A BUSINESS JUDGMENT RULE FOR INCORPORATING JURISDICTIONS IN ASIA?

Australia, Malaysia, South Africa, several US states, and other jurisdictions have adopted statutory codifications of the common law business judgment rule. The rule protects directors from liability for errors in judgment or lapses of ordinary care. As an incorporation jurisdiction, whether Singapore should adopt a codification is the issue running throughout this article. To answer that question, parties must develop a feel for the rule: what it is, the policies behind it, how it might operate in practice, and the cons of statutory adoption.

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I. Introduction

1 The much misunderstood business judgment rule is not a rule at all. It has no mandatory content. It involves no substantive "dos" or "don'ts" for officers or directors of corporations. Instead, the business judgment rule is a standard of judicial review, entailing only slight review of business decisions. Alternatively, the rule could be called a standard of non-review, entailing no review of the merits of a business decision if directors have not been somnambulant.[1]

2 Where it exists, the business judgment rule generally remains uncodified. Authoritative, indeed official, commentary to the widely adopted US Model Business Corporation Act confirms this.[2] Nonetheless, judges and litigants both frequently mistake the statutory statement of the standard of care, "the care … of an ordinarily prudent

1 See generally Douglas M Branson, *Corporate Governance* (Lexis Law Pub, 1993) at paras 7.01–7.20.

2 Model Business Corporation Act Annotated (American Bar Association, 3rd Ed, 2005 Supp) Official Comment to §8.30 at 8-163 ("[t]he elements of the business judgment rule and the circumstances for its adoption are continuing to be developed by the courts").

person in a like position under similar circumstances", as the business judgment rule.[3] One expression of the difference is that the former is the standard of conduct while the latter is the standard of review.

3 Recent years have witnessed a few codifications, in Australia, Malaysia, South Africa and Germany, as well as in the US state of Nevada.[4] Scholarly articles have called for a statutory formulation elsewhere, evidently to no avail.[5] Why more jurisdictions have not considered a statutory rule is imponderable.

4 This article is about the tangible and the concrete rather than the imponderable, leaving aside speculation as to why more jurisdictions, especially pro-business jurisdictions such as Singapore,[6] have not adopted a statutory provision. The article backs into treatment of the subject, first discussing what the business judgment rule is not, some of the uses to which the rule may be put, and certain of the policy bases which underlie a business judgment rule.

5 Second, the article sets forth common formulations of the rule, at least in US jurisdictions.

6 Third, the article sets forth further policy bases for the rule.

7 Fourth, the relationship between the standard of conduct and the rule is illustrated further with an example of how the two might work in tandem.

8 Fifth, the treatment pages through the elements of the rule in greater detail, noting certain of the criticisms levelled at modern versions of the business judgment rule.

9 Sixth, and seventh, two sections of the article explain in greater detail how the rule operates in particularised contexts, namely, the dismissal of shareholders derivative litigation and the adoption of takeover defences, at least in jurisdictions in which directors have some latitude for adoption of defences.

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3 Fred W Triem, "Judicial Schizophrenia in Corporate Law: Confusing the Standard of Care with the Business Judgment Rule" (2007) 24 Alaska L Rev 23.

4 See paras 80–91 of this article.

5 See, *eg*, Douglas M Branson & Low Chee Keong, "Balancing the Scales: A Statutory Business Judgment Rule for Hong Kong?" (2004) 34 Hong Kong LJ 303.

6 One recent study, that of the World Economic Forum, ranked Singapore as the third most competitive economy of 139 nation states surveyed, behind Switzerland and Sweden. The US ranked fourth, followed by Germany (5), Finland (6), the Netherlands (7), Denmark (8), and Canada (9). Simon Kennedy, "US Drops to 4th Place in Competitiveness" *The Seattle Times* (10 September 2010) at p A-20.

10 Eighth, and finally, the article sets forth and parses the few codifications that have entered modern company law codes.

