderson, 87 A.3d 648, 666 n.2 (Del. Ch. 2014) (noting that the business judgment rule's application to officers

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1 is unsettled); In re Xura, Inc. Stockholder Litig., 2018 WL 6498677 *16, n.113 (Del. Ch. 2018)
2 (presuming that the business judgment rule applies to defendant CEO but stating that "this point
3 is not settled in our law and that there is a lively debate among members of the academy regarding
4 whether corporate officers may avail themselves of business judgment rule protection."). The
5 balance of authority holds that the business judgment rule applies to officers as well as directors.
6 See Lewis v. Aronson, 466 A.2d 375, 384 (Del. Ch. 1983) (the business judgment rule "is a
7 presumption that a rational business decision of the officers or directors of a corporation is proper
8 unless there exists facts which remove the decision from the protection of the rule"); Para-Medical
9 Leasing v. Hangen, 739 P.2d 717, 721 (Wash. Ct. App. 1987) ("Although the 'business judgment'
10 rule is usually stated in terms of director functions, it is no less applicable to officers in the exercise
11 of their authority and may be applicable to controlling shareholders when they exercise their more
12 extraordinary management functions."), citing HARRY J. HENN & JOHN R. ALEXANDER, LAWS of
13 CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 242, at 663 (3d ed. 1983). For additional
14 cases holding that the business judgment rule applies to both officers and directors, see Sneed v.
15 Webre, 465 S.W.3d 169 (Tex. 2015); Davis v. Lakewood Prop. Owners Ass'n, 536 S.W.3d 743
16 (Mo. Ct. App. 2017); Munford v. Valuation Rsch. Corp. (In re Munford, Inc.), 98 F.3d 604 (11th
17 Cir. 1996) (applying Georgia law). Compare Gaillard v. Natomas Co., 256 Cal. Rptr. 702 (Cal.
18 App. 3d 1989) (because the directors were "acting as officer employees of the corporation . . . the
19 business judgment rule therefore should not apply."). Relatively few cases explicitly address the
20 question. See Brandon J. Stout, Note, *Corporate Directors [and Officers] Making Business*
21 *Judgments in Tennessee: The Business Judgment Rule*, 44 U. MEM. L. REV. 455, 475 (2013)
22 (observing that "judicial assertions concerning the rule's application to officers often constitute
23 mere dicta.").

24 There is an extensive academic debate on the issue of whether the business judgment rule
25 should extend to officers. See, e.g., Stephen M. Bainbridge, CORPORATION LAW AND ECONOMICS
26 286 (2002) (explaining that "[m]ost of the theoretical justifications for the business judgment rule
27 extend from the boardroom to corporate officers,"); Lawrence A. Hamermesh & A. Gilchrist
28 Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson,* 60
29 BUS. LAW. 865 (2005) (arguing that, as with directors, "liability for ordinary negligence would
30 discourage valuable risk-taking by officers"); Margo Brandenburg, *You're the Problem Officer,*
31 *Whether Executive Officers should be Subjected to the Same Standards of Liability as Directors*
32 *under Current Corporate Governance Law*, 89 U. CIN. L. REV. 710, 726 (2021) (arguing that
33 applying the business judgment rule to officers preserves the board's role as the central
34 decisionmaker of the corporation); but see Lyman P.Q. Johnson, *Corporate Officers and the*
35 *Business Judgment Rule*, 60 BUS. LAW. 439, 458-469 (2005) (discussing policy reasons why the
36 business judgment rule should not apply to officers). See also Michael Follett, Note*, Gantler v.*
37 *Stephens, Big Epiphany or Big Failure? A Look at the Current State of Officers' Fiduciary Duties*
38 *and Advice for Potential Protection*, 35 DEL. J. CORP. L. 563 (2010) (arguing that applying
39 business judgment rule but not exculpation to officers will allow officers to engage in an
40 appropriate amount of risk-taking).

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15. *Comparison to waste.* If a plaintiff fails to rebut the business judgment rule, the plaintiff can only recover if the transaction constitutes waste. In re Walt Disney Co. Derivative Litig., 906 A.2d at 73–74. For cases articulating the doctrine of waste, see *Brehm* at 263 (claims of waste are "confined to unconscionable cases where directors irrationally squander or give away corporate assets"); Kandell ex rel. FXCM, Inc. v. Niv, 2017 WL 4334149, at *15 (Del. Ch. Sept. 29, 2017), quoting Steiner v. Meyerson, 1995 WL 441999, at *1 (Del. Ch. July 19, 1995) ("the standard for showing waste is 'obviously an extreme test, very rarely satisfied by a shareholder plaintiff.'").

16. *Pleading requirement*. For an articulation that plaintiffs must affirmatively plead noncompliance with the requirements of the business judgment rule, see Stanziale v. Nachtomi (In re Tower Air, Inc.), 416 F.3d 229, 238 (3d Cir. 2005) (To survive the motion to dismiss under Rule 12(b)(6), the plaintiff must "plead around the business judgment rule."); In re Robotic Vision Sys., Inc., 374 B.R. 36, 49 (D.N.H. 2007) (requiring bankruptcy trustee "to plead that he can overcome the presumption created by the business judgment rule in order to survive a motion to dismiss"); Larry A. Hamermesh & Michael L. Wachter, *The Importance of Being Dismissive: The Efficiency Role of Pleading Stage Evaluation of Shareholder Litigation*, 42 IOWA J. CORP. L. 597, 615 (2017) ("what we find are judicially developed requirements for pleading specific facts that would rebut the substantive deference to director conduct afforded by the business judgment rule"). The requirement may depend, in part, on whether the case is filed in federal court and therefore subject to the pleading requirements of Ashcroft v. Iqbal, 556 U.S. 662 (2009) and Twombly v. Bell Atl. Corp., 550 U.S. 544, 570 (2007). On the demand requirement see, e.g., [x.xx] (forthcoming Section on the demand requirement). Delaware requires particularized pleading of a plaintiff who seeks to be excused from the requirement of presuit demand. See United Food & Commer. Workers Union v. Zuckerberg, 262 A.3d 1034, 1059 (Del. 2021) (adopting three-part pleading test for evaluating allegations of demand futility).

Compare Springs Villas II Homeowners Assn., Inc. v. Parth, 204 Cal.Rptr.3d 507, 517 (Cal. Ct. App. 2016) (holding that, where there is no disagreement surrounding material facts, a motion for summary judgment is an appropriate method to determine whether the business judgment rule applies, with Marsalis v. Wilson, 778 N.E.2d 612, 642 (Ohio 2002) (holding that the burden of the business judgment rule only applies at trial).

17. *Illegal conduct*. For cases stating that the business judgment rule does not apply to illegal conduct, see In re Abbott Depakote S'holder Derivative Litig., 2013 WL 2451152, *11 (N.D. Ill. June 5, 2013) ("the business judgment rule does not apply when a Board has notice of illegal conduct occurring on its watch, does nothing to remedy the situation and that inaction results in a loss to the company"); Roth v. Robertson, 118 N.Y.S. 351, 352 (Sup. Ct. 1909); Miller v. American Tel. & Tel Co., 507 F.2d 759 (3rd Cir. 1974).

18. *Gross negligence and bad faith*. The business judgment rule does not protect the actions of officers and directors who engage in grossly negligent conduct (although other provisions such as exculpation may shield directors from liability even for gross negligence). Gross negligence has been described as "conduct that constitutes reckless indifference or actions that are without the bounds of reason." McPadden v. Sidhu, 964 A.2d 1262, 1274 (Del. Ch. 2008). Gross negligence

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1 is also distinguished from bad faith. See id. (“from the sphere of actions that was once classified
2 as grossly negligent conduct that gives rise to a violation of the duty of care, the Court has carved
3 out one specific type of conduct—the intentional dereliction of duty or the conscious disregard for
4 one’s responsibilities—and redefined it as bad faith conduct, which results in a breach of the duty
5 of loyalty.”).
6 19. *Illustrations*. The facts of Illustration 3 are drawn in part from Kamin v. Am. Express
7 Co., 86 Misc. 2d 809 (N.Y. Sup. 1976). The facts of Illustration 4 are drawn in part from Marchand
8 v. Barnhill, 212 A.3d 805 (Del. Sup. 2019). The facts of Illustration 5 are a modified version of
9 the facts in In re Clovis Oncology, Inc. Derivative Litig., 2019 WL 4850188 (Del Ch. 2019). The
10 facts of Illustration 6 are a modified version of the facts In re Walt Disney Co. Derivative Litig.,
11 906 A.2d 27 (Del. 2006) (en banc).

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CHAPTER 5
DUTY OF LOYALTY

§ 5.01. The Duty of Loyalty

A director or officer has a duty to act in the good-faith belief that such actions are in the best interests of the corporation and to give precedence to the interests of the corporation over any personal interest.

Comment:

a. Comparison with the PCG. The black letter is new and broader than the duty of fair dealing set forth in the Principles of Law, Corporate Governance: Analysis and Recommendations (PCG), which it replaces. The black letter defines the duty of loyalty applicable to officers and directors and sets out the parameters of that duty in positive terms (as opposed to a prohibition on specified conduct). Subsequent sections describe the application of this definition in specific situations. The process by which fair dealing is evaluated in transactions in which an officer or director is interested is set out in § 5.02. The duty of loyalty also applies to certain transactions involving a controlling shareholder, and the scope of that duty is addressed in § 5.10. [future Sections will address other components of the duty of loyalty].

b. Duty of loyalty defined. Although the duty of loyalty is widely discussed, cases and statutes rarely provide precise definitions of the duty of loyalty applicable to corporate officers and directors. The black letter is intended to supply a definition that applies across the range of contexts in which it has been used. In addition, the definition is intended to create an affirmative obligation—that of loyalty—rather than simply requiring that a director abstain from certain prohibited conduct.

c. Disloyal conduct. The formulation of the duty of loyalty in § 5.01 distinguishes the quality of a corporate official's conduct from his or her underlying motivation. A corporate official's negligent actions are violations of the duty of care under § 4.01. Actions that are taken without regard to the corporation's best interests or consciously for an improper purpose are violations of the duty of loyalty. The duty of loyalty thus focuses on the state of mind that should motivate the actions of a corporate fiduciary.

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d. Relationship between disloyalty and self-dealing. Self-dealing is one kind of breach of a fiduciary's obligation to put the interests of the corporation against the fiduciary's personal interests or those of a third party. See §§ 5.02, 5.10. The law does not prohibit transactions in which there is a conflict of interest, but, absent an appropriate cleansing act, it subjects such transactions to the heightened scrutiny of an entire fairness review. Disloyal conduct is not limited, however, to actions involving self-dealing. More recent cases have explained that the duty of loyalty also includes an affirmative obligation to act in good faith. The complete failure of corporation's directors to police a self-dealing transaction also implicates the duty of loyalty, as does engaging in knowingly illegal conduct or deliberately lying to shareholders. An individual director need not have a personal interest in a transaction to violate the duty of loyalty; acting with a "controlled mindset" is sufficient, as is pursuing, or refusing to pursue, a course of action because of some extraneous consideration.

Illustrations:

1. Corporation A is required by federal law to file suspicious-activity reports in connection with any cash transaction over $5,000 for which the corporation knows, suspects, or has reason to suspect involves funds derived from illegal activities. A's largest customer X regularly engages in cash transactions exceeding $5,000. Although A's compliance procedures require A to file suspicious-activity reports for these transactions, X, who has recently been indicted on federal money-laundering charges, requests that A not file them in order to avoid bringing the transactions to the attention of regulators. Desiring to retain a valuable customer, A's board agrees and does not cause A to file the reports. A's board has not acted in accordance with § 5.01.

2. Corporation B has negotiated an arms-length merger with Corporation C. Under the terms of the merger agreement X, B's CFO, is to receive a lucrative contract for continued employment. B's board consisted entirely of disinterested directors who have no personal interest in the merger. The board is satisfied that both the terms of the merger and X's employment contract are fair, but because of the frequency with which mergers are subject to shareholder litigation, B's board decides not to disclose X's employment contract to B's shareholders in the proxy statement. B's board has not acted in accordance with § 5.01.

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1 *f. Best interests of the corporation.* Corporate law takes the position that corporate
2 fiduciaries have an obligation to serve the best interests of the corporation and its shareholders.
3 The term "best interests" is rarely defined in case law and is commonly understood to refer to
4 economic value. See § 2.01(a). Many states have adopted constituency statutes that expressly
5 authorize directors to consider nonshareholder constituencies such as employees, creditors, and
6 customers, in determining the best interests of their corporations. The extent to which boards, in
7 determining their corporations' best interests, may consider nonshareholder or noneconomic
8 interests absent express statutory authorization depends on the factual context.

REPORTERS' NOTES

9 *1. Definition.* The black letter draws from the definition offered by Leo E. Strine, Jr.,
10 Lawrence A. Hamermesh, R. Franklin Balotti, & Jeffrey M. Gorris in *Loyalty's Core Demand:*
11 *The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 631 (2010) ("the basic
12 definition of the duty of loyalty is the obligation to act in good faith to advance the best interests
13 of the corporation"). Accord, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)
14 ("[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes
15 precedence over any interest possessed by a director, officer or controlling shareholder and not
16 shared by the stockholders generally.")
17 *2. Related concepts.* The Restatement of the Law Third, Agency § 8.01 (AM. LAW INST.
18 2006) provides generally that "[a]n agent has a fiduciary duty to act loyally for the principal's
19 benefit in all matters connected with the agency relationship." This definition is followed by
20 several Sections enumerating specific components of the duty of loyalty. Section 2.02 of the
21 Restatement of the Law, Charitable Nonprofit Organizations (AM. LAW INST. 2021) defines a
22 fiduciary's duty of loyalty to include "a duty to: (a) act in good faith and in a manner the fiduciary
23 reasonably believes to be in the best interests of the charity in light of its purposes; [and]
24 (b) address reasonably situations that involve the potential for self-dealing in which the interests
25 of a fiduciary or related person may conflict with the interests of the charity[.] .").
26 *3. Scope of duty beyond self-dealing*. For an explanation of the traditional scope of the duty
27 of loyalty see In re Walt Disney Co. Derivative Litig. (Disney IV), 907 A.2d 693, 751 (Del. Ch.
28 2005) ("The classic example that implicates the duty of loyalty is when a fiduciary either appears
29 on both sides of a transaction or receives a personal benefit not shared by all the shareholders.");
30 Labor Ready, Inc. v. Williams Staffing, LLC, 149 F. Supp. 2d 398, 415 n.14 (N.D. Ill. 2001)
31 (noting that in Illinois, "[c]orporate officers owe a fiduciary duty of loyalty to their corporate
32 employer not to actively exploit their positions within the corporation for their own personal
33 benefit or hinder the ability of a corporation to continue the business for which it was developed").
34 In Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006), the Delaware Supreme Court held that a
35 director's failure to act in good faith, even in the absence of a conflict of interest, constituted a
36 breach of the duty of loyalty. See also Fed. Deposit Ins. Co. v. Dodson, Case No. 4:13-cv-416,

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2014 WL 11511068, at *7 (N.D. Fl. 2014) (concluding that claim for breach of the duty of loyalty, under Florida law, does not require allegations of self-serving behavior); Ryan v. Gifford, 918 A.2d 341, 355 (Del. Ch. 2007) ("it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder approved plan, no less), and yet satisfy his duty of loyalty").

See also Claire A. Hill & Brett McDonnell, Stone v. Ritter *and the Expanding Duty of Loyalty*, 76 Fordham L. Rev. 1769, 1780 (2007) (explaining that the duty loyalty now "encompass[es] cases of culpable conduct not constituting breaches of the duty of loyalty as traditionally conceived."); Leo Strine, et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 633 (2010) ("the duty of loyalty most fundamentally requires that a corporate fiduciary's actions be undertaken in the good faith belief that they are in the best interests of the corporation and its stockholders").

4. Loyalty as an affirmative obligation. For a defense of the duty of loyalty as an affirmative obligation see Lyman Johnson, *After Enron: Remembering Loyalty Discourse in Corporate Law*, 28 DEL. J. CORP. L. 27, 46 (2003) (explaining that viewing loyalty as an affirmative obligation "is a considerably more demanding directorial duty than mere nonbetrayal").