II. What the business judgment rule is not

11 As seen above, under the Model Business Corporation Act a director is to discharge her duties "with the care an ordinarily prudent person in like position would exercise under similar circumstances".[7] Australia's statute is similar.[8] The standard of conduct is not "slight care" or "gross negligence" or anything other than due care. The standard of review, however, which becomes a defence if the directors have made a decision or judgment, is the business judgment rule.

12 The rule is multi-faceted, pervading all aspects of business decision-making.[9] Most generally, the business judgment rule acts as a presumption in favour of corporate managers' actions. Stronger still, the rule provides a safe harbour that makes both directors' and officers' actions unassailable if certain prerequisites have been met. In litigation, the rule is a means of conserving judicial resources, thereby permitting courts to avoid being mired down in business decisions that are inherently subjective and ill suited for judges, as opposed to business men and women. Last of all, the rule is the law's implementation of broad economic policy, built upon economic freedom and the encouragement of informed risk taking.[10]

13 Newer uses to which the business judgment rule may be put include the means by which boards of directors adopt takeover defences, at least in those jurisdictions which give play to directors rather than shareholders, to adopt defence measures. After the fact, using the

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7 See, *eg*, *Theroit v Berg* 691 So 2d 213 at 222 (La App, 1997) ("the applicable standard of conduct is that set forth by the plain language" of Louisiana's version of the Model Business Corporation Act; adoption of a gross negligence standard would amount to "impermissible judicial negation of the legislature's acts"); Stuart R Cohn, "Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule" (1983) 62 Tex L Rev 591 at 604 and 617–623 (courts and commentators err in their collapse of the standard of care into the business judgment rule).

8 See Corporations Act 2001 (Cth) (Australia) s 232(4): "[S]uch care and diligence as a reasonable person would use in like position in the corporation's circumstances".

9 Accord Stephen M Bainbridge, "The Business Judgment Rule as an Abstention Doctrine" (2004) 57 Vanderbilt L Rev 83 at 83 and n 1 ("[t]he business judgment rule pervades every aspect of state corporate law, from the review of allegedly negligent decisions by directors, to self-dealing transactions, to board decisions to seek dismissal of shareholder litigation, and so on").

10 The rule may be applied to many forms of decision-making, not just business decisions. See, *eg*, *Lane v City of Seattle* 194 P 3rd 979 (Wa, 2008) ("courts review governmental business type decisions under the business judgment rule and infrequently reverse a business decision").

business judgment rule, courts review the adoption of those defences at the behest of disgruntled shareholders who have pursued litigation. Another use is as a means whereby corporate directors and their attorneys evaluate and, based upon that evaluation, recommend that courts dismiss derivative litigation.

14 One last curiosity to be noted before delving into the rule itself is that despite the vastly increased number of invocations of the rule in the modern era, at least in the US,[11] with one exception, the US business judgment rule remains uncodified. On an international basis, however, the picture is different. In 1999, Australia, based upon a well-known US "soft law" codification,[12] enacted a statutory version of the business judgment rule.[13] Malaysia, South Africa and Germany have all recently followed Australia's footsteps.[14] Whether this incipient trickle will morph into a waterfall, a cascade, or a torrent, remains to be seen.

III. Common formulations of the rule

15 Courts are major perpetrators of the error of stating policy bases of the rule for the rule itself. "Courts", one venerable court stated, will not review "an honest mistake of business judgment".[15] This economium is a statement of the effect of the rule, not the rule itself.

16 Similar is the statement that "[d]irectors of a commercial corporation may take chances, the same kind of chances that a man would take in his own business".[16] Yet another court recited that "[o]rdinarily neither the directors nor the other officers of a corporation are liable for mere mistakes or errors of judgment".[17] Again, the statement is a summary of the effect of the rule and also a hint at the policy behind the rule, rather than the rule stated in any analytical way.

17 Courts persist in talking about the rule's effect rather than the rule itself: "The rule prevents a judge or jury from second guessing

11 A Westlaw search on 15 September 2010, using the search terms "business /s judgment /s rule" produced 8,683 appellate court uses of the phrase (5,101 in Allstates database, 3,582 in the Allfeds database) (search on file with the author).

12 "Soft law … often finds its source in items that are not law-related at all, or only tangentially so, such as statements of good practices, stock exchange requirements that corporations disclose corporate governance requirements, and an emphasis on structure and process, particularly at the board of directors level …": Douglas M Branson, "Teaching Comparative Corporate Governance: The Significance of 'Soft Law' and International Institutions" (2000) 34 Ga L Rev 669 at 670.

13 See Corporations Act 2001 (Cth) (Australia) s 180(2).

14 See paras 80–89 of this article.

15 *Bodell v General Gas & Electric Corp* 140 A 2d 264 at 267 (1927).

16 *Ski Roundtop, Inc v Hall* 658 P 2d 1071 at 1078 (Mont, 1983).

17 *Nursing Home Bldg Corp v DeHart* 535 P 2d 137 at 143–144 (Wash App, 1975).

director decisions."[18] The same court speaks of how the rule works and the strong policies behind it: "The business judgment rule is process oriented and informed by a deep respect for all good faith board decisions."[19]

18 There are really only two formulations of the rule in wide currency: the Delaware business judgment rule and the American Law Institute ("ALI") formulation.[20]

19 Although not without its critics,[21] the ALI formulation, promulgated in final form in 1994, has been adopted by the highest courts of several US states.[22] The ALI section states:[23]

> (c) A director or officer who makes a business judgment in good faith fulfills [the duty of care] if the director or officer:
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> > (1) is not interested in the subject of his business judgment;
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> > (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
> >
> > (3) rationally believes that the business judgment is in the best interests of the corporation.

20 In more understandable terms, a director and her decision are shielded from legal review if: first, she and her colleagues made a judgment or decision; second, the decision makers were free of disabling conflicts of interest in the matter; third, they exercised some (not necessarily reasonable) care in informing themselves about the matter decided; and, fourth, they had a rational (not necessarily reasonable) basis for the decision they made.

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18 *In re Citigroup, Inc Shareholder Litigation* 964 A 2d 106 at 124 (Del Ch, 2009) (Chandler, Ch).

19 *In re Citigroup, Inc Shareholder Litigation* 964 A 2d 106 at 123 (Del Ch, 2009) (Chandler, Ch).

20 *Cf* Fred W Triem, "Judicial Schizophrenia in Corporate Law: Confusing the Standard of Care with the Business Judgment Rule" (2007) 24 Alaska L Rev 23 at 26 and n 19 ("[t]here are three principal formulations of the Business Judgment Rule").

21 See, *eg*, William J Carney, "Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?" (1988) 66 Wash ULQ 239 at 271–288.

22 See, *eg*, *Rosenfield v Metals Selling Corp* 643 A 2d 1253 at 1261 (Conn, 1994); *Omnibank v United Southern Bank* 607 So 2d 76 at 85 (Miss, 1992); *Cuker v Mikalauskas* 92 A 2d 1042 at 1045–1046 (Pa, 1997).

23 American Law Institute Principles of Corporate Governance and Structure §4.01(c).

21 One principal function of the rule is as a conservator of judicial resources. If the rule required reasonable care or a reasonable basis for the decision made, courts would have to hold plenary hearings (trials) because it is in those fora in which questions of reasonableness are determined. Instead, under the ALI rule, once other prerequisites are demonstrated to have been present (proactive directors making decisions, free of conflicts of interest, and so on), the defending directors need only demonstrate some care and only a rational (plausible) basis for the decision made. Defending directors can make these showings in a pre-trial application for summary treatment, what a US lawyer would term a motion for summary judgment.