5. Best interests of the corporation. Although cases describe fiduciary obligations in terms of the best interests of the corporation and its shareholders, the duty is commonly understood to run to the corporation rather than shareholders in their individual capacities. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (describing the board's "fundamental duty and obligation to protect the corporate enterprise"). There is continuing debate about the extent to which boards may consider the interests of nonshareholder constituencies in determining the corporation's best interests absent explicit statutory authorization to do so. Cf. *Unocal* at 956 (recognizing the right of a board, in the context of a hostile takeover bid, to consider "the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)"). Many states have adopted constituency statutes that explicitly authorize the inclusion of nonshareholder interests in a director's determination of the best interests of the corporation. See, e.g., Connecticut constituency statute, which states that a director of a corporation:

> may consider, in determining what the director reasonably believes to be in the best interests of the corporation, (1) the long-term as well as the short-term interests of the corporation, (2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation, (3) the interests of the corporation's employees, customers, creditors and suppliers, and (4) community and societal considerations, including those of any community in which any office or other facility of the corporation is located. A director may also consider, in the discretion of such director, any other factors the director reasonably considers appropriate in determining what the director reasonably believes to be in the best interests of the corporation.

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CONN. GEN. STAT. ANN. § 33-756 (2017). Some commentators have also argued that the directors may consider noneconomic as well as economic interests. See, e.g., Barnali Choudhury, *Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm*, 11 U. PA. J. BUS. L. 631, 658 (2009) ("to the extent that the law recognizes fiduciary duties as flowing to the corporation, corporate managers can undertake acts of social responsibility that are in the best interests of the corporation."); Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. & ACCT. 247, 270 (2017) (arguing that "shareholder welfare and market value are not the same, and that companies should maximize the former not the latter").

6. Acting with a "controlled mindset." For cases indicating that, even in the absence of a conflict of interest, an individual director can violate the duty of loyalty by acting with a "controlled mindset," see Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1241 (Del. 2012) (affirming the Delaware Court of Chancery's finding that members of a special committee violated their duty of loyalty by falling "victim to a controlled mindset" and allowing the controlling stockholder to dictate the terms of a merger); In re Viacom Inc. Stockholders Litig., C.A. No. 2019-0948, 2020 WL 7711128, at *23–24 (Del. Ch. Dec. 30, 2020) (explaining that a controlled mindset impedes directors in furthering the best interests of all shareholders and therefore would constitute a breach of the duty of loyalty, even for directors who do not themselves have a conflict of interest). See also RJR Nabisco, Inc. S'holders Litig., CIV. A. No. 10389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989) ("Greed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge, or, as is here alleged, shame or pride. Indeed any human emotion may cause a director to place his own interests, preferences or appetites before the welfare of the corporation.").

§ 5.02. Interested Transactions Involving a Director or Officer

(a) If a corporation enters into a transaction in which a director [§ 1.13] or officer [§ 1.27] is interested [§ 1.23] (other than a transaction involving the payment of compensation), the director or officer fulfills the duty of loyalty to the corporation and its shareholders with respect to the transaction if:

(1) the transaction is fair to the corporation when entered into; or

(2) after disclosure concerning the conflict of interest [§1.14(a)] and the transaction [§1.14(b)], the transaction is authorized in advance or ratified by disinterested directors [§ 1.15] or, in the case of an officer who is not a director, by a disinterested superior, acting in good faith and on reasonable inquiry; or

(3) after disclosure concerning the conflict of interest and the transaction, the transaction is authorized in advance or ratified by disinterested shareholders [§ 1.16],

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and it does not constitute a waste of corporate assets [§ 1.42] at the time of the authorization or ratification.

(b) A party who challenges a transaction between a director or officer and the corporation has the burden of proving that the director or officer is interested in the transaction. If such party establishes that the transaction is an interested transaction, the interested director or officer has the burden of proving that the conditions of subsections (a)(1), (a)(2), or (a)(3) are satisfied, except that the party challenging the transaction has the burden to establish waste under subsection (a)(3).

Comment:

a. Comparison with existing law. This Section restates current law in both Delaware and states that have enacted the Model Business Corporation Act (MBCA). It modifies slightly the standard articulated in § 2.01 of the Principles of Law, Corporate Governance: Analysis and Recommendations (PCG). As discussed above in the Introductory Note to Chapter 5 [to be drafted], the duty of loyalty includes a duty to deal fairly with the corporation (the "duty of fair dealing"). Both terms are used in this Section.

Section 5.02 provides that when a corporation enters into a transaction in which a director or officer is interested, the interested director or officer has the burden of proving that the transaction is fair to the corporation unless the transaction is appropriately authorized in advance or ratified (§ 5.02(a)(2)) by disinterested directors, or, in the case of an officer who is not a director, appropriately authorized in advance by a disinterested superior, or authorized in advance or ratified by disinterested shareholders (§ 5.02(a)(3)). This is the basic rule in all states, including Delaware, MBCA states, and others. Although the old common-law rule was that such "related party" transactions were void or voidable, that rule has long been abrogated by "safe harbor" statutes relating to transactions between directors and the corporation. An interested director or officer who has complied with § 5.02(a) has satisfied the duty of loyalty.

Section 5.02 provides that an interested director or officer can satisfy the duty of loyalty in several different ways beyond establishing that the transaction is fair to the corporation. First, under § 5.02(a)(2), full disclosure combined with effective disinterested director approval or ratification will satisfy the duty. In order for disinterested director approval or ratification to be effective, the disinterested directors must have acted "in good faith and on reasonable inquiry."

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This is a "procedural" rather than "substantive" inquiry and is not an opportunity for a judge to second-guess the business judgment of disinterested directors. Second, under § 5.02(a)(3), full disclosure combined with disinterested-shareholder approval or ratification will satisfy the duty so long as the transaction does not constitute "waste."

These measures for responding to the conflict of interest are often referred to as "cleansing devices." They are used to manage transactions in which a director or officer is interested, as described in this Section, as well as transactions in which a controller is interested (§ 5.10). They also find application in a variety of other conflict-of-interest contexts. They are known as cleansing devices because they may partially or fully "cleanse" a transaction or conduct of the taint of a conflict of interest. When they are effective, they may shift the burden of proof to the party challenging the transaction or conduct or change the standard of review.

Courts have generally held that the party challenging the transaction has the burden of establishing that the transaction is an "interested transaction." Once the plaintiff has met that burden, the interested director or officer has the burden of establishing fairness or the effectiveness of a cleansing device. Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155, 183 (Del. Ch. 2014).

The procedure provided in § 5.02 for approval of transactions by disinterested directors or shareholders is not intended to affect or supersede statutory provisions that limit or prohibit certain specified transactions (in particular, loans to officers or directors), or require specified action by directors or shareholders to approve particular transactions (such as a charter amendment).

b. Fairness. We use the terms "fair" and "fairness" in the black-letter of this Section rather than the terms "entirely fair" or "entire fairness" or "inherent fairness" or "intrinsic fairness," as is used in some jurisdictions, for the sake of simplicity. As discussed in detail in the Introductory Note [to be drafted] to Chapter 5, "fairness" involves an examination of both process and price, and often results in a range. The court's evaluation of the process often affects whether a price in the range is considered fair. Sometimes the process is so lacking that only a very high price will be considered fair; sometimes a price is so fair that it can make up for procedural failings. Although fairness is the most stringent standard used in corporate law, it is not outcome determinative: fiduciaries often prevail under a fairness standard. On the other hand, because of the relative unpredictability of any fairness analysis, good corporate practice usually involves seeking advance authorization and complying with the requirements of § 5.02(a)(2) and/or § 5.02(a)(3).

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1 *c. Transactions subject to § 5.02.* Section 5.02 applies the general principle of § 5.01 to all
2 forms of dealing between a director or officer and the corporation, other than transactions
3 involving compensation. Such dealings include: supplying property to the corporation or acquiring
4 property from the corporation, by sale, lease, or otherwise; furnishing services to the corporation
5 in some capacity other than as a director or officer, such as an investment advisor, investment
6 banker, or attorney; acquiring services from the corporation, or making loans to or receiving loans
7 from the corporation.
8 Section 5.02 also applies to transactions that are not directly between the corporation and
9 a director or officer but as to which the director or officer is interested. Importantly, § 5.02 applies
10 to management buyouts in which the senior-management team partners with a financial sponsor
11 to acquire the company, whether through a merger with an acquisition vehicle or by means of a
12 tender offer.
13 A variety of transactions involving officers and directors do not fall under §5.02. First,
14 transactions in which the officers and directors do not have different interests from the
15 shareholders, such as receiving a dividend or participating in a stock buyback, are typically not
16 encompassed. Second, under the de minimis principle, § 5.02 should not be applied to transactions
17 that involve relatively trivial dollar amounts. Third, a fairness test and special approval procedures
18 should not be applied under § 5.02 to transactions that, by their nature, are unlikely to involve
19 favored treatment, such as transactions involving goods or services that are purchased by or sold
20 to a director or officer in the ordinary course of business on terms that are available on the same
21 basis to members of the public. For the same reasons, a fairness test and special approval
22 procedures should normally not be applied to transactions with terms that are determined by
23 competitive bids submitted to the corporation or result from purchases at the best prices in spot
24 markets, unless competition has been artificially diminished or eliminated through the framing of
25 specifications, through the withholding of material nonpublic information, or through other
26 devices. When the terms of the transaction are determined by competitive bids or a competitive
27 market, the lack of advance approval by disinterested directors or a disinterested superior, or the
28 lack of ratification by disinterested directors, would not be significant, and such transactions
29 should, in effect, be conclusively presumed to be fair.

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Illustrations:

1. Corporation C is a large, publicly held corporation in the steel business. A, an officer of Corporation C, purchases from C for $500 a used computer that originally cost $1,400. The transaction should not be subject to a fairness review, and no special disclosure obligations should be placed on A, because the transaction is de minimis.

2. Corporation C is in the oil-refinery business. A, an officer of C, owns a majority interest in a family corporation, T Company, that is engaged in the trucking business. T Company purchases $ 50,000 in gasoline from Corporation C each year at the local posted price, which is equivalent to the price offered by other sellers in the local market. Gasoline is not in short supply, C does not discount from its posted price, and any member of the public could have purchased gasoline in that quantity and would have paid the posted price if it had done so. Under these circumstances, the transactions do not lend themselves to favored treatment. T Company's purchases should not be subject to an independent fairness test, and no special disclosure obligations should be imposed on T Company.

3. Corporation C is a gold-mining company. A, an officer of C, purchases a parcel of land from C through a competitive auction without disclosing to C or to the other bidders that a recent core sample showed high concentrations of gold ore beneath the parcel. The fact that A purchased the parcel through competitive bids is not sufficient to satisfy A's duty of loyalty because, by withholding material nonpublic information, A prevented the competitive auction from protecting the corporation's interests.

Section 5.02 applies to a transaction between the corporation and a director or officer who acts either directly on his or her own behalf or as a principal acting through an agent. Section 5.02 also applies to transactions between the corporation and a person [§ 1.28] with whom a director or officer has a virtually complete economic identity of interest, such as a spouse who shares finances or a closely held corporation or other like business organization in which the director or officer owns all or most of the equity, when the director or officer is or should be aware of the transaction. In such cases, and in cases governed by § 5.08, Conduct on Behalf of Associates of Directors or Officers, which applies when the director or officer knowingly advances the pecuniary interest of an associate, the director or officer will be personally responsible for any breach of the duty of fair dealing under § 5.02.

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1 When the corporation enters into a contract in accordance with the requirements of § 5.02,
2 the director or officer is not required to comply again with the procedures set forth in § 5.02 when
3 the contract is later performed.
4 The acquisition by a director or officer of outstanding debt securities of or other claims
5 against the corporation from a third party is not treated as a transaction with the corporation subject
6 to § 5.02, nor is the later payment by the corporation of such claims, in accordance with their terms,
7 ordinarily so treated, so long as the director or officer is not receiving preferential treatment
8 compared to other creditors.
9 *c. Other persons subject to a duty of fair dealing.* The fact that officers other than senior
10 executives [see § 1.27 (definition of "officer")] and subordinate employees are not specifically
11 included under Chapter 5 does not mean that they are not subject to a duty of fair dealing in
12 transactions by the corporation in which they are interested. Under the law of agency, officers who
13 are not senior executives and subordinate employees are generally subject to the same duties of
14 fair dealing as are imposed on officers under Chapter 5. Generally speaking, approval by a
15 disinterested superior of a transaction between such an officer or employee and the corporation
16 should have the same effect as approval by disinterested directors under § 5.02.
17 *d. Comment to § 5.02(a).* A director or officer may not deal with the corporation as a
18 stranger at arms' length, except for limited exceptions discussed in this Section. In particular,
19 officers and directors have an "unremitting duty" to deal candidly with fellow officers and
20 directors. Mills v. McMillan, Inc., 559 A.2d 1261, 1282–1283 (Del. 1989). Whether this duty of
21 disclosure has been satisfied is relevant both to the holistic "fairness" inquiry under § 5.02(a)(1)
22 as well as to the effectiveness of cleansing devices under § 5.02(a)(2) and § 5.02(a)(3). Even if a
23 director or officers discloses their conflict of interest, the director or officer nevertheless maintains
24 a relationship of "trust and confidence" with the corporation that requires disclosure of "material
25 matters," rather than the relationship of a stranger to the corporation with a much more limited
26 duty of disclosure. Compare Restatement of the Law Third, Torts: Liability for Economic Harm
27 § 13(b)) with Restatement of the Law Third, Torts: Liability for Economic Harm § 13(a). See also
28 Restatement of the Law Third, Torts: Liability for Economic Harm § 13(a), Comments *c* and *d*.
29 The duty of one who occupies a relationship of trust and confidence to disclose material facts is
30 widely recognized. See, e.g., Restatement of the Law Second, Contracts § 161, Comment *f*;
31 Restatement of the Law Third, Agency §§ 8.03, 8.06. A director or officer owes a duty to the

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corporation to avoid misleading it by making misstatements or omissions and to disclose the material facts known to the director or officer. The interested director or officer also has an obligation to explain the implications of a transaction when he or she is in a position to realize those implications and the disinterested superior or directors reviewing the transaction are not in a position to do so. See Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483 (1918). This disclosure obligation is fundamental to the fiduciary relationship and continues even when a corporation has appointed a committee of disinterested directors to negotiate the terms of the interested transaction, unless the committee either knows the facts or appropriately agrees to proceed without disclosure. See HMG/Courtland Props., Inc. v. Gray, 749 A.2d 94, 114 (Del. Ch. 1999); Restatement of the Law Third, Agency § 8.06(1)(a)(ii); Comment *g* to this Section and Illustrations 15 and 16.

According to MBCA § 8.60: "'Required disclosure' means disclosure of (i) the existence and nature of the director's conflicting interest, and (ii) all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction."

Section 1.14 follows the MBCA's approach and sets forth the required elements of disclosure; § 1.25 sets forth the definition of material facts that are required to be disclosed. Under § 5.02, a director or officer who fails to make such disclosure may fail to fulfill the duty of fair dealing, even if the financial terms of the transaction are fair by reference to market benchmarks. A contract price might be fair in the sense that it corresponds to market price, and yet the corporation might have refused to make the contract if a given material fact had been disclosed. See, e.g., Illustrations 4 and 6. Furthermore, as pointed out in the Introductory Note to Chapter 5 [to be drafted], fairness of price will often involve a range of values, rather than a single point, and disclosure of a material fact might have induced the corporation to bargain down the price lower in the range.

The general rule governing interested transactions requires the interested director or officer to disclose material facts relating to the transaction. A review of cases applying the disclosure requirement supports the following generalizations:

(1) the interested director or officer must fully and fairly disclose all of the material terms of the proposed transaction;

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(2) the interested director or officer must disclose all material facts relating to the use or value of the assets in question to the corporation itself. Such facts would include alternative uses for assets or "hidden value" (e.g., there is oil under the land subject to the sales negotiation); and

(3) the interested director or officer must disclose all material facts which he or she knows relating to the market value of the subject matter of the proposed transaction (except when such facts are generally available and the fiduciary has no special knowledge regarding them). A director or officer would have to disclose, for example, forthcoming changes in legal regulations or technological changes that would affect the value of the asset in question to the corporation or to others.

This list of items that generally must be disclosed is intended to include all material information known to the director or officer except that information that relates only to the director's or officer's consideration of the price at which the director or officer is willing to buy or sell and how the director or officer would finance a purchase or invest the proceeds of a sale, and information about the market that is generally available (e.g., real-estate appraisals). Kahn v. Tremont Corp., 1996 WL 145452 at *16 (Del. Ch. 1996), rev'd on other grounds, Kahn v. Tremont, 694 A.2d 422 (Del. 1997); followed by In re Orchard Enters., Inc. S'holder Litig., 88 A.3d 1, *27 (Del. Ch. 2014); Frederick Hsu Living Trust v. Oak Hill Capital Partners III, LP, 2017 WL 1437308, n. 18 (Del. Ch. 2017).

The use of proprietary corporate information by a fiduciary raises particular concern. In general, an officer or director may not, without permission, communicate proprietary corporate information to a third party for any noncorporate purpose (such as to a potential financial sponsor for the purpose of formulating an offer to acquire the company in a management buyout). A director's or officer's undisclosed use of material proprietary information is evidence that: a transaction is not fair under § 5.02(a)(1); that disinterested director approval or ratification of a transaction is not effective under § 5.02(a)(2); and that disinterested-shareholder approval or ratification of a transaction is not effective under § 5.02(a)(3). The use of corporate information by a fiduciary is dealt with in further detail in § 5.04, Use by a Director or Senior Executive of Corporate Property, Material Nonpublic Information, or Corporate Position, and § 5.11, Use by a Controller of Corporate Property, Material Nonpublic Corporate Information, or Corporate Position.

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1 Under § 5.02(a)(2), the disclosure requirements of § 5.02(a)(1) will be deemed to be
2 satisfied if, at any time before a lawsuit challenging the transaction is filed, the transaction is
3 ratified, following such disclosures, by the disinterested directors, or by a disinterested corporate
4 decisionmaker who initially approved the transaction. In considering whether to ratify a transaction
5 despite delayed disclosure, one of the factors that the disinterested directors should consider is
6 whether the director's or officer's failure to disclose was deliberate, the significance of the
7 nondisclosed information, and whether the delayed disclosure disadvantaged the corporation.
8 Ratification under § 5.02(a)(3), by contrast, can only be effective if full disclosure has been made
9 to shareholders prior to their vote.
10 Section 5.02 accordingly views the disclosure obligation under § 5.02(a) as a key element
11 for satisfying the duty of loyalty. An officer or director who enters into an interested transaction
12 without making disclosure concerning the conflict of interest and the transaction assumes a risk
13 that a court will order rescission or disgorgement or impose damages, even when there is evidence
14 that the price was fair.
15 **Illustrations:**
16 4. A, a director of X Corporation, following disclosure and authorization of the
17 transaction in advance by disinterested directors, as contemplated in § 5.02(a)(2),
18 purchases a surplus parcel of land owned by X Corporation at its fair market value. Six
19 months later, Y, a third party, decides to build a sizable shopping center on the property
20 adjoining the land purchased by A, resulting in a substantial increase in its value. The
21 transaction satisfies § 5.02(a), even though, judged in hindsight, X Corporation could have
22 sold the property for a substantially higher price. If, however, A knew of Y's plans at the
23 time A purchased the land from X Corporation and failed to disclose that fact to X
24 Corporation, A would not have fulfilled the duty to the corporation under § 5.02(a), even
25 though the price at which the parcel was purchased was the fair market value at the time.
26 5. X Corporation is seeking a new headquarters building. D, a vice president of X
27 Corporation, owns all the stock of R Corporation, which owns an office building. D causes
28 a real estate agent to offer R Corporation's building to X Corporation, but D does not
29 disclose D's ownership of R Corporation. X Corporation's board of directors agrees to
30 purchase the building at the market price. Two weeks later, X Corporation learns of D's
31 interest in R Corporation. D has not fulfilled his duty to the corporation under §§ 5.02(a)

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[and 5.08 (Conduct on Behalf of Associates of Directors or Officers)] unless D establishes that the transaction was fair to X Corporation, and D's failure to disclose the conflict of interest will bear on the evaluation of fairness.

6. The facts being otherwise as stated in Illustration 5, D, before the acquisition, discloses to X Corporation D's interest in R Corporation. D, however, fails to disclose that D has information, not publicly available, that the highway department of the state in which the building is located has formally decided to run a highway through the property on which R Corporation's building stands and to condemn the building under its power of eminent domain. The price paid by X Corporation is fair, even taking the proposed condemnation into account, because the condemnation award is likely to equal or exceed the price; but had X Corporation known that the highway department had decided to condemn the property, it likely would not have expended resources acquiring the building. Two weeks after the acquisition, X Corporation learns of the highway department's decision. D has not fulfilled D's duty to the corporation under § 5.02(a)(2).

8. A, a director of X Corporation, expresses interest in purchasing a surplus parcel of land owned by the company. X Corporation creates a committee of disinterested directors and gives it the responsibility for negotiating terms with A. The committee receives appraisals of the land from local real-estate appraisers and agrees on a price with A. It later emerges that A also got an appraisal that A did not disclose to the committee. A's appraisal was not based on any confidential information of X Corporation and was conducted by a local appraiser using standard procedures employed in all engagements. A has fulfilled A's duty to the corporation even though A did not disclose A's appraisal because the facts relating to the market value were generally available and A did not have any special knowledge.

e. Comment to § 5.02(a)(1). If disinterested directors (or, in the case of an officer who is not a director, a disinterested superior) or shareholders have not approved the transaction, courts will have no basis for according deference to actions of directors, shareholders, or disinterested superiors, and courts will be expected to give close scrutiny to the transaction, with the burden on the interested director or officer under § 5.02(a)(1) to prove that the transaction is fair. The test of fairness is an objective test. Cf. Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49, 54 (5th Cir. 1980), cert. denied, 101 S. Ct. 1738 (1981). In determining fairness, a court may take into account

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the process by which the transaction was shaped and approved (such as whether there was undue pressure on the corporate decisionmaker who approved the transaction), whether the interested officer or director disclosed the conflict of interest and relevant details about the transaction, and any relevant objective indicators of fairness of price (such as comparable transactions between parties dealing at arm's length). But fairness is not judged solely based on whether the transaction price falls within a range determined by reference to comparable arm's-length transactions. Fairness also requires a showing that the transaction is in the "best interests of the corporation." For example, while the price at which a director sold a parcel to the corporation might be the market price, the corporation may not need the parcel; and it may not be in the interest of the corporation to acquire it, even at a fair price, if it would not have purchased it from an unrelated party. See Illustration 11.

There is an additional sense in which fairness and the best interests of the corporation may be context-dependent, particularly when it is not in the interest of the corporation to forgo a transaction with a director or officer. For example, a director or officer may hold a particular parcel of property or contract right that has a special strategic value to the corporation such that the corporation would be justified in paying more than the general market price for it, that is, a price higher than anyone who would not place such strategic value on the property or contract right would pay. If the corporation would be warranted in paying that price to a third party dealing at arm's length, it would also be warranted in paying that price to the director or officer. In mandating fairness, the law does not command the board to ignore the aggregate effects of a transaction on the corporation and to focus solely only on the fair value of a single component of the total transaction. Fairness will be judged only as of the time a transaction is entered into.

Ultimately, a variety of factors are relevant to the determination of fairness in the context of interested transactions. These factors include whether adequate disclosure has been made, whether there are any legitimate reasons for lack of disclosure, whether the corporation was independently represented in negotiating the transaction by a disinterested decisionmaker, and how the transaction was initiated. If a transaction was initiated on behalf of the corporation by disinterested persons, that circumstance may, under the facts of a particular case, assist in demonstrating the fairness of the transaction to the corporation. See in this connection the analysis applied by the Delaware Court of Chancery in Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971).

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f. Advanced authorization. Section 5.02(a)(2) governs self-interested transactions that have been authorized in advance or ratified by disinterested directors, or, in the case of an officer who is not a director, by a disinterested superior. There are several reasons why board review of a conflict-of-interest transaction should be subject to closer scrutiny than a transaction with an unrelated third party.

First, transactions of the types covered by § 5.02 are, as a matter of accepted business practice, normally regarded as deserving of closer scrutiny than transactions with unrelated third parties. In fact, corporate codes of conduct adopted by many public corporations prohibit transactions between the corporation and its officers and employees.

Second, the presence of close relationships among colleagues on the board or in management, particularly in smaller corporations, may sometimes interfere with the ability of directors or superiors to deal with a colleague with the degree of wariness that is employed in arm's-length transactions.

Third, a court may, under appropriate facts, have cause to inquire whether the process of approval produced an unfair result because, for example, an interested director or officer exerted improper pressure on the decisionmakers to obtain the approval. See Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378 (N.Y. 1918); cf. Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985).

In practice, when scrutinizing transactions between an officer or director and the corporation that have been approved in advance or ratified by directors, courts look closely at three overlapping factors: was there adequate disclosure?; were the directors in fact disinterested?; did they act in good faith and with reasonable inquiry before approving the transaction? Each of these inquiries is critical and provides the framework within which courts can determine whether the disinterested director approval of the transaction is worthy of deference.

These overlapping factors are particularly important when key members of the senior-management team partner with a financial sponsor to acquire the whole company in a "management buyout." Senior managers, by virtue of their position, will have a deep understanding of the company and where unexploited value may lie. The normal practice is that a special committee of disinterested directors, assisted by independent financial and legal advisers, will negotiate with the management team and, if appropriate, seek competing bids. In this process, the special committee will typically ask the management team for information on its plans for the company and on where any unexploited value lies, and the management team will typically

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respond. In reviewing such transactions to determine whether the committee acted in good faith and on reasonable inquiry, courts closely examine the independence of the members of the special committee and the process the special committee followed, including the timing, nature, and extent of the information provided to—or withheld from—the committee.

If the approval process is tainted in any way (for example, by improper pressure exerted by the interested party), a court will review the transaction under the fairness standard of § 5.02(a)(1) because there was no effective authorization by disinterested directors or a disinterested superior. Similarly, if disinterested directors or superiors who authorize transactions do not act in good faith or with reasonable inquiry, courts will not give their approvals effect under § 5.02. It is worth noting that the question at issue in § 5.02(a)(2) is whether the disinterested directors' approval will insulate the transaction from a fairness review and insulate the interested director or officer from liability for breach of the duty of loyalty; it is not whether the disinterested directors who approved the transaction breached any fiduciary duties or are liable for damages. Rather, the duties of the disinterested directors and their potential liability must be separately analyzed under the duties of care and loyalty. See §§ 4.02 and 4.03.

Illustrations:

9. Corporation C is engaged in commercial agriculture. C's board consists of L, its CEO and president, and N, O, and P, who own other types of agricultural businesses. C is potentially in the market for a new headquarters building. L recently inherited a commercial building that is somewhat rundown and only partially rented. Although L has no experience in real estate, L is convinced that with a $1 million renovation the building will be worth $9 million. L offers the building to a number of sophisticated buyers, whose bids range between $3 million and $5 million. Later, L lists the building with a commercial-real-estate broker for six months at a price of $7.5 million, but receives no offers. L then offers the building to C's board for $7.5 million, making full disclosure but arguing that this is a bargain price. N, O, and P, who are disinterested within the meaning of § 1.15, consult a real-estate expert, who advises that the building might conceivably be worth $7.5 million but that would be an extremely high price and the expert would not pay it. The board nevertheless accepts L's offer. Even though they are disinterested, N, O, and P's approval will not be effective because their agreement to the transaction at $ 7.5 million when outside bids were much lower, without more, is unlikely to satisfy the requirement

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1 to act in good faith and on reasonable inquiry. The transaction fails to meet the standard of
2 § 5.02(a)(2).
3 10. A, the chief executive officer of X Corporation, a real-property-development
4 corporation, enters into a contract to sell a parcel of undeveloped real property to X
5 Corporation for $ 500,000. The board of directors of X Corporation (consisting of A and
6 two other directors who are disinterested within the meaning of § 1.15) authorizes the
7 transaction in advance, with A not participating in the voting, relying on an appraisal of
8 $ 500,000 supplied by an employee of X Corporation to support the fairness of the purchase
9 price. An independent appraiser has supplied the directors with an appraisal showing the
10 property to have a fair value of $ 150,000. The transaction fails to meet the standard of
11 § 5.02(a)(2) because the board's reliance on the appraisal of an employee of A (whose job
12 security was subject to A's control) rather than on an independent appraiser—particularly
13 in light of the value assigned to the property by an independent appraiser—would, without
14 more, not satisfy the requirement to act in good faith and on reasonable inquiry. Had the
15 transaction been with an unrelated third party rather than A, the directors would not be
16 required to utilize an independent appraiser, because no special procedures would have
17 been required to protect X Corporation.
18 11. D Corporation is a manufacturing company. At a time when D Corporation is
19 struggling, the chief executive officer, A, offers to sell a sailing yacht to D at 10 percent
20 below its current market value, as confirmed by an independent appraiser. A has made full
21 disclosure regarding A's conflict and regarding the condition of the yacht. A decision by
22 the disinterested directors to approve the use of scarce working capital to purchase the
23 yacht at 10 percent below its current market price will not be sufficient to satisfy
24 § 5.02(a)(2) because, without more, it will not persuade a court that the transaction was fair
25 in the sense that it was reasonably made to further the business interests of the corporation
26 and, as a result, will not satisfy the requirement to act in good faith and on reasonable
27 inquiry. The transaction fails to meet the standards of § 5.02(a)(1) or (2).
28 12. C is the chief executive officer and a director of M Corporation. C, along with
29 senior-management colleagues, teams up with F Corporation, a financial sponsor of
30 management buyouts. C announces to the board of M Corporation that C and other senior
31 managers are pursuing a management buyout of the company. The M board appoints a

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special committee of disinterested directors to consider whether a buyout is in the interests of the M Corporation and its shareholders as a whole, to negotiate with C and C's team, and, if appropriate, to seek competing offers. The special committee retains independent bankers and lawyers to advise it. C cooperates with the special committee and its advisers and shares the projections that C uses in arranging financing for the transaction, as well as C's future plans for M Corporation. The special committee, after canvassing the market, ultimately approves the buyout. The transaction meets the standard of § 5.02(a)(2).

13. The facts otherwise being the same as in Illustration 12, C takes a variety of actions to intimidate members of the special committee and misleads the special committee by submitting pessimistic projections to the committee while using different (undisclosed and more optimistic) projections to arrange financing. The special committee ultimately approves the buyout. The transaction fails to meet the standard of § 5.02(a)(2).

The use of the term "authorized" in § 5.02 (and other Sections of Chapter 5) is not intended to suggest that any transaction between a corporation and its directors or officers requires the approval of disinterested directors or shareholders to be a valid corporate act. On the contrary, approval by disinterested directors or shareholders is not a condition for the validity of any corporate act under modern corporate law, except as may be explicitly required by statute.

In the case of transactions expected to recur in the ordinary course of business, a corporation may adopt a standard of the corporation that provides advanced authorization if the standard complies with § 5.09. Such advanced authorization then has the same effect as authorization in advance by disinterested directors. See § 5.09, Comment *c*.

Section 5.02(a)(2) does not require that disinterested directors be involved in negotiating the transaction or that they review and authorize each individual purchase or sale if the overall transaction involves an ongoing course of dealing in the ordinary course of business. For § 5.02(a)(2) to apply, however, the disinterested directors must authorize in advance the overall aspects of a transaction and they must determine both whether to enter into the overall transaction and the terms upon which to do so.