22 Delaware courts state the business judgment rule more succinctly and do so using the language of presumption. Thus 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".[24]

23 Delaware courts look for the same elements as do courts applying an ALI type safe harbour rule: a judgment or decision (including the decision to make no decision), some care, good faith (absence of conflicts of interest or of base motives). A principal difference is because of the use of presumption, a plaintiff shareholder has the burden of going forward, attempting to upset the presumed facts. The challenging shareholder must demonstrate that the collegial body (the board) was infected by conflicts of interest on the part of a critical group (perhaps less than a majority) of directors.[25] Or the shareholder might offer credible proof that the directors merely rubber-stamped the Chief Executive Officer's ("CEO") decision, not making or attempting any judgment or decision on their own.[26]

24 In contrast, the ALI version of the rule is a safe harbour. The directors have the burden of establishing the presence of the rule's elements. Once they do so, however, the payoff is greater. The directors will have sailed into an impregnable safe harbour. Presumptions may be upset, meaning that perhaps the directors will have to go through the

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24 *Aronson v Lewis* 473 A 2d 805 at 812 (Del, 1984). The earlier and other oft cited Delaware precedent is *Warshaw v Calhoun* 221 A 2d 487 at 492–493 (1966).

25 See *Cede & Co v Technicolor, Inc* 634 A 2d 345 at 363–365 (Del, 1993) (the question is how much self-dealing or other conflicting interest transactions taint "the collective independence of the board").

26 An example would be *Smith v Van Gorkom* 488 A 2d 858 (Del, 1985), in which the directors made a decision to sell a large public company after only a two-hour meeting, called on short notice, and without benefit of a term sheet or any other documents, essentially rubber-stamping the choice of an aged CEO who wanted to sell his large block of holdings in the company so that he could retire.

ordeal of a full blown trial in order to vindicate themselves or their decision.

25 There are outlier formulations of the business judgment rule. In the late 1980s and early 1990s, seemingly every savings and loan (building society) in the US failed and directors were being sued left and right. For the most part, Lone Star State (Texas) courts protected them: "Texas courts to this day will not impose liability upon a non-interested director unless the challenged transaction is *ultra vires* or tainted by fraud … Such is the business judgment rule in Texas."[27] The statement seems to be another restatement of the effect of the rule rather than the rule itself. More importantly, the rule phrased in such a way protects directors who did nothing. Most courts recognise that the business judgment rule does not protect complete absences of care, abdications and the like.[28] Directors who have been asleep at the wheel do not enjoy the rule's protection. They must go to trial, at which point they will have to establish that they not only exercised some care, but due care.

26 To be distinguished from outlier statements of the business judgment rule (as in Texas), a few US state legislatures, lobbied by business interests in their state, have amended their state's corporate law to change the standard of conduct applicable to directors. Rather than elucidate a standard of review, these few US states have adopted "warm heart, empty head" standards of conduct. These statutes would absolve directors who did nothing, as directors under one standard are liable for money damages only if they engaged in "wilful misconduct or recklessness".[29] Virginia and Wisconsin have adopted similar statutes.[30] They are, of course, outliers, and bad policy as well.

27 *Resolution Trust Co v Norris* 830 F Supp 351 at 356 (SD Tex, 1993). See also *FDIC v Brown* 812 F Supp 722 at 724 (SD Tex, 1992).

28 See, *eg*, Douglas M Branson, *No Seat at the Table – How Governance and Law Keep Women Out of the Boardroom* (New York University Press, 2006) at p 56 ("[o]ne salient feature of the rule is that the directors must have made a decision or judgment – the rule does not protect directors who do nothing").

29 Indiana Code §23-1-35-1(e) (1989). In *Brane v Roth* 590 NE 2d 587 at 591 (Ind App, 1992), the court refused to give the new statute retroactive application, finding that the actions of directors in failing to cause the managers to enter into a hedging transaction was not protected by the business judgment rule and further violated the standard of care applicable to corporate directors.

30 See Wisconsin Stat Ann §180.357 (West Supp, 2001).

IV. Further policy bases behind the rule

27 The "good" governance movement of the last 20 or so years[31] contemplates a board comprised of a significant number, or a numerical majority, or, indeed, depending upon the jurisdiction, a super majority of directors who are independent, that is, directors who are free of any significant financial, familial, and sometimes even social ties to the company or its senior executives.[32] In some jurisdictions, corporate governance observers term such directors "INEDs", meaning independent, non-executive directors. Today, even traditional candidates for board service, such as the trusted outside lawyer, investment banking firm partners or commercial banker, known to some as "gray insiders", are considered non-independent and have become a rarity of sorts on large company boards of directors.