Section 1.15 permits a majority (but not less than two) of the disinterested directors on the board of directors or a board committee to approve a transaction, regardless of whether the majority constitutes a quorum. See MBCA § 8.62(a) (2019). It is therefore unnecessary to include in § 5.02 a provision (often found in state corporation statutes) that a director who has an interest in a

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transaction may be counted in determining whether a quorum is present so long as that director's vote is not counted for purposes of approving the transaction. As a matter of corporate practice, after an interested director makes an adequate disclosure in accordance with § 1.14, that director should withdraw from any meeting at which the transaction in question is being discussed and at which the director's presence is not requested by the other directors and their advisors for the purpose of answering their questions and responding to their requests for information and context. The interested director's participation or lack of participation in the approval process does not affect the allocation of the burden of proof under § 5.02(b). Under that rule, once the plaintiff proves that the director or officer is interested, then the interested director has the burden of proving that the conditions of § 5.02(a)(1), (2) or (3) are satisfied.

By reason of the provisions of § 1.15, it is possible for a committee of disinterested directors who constitute only a minority of the full board of directors to approve an interested transaction. A committee of directors should not be used to obtain such approval if it is clear that approval could not be obtained from a majority of the disinterested directors on the full board. Proof that this had occurred could invalidate the committee approval.

A disinterested director who approves a transaction between the corporation and an interested director or officer that does not satisfy § 5.02 is not, for that reason subject, to liability as an accessory to a breach of duty under § 5.02. The disinterested director's conduct will be subject to review only under § 4.01, and the director will be protected by the business judgment rule, § 4.02, if the disinterested director acts in good faith and otherwise satisfies the requirements of § 4.02; the director may be also protected by an [exculpation provision].

g. Waiving the default rule. Even though the "default" is that an interested officer or director must make disclosure concerning the transaction, there may be circumstances in which it is appropriate for an interested fiduciary and a special committee to agree to negotiate at arms' length. This circumstance may arise, for example, when a director is also an officer or director of a potential counterparty (a "dual fiduciary"). In appropriate circumstances, disinterested directors may agree on behalf of the corporation. When they do so, the disinterested directors' approval of the transaction will be effective in cleansing it of the conflict-of-interest taint.

For the disinterested directors' approval to be effective, it must be in good faith and on reasonable inquiry. This standard requires that, before disinterested directors agree to negotiate at arms' length, they should ordinarily ask the interested officer/director to disclose, and the

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director/officer should disclose, all facts about the transaction that are derived from company information and may be material to the disinterested directors' decision to approve the transaction.

In the event that the interested officer or director reasonably believes that disclosure would violate a duty imposed under law, a legally enforceable obligation of confidentiality, or a professional ethics rule, the disinterested directors may agree to proceed in the absence of disclosure so long as the interested officer or director discloses all other information required to be disclosed, the existence and nature of the conflicting interest, and the nature of the interested officer or director's duty not to disclose the confidential information. MBCA § 8.62(b).

Illustrations:

14. A is a director of B Corporation and is also chief executive and a director of T Corporation. B Corporation is interested in buying T/sub, a subsidiary of T Corporation. Recognizing A's conflict of interest, B Corporation establishes a committee of disinterested directors that approaches A about the possibility of buying T/sub. A says: "As CEO of T Corp, I have an obvious conflict of interest. We at T Corp are willing to consider selling T/sub to you, but I want it to be done entirely on an arms'-length basis. As the CEO of T Corp, I owe T Corp fiduciary duties and cannot share with you confidential information. You'll get the same disclosures that all of the other potential buyers will get. Unless we proceed this way, we are not willing to consider you as a buyer for T/sub." The B Corporation board committee, after consulting with counsel, agrees to these terms. B Corporation offers the highest price and acquires T/sub. A has fulfilled A's duty to B Corporation even if A has not disclosed material information about T/sub.

15. D is a director of T Corporation and is also chief executive officer and a director of B Corporation. B Corporation is interested in buying T Corporation. Recognizing D's conflict of interest, D is recused, and T Corporation establishes a special committee of independent directors. D says: "As a director of T Corp and CEO of B Corp, I have a conflict of interest and owe both B and T fiduciary duties. We at B Corp are interested in buying T Corp, but I want it to be done entirely on an arm's-length basis. I have sat on the board of T Corp for many years and, as a result, have insight into T Corp and its assets that is more informed than any third-party buyer. Indeed, I obviously have proprietary T Corp information that informs B Corp's decision and the price that B Corp will offer. Unless that is acceptable to you, B Corp will not make an offer."

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The T Corporation special committee, after consulting with counsel, specifically asks Director D whether there are any special synergies between B Corporation and T Corporation. D is unwilling to answer this question because of D's fiduciary obligations to B Corporation. The committee allows B Corporation to make an offer for T Corporation. When B Corporation offers the highest price, the special committee and the board approves the sale, and B Corporation acquires T Corporation. It later turns out to be an extraordinarily profitable transaction for B Corporation because of unique technical synergies between B Corporation's patent portfolio and T Corporation's patent portfolio (of which the board of T Corporation's and its shareholders were unaware). Approval by the special committee in these circumstances will be effective, and D has fulfilled D's duty to T Corporation even if D has not disclosed material information about the transaction.

h. After-the-fact authorization. Transactions that are ratified by disinterested directors require closer scrutiny than transactions that are authorized in advance by disinterested directors or a disinterested superior process because, in such cases, the board of directors is put in the difficult position of either having to ratify a transaction that had not been presented beforehand, rescind the transaction, or expose the interested director or officer to a lawsuit. That said, statutes and case law do not draw a formal, doctrinal distinction between the two situations, and neither does the black-letter law of this Restatement. In addition, there may be cases in which advance authorization is obtained but an issue is later raised as to whether the disclosure made to obtain the approval was complete. The additional challenges posed by ratification are handled through the analysis of whether approval of the transaction by disinterested directors is effective to change the standard of review or shift the burden of proof. This case-by-case, fact-specific, analysis of whether the disinterested directors' approval was in good faith and on reasonable inquiry allows judges to address the potential opportunistic avoidance of pretransaction disclosure and authorization.

In doing so, the court should consider whether:

(1) A corporate decisionmaker who is not interested in the transaction acted for the corporation in the transaction in good faith and on reasonable inquiry;

(2) The interested director or officer made disclosure to such decisionmaker to the extent such director then knew of the material facts;

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(3) The interested director or officer did not act unreasonably in failing to seek advance authorization of the transaction by disinterested directors or a disinterested superior; and

(4) The failure to obtain advance authorization of the transaction by disinterested directors or a disinterested superior did not adversely affect the interests of the corporation in a significant way.

Normally, an interested person would have acted unreasonably by failing to seek advance authorization from disinterested directors or a disinterested superior when the transaction in question is of obvious importance to the corporation by reason of the materiality of the transaction in relation to the assets or revenues of the corporation. An interested person who knew of the conflict of interest would have acted unreasonably by failing to seek advance authorization from disinterested directors or a disinterested superior when the interested person controls or can directly influence the corporate decisionmaker by reason of being the decisionmaker's superior or otherwise. When an officer's compensation or performance is subject to direct review by an interested director, either as a member of a compensation or other committee or as a member of the full board, the officer would not be free of the interested director's influence or control.

Other examples of circumstances in which an interested director or officer would not have acted reasonably, within the meaning of § 5.02(a)(2), in failing to seek advance authorization include:

(1) The interested director or officer knew that the transaction in question was not within the scope of the usual responsibilities of the decisionmaker who acted upon the transaction;

(2) An explicit corporate policy precluded or discouraged particular kinds of transactions between an officer or director and the corporation, or explicitly required advance approval of those transactions by a disinterested superior or disinterested directors;

(3) The subject matter of the transaction was the settlement of a claim that the corporation has or may have against the interested person;

(4) The interested party believed that prior authorization would likely have been denied.

Section 5.02(a)(2) assumes that the interested director or officer acted reasonably and in good faith in seeking ratification. The failure of an interested director or officer to seek ratification of a transaction with reasonable promptness should be considered by a reviewing court in determining whether the interested person acted reasonably and in good faith.

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1 Among the examples of cases in which a director or officer has acted reasonably in failing
2 to seek prior approval from disinterested directors or a disinterested superior are those in which
3 the failure to seek such approval was inadvertent, such as when the director or officer does not
4 know that a conflict-of-interest transaction that could be imputed to the director or officer has
5 occurred. Other cases in which ratification may be reasonable is when an interested director
6 mistakenly failed to make full disclosure in advance of a disinterested director's approval. As a
7 practical matter, it may sometimes be difficult to determine whether a given fact was or was not
8 material. Accordingly, if a transaction was authorized in advance in accordance with § 5.02(a)(2)
9 and, at that time, disclosure was made of the conflict of interest and all those known facts that the
10 fiduciary believed in good faith were material to the transaction, then ratification of the transaction
11 by disinterested directors or by the disinterested superior, following the disclosure required under
12 §§ 1.14 and 1.25, should be deemed to have a curative effect as to any material facts not previously
13 disclosed. In such a case, the burden of proof will be on the party challenging the transaction, and
14 that party will have to show that the disinterested directors or disinterested superior who ratified
15 the transaction did not act in good faith or on reasonable inquiry, just as if proper disclosure had
16 been made at the time of the original authorization. If an interested fiduciary had timely disclosed
17 a conflict of interest (§ 1.14(a)), this will be strong evidence that the conflicted director or officer
18 acted in good faith.
19 Curative ratification of a prior advance authorization, following further disclosure, must
20 occur before a lawsuit has been filed contesting the underlying transaction. Once suit has been
21 filed, a separate set of doctrines become relevant to dismissal, and ex post ratification of a
22 transaction is not generally sufficient. See Chapter 7.
23 As in the case of advance authorization, disinterested directors' ratification that is not in
24 good faith or on reasonable inquiry would not be given effect under § 5.02(a)(2).
25 **Illustrations:**
26 16. B is vice president of finance of X Corporation, which has instituted a program
27 to dispose of surplus real estate. The program is administered by C, who is X Corporation's
28 vice president of real estate, and who is not subject to supervision or control, directly or
29 indirectly, by B. A, who is B's spouse and is in business for himself, makes an offer to C
30 to purchase one of X Corporation's surplus parcels. B is unaware that A is making this
31 offer. C is unaware that A is the spouse of B. C agrees to sell the parcel of real estate to A

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at the price offered by A, without further negotiation, because the price offered is within the range of fair value of the property established by appraisals that C had obtained as part of the program for disposing of the property and, after having advertised the property for sale, C received no other indications of interest. After the sale is consummated, B learns for the first time that A has purchased the property from X Corporation. B then obtains ratification of the transaction from the board of directors of X Corporation, none of whom is interested in the transaction. If the transaction is challenged, it will be subject to review under § 5.02(a)(2), because B did not act unreasonably in failing to seek advance authorization, and the failure to obtain advance authorization did not affect the interests of the corporation in a significant way.

17. The board of directors of X Corporation authorizes in advance the purchase of a parcel of real property from Y Corporation in which A, a director of X Corporation, is a majority shareholder. A abstains from voting on the transaction and discloses all material facts concerning the transaction, except that A fails to disclose that Y Corporation purchased the property two years earlier and will be making a substantial profit on the transaction, because A believes in good faith that those facts are not material to the transaction. If A later discloses these facts to the disinterested directors and they ratify the transaction without A's participation in the vote, then, if the transaction is later challenged, it will be subject to review under § 5.02(a)(2) because A did not act unreasonably in failing to seek advance authorization and A's failure to obtain advance authorization did not affect the interests of the corporation in a significant way.

It may occasionally happen that a director or officer believes reasonably and in good faith that a transaction has been authorized in advance by disinterested directors or a disinterested superior when, through inadvertence, such an authorization had not been given. If such a case occurs, subsequent ratification will be effective to change the standard of review or shift the burden of proof under § 5.02(a)(2) despite the absence of advance authorization by a disinterested corporate decisionmaker.

Illustration:

18. Privately held Company A has an internal requirement (bylaw or board resolution) that the board of directors approve loans to officers. A list of proposed loans is included as a routine matter in a "black book" prepared for the board meeting. The secretary

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who compiles the list inadvertently omits a proposed loan to B, the executive vice president (the incoming memo describing the loan having been misplaced). B is not at the board meeting at which the list is presented and simply assumes that this loan, along with others, was approved. The omission is discovered eight months later in a routine internal-audit check of loan approvals. B then obtains ratification of the transaction from the board of directors of A, none of whom is interested in the transaction. If the transaction is challenged, it will be subject to review under § 5.02(a)(2) because B reasonably believed that advance authorization by disinterested directors had been obtained, and B's failure to obtain advance authorization did not affect the interests of the company in a material way.

Once demand has been made to institute a derivative action, any motion to dismiss the action is governed by Chapter 7, and not by the principles set forth in § 5.02(a)(2), except as incorporated by reference in Chapter 7.

i. Comment to § 5.02(a)(3). If a transaction has either been authorized in advance or ratified by disinterested shareholders under § 5.02(a)(3), a party challenging the transaction must prove that the transaction constituted a waste of corporate assets. For shareholder ratification to have this effect, the shareholder vote must be fully informed and uncoerced.

By setting forth a standard of judicial review based on waste of corporate assets, § 5.02(a)(3) does not preclude judicial review on some basis other than the conflict-of-interest aspect of the transaction, such as, for example, whether the transaction complied with other applicable provisions of law.

Section 5.02(a)(3) does not require advance shareholder authorization, since in many cases it may be inconvenient or impossible for a publicly held corporation to postpone the transaction until it can solicit proxies from its shareholders to authorize the transaction.

The use of shareholder authorization under § 5.02(a)(3) is not intended to be limited to those instances in which approval of disinterested directors cannot be obtained. Although in the usual case a transaction will be approved by directors before being presented to shareholders for their approval, approval by directors is not a prerequisite to the operation of § 5.02(a)(3). When the board acts before submitting a matter to the shareholders for ratification, a director is encouraged not to participate in the discussion of, e.g., whether to submit the matter for shareholder ratification or vote on transactions in which the director has an interest, unless the director's vote is required by law to effectuate the transaction.

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j. Comment to § 5.02(b). Section 5.02(b) places on the party attacking a transaction the burden of establishing that the transaction is an interested transaction. Once that has been established, however, the interested director or officer has the burden of proving fairness or, if seeking to rely on disinterested director or shareholder approval or ratification, of establishing that the requirements of the cleansing devices have been satisfied. Quadrant Structured Prods. Co. v. Vertin, 102 A.3d 155, 183 (Del. Ch. 2014).

Section 5.02(b) addresses the allocation of the burden of proof at trial. It does not address the procedural burdens that operate at different stages of a case, such as the pleading burden that a plaintiff must meet to survive a motion to dismiss or the evidentiary burden a party must carry to survive a motion for summary judgment. At the pleading stage, for example, a complaint may be dismissed if the plaintiff fails to plead facts that serve to undermine the integrity of a special-committee decision or a stockholder vote that otherwise would be effective to ratify an interested transaction with a director or officer. The settlement of a controversy between a director or officer and the corporation involving an alleged failure to fulfill the duty of loyalty under Chapter 5, prior to the filing of a derivative action, constitutes a transaction subject to § 5.02. Any settlement approved thereafter is subject to the rules applicable to settlement of derivative actions.

Section 5.02(b) does not preclude an administrative agency from determining the fairness of a transaction to the corporation. For an administrative determination to have a res judicata effect on complaining shareholders seeking to assert the interest of the corporation, the agency must provide for notice to and an opportunity for shareholders to participate in the proceeding and otherwise satisfy the requirements of Restatement of the Law Second, Judgments §§ 27, 28, & 83. When an administrative determination does not satisfy these requirements, but the agency nevertheless approves a transaction to which the corporation is a party as being "in the public interest," the courts should not be precluded from reviewing the fairness of the transaction to the corporation or its shareholders.

Comment k: Remedies. The consequences of breach of the duty of fair dealing (including damages for loss suffered and improper benefits received) are addressed generally in Chapter 7, Remedies. See § 7.18. In the context of § 5.02, the corporation, in the absence of full disclosure, may in certain circumstances have the option to affirm the transaction or rescind it, so long as the corporation acts promptly. When it affirms the transaction, it may seek to have a conflicted director or officer disgorge gains made or losses avoided on the principle that agents who breach their duty

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of loyalty must account for all gains made or losses avoided, whether or not the breach damaged the principal. Restatement of the Law Third, Agency § 8.02, Comment *e*. In recognizing the corporation's option to affirm or rescind a transaction when there has not been the full disclosure required by § 5.02 (absent ratification), § 5.02 reaches a result similar to that reached in State ex rel. Hayes Oyster Co. v. Keypoint Oyster Co., 391 P.2d 979 (Wash. 1964). The importance of disclosure as a separate aspect of the duty of fair dealing to the corporation was also recognized as an aspect of "fair dealing" by the Supreme Court of Delaware in Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

Illustration:

19. The facts being otherwise as stated in Illustration 5, X Corporation's board ratifies the acquisition after it learns of D's interest in R Corporation. X Corporation cannot thereafter seek rescission of the transaction with R Corporation on the basis of nondisclosure.

REPORTERS' NOTES

1. Background. The great weight of authority today permits a director or officer to enter into transactions with the corporation if the director or officer has acted fairly in dealing with the corporation. See cases collected in 3 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 931 (Sept. 2019 update); Harry J. Henn & John R. Alexander, LAW OF CORPORATIONS § 238 at 637 et seq. (3d ed. 1983). The evolution of the case law from the view that such transactions are voidable without regard to fairness to the current view is traced in Harold Marsh Jr., *ARE DIRECTORS TRUSTEES? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

So-called "safe harbor" statutes in all 50 states and the District of Columbia have sought to codify in varying ways the view adopted by most courts that a transaction between a director or officer and the corporation is not voidable simply because of the existence of a fiduciary relationship between the parties. This liberalizing trend has been viewed as in keeping with the needs and practices of modern business life. See Am. Timber & Trading Co. v. Niedermeyer, 558 P.2d 1211, 1218 (Or. 1976).

There have been several stages to the statutory evolution. The first stage was statutes that take the form of § 144 of the Delaware General Corporation Law (Del. Gen. Corp. L.) and § 41 of the Model Business Corporation Act (MBCA) (1969). These statutes reversed the common-law rule of void or voidability when the transaction is fair, or when it has been approved by disinterested director or approved by disinterested shareholders, and do not, by their terms, define when an interested transaction will be valid.

Nine states follow this approach, with some local variations: Delaware, Nevada, Rhode Island, New Jersey, Pennsylvania, Missouri, Kansas, Ohio, and Oklahoma.

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The second stage came with 1984 revision of the MBCA in which § 41 was revised and renamed § 8.31. Section 8.31 retained § 41's approach and provided more detail on its scope and on the required disclosure by the interested director (disclosure of the director's interest and disclosure of material facts about the transaction). Eleven states adopted § 8.31 (again with some local variations): Arkansas, Indiana, Kentucky, Massachusetts, Michigan, New Mexico, North Carolina, Oregon, South Carolina (with express provision for burden shift), Virginia, and Wisconsin.

The third stage came with the 1989 replacement of MBCA § 8.31 with Subchapter F (§§ 8.60–8.63). Importantly, unlike Del. Gen. Corp. L. § 144, MBCA § 41, and MBCA § 8.31, Subchapter F sought to provide the conditions of validity for interested-party transactions. Section 8.61(b) provides in relevant part that:

> (b) A director's conflicting interest transaction may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director of the corporation, in a proceeding by a shareholder or by or in the right of the corporation, on the ground that the director has an interest respecting the transaction, if:
>
> (1) directors' action respecting the transaction was taken in compliance with section 8.62 at any time; or
>
> (2) shareholders' action respecting the transaction was taken in compliance with section 8.63 at any time; or
>
> (3) the transaction, judged according to the circumstances at the relevant time, is established to have been fair to the corporation.

The official comments to Subchapter F were substantially revised in 2005. American Bar Association, *Changes in the Model Business Corporation Act—Amendments Relating to Chapters 1, 7, 8 and 14*, 60 BUS. LAW. 943 (2005). Nineteen states and the District of Columbia have adopted these provisions: Alabama, Arizona, Connecticut, Georgia, Hawaii, Idaho, Iowa, Louisiana, Maine, Mississippi, Montana, Nebraska, New Hampshire, South Dakota, Tennessee, Utah, Vermont, Washington, and Wyoming.

Six states have adopted unique or hybrid provisions: Colorado, Florida (unclear), Alaska (just Delaware/Old MBCA § 41?), Illinois (fairness specified as key issue with shifting burden), Texas (unclear), and West Virginia (analogous to Delaware and perhaps should be classified there).

The key areas of variation among states raise the fundamental issues that must be addressed. First, what are the transactions involving directors or officers to which the provision applies? This is particularly an issue for the 1989 MBCA Subchapter F approach which, by its terms, entirely eliminates judicial review of covered transactions. Second, what is the effect of approval by disinterested directors or by shareholders, including what sort of process by disinterested directors is required for their approval to be effective in changing the standard of review or shifting the burden of proof? Does it merely reverse the common-law rule of void or voidability or does it render the transaction valid? Third, what sort of disclosure is required? Is it

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sufficient for the interested director to disclose the director's interest? Or must the director also disclose material facts about the transaction? Fourth, what role may interested directors play, and how does that interact with the quorum requirements for effective board action? Finally, who has the burden of proof?

There is now a large body of case law arising out of these statutes. The leading treatises in major jurisdictions do a very nice job tracking the state variations and the details of application. In Delaware, full treatment is provided in EDWARD P. WELCH, ROBERT S. SAUNDERS, ALLISON L. LAND, & JENNIFER C. VOSS, FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 144 (6th ed., 2020-2 Supp. 2013–2014); R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.16 (3rd ed., 2020-2 Supp. 1998) (Duty of Loyalty). For other states, see, inter alia, HENRY W. BALLANTINE & GRAHAM L. STERLING, BALLANTINE & STERLING CALIFORNIA CORPORATE LAWS § 103; ALLEN C. GOOLSBY AND STEPHEN M. HAAS. GOOLSBY & HAAS ON VIRGINIA CORPORATIONS § 9.8 (5th ed. 2014); Byron F. Eagan, EAGAN ON ENTITIES; CORPORATIONS, PARTNERSHIPS AND LIMITED LIABILITY COMPANIES IN TEXAS (2016); CHRISTOPHER M. POTASH, DAVID A. SHEVLIN, RICHARD E. HONEN, EDWARD H. COHEN, STEVEN R. GERSZ, JAMES. J. CANFIELD, WHITE, NEW YORK BUSINESS ENTITIES, Business Corporation Law § 713 (14th ed.); RUSSELL L. ROBINSON, ROBINSON ON NORTH CAROLINA CORPORATION LAW (7th ed. 2021).

2. Comparison to the Principles of Corporate Governance. The principal difference between Restatement § 5.02 and Principles of Law, Corporate Governance: Analysis and Recommendations (PCG) § 5.02 (AM. LAW. INST. 1994) is with regard to the standard of review of the disinterested directors' approval of an interested transaction. Under PCG § 5.02, approval by disinterested directors would be effective to change the standard of review or shift the burden of proof if the directors "could reasonably have concluded that the transaction was fair to the corporation." Under Restatement § 5.02, disinterested directors' approval will be effective when they acted "in good faith and on reasonable inquiry." This language is taken from the official comments to MBCA § 8.61(B):

> The fact that a transaction has been nominally passed through safe harbor procedures does not preclude a subsequent challenge based on any failure to meet the requirements of section 8.62. Recognizing the importance of traditional corporate procedures where the economic interests of a fellow director are concerned, a challenge to the effectiveness of board action for purposes of subsection (b)(1) might also assert that, while the conflicted director's conduct in connection with the process of approval by qualified directors may have been consistent with the statute's expectations, the qualified directors dealing with the matter did not act in good faith or on reasonable inquiry.

3. Adoption of PCG approach. We are not aware of any cases that have adopted the standard set forth in PCG § 5.02. While we agree with the drafters of the PCG that courts will not find disinterested director approval to be effective when directors could not reasonably have concluded that the transaction was fair to the corporation, we believe that they would do so in the

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1 context of a review of the directors' decision for "good faith" and "reasonable inquiry."
2 Accordingly, we believe that our language better restates the prevailing standard.
3 *4. Fairness.* For a discussion of "fairness" including "fair dealing" and "fair price," see the
4 Introductory Note to Chapter 5 and the Reporters' Notes following it. As discussed further there,
5 there is a complex, context-dependent relationship between "fair dealing" and "fair price."
6 *5. Loans to directors or officers.* Some state corporation statutes require shareholder
7 approval of loans to directors or officers. See, e.g., N.Y. BUS. CORP. LAW § 714 (McKinney 1998).
8 Where such specific legislation exists, the loan is subject to both the requirements of § 5.02 and
9 any additional limitations imposed by the legislation. For public companies, § 13(k) of the 1934
10 Act, 15 U.S.C.A. § 78m(k) (2015), added by § 402(a) of the Sarbanes-Oxley Act of 2002, prohibits
11 personal loans to directors and executive officers.
12 *6. Item 404, Regulation S-K.* For public companies, Item 404 of Regulation S-K mandates
13 comprehensive disclosure of "[t]ransactions with related persons, promoters and certain control
14 persons," 17 C.F.R. § 229.404. Item 404 requires disclosure when the amount involved exceeds
15 $120,000 and requires the issuer to describe its policies and procedures for the review, approval,
16 or ratification of any reportable transactions.
17 *7. Family members.* Courts have recognized that a transaction between the spouse of a
18 director or officer and the corporation will be treated in the same manner as if the director or officer
19 was the contracting party. See cases collected in 3 FLETCHER CYCLOPEDIA OF THE LAW OF
20 CORPORATIONS § 946 (Rev. 1986, 1991 Supp.). Chapter 5 expands the concept to other family
21 members by its definition of "associate" [§ 1.03] but affords certain protection to an associate not
22 extended to the director or officer. See § 5.08. Connecticut Stock Corp. Act § 33-323 also subjects
23 transactions between members of the immediate family of a director (defined to include spouse,
24 parents, and children) and the corporation to the requirement of fairness.
25 *8. Independent representation.* With respect to the need for independent representation of
26 the corporation in negotiating a transaction with a director or officer, see cases collected in 3
27 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS §§ 922–926 (Rev. 1986, 1991 Supp.).
28 Section 5.02 does not embrace this view.
29 *9. Disclosure of material facts of the transaction.* By requiring disclosure of the material
30 facts of the transaction as well as the director's or officer's interest to the directors or shareholders
31 who approve the transaction under § 5.02, the Restatement follows the approach taken in many
32 jurisdictions. See Reporters' Note 1. The following cases express support for the approach adopted
33 in § 5.02 that the failure to make the required disclosure may afford a sufficient basis for setting
34 aside a transaction, whether or not it may otherwise be fair: State ex rel. Hayes Oyster Co. v.
35 Keypoint Oyster Co., 391 P.2d 979 (Wash. 1964); Talbot v. James, 190 S.E.2d 759, 763–765 (S.C.
36 1972); Kessler v. Commonwealth Doctors Hospital, Inc., 185 S.E.2d 43 (Va. 1971); Schemmel v.
37 Hill, 169 N.E. 678 (Ind. App. 1930); cf. Wisconsin Ave. Assocs., Inc. v. 2720 Wisconsin Ave.
38 Coop. Ass'n, Inc., 441 A.2d 956 (D.C. App. 1982), cert. denied, 103 S. Ct. 62 (1982); Rosenthal v.
39 Four Corners Oil & Minerals Co., 403 P.2d 762, 766 (Colo. 1965); Stern v. Lucy Webb Hayes Nat.
40 Training School for Deaconesses & Missionaries, 381 F.Supp. 1003, 1014–1015 (D.D.C. 1974).

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The following cases treat failure to disclose as one of the factors to be considered in determining whether a transaction is unfair: Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186, 195 (6th Cir.1974); Shlensky v. S. Parkway Bldg. Corp., 166 N.E.2d 793, 801–802 (Ill. 1960); Romanik v. Lurie Home Supply Center, Inc., 435 N.E.2d 712, 727 (Ill. App.1982); cf., Voss Oil Co. v. Voss, 367 P.2d 977, 979 (Wyo. 1962); Yarnall Warehouse & Transfer, Inc. v. Three Ivory Brothers Moving Co., 226 So.2d 887, 891 (Fla. Dist. Ct. App. 1969); Roche v. Golden Sky Lands, Inc., 487 P.2d 756, 758 (Ariz. 1971).

On the issue whether disclosure of profit is required, see, e.g., Robinson v. Brier, 194 A.2d 204 (Pa. 1963) (amount of profit realized by fiduciary need not be disclosed); Schoff v. Clough, 380 P.2d 464 (Nev. 1963) (no obligation to disclose profit); but see Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

10. Limited judicial scrutiny. When there has been disinterested-shareholder approval, courts have limited judicial scrutiny of the fairness of a transaction by requiring a showing of waste, illegality, ultra vires, or fraud. See Kerbs v. California E. Airways, 90 A.2d 652 (Del. 1952); Alcott v. Hyman, 208 A.2d 501 (Del. Ch. 1965); Kaplan v. Goldsamt, 380 A.2d 556 (Del. Ch. 1977); Michelson v. Duncan, 407 A.2d 211 (Del. 1979); Cohen v. Ayers, 596 F.2d 733, 740–741 (7th Cir.1979); Abramson v. Nytronics, Inc., 312 F.Supp. 519, 527 (S.D.N.Y. 1970); but see Scott v. Multi-Amp Corp., 386 F.Supp. 44, 67–68 (D. N.J. 1974) (disinterested approval does not shift burden to challenger, but lessens director's or officer's burden). Where it is alleged that there has been a waste or gift of corporate assets, unanimous shareholder ratification is necessary in order to foreclose judicial review. See Schreiber v. Bryan, 396 A.2d 512, 518 (Del. Ch. 1978); Am. Timber & Trading Co. v. Niedermeyer, 558 P.2d 1211 (Or. 1976); Meredith v. Camp Hill Estates, Inc., 77 A.D.2d 649 (N.Y. App. Div. 1980).

11. Fairness of loans. With respect to the limitations of fairness on a director's or officer's loans to or from the corporation, see cases collected in 3 FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS §§ 908, 952, & 955 (Rev. 1986, 1991 Supp.). When the corporation lends money to the director or officer, there is authority for the view that the corporation should receive the same terms as the borrower would otherwise have to pay, including maintenance of compensating balances. See Maxwell v. Northwest Indus., Inc., 339 N.Y.S.2d 347 (N.Y.S.2d 1972). However, such a view does not preclude the corporation from making a loan to an officer upon preferential terms as a form of compensation or perquisite, where not otherwise precluded by law, if the tests in § 5.03 governing compensation are met. For public companies, Section 13(k) of the 1934 Act, 15 U.S.C.A. § 78m(k) (2015), added by the Sarbanes-Oxley Act, prohibits personal loans to directors and executive officers and renders these doctrines moot.

12. Effect of administrative action. Chelrob, Inc. v. Barrett, 57 N.E.2d 825 (N.Y. 1944), expresses the view that action by an administrative agency will not divest a court of jurisdiction to set aside self-dealing transactions on equitable grounds (except under principles of res judicata). Some courts have taken a more expansive view of the effect of administrative action by holding that when the terms of a transaction are "imposed" by a third party, such as the federal or a state government, a transaction will be upheld absent a showing of gross and palpable overreaching.

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See Trans World Airlines, Inc. v. Summa Corp., 374 A.2d 5 (Del. Ch. 1977); Getty Oil Co. v. Skelly Oil Co., 255 A.2d 717 (Del. Ch. 1969).

13. Recusal. While nothing in § 5.02 disqualifies a director from participating in consideration of or voting as a director with respect to a transaction in which the director is interested, the director should be encouraged not to participate. Some provisions of law go further and, in specific situations, preclude the director from participating in the discussion or attempting to influence the voting by the board of directors with respect to a transaction in which the director is interested. See 12 C.F.R. § 215.4(b) (1991) (dealing with approval of extension of bank credit).