28 Now, more than ever, something akin to a business judgment rule is necessary to encourage independent persons, especially those of expertise and stature, to serve on corporate boards. "Persons of reason, intellect and integrity would not serve" if *ex ante* the law requires of them that they have possessed a degree of prescience others do not possess.[33] Once such persons are on boards as directors, a strong, clear business judgment rule is necessary to encourage those directors to engage in the type of informed risk taking and strategic planning that are essential to business success.[34]

29 Statutory or contractual provisions for advances to directors for expenses (principally legal fees) and for indemnification of any judgment or settlement paid may lessen a potential director's apprehension of the prospect of being sued. Being able to avoid protracted litigation and to get rid of many lawsuits early in the process, as a business judgment rule would enable them to do, lessens quite a bit further would-be directors' discomfort over the possibility of being sued.

30 In business judgment rule cases, courts also buttress their non-involvement in the merits of business decisions with a statutory

31 See, *eg*, Douglas M Branson, "Corporate Governance 'Reform' and the New Corporate Social Responsibility" (2001) 62 U Pitt L Rev 605 at 627 (describing the "good governance movement").

32 For example, post-*Enron*, the listing rules of the New York Stock Exchange ("NYSE") requires that a majority of any listed company's directors be independent. See para 41 of this article.

33 Samuel Arsht, "The Business Judgment Rule Revisited" (1979) 8 Hofstra L Rev 93 at 97.

34 "The business judgment rule serves to protect and promote the role of the board as the ultimate manager of the corporation": *Sherman v Ryan* 911 NE 2d 378 at 389 (Ill App, 2009).

argument. Corporate statutes universally provide that it is the board of directors (and by inference not a court of law) which is to manage or supervise the management of a corporation's business and affairs.[35] Recent judicial decisions in Delaware place renewed emphasis on this basis for a business judgment rule.[36]

V. Relationship to the standard of conduct – An illustration

31 The standard of conduct is due care. It is not slight care or gross negligence. Given that theoretical schematic, however, the business judgment rule's application may fix the *de facto* standard of conduct, at least in cases in which directors are proactive, to making a decision or judgment, including a decision to take no action or to postpone any decision, as opposed to cases of complete nonfeasance.[37]

32 A hypothetical example might show how the rule and the standard of conduct play off one another. After a shareholder has filed a lawsuit alleging breaches by directors and officers of their duties of supervision and oversight (care), and after some investigation and deliberation, the directors and the corporation file an application for summary disposition of the case. They could append thereto an affidavit by the Chief Financial Officer that she had prepared and distributed to the directors a written report on the pros and cons of the decision to be made, perhaps attaching a copy of the report. A second affidavit by a director or two could state that the board met on such and such a date, on that occasion discussing the matter in dispute and receiving an oral report from a corporate executive or an outside consultant. A resolution of the board of directors, certified by the corporate secretary as a true and correct copy of the resolution contained in the board's meeting minutes, might round out the package counsel presents to the court. The court would examine such affidavit evidence. The business

35 See, *eg*, the US Model Business Corporation Act (3rd Ed) §8.01: "All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the directions of, a board of directors … ."

36 See, *eg*, *In re Citigroup, Inc Shareholder Litigation* 964 A 2d 106 at 124 (Del Ch, 2009) ("the rule prevents a judge or jury from second guessing director decisions").

37 Some US courts, especially intermediate appellate courts in several of the states, are confused over this. Some are too strict, requiring a full measure of due care even in cases in which the business judgment rule applies. See, *eg*, *Davis v Dyson* 900 NE 2d 698 at 716 (Ill App, 2008) (the business judgment rule requires proof that directors "were diligent and careful": failure by directors to review bank statements renders the rule inapplicable in case of manager's embezzlement). Other courts give directors too much latitude, holding the standard of conduct to be gross negligence even in cases in which directors did nothing or abdicated their duties. See, *eg*, *Risk Management Services LLC v Mass* 40 So 3rd 176 at 182 (La App, 2010) (gross negligence across the board); *Wahlcometroflex Inc v Baldwin* 991 A 2d 44 at 48 (Me, 2010) (standard of conduct is gross negligence even if the business judgment rule is inapplicable).

judgment rule requires only a showing of some care, so the court need not undertake a plenary review of the decision-making process. The court might then grant the defence motion.