14. Interested directors. The fact that directors of a corporation have working relationships with each other does not for that reason cause them to be interested when passing on each other's transactions. Burks v. Lasker, 99 S. Ct. 1831 (1979). The receipt of reasonable compensation as a director unrelated to a transaction, or the interest of a director for other than pecuniary reasons in the continuation of the directorship, does not of itself result in the director being interested for purposes of Chapter 5. Warshaw v. Calhoun, 221 A.2d 487, 493 (Del. 1966); Panter v. Marshall Field & Co., 646 F.2d 271, 295 (7th Cir. 1981), cert. denied, 102 S. Ct. 658 (1981); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 703 (2d Cir. 1980); Brayton v. Ostrau, 561 F.Supp. 156, 165 (S.D.N.Y. 1983). For illustrations of cases in which courts have analyzed the independence of directors, see Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971); Lewis v. Fuqua, 502 A.2d 962 (Del. Ch. 1985); Stein v. Bailey, 531 F.Supp. 684 (S.D.N.Y. 1982); Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49 (5th Cir. 1980), cert. denied, 101 S. Ct. 1738 (1981); Gries Sports Enters., Inc. v. Cleveland Browns Football Co., Inc., 496 N.E.2d 959 (Ohio 1986). See also the Comment to § 1.23.

15. Effect of Sarbanes-Oxley Act. Beginning with rules issued under Section 406 of the 2002 Sarbanes-Oxley Act, and continuing with the NYSE Listed Companies Manual and the NASDAQ Listing Requirements, public companies now typically have a "Corporate Governance Charter" and a "Code of Business Conduct and Ethics" that address conflict of interests, including related-party transactions. Paragraph 303A.10 the NYSE's Listed Company Manual provides that "[t]he listed company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the listed company."

16. Illustration 11 is drawn from Changes in the Model Business Corporation Act—Proposed Amendments Relating to Chapter 1 and Chapter 8 (Including Subchapters F and G and Duties of Directors and Officers), 59 BUS. LAW. 569, 581 (2004).

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1 **§ 5.10. Interested Transactions Involving a Controller**

2 **(a) If [when?] the corporation enters into a transaction in which a controller [§ 1.10]**
3 **is interested [§ 1.23], the controller fulfills its duty of loyalty to the corporation and its**
4 **shareholders with respect to the transaction if:**

5 **(1) the transaction is fair to the corporation at the time it is entered into; or**

6 **(2) the transaction is conditioned on it being approved in advance, and is so**
7 **approved, by both disinterested directors [§ 1.15], acting in good faith and on**
8 **reasonable inquiry with the power to retain their own professional advisers and to**
9 **negotiate the terms of the transaction, and disinterested shareholders [§ 1.16], in each**
10 **case following disclosure concerning the conflict of interest [§ 1.14(a)] and the**
11 **transaction [§ 1.14(b)] to the disinterested directors and disinterested shareholders,**
12 **respectively.**

13 **(b) Notwithstanding § 1.14(b), if the corporation conditions a transaction in which a**
14 **controller is interested on it being approved in advance by disinterested directors who have**
15 **the power to retain their own professional advisors and to negotiate the terms of the**
16 **transaction, the controller has no duty to disclose any material facts concerning the**
17 **transaction that would not have to be disclosed under normal standards of arm's-length**
18 **bargaining, except to the extent that the controller has, directly or indirectly, obtained such**
19 **information from the corporation without the consent of the disinterested directors.**

20 **(c) The interested controller has the burden of proof as to all of the elements of**
21 **subsections (a)(1) and (a)(2). If the transaction was conditioned on it being approved and was**
22 **approved in advance by disinterested directors [§ 1.15], acting in good faith and on**
23 **reasonable inquiry with the power to retain their own professional advisers and to negotiate**
24 **the terms of the transaction, or if it was conditioned on it being approved and was approved**
25 **in advance by disinterested shareholders [§ 1.16], in either case following disclosure**
26 **concerning the controller's conflict of interest [§ 1.14(a)] and the transaction [§ 1.14(b)] to**
27 **the disinterested directors or shareholders, the party challenging the transaction has the**
28 **burden of proof as to fairness. If the transaction was not so conditioned and approved, the**
29 **controller has the burden of proof as to fairness.**

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Comment:

a. Comparison with existing law. Section 5.10(a) reflects the approach taken by the Delaware Supreme Court in Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014) (MFW) and Kahn v. Lynch, 638 A.2d 1110 (Del. 1994). Under these precedents, if a transaction between a corporation and a controller is approved by both disinterested directors and disinterested shareholders, courts will not further review the transaction for fairness; if the transaction is approved by either disinterested directors or disinterested shareholders—but not by both of these bodies—courts will continue to review the transaction under the entire fairness standard of review, but the burden of proof on the issue of entire fairness shifts from the defendant to the plaintiff. These cases also require that certain additional conditions be satisfied in order for the approvals by disinterested directors and disinterested shareholders to change the standard of review or shift the burden of proof. In order for the standard of review to shift from entire fairness to the business judgment rule, MFW requires that an organization's controller condition the transaction on it being approved by both a special committee composed of disinterested directors and the corporation's disinterested shareholders and that the special committee be empowered to freely select its own advisers and meet its duty of care in negotiating a fair price.

b. Scope of § 5.10. Section 5.10 covers both transactions between a controller and the controlled corporation (such as a merger between the corporation and the controller or an affiliate of the controller or a purchase of property by the corporation from a controller) and transactions between the corporation and other parties from which a controller stands to obtain a material benefit that is not shared with the other shareholders, even if the controller is not a party to the transaction (such as a merger between the corporation and a third party in which the per-share consideration received by the controller is materially superior to the one received by the other shareholders). Section 5.10, however, does not cover mergers to the extent that [§ 7.xx] Exclusivity of Appraisal Remedy – to be revised] applies or any transaction to which the corporation is not a party. The latter type of transaction includes tender offers made by a controller for shares of the corporation (addressed by [§ x.xx]), and sales of a control block made by the controller to a third party (addressed by [§ x.xx]). Section 5.10 is also not intended to cover transactions in which the controller is not a party and which result in a material detriment to the controller, as such transactions do not raise concerns that the controller or persons acting on its behalf are using their power to gain an advantage at the expense of other shareholders; nor is it intended to cover

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decisions by the corporation not to pursue a transaction that would result in a material detriment to the controller. To the extent that a controller is also a director or senior executive, both § 5.10 and § 5.02 (Interested Transactions Involving a Director or Officer) apply.

Illustrations:

1. Z Corporation is a controller of X Corporation. The board of X Corporation approves a merger between X Corporation and C Corporation, a wholly owned subsidiary of Z Corporation. Pursuant to the merger agreement, shareholders of X Corporation other than Z Corporation will receive $20 per share of X Corporation and Z Corporation will become the sole shareholder of the surviving corporation. X Corporation's shareholders approve the merger. The merger is subject to § 5.10 because Z Corporation is a party to the merger transaction. See also Comment *e* to § 1.23.

2. X Corporation has 1 million shares of Class A common stock and 100 million shares of Class B common stock issued and outstanding. Class A and Class B common stock do not differ in their entitlement to dividends, but holders of Class A stock are entitled to elect a majority of the directors of X Corporation. A, the chief executive officer of X Corporation, owns all of the shares of Class A stock. Z Corporation, a corporation with no connection to X Corporation or CEO A, enters into a merger agreement with X Corporation. Pursuant to the agreement, holders of Class B common stock would receive $20 per share in the merger. For each share of Class A stock, CEO A would receive one share of convertible preferred stock of X Corporation, which would be redeemable at the holder's option for $22 per share.

CEO A is interested in the merger, even though A is not a party to the merger agreement, because the per-share consideration received by holders of Class A stock has a higher value than the per-share consideration received by holders of Class B stock. CEO A thus has the burden of showing compliance with § 5.10.

3. The facts being otherwise as stated in Illustration 2, the merger agreement provides that both holders of Class A and holders of Class B shares would receive $20 per share. CEO A is not interested in the merger because A and the other shareholders of X Corp. receive the same per-share consideration in the merger.

c. Proof of fairness under § 5.10(a)(1) and 5.10(c). Section 5.10(a)(1) provides that if a corporation enters into a transaction in which a controller is interested, the controller satisfies its

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duty of loyalty if the transaction is fair to the corporation. The test of fairness under § 5.10(a)(1) is the same as the test that applied under § 5.02(a)(1) and includes aspects of fair price and procedural aspects of fair dealing. This standard is often referred to as "entire fairness." Procedural aspects of fair dealing, in turn, include whether the controller has made disclosures concerning the conflict of interest [§ 1.14(a)] and disclosures concerning the transaction [§ 1.14(b)]. While a failure to make such disclosures is not a per se violation of the controller's duty of loyalty, such failure is a factor to be considered in assessing whether the transaction is fair. When the transaction involves a purchase or sale of goods or services that are of comparable quality to goods or services purchased or sold in contemporaneous arm's-length transactions between unaffiliated parties, the terms of such contemporaneous transactions constitute presumptive evidence of fair price.

Section 5.10(c) provides that a single cleansing act—approval by disinterested directors or approval by disinterested shareholders that meet the respective requirements to make such approval effective—shifts the burden of proof as to fairness from the controller to the plaintiff. Beyond burden-shifting, a cleansing act will go a long way to showing that the controller engaged in fair dealing. In particular, when a transaction was conditioned on it being approved by disinterested directors with the requisite powers, and disinterested directors approved the transaction in good faith and on reasonable inquiry—a standard that usually requires disinterested directors to obtain independent financial advice or canvass the market— it is in practice hard for the plaintiff to meet the burden of proving that the transaction was not fair.

Illustrations:

4. Z Corporation is a controller of X Corporation. X Corporation is seeking a new headquarters building. Z Corporation owns an office building and offers to sell it to X Corporation for $30 million. X Corporation accepts the offer. Z Corporation has to prove that the transaction was fair to X Corporation.

5. C Corporation is in the oil-refinery business. A owns 60 percent of the stock of C Corporation and all of the stock of T Company, a corporation engaged in the trucking business. T Company purchases $50,000 in gasoline from C Corporation each year at the local posted price, which is equivalent to the price offered by other sellers in the local market. Gasoline is not in short supply, C does not discount from its posted price, and any member of the public could have purchased gasoline in that quantity and would have paid the posted price if they had done so. As the controller of C Corporation, A bears the burden

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of proving that T Company's purchases of oil are fair to C Corporation. Under these circumstances, evidence that T Company purchased gasoline at the price charged to other buyers by C Corporation and by other sellers is adequate to meet that burden of proof.

6. Z Corporation is a controller of X Corporation. Using data obtained from X Corporation, Z Corporation determines that if it obtained full ownership of X Corporation it would create highly valuable synergies and that it would be profitable to pay up to $30 per share for X Corporation. Without disclosing this analysis, Z Corporation proposes to acquire X Corporation in a merger for $23 per share. At the time of the proposal, the current market price per share of X Corporation was $20. At a meeting of the board of directors of X Corporation, the directors affiliated with Z Corporation recuse themselves, and the remaining directors vote to approve a merger at $23 per share. Z Corporation has the burden of proving the fairness of the transaction under § 5.10(a)(1). In evaluating whether Z Corporation has met its burden, its failure to disclose information regarding the synergies to be obtained by its acquisition of full ownership of X Corporation constitutes unfair dealing, which a court will take into account in assessing the overall fairness of the transaction.

d. Approval by disinterested directors. Corporations typically condition transactions on disinterested director approval by forming a special committee consisting of some or all of the corporation's disinterested directors and granting the committee the requisite powers. However, other methods can, in principle, also satisfy the requirements of the proviso in subsection (a)(2), as long as they are effective in assuring that disinterested directors have the requisite powers. For example, if the board of a corporation with a controller consists entirely of disinterested directors, the board would ordinarily satisfy the requirements of the proviso without having to form a special committee.

e. Effectiveness of approval by disinterested directors. In order for the disinterested directors' approval of a transaction to shift the standard of review from entire fairness to the business judgment rule under § 5.10(a)(2) in conjunction with it being approved by disinterested shareholders, or to shift the burden of proof under § 5.10(c), the disinterested directors must act in good faith, engage in reasonable inquiry, have the power to retain their own professional advisers and to negotiate the terms of the transaction, and have the power to reject the transaction.

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Factors that a court may consider in determining whether the disinterested directors' approval was effective to change the standard of review or shift the burden of proof include: the attention and care that the disinterested directors devoted to negotiating and deciding whether to approve the transaction; whether the transaction is in the ordinary course of business; whether the disinterested directors obtained financial and legal advice from independent advisers; and whether the disinterested directors were subject to improper influence by or threats from the controller. In general, the size of the transaction to be approved bears on whether the conduct by disinterested directors meets the standards of good faith and reasonable inquiry, with a greater degree of care and a higher level of information typically required for larger transactions. Although disinterested directors should always be given the power to retain their own professional advisers and to negotiate the terms of the transaction, in some situations, disinterested directors may be able to meet the standard of good faith and reasonable inquiry without in fact hiring their own professional advisers or without asking for changes to the terms of a transaction presented to them. Even if a court finds that an approval by disinterested directors was not effective to change the standard of review or shift the burden of proof, the court may consider the fact that the controller sought to obtain such approval and any information obtained by the disinterested directors in evaluating the fairness of the transaction under § 5.10(a)(1).

Illustrations:

7. Z Corporation is a controller of X Corporation. Z Corporation proposes to sell 60 million shares of Y Corporation to X Corporation for $200 million and makes the disclosures specified in § 1.14 concerning the conflict of interest and the transaction. The board of X Corporation forms a special committee consisting of three disinterested directors of X Corporation. The committee has the power to retain its own professional advisers and to negotiate the terms of the transaction, and Z Corporation and X Corporation condition the transaction proposed by Z Corporation on the committee approving the transaction. Upon Z Corporation's recommendation, the special committee retains ABC & Co. as financial adviser. In the past, ABC & Co. has obtained material fees from its work for X Corporation. ABC & Co. makes a presentation to the special committee advising it that $200 million is a fair price for the 60 million shares of Y Corporation. Only one member of the special committee attends the presentation. The following day, the special committee holds a 15-minute meeting in which it votes unanimously to approve the

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1 transaction on the terms proposed by X Corporation. Z Corporation has the burden of
2 proving fairness because the disinterested directors failed to act in good faith and on
3 reasonable inquiry in approving the transaction.
4 8. The facts being otherwise as stated in Illustration 7, Z Corporation has not
5 recommended ABC & Co. to the committee, and ABC & Co. has no prior material business
6 relationships with Z Corporation or any of its affiliates. All committee members attend
7 ABC & Co.'s presentation. After a two-hour meeting following the presentation, and after
8 hearing the advice from ABC & Co. that $200 million was a fair price, the committee
9 decides to make a counteroffer of $170 million. After negotiations between the
10 committee's representatives and Z Corporation, the committee and Z Corporation agree on
11 a $187 million price for the 60 million shares of Y Corporation. The burden of proof on
12 the issue of fairness has shifted from Z Corporation to a party challenging the transaction
13 because the transaction was conditioned on disinterested directors approving it in advance,
14 and the disinterested directors acted in good faith and on reasonable inquiry.
15 *f. Effectiveness of approval by disinterested shareholders*. For disinterested shareholders'
16 approval of a transaction to shift the standard of review from entire fairness to the business
17 judgment rule under § 5.10(a)(2) in conjunction with approval by disinterested directors, or to shift
18 the burden of proof under § 5.10(c), the disinterest shareholders' approval must be fully informed
19 and uncoerced and the transaction must be conditioned on the corporation obtaining disinterested
20 shareholder approval. When the transaction at issue requires approval by a majority of
21 shareholders entitled to vote, the transaction must be conditioned on it being approved by a
22 majority of disinterested shareholders entitled to vote in order for such approval to be effective.
23 Conditioning the transaction on it being approved by a requisite majority of shareholders
24 unaffiliated with the controller generally satisfies the requirement that the transaction be
25 conditioned on disinterested shareholder approval if, according to the terms of the transaction, all
26 such unaffiliated shareholders are treated equally. See Comment *b* to § 1.23.
27 g. *Conditioning transaction on approvals*. For disinterested director approval and
28 disinterested shareholder approval to shift the standard of review from entire fairness to the
29 business judgment rule under § 5.10(a)(2), the transaction must be conditioned on such approvals
30 before the substantive negotiations about the material terms of the transaction have started.