33 Suppose, however, that plaintiff shareholders state with particularity why a critical mass of directors, or their relatives, had a pecuniary interest in the subject matter of the board decision. In that case, the court would deny the defence motion.

34 Loss of the motion, however, does not translate into perdition for the directors. It means merely that the court will hold the matter over for trial. At trial, the directors might assert again the business judgment defence, with particular emphasis on negating the plaintiffs' showings earlier on conflict of interest issues. As a second argument, the directors might ask that the court review the entire decision-making process because they have met the standard of conduct, that is, they exercised not only some care but due care. The directors might also assert other substantive defences, such as lack of causation, superseding cause,[38] or that the corporation had suffered no legally cognisable damage.[39]

VI. Components of the rule

A. There must have been a decision or judgment

35 Sometimes it is said that there must have been an *independent* judgment. Rubber-stamping the CEO's or controlling shareholder's wish or command will not do. The issue arises frequently in cases in which plaintiffs allege that a critical number of directors on the board are cronies of the controlling shareholder or the CEO.

36 One of the classic US cases involved a shareholder contention that, when the directors of the Chicago Cubs baseball club voted to uphold majority owner (and chewing gum magnate) P K Wrigley's decision to have no floodlights at the home baseball park, they merely implemented Wrigley's inveterate belief that God meant baseball as a game to be played in the day time. Unlike every other professional baseball team, the Chicago Cubs were unable to play night baseball, which would have generated additional revenues. According to the plaintiff minority shareholder, the reasoning given by the directors – that night-time baseball would ruin the neighbourhood surrounding

38 See, *eg*, Douglas M Branson, *Corporate Governance* (Lexis Law Pub, 1993) at paras 6.11–6.14.
39 Douglas M Branson, *Corporate Governance* (Lexis Law Pub, 1993) at para 6.14.

the Cubs' home field (Wrigley Field) – was pretextual.[40] The directors were rubber stamps. Nonetheless, the Illinois Appellate Court disagreed, affording business judgment rule protection to the Chicago Cubs' board of directors and their purported decision.

37 A decision to make no decision is a decision for purposes of the rule's application.[41] Experienced directors, however, say that on the boards on which they have served, directors often act by consensus and that consensus builds by a process of accretion, over time. A requirement that all matters be put to motions and votes forces confrontation. The judgment or decision requirement forces boards to act like legislative bodies or, worse yet, like university faculty meetings. It does not wear well over time which is the setting directors find themselves in, serving together as a small group for ten, 12 or more years. Incessant confrontation and formal voting may rub feelings raw over even an intermediate term, let alone over longer periods of time.

38 The modern governance emphasis upon the process leading to formal judgments is also frequently viewed as "make-work" for lawyers, who have come to have a larger role in corporate governance, most particularly inside the board room, than they should have. Similarly, critics say that the modern business judgment rule's insistence on formal decisions places a premium on play acting and on paper trails, rather than improving the quality of the decisions that boards of directors make.

39 Last of all, although the directors have made an independent judgment, the decision made may not have been theirs to make. The articles of incorporation, or company's constitution, or some other organic document may control the situation so that the directors have no discretion. The same may be true when the corporation, or its board, are bound by contract. For example, in *Weiss v Swanson*,[42] Delaware Vice-Chancellor Lamb noted that, while the business judgment rule protects many board compensation decisions, that is only when the terms of a governing contract (there a stock option plan) are adhered to.

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40 *Shlensky v Wrigley* 237 NE 2d 776 (Ill App, 1968); see also *McMullin v Beran* 765 A 2d 910 at 916–920 and 924 (Del, 2000) (finding that the directors of a subsidiary corporation delegated their decision-making to the board of the parent corporation when they "had an ultimate statutory duty and fiduciary responsibility to make an informed and independent decision": no business judgment rule protection).