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Illustrations:

9. Z Corporation is a controller of X Corporation. Z Corporation proposes a merger between X Corporation and a subsidiary of Z Corporation in which all shareholders of X Corporation would receive $20 a share and Z Corporation would become the sole shareholder of the surviving corporation. Z Corporation conditions the transaction on it being approved by a special committee of disinterested directors and by a majority of disinterested shareholders entitled to vote. X Corporation forms a special committee of disinterested directors with the power to retain its own professional advisers and to negotiate the terms of the transaction. After its financial advisers have reviewed the proposed merger, the special committee asks Z Corporation to raise the price offered from $20 to $25 per share. In response, Z Corporation raises its offer to $22 per share and states that if the special committee does not approve the merger on these terms, it will terminate the negotiations. The members of the special committee, believing in good faith and on reasonable inquiry that $22 per share is a fair price, approve the merger at that price. After disclosures, the merger is approved by a majority of the disinterested shareholders entitled to vote. Z Corporation has fulfilled its duty of loyalty.

10. The facts being otherwise as stated in stated in Illustration 9, Z Corporation raises its offer to $22 per share and states that if the special committee does not approve the merger at that price, it will commence a tender offer for the X Corporation without the approval of the special committee. Z Corporation has not satisfied the conditions of § 5.10(a)(2) because its threat to commence a tender offer was inconsistent with the requirement that the transaction be conditioned on it being approved by disinterested directors.

h. Disclosure concerning the transaction under § 5.10(a)(2) and (c). The scope of the disclosures concerning the transaction that are required to shift the standard of review from entire fairness to the business judgment rule under § 5.10(a)(2), or to shift the burden of proof under § 5.10(c), depends on whether the corporation has conditioned the transaction on it being approved by disinterested directors with the power to retain their own professional advisers and to negotiate the terms of the transaction. Conditioning a transaction on approval by such directors is designed to simulate an arm's-length transaction. The controller is thus not obligated to disclose any material facts concerning the transaction that would not have to be disclosed under normal standards of arm's-length bargaining. The only exception relates to information that the controller has obtained,

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directly or indirectly, from the corporation without the consent of its disinterested directors, as such information would not be available to a third party in an arm's-length transaction. If the controller has obtained such information, the controller must either disclose the information or seek retroactive consent from the disinterested directors to use such information.

In circumstances in which the corporation has conditioned the transaction on approval by disinterested directors with the power to retain their own professional advisers and to negotiate the terms of the transaction, and the transaction is conditioned on it being approved by both disinterested directors and disinterested shareholders, the required disclosures to the disinterested shareholders are of the same scope as the required disclosures to disinterested directors. If the corporation has not conditioned the transaction on it being approved by disinterested directors with the power to retain their own professional advisers and to negotiate the terms of the transaction, the disclosures that must be made to disinterested shareholders concerning the transaction are those stated in § 1.14(b) and include all material facts known to the controller concerning the transactions to the extent such facts are not known by the disinterested directors or disinterested shareholders, as the case may be. However, even if a transaction is formally conditioned on it being approved by disinterested directors, if the controller undermines the effectiveness of such approval (e.g., by pressuring the disinterested directors to retain the controller's bankers and lawyers), the disinterested directors' approval will not be effective in cleansing the transaction under § 5.10(a)(2), and the formal conditioning of the transaction on it being approved by disinterested directors will not change the controller's disclosure obligations under § 1.14(b).

Illustrations:

11. Z Corporation is a controller of X Corporation. Z Corporation proposes to sell 40 million unregistered shares of Z Corporation to X Corporation for $800 million and conditions the transaction on it being approved by a special committee of disinterested directors and by a majority of disinterested shareholders. X Corporation forms a special committee of disinterested directors with the power to retain its own professional advisers and to negotiate the terms of the transaction. The current market price for one publicly traded share of Z Corporation is $20. Z Corporation does not disclose to the committee that its financial adviser had informed it that the 40 million unregistered shares of Z Corporation would be illiquid and, in the financial adviser's estimate, the shares should be valued at a 15 percent liquidity discount.

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The committee, after reasonable inquiry and acting in good faith, engages in negotiations and approves the purchase of 40 million shares of Z Corporation for $740 million. At a shareholder meeting, a majority of disinterested shareholders approve the transaction.

Because Z Corporation did not obtain the information regarding the estimated liquidity discount from X Corporation and because X Corporation had formed a committee of disinterested directors with the power to retain its own professional advisers and to negotiate the terms of the transaction, the opinion that Z Corporation received from its adviser regarding the estimated liquidity discount does not have to be disclosed to the committee or to the shareholders of X Corporation.

12. Z Corporation is a controller of X Corporation. Z Corporation proposes a merger between X Corporation and a subsidiary of Z Corporation in which all shareholders of X Corporation would receive $20 a share and conditions the transaction on it being approved by a special committee of disinterested directors and by a majority of disinterested shareholders entitled to vote. X Corporation forms a special committee of disinterested directors with the power to retain its own professional advisers and conditions the transaction upon approval by the special committee. The special committee, through its financial adviser, asks management of X Corporation for its current financial projection. At the behest of Z Corporation, management provides data that substantially understate the projected revenue and profits of X Corporation. Based on the false projections, the special committee negotiates and approves a merger at $23 a share. At a shareholder meeting, a majority of disinterested shareholders entitled to vote also approve the merger. Z Corporation has the burden of proving fairness because neither the approval by the special committee nor the approval by shareholders satisfies § 5.10(c)'s requirement that the transaction be approved following proper disclosures concerning the transaction.

REPORTERS' NOTES

1. Fiduciary duties of controllers. Almost all jurisdictions that have considered the issue have concluded that a controller owes fiduciary duties to the corporation or the minority shareholders. See, e.g., Mims v. Valley Nat'l Bank, 481 P.2d 876, 878 (Ariz. Ct. App. 1971) (holding that a controller "ought to be held to owe the same standard of conduct towards the stockholders of the company as is due from an officer or director" (quoting Steinfeld v. Nielsen, 139 P. 879, 887 (Ariz. 1914))); Sheley v. Harrop, 215 Cal. Rptr. 3d 606, 624 (Ct. App. 2017)

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1 (explaining that controller has "responsibility to the minority . . . to use their ability to control the
2 corporation in a fair, just, and equitable manner" (quoting Jones v. H. F. Ahmanson & Co., 460
3 P.2d 464, 471 (Cal. 1969))); Van Schaack Holdings, Ltd. v. Van Schaack, 867 P.2d 892, 897 (Colo.
4 1994) (requiring under existing Colorado law that "controlling shareholders act with an extreme
5 measure of candor . . . in relation to remaining shareholders"); Yanow v. Teal Indus., Inc., 422
6 A.2d 311, 322 (Conn. 1979) ("[T]he majority has the right to control, but when it does so, it
7 occupies a fiduciary relationship toward the minority, as much as the corporation itself or its
8 officers and directors."); Kahn v. Lynch Commc'n Sys., 638 A.2d 1110 (Del. 1994) (Lynch)
9 (controller owes fiduciary duties); Dormeyer v. Weseman, No. 01-2017-CA-4239, 2019 Fla. Cir.
10 LEXIS 3754, at *21 (Nov. 8, 2019) ("A majority shareholder of a corporation has a fiduciary duty
11 not to utilize his control of the corporation to his advantage and to the detriment of the minority
12 shareholder." (citing Tills v. United Parts, 395 So. 2d 618, 619 (Fla. Dist. Ct. App. 1981))); Perl
13 v. IU Int'l Corp., 607 P.2d 1036, 1046 (Haw. 1980) (holding under Hawaii law that "fiduciary
14 principles govern[] the relationship between controlling and minority shareholders"); Rapkin Grp.,
15 Inc. v. Cardinal Ventures, Inc., 29 N.E.3d 752 (Ind. Ct. App. 2015) ("The standard imposed by a
16 fiduciary duty is the same whether it arises from the capacity of a director, office, or shareholder
17 in a closely held corporation."); Mona v. Mona Elec. Grp., Inc., 934 A.2d 450, 464 (Md. Ct. Spec.
18 App. 2007) ("Maryland common law recognizes that minority shareholders are entitled to
19 protection against fraudulent or illegal action of the majority."); Brundage v. N.J. Zinc Co., 226
20 A.2d 585, 599 (N.J. 1967) (holding that majority shareholders owe a duty of fairness to minority
21 shareholders in the context of mergers); Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 25 (N.Y.
22 1984) (holding that majority shareholders "have an obligation to all shareholders to adhere to
23 fiduciary standards of conduct and to exercise their responsibilities in good faith when undertaking
24 any corporate action"); Freese v. Smith, 428 S.E.2d 841, 847 (N.C. Ct. App. 1993) ("In North
25 Carolina it is well established that a controlling shareholder owes a fiduciary duty to minority
26 shareholders."); Renberg v. Zarrow, 667 P.2d 465, 472 (Okla. 1983) ("[A] majority shareholder
27 has a fiduciary duty not to misuse his power by promoting his personal interests at the expense of
28 the corporation, and the majority shareholder has the duty to protect the interests of the minority.");
29 Munson v. Valley Energy Inv. Fund, U.S., Ltd. P'ship, 333 P.3d 1102, 1122 (Or. Ct. App. 2014)
30 (controller owes a fiduciary duty to the minority shareholders under Colorado law); Papay v.
31 Papay, No. 2006-C-2956, 2011 Pa. Dist. & Cnty. Dec. LEXIS 878, at *8 (Pa. C.P. June 10, 2011)
32 ("Pennsylvania recognizes that controlling shareholders owe a fiduciary duty."); Cambio Health
33 Sols., LLC v. Reardon, 213 S.W.3d 785, 788 (Tenn. 2006) ("Under Tennessee law, a majority
34 shareholder owes a fiduciary duty to minority shareholders."); but see Ritchie v. Rupe, 443 S.W.
35 3d 856, 874–875 n.27 (Tex. 2014) (stating that Supreme Court of Texas "has never recognized a
36 formal fiduciary duty between majority and minority shareholders in a closely-held corporation."
37 *2. Effect of disinterested director and disinterested shareholder approval.* The standard of
38 review established by the Delaware Supreme Court in in Kahn v. M&F Worldwide Corp., 88 A.3d
39 635 (Del. 2014) (MFW) has also been adopted by New York (In re Kenneth Cole Prods., Inc.,
40 S'holder Litig., 52 N.Y.3d 214 (2016) but has been rejected by Oklahoma (Watkins v. Cont'l Res.,

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1 Inc., No. CJ-2012-4466, 2013 Okla. Dist. LEXIS 2006, at *9 (Sept. 30, 2013)). The weight of
2 authority supports the proposition that in conflict-of-interest transactions involving a controller,
3 approval by disinterested directors on their own, or disinterested shareholders on their own, merely
4 shifts the burden of establishing fairness. See *Lynch* at 1117; In re EZCORP Inc., No. 9962, 2016
5 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) (noting that this burden-shifting doctrine also applies
6 to nonmerger transactions); HCI Invs., LLC v. Fox, 412 S.W.3d 424, 437 (Mo. Ct. App. 2013)
7 (applying Kansas law); Potok v. Rebh, No. 3768, 2014 Phila. Ct. Com. Pl. LEXIS 318, at *57
8 (Sep. 16, 2014), aff'd, 2017 WL 1372754 (Pa. Super. Apr. 13, 2017) (applying Pennsylvania law);
9 see also Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New*
10 *Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 678 (2005).

11 For that reason, when a controlling stockholder is on the other side of the deal from
12 the corporation, our law has required that the transaction be reviewed for
13 substantive fairness even if the transaction was negotiated by independent directors
14 or approved by the minority stockholders. To encourage the use of these
15 protections, however, when these protections are deployed, the burden of proving
16 that the transaction is fair falls not on the controlling stockholder or the corporation,
17 but on the stockholders who sue, who must show that the transaction is unfair.

18 *3. Conflict transactions other than mergers*. Lower courts have applied the *MFW/Lynch*
19 framework outside of the merger context to a sale of a controlled company to a third party that
20 involved: side benefits to the controller (In re Martha Stewart Living Omnimedia, Inc. S'holder
21 Litig., 2017 WL 3568089 (Del. Ch. Aug. 18, 2017)); a stock reclassification (Ira Tr. FBO Bobbie
22 Ahmed v. Crane, No. 12742, 2017 WL 7053964 (Del. Ch. Dec. 11, 2017)); a self-tender offer by
23 a controlled company for shares held by minority shareholders (Buttonwood Tree Value Partners,
24 L.P. v. R.L. Polk & Co., No. 9250, 2017 WL 3172722 (Del. Ch. July 24, 2017)); a service
25 agreement between the controlled company and another entity owned by the controller (T. Rowe
26 Price Recovery Fund, L.P. v. Rubin, 770 A.2d 536 (Del. Ch. 2000)); a company's repurchase of
27 its shares from its controller in return for a combination of cash and stock (Levco Alternative Fund
28 Ltd. v. Reader's Digest Ass'n, Inc., 803 A.2d 428 (Del. 2002)); a license agreement between a
29 company and its controller (Quadrant Structured Prods. Co., Ltd. v. Vertin, 102 A.3d 155 (Del.
30 Ch. 2014)); a controlled company's decision not to defer the payment of interest on notes owned
31 by the controller when it would have been prudent to do so (id.); an advisory-service agreement
32 between the company and an affiliate of its controller (*EZCORP*, 2016 WL 301245); executive
33 compensation payments made to a controller (Tornetta v. Musk, 250 A.3d 793 (Del. Ch. 2019),
34 but see Friedman v. Dolan, No. 9425, 2015 WL 4040806 (Del. Ch. June 30, 2015)); various fees
35 paid to a controller, see *Quadrant*, 102 A.3d at 183–185 (license fees), Dweck v. Nasser, No. 1353,
36 2012 WL 161590, at *22 (Del. Ch. Jan. 18, 2012) (consulting fees), Carlson v. Hallinan, 925 A.2d
37 506, 529 (Del. Ch. 2006) (management fees paid to affiliates of the controller), and HOMF II Inv.
38 Corp. v. Altenberg, No. 2017-0293, 2020 WL 2529806, at *45 (Del. Ch. May 19, 2020)
39 (management fees)); and a controller causing the controlled company to pursue a strategy of
40 accumulating cash to maximize the near-term value of the controller's redemption right rather than

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investing the cash productively (Frederick Hsu Living Tr. v. Oak Hill Capital Partners III, L.P., No. 12108-VCL, 2020 WL 2111476 (Del. Ch. May 4, 2020).

The Delaware Supreme Court has endorsed the application of the *Lynch* burden-shifting standard in the context of a purchase by the controlled company of stock in another entity from the controller (Kahn v. Tremont Corp., 694 A.2d 422, 428 (Del. 1997)) (Tremont)

> Ordinarily, in a challenged transaction involving self-dealing by a controlling shareholder, the substantive legal standard is that of entire fairness, with the burden of persuasion resting upon the defendants. . . . The burden, however, may be shifted from the defendants to the plaintiff through the use of a well functioning committee of independent directors.

4. The "entire fairness" standard of review. Many jurisdictions apply an "entire fairness" standard of review to transactions involving a conflict of interest under which they consider both the substantive fairness of the terms of a transactions and procedural aspects of fair dealing. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, 710–711 (Del. 1983) (holding that conflict transactions involving controller are evaluated under entire fairness standard, which encompasses considerations of fair price and fair dealing); Brooks v. Horner, 344 P.3d 294, 301 (Alaska 2015) (applying Delaware law's entire fairness test to define a "just and reasonable" self-dealing transaction under Alaska law); Williams v. Stanford, 977 So. 2d 722 (Fla. Dist. Ct. App. 2008) (adopting Delaware's entire fairness analysis in the context of a controller self-dealing transaction under Florida law); Fisher v. Grove Farm Co., 230 P.3d 382 (Haw. Ct. App. 2009); Johnson v. Witkowski, 573 N.E.2d 513 (Mass. Ct. App. 1991) (holding that the entire fairness standard is implicated where a controller has a conflict); Lee v. Chem. Fin. Corp., No. 2016-151642-CB, 2016 Mich. Cir. LEXIS 1774 (Feb. 22, 2016) (same); Sifferle v. Micom Corp., 384 N.W.2d 503, 507 (Minn. 1986) (holding under Minnesota law that where a director deals with her corporation, "rigorous scrutiny" applies, which requires the "director to establish the entire fairness of the transaction"); HCI Invs., LLC v. Fox, 412 S.W.3d 424, 432 (Mo. Ct. App. 2013) ("'The entire fairness standard is exacting and requires judicial scrutiny regarding both fair dealing and fair price.'" (quoting Burcham v. Unison Bancorp, Inc., 77 P.3d 130, 149 (Kan. 2003))); In re Kenneth Cole Prods., Inc., S'holder Litig*.,* 52 N.E.3d 214, 219 (N.Y. 2016) (holding under New York law that transactions where there are directors or a majority shareholder "between the parties" are subject to an "'entire fairness' standard"); Klein v. Fisher Foods, Inc., 216 N.E.2d 647 (Ohio 1965) (adopting the entire fairness standard articulated in Delaware under Ohio law); Potok v. Rebh, No. 3768, Phila. Ct. Com. Pl. LEXIS 318 (Sep. 16, 2014) (holding that where directors or controllers stand on both sides of a transaction, strict or entire fairness applies); Hamed v. Yusuf, 62 V.I. 38 (2014); Beard v. Love, 173 P.3d 796 (Okla. Ct. App. 2007).