41 *Cf Brane v Roth* 590 NE 2d 587 at 592 (Ind App, 1992) ("the rule does not protect directors who have abdicated their position or absent a conscious decision"); *Miller v Schreyer* 683 NYS 2d 51 at 54 (App Div, 1999) ("where the wrong alleged is inaction of the board rather than a conscious decision … the business judgment rule is inapplicable").

42 948 A 2d 433 at 441 (Del Ch, 2008).

In *Hawkins v Waikoloa Village Assn*,[43] the Supreme Court of Hawaii observed that the business judgment rule does not protect directors' decisions to violate clear provisions of the Declaration of Protective Covenants or of the corporation's by-laws.

B. Absence of disabling conflicts of interest

40 Conflicts that disable most frequently are direct pecuniary interests of the director, her family, her business associates, or another company or partnership in which she has an interest in the matter under consideration. In those ways, she may be viewed as being on both sides of the proposed transaction.

41 Yet receipt of normal directors' fees from the corporation, or the desire to retain them, does not disable directors from setting and passing on the level of fees. In *Marx v Akers*,[44] New York's highest court (styled the Court of Appeals rather than Supreme Court, as in other US states) held that as a matter of law the amount of $80,000 did not disable IBM's directors from setting those fees. That a director was an across-the-street neighbour of a senior executive of the corporation on the other side of the transaction did not disable: conclusionary allegations of personal affinity are insufficient to take the case out of the rule's ambit.[45]

42 Pre-*Enron*, receipt by an investment banking firm of $229,000 in annual fees did not disable the firm's partner from participating as a Chevron, Inc director in a decision about a proposed transaction as to which the banking firm had rendered professional advice.[46] The Enron debacle brought to light that not only did each of the Enron directors receive an excessive amount of compensation (about $350,000 annually), creating a moral hazard for the directors (who would tend not to want to rock the boat as long as they were so well taken care of), but also that Enron paid fees to many directors' consulting firms, professional partnerships, and the like, as well as made gifts to directors' favoured charities.[47] Both the New York Stock Exchange and the NASDAQ then passed rules that receipt by a director's firm of $100,000 or more in annual fees would render that director non-independent,

43 187 P 3rd 593 (Hawaii, 2008).
44 666 NE 2d 1034 (NY, 1996).
45 *Odyssey Partners v Fleming Cos* 735 A 2d 386 at 409–410 (Del Ch, 1999).
46 *Katz v Chevron Corp* 22 Cal App 1352 at 1368 (1994).
47 See US Senate Report, *The Role of the Board Of Directors in Enron's Collapse* (S Prt 107-70) at pp 11 (annual fees) and 51–52 (consulting fees and gifts to charities). While directors in US *Fortune 500* corporations received an average of $138,747 in annual fees, at Enron they received $350,000, and generous consulting fees on top of that. US Senate Report at p 11. See also Branson, "Enron – When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?" (2003) 48 Villanova L Rev 989 at 1019–1020.

meaning that she could not be on the audit committee, her vote could not count as the swing vote, and her presence could result in the loss of business judgment rule protection.[48] Future courts no doubt will find those guidelines highly persuasive.

43 Service as faculty in the law and business schools of a major university disqualified two directors from service on a special litigation committee when the corporation on whose board they sat was a major donor to the university and various of its programmes.[49]

44 Other conflicts that disable include receipt by a director of an undisclosed $150,000 finder's fee in the transaction.[50] The further question, which often is present, is whether the taint of self-interest on the part of one or several directors infected a decision made by all directors, or a subgroup of them, the majority of whom were free of material conflicts and therefore not disabled.[51]

45 The Delaware Court of Chancery has determined that it will view the matter of pecuniary interest in relative rather than absolute terms. Thus, the personal effect of an opposite decision while large in an absolute sense ($200,000) did not disable a particular director in light of that director's overall wealth, which was substantial.[52]