As several courts have explained, "[t]he 'range of fairness' aspect of the fair price inquiry 'has most salience when the controller has established a process that simulates arm's-length bargaining, supported by appropriate procedural protections.' That is, '[a] strong record of fair dealing can influence the fair price inquiry, reinforcing the unitary nature of the entire fairness test.'" S. Muoio & Co. LLC v. Hallmark Ent. Invs. Co., No. 4729, at *65, 2011 WL 863007 at *16

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(Del. Ch. Mar. 9, 2011) (citing Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 467 (Del. Ch. 2011)); see also FrontFour Capital Grp. LLC v. Taube, No. 2019-0100-KSJM, 2019 WL 1313408 at *26 (Del. Ch. Mar. 11, 2019) ("The two aspects of the entire fairness standard interact. Just as '[a] strong record of fair dealing can influence the fair price inquiry, . . . process can infect price.' Any inability to determine the degree to which the flawed process infected the price works to Defendants' detriment, as they bear the burden of proof on this issue." (quoting *Reis*, 28 A.3d at 467)).

Other courts have resorted to the concept of "fairer" price to explain that a price at the bottom of the range of fair prices may not be "fair" in the presence of unfair dealing. ACP Master, Ltd. v. Sprint Corp., No. 8508, 2017 WL 3421142, at *19 (Del. Ch. July 21, 2017); see also In re Dole Food Co., S'holder Litig., No. 8703, 2015 WL 5052214 (Del. Ch. Aug. 27, 2015); *Reis*, 28 A.3d; Basho Techs. Holdco B, LLC v. Georgetown Basho Invs., LLC, No. 11802, 2018 WL 3326693 (Del. Ch. July 6, 2018); HMG/Courtland Props, Inc. v. Gray, 749 A.2d 94, 117 (Del. Ch. 1999) (finding that although price fell within the lower range of fairness, "[t]he defendants have failed to persuade me that HMG would not have gotten a materially higher value for Wallingford and the Grossman's Portfolio had Gray and Fieber come clean about Gray's interest. That is, they have not convinced me that their misconduct did not taint the price to HMG's disadvantage.").

5. Significance of burden shifting. Some cases have observed that the allocation of the burden of proof on entire fairness only plays a role where the evidence is in equipoise, which occurs in "very few cases." In re Cysive, Inc., S'holder Litig., 836 A.2d 531, 548 (Del. Ch. 2003); see also Ams. Mining Corp v. Theriault, 51 A.3d 1213, 1242 (Del. 2012) (describing the effect of the burden shift as "modest"). But as the Delaware Supreme Court has observed:

> [A]ny board process is materially enhanced when the decision is attributable to independent directors. Accordingly, judicial review for entire fairness of how the transaction was structured, negotiated, disclosed to the directors, and approved by the directors will be significantly influenced by the work product of a properly functioning special committee of independent directors. Similarly, the issue of how stockholder approval was obtained will be significantly influenced by the affirmative vote of a majority of the minority stockholders. A fair process usually results in a fair price. Therefore, the proponents of an interested transaction will continue to be incentivized to put a fair dealing process in place that promotes judicial confidence in the entire fairness of the transaction price.

Id. at 1243–1244.

In a comprehensive review of cases involving controller-conflict transactions that went to trial, the burden of proof had shifted to the plaintiff in three cases and had remained on the defendant in 13 cases. In all three cases in which the burden had shifted (in each case due to it the transaction having been approved by a properly functioning committee of disinterested directors), the court found that the price was fair. In the 13 cases in which the burden had remained on the defendant, the court found that the price was fair in only two cases. Although this sample of cases is small and one should be careful to draw conclusions based on litigated cases due to selection

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1 effects (see George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J.
2 LEGAL STUD. 1 (1984) (arguing that litigated cases are subject to selection effects that results in
3 them differing from cases that are settled)), the outcomes in this sample of cases is consistent with
4 the notion that approval by a properly functioning committee of disinterested directors makes it
5 hard for the plaintiff to meet the burden of proving that the transaction was not entirely fair.
6 *6. Requirements for approval by disinterested directors*. For cases assessing the
7 effectiveness of a special committee of disinterested directors, see *Tremont*, 694 A.2d at 429 (to
8 obtain burden-shifting, a special committee must "function in a manner which indicates that the
9 controlling shareholder did not dictate the terms of the transaction and that the committee exercised
10 real bargaining power 'at an arms-length.'"); Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1240
11 (Del. 2012) (same); and Emerald Partners v. Berlin, 726 A.2d 1215, 1222–1223 (Del. 1999)
12 (describing that the special committee must exert "real bargaining power" in order for defendants
13 to obtain a burden shift); see also Beam v. Stewart, 845 A.2d 1040, 1055 n.45 (Del. 2004) (noting
14 that the test articulated in *Tremont* requires a determination as to whether the committee members
15 "in fact" functioned independently).
16 *7. Required vote for approval by disinterest directors*. When a transaction requires the vote
17 of a majority of shareholders entitled to vote, an abstention is functionally equivalent to a "no"
18 vote. Courts have hence reasoned that to constitute a cleansing act, a transaction that requires
19 approval by majority of shareholders entitled to vote would have to be approved by a majority of
20 disinterested shareholders entitled to vote. See In re PNB Holding Co. S'holders Litig., No. 28-N,
21 2006 WL 2403999 (Del. Ch. Aug. 18, 2006) (finding that if an underlying transaction requires
22 approval by majority of shareholders entitled to vote, the requisite majority for a cleaning act is a
23 majority of disinterested shareholders entitled to vote); Tornetta v. Musk, 250 A.3d 793 (Del. Ch.
24 2019) (finding that if an underlying transaction requires approval by a majority of disinterested
25 shareholders, a vote of a majority of *outstanding* disinterested shares is *not* required to provide a
26 cleansing act).
27 *8. Conditioning a transaction on approvals*. Several cases elaborate on what it means to
28 have a transaction conditioned on approvals so as to shift the standard of review from fairness to
29 the business judgment rule and when such condition must be imposed. See *MFW*, 88 A.3d at 644
30 (approval conditions must be imposed "*ab initio*"); Flood v. Synutra Int'l, Inc., 195 A.3d 754, 762
31 (Del. 2018) (defining "*ab initio*" as "early in the process—i.e., before any substantive economic
32 negotiations begin"). Courts have interpreted "substantive economic negotiations" to include a
33 joint valuation exercise (Olenik v. Lodzinski, 208 A.3d 704, 717 (Del. 2019)); "discussions
34 concern[ing] the key economic term of the Transaction—the price" (In re HomeFed Corp. S'holder
35 Litig., No. 2019-0592, 2020 WL 3960335, at *12 (Del. Ch. July 13, 2020)); and "negotiations . . .
36 concern[ing] deal structure, exchange ratio, and price terms" (Ark. Teacher Ret. Sys. v. Alon USA
37 Energy, Inc., No. 2017-0453-KSJM, 2019 Del. Ch. LEXIS 245, at *46, 2019 WL 2714331, at *20
38 (Del. Ch. June 28, 2019)).
39 There are several rationales for requiring that a transaction be conditioned on approval in
40 order for the approval to shift the standard of review. First, disinterested director and disinterested

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shareholder approval of conflict transactions involving controllers are meant to replicate, to the greatest extent possible, arm's-length bargaining. Conditioning a transaction on approval it being approved by disinterested shareholders and directors gives disinterested shareholders and directors the power to say "no," which is an inherent feature of arm's-length bargaining. Second, disinterested directors and, in particular, disinterested shareholders, have greater incentives to become informed about a transaction if the transaction requires their approval. Third, an *ex ante* commitment by the controller not to undertake a transaction unless it receives the requisite approval is an indication of good faith on the part of the controller. See In re S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 793–794 (Del. Ch. 2011) ("It is a very different thing for stockholders to know that their vote is in fact meaningful and to have a genuine chance to disapprove a transaction than it is to be told, as they were in this case, that the transaction required a two-thirds vote, which would be satisfied certainly because [the controller] had the voting power to satisfy that condition and [was] clearly intent on voting yes. In the latter situation, the vote has little meaning except as a form of protest, especially in a situation like this when there were no appraisal rights.")

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APPENDIX
BLACK LETTER OF TENTATIVE DRAFT NO. 1

CHAPTER 1
DEFINITIONS

§ 1.10. Controller

A "controller" of a corporation means a person [§ 1.28] or a group of persons that, directly or indirectly:

(a) Owns voting securities [§ 1.43] of the corporation entitling the holder to cast more than 50 percent of the votes in the election of the directors of the corporation; or

(b) Otherwise exercises a controlling influence over the business and affairs of the corporation.

§ 1.23. Interested

(a) A director, officer, or controller of a corporation is "interested" in a transaction involving the corporation or conduct by the corporation if either:

(1) both the corporation and the director, officer, or controller are parties to the transaction; or

(2) the director, officer, or controller receives a benefit (or suffers a detriment) as a result of the transaction or conduct when the benefit (or detriment) is not shared with shareholders pro rata according to the number of shares held, and that benefit (or detriment) is of such significance to that particular director, officer, or controller that it would reasonably be expected to affect the director's, officer's, or controller's judgment with respect to the transaction or conduct.

(b) A shareholder of a corporation is "interested" in a transaction involving the corporation or in conduct by the corporation for purposes of § 1.16 if:

(1) the shareholder is a director, officer, or controller of the corporation, or an affiliate of a director, officer, or controller of the corporation, that is interested in the transaction or conduct or that is not independent of a person that is interested in the transaction or conduct; or

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(2) both the corporation and the shareholder are parties to the transaction or conduct; or

(3) the shareholder receives a benefit (or suffers a detriment) in the transaction or conduct which is not generally shared with (or suffered by) the other shareholders of the corporation, and that benefit (or detriment) is of such significance to that particular shareholder that it would reasonably be expected to affect the shareholder's judgment with respect to the transaction or conduct.

§ 1.24. Independent

A director is "independent" with respect to a transaction or conduct if the director is not subject to the influence of, and does not have a relationship with, a person who is interested in the transaction or conduct such that the person's influence or relationship would reasonably be expected to affect the director's judgment regarding the transaction or conduct.

CHAPTER 2
THE OBJECTIVE OF A CORPORATION

§ 2.01. The Objective of a Corporation

(a) The objective of a corporation is to enhance the economic value of the corporation, within the boundaries of the law;

(1) in common-law jurisdictions: for the benefit of the corporation's shareholders. In doing so, a corporation may consider:

(a) the interests of the corporation's employees;

(b) the desirability of fostering the corporation's business relationships with suppliers, customers, and others;

(c) the impact of the corporation's operations on the community and the environment; and

(d) ethical considerations related to the responsible conduct of business;

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(2) in stakeholder jurisdictions: for the benefit of the corporation's shareholders and/or, to the extent permitted by state law, for the benefit of employees, suppliers, customers, communities, or any other constituencies.

(b) A corporation, in the conduct of its business, may devote a reasonable amount of resources to public-welfare, humanitarian, educational, and philanthropic purposes, whether or not doing so enhances the economic value of the corporation.

CHAPTER 4
DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

§ 4.01. The Duty of Care

A director or officer has a duty to the corporation to perform the director's or officer's functions with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

§ 4.02. The Business Judgment Rule

(a) A director or officer who makes a business judgment is not liable to the corporation or its shareholders if the director or officer:

(1) acts in good faith;

(2) is independent with respect to and not interested in the subject of the business judgment;

(3) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes is appropriate under the circumstances; and

(4) rationally believes that the business judgment is in the best interests of the corporation.

(b) A court shall defer to a corporation's business judgment unless the person challenging that judgment proves that the decisionmakers of the corporation have not met the requirements of subsection (a).

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CHAPTER 5
DUTY OF LOYALTY

§ 5.01. The Duty of Loyalty

A director or officer has a duty to act in the good-faith belief that such actions are in the best interests of the corporation and to give precedence to the interests of the corporation over any personal interest.

§ 5.02. Interested Transactions Involving a Director or Officer

(a) If a corporation enters into a transaction in which a director [§ 1.13] or officer [§ 1.27] is interested [§ 1.23] (other than a transaction involving the payment of compensation), the director or officer fulfills the duty of loyalty to the corporation and its shareholders with respect to the transaction if:

(1) the transaction is fair to the corporation when entered into; or

(2) after disclosure concerning the conflict of interest [§1.14(a)] and the transaction [§1.14(b)], the transaction is authorized in advance or ratified by disinterested directors [§ 1.15] or, in the case of an officer who is not a director, by a disinterested superior, acting in good faith and on reasonable inquiry; or

(3) after disclosure concerning the conflict of interest and the transaction, the transaction is authorized in advance or ratified by disinterested shareholders [§ 1.16], and it does not constitute a waste of corporate assets [§ 1.42] at the time of the authorization or ratification.

(b) A party who challenges a transaction between a director or officer and the corporation has the burden of proving that the director or officer is interested in the transaction. If such party establishes that the transaction is an interested transaction, the interested director or officer has the burden of proving that the conditions of subsections (a)(1), (a)(2), or (a)(3) are satisfied, except that the party challenging the transaction has the burden to establish waste under subsection (a)(3).

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§ 5.10. Interested Transactions Involving a Controller

(a) If [when?] the corporation enters into a transaction in which a controller [§ 1.10] is interested [§ 1.23], the controller fulfills its duty of loyalty to the corporation and its shareholders with respect to the transaction if:

(1) the transaction is fair to the corporation at the time it is entered into; or

(2) the transaction is conditioned on it being approved in advance, and is so approved, by both disinterested directors [§ 1.15], acting in good faith and on reasonable inquiry with the power to retain their own professional advisers and to negotiate the terms of the transaction, and disinterested shareholders [§ 1.16], in each case following disclosure concerning the conflict of interest [§ 1.14(a)] and the transaction [§ 1.14(b)] to the disinterested directors and disinterested shareholders, respectively.

(b) Notwithstanding § 1.14(b), if the corporation conditions a transaction in which a controller is interested on it being approved in advance by disinterested directors who have the power to retain their own professional advisors and to negotiate the terms of the transaction, the controller has no duty to disclose any material facts concerning the transaction that would not have to be disclosed under normal standards of arm's-length bargaining, except to the extent that the controller has, directly or indirectly, obtained such information from the corporation without the consent of the disinterested directors.

(c) The interested controller has the burden of proof as to all of the elements of subsections (a)(1) and (a)(2). If the transaction was conditioned on it being approved and was approved in advance by disinterested directors [§ 1.15], acting in good faith and on reasonable inquiry with the power to retain their own professional advisers and to negotiate the terms of the transaction, or if it was conditioned on it being approved and was approved in advance by disinterested shareholders [§ 1.16], in either case following disclosure concerning the controller's conflict of interest [§ 1.14(a)] and the transaction [§ 1.14(b)] to the disinterested directors or shareholders, the party challenging the transaction has the burden of proof as to fairness. If the transaction was not so conditioned and approved, the controller has the burden of proof as to fairness.

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