46 When a critical mass of directors wore second hats as well paid, long-term consultants, hired by the controlling shareholder, those directors' decisions were not entitled to business judgment rule protection.[53] Bank directors who circumvented a state's banking laws by forming a competing entity, styled a "loan company", were not entitled to the rule's protection for the decision to create the new entity because the directors later accepted management fees from the loan company.[54]

47 A few universal principles may be stated. Structural bias, that is, the alleged predilection of directors to favour those of the same social or

48 US self-regulatory organisations ("SRO") such as the NYSE and the NASD require that a majority, or more, of listed companies' directors be independent, and as the text states, the SRO rules define independence. *See* NYSE Listed Company Manual §303A.02(b); NASDAQ Corporate Governance Rules Summary (4 November 2003). See also Douglas M Branson, "Too Many Bells? Too Many Whistles? Corporate Governance in the Post-Enron, Post WorldCom Era" (2006) 58 South Carolina L Rev 65 at 84–85.

49 *In re Oracle Corp Derivative Litigation* 824 A 2d 917 (Del Ch, 2003) (Strine VC).

50 *Cede & Co v Technicolor, Inc* 634 A 2d 345 at 362 (Del, 1993).

51 It is universally held that when a majority of the decision makers have material conflicts of interest no business judgment rule protection can attach.

52 *LC Capital Master Fund, Ltd v James* 990 A 2d 435 (Del Ch, 2010) (allocation of cash merger proceeds between preferred and common shares).

53 *Clark v Lomas & Nettleton Fin Corp* 625 F 2d 49 at 52–53 (5th Cir, 1980).

54 *Warren v Century Bankcorp, Inc* 741 P 2d 846 at 848 (Okla, 1987).

economic class, such as fellow directors or senior executives, in the eyes of most courts does not disable. The argument of structural bias is frequently made by plaintiff shareholders in the context of a special litigation committee's recommendation that a derivative suit's continuation is not in the corporation's best interest and should be discontinued. The "there but for the grace of God go I" motivation that may lie behind a director's decision that litigation against a fellow or former director is not in the corporation's interests, while real, generally is not legally cognisable.[55]

48 Another universal principle is that if a single decision maker seeks business judgment rule protection, she must, "like Caesar's wife, be above reproach".[56]

49 A subspecies of conflict of interest cases involves dominated director cases. Rather than a pecuniary or other discernable interest which the decision maker may have had in the matter decided, the plaintiff shareholder alleges that many or all of the directors are beholden generally to a controlling shareholder or CEO, and thus disabled by their lack of independence. Any plaintiff who makes such an argument faces an uphill battle.[57] Courts are loath to find that a person of stature and reputation is not his or her own person. Courts would rather rely on an identifiable pecuniary interest to ground a finding that a particular decision maker was disabled.

50 Nonetheless, lack of independence, or dominated director, cases succeed from time to time. When the owner of a professional football club staffed the corporation's five-person board with outside counsel, inside counsel, a corporate employee, and himself, the Supreme Court of Ohio found that the board had been dominated. Its decisions were not entitled to be shielded from scrutiny by the business judgment rule.[58]

51 By contrast, if corporate counsel scrubs the board clean, removing all inferences of conflicts of interest and of board

55 Nonetheless, out of an abundance of caution, and probably also a subliminal recognition that the structural bias problem is real, most boards of directors staff special litigation committees ("SLC") with "expansion directors", persons who can in no way be alleged to have had any knowledge or other connection with the alleged wrongdoing, which of course occurred sometime before the board selected the new directors/SLC members.

56 *Kahn v Tremont Corp* 694 A 2d 422 at 430 (Del Ch, 1997), quoting *Lewis v Fuqua* 502 A 2d 962 at 967 (Del Ch, 1985).

57 As does the plaintiff who argues that "the directors' decision was an imprudent one", which "is precisely the kind of argument precluded by the business judgment rule": *In re Lear Corp Shareholders' Litigation* 967 A 2d 640 at 651 (Del, 2008).

58 *Gries Sports Entertainment v Cleveland Browns Football Co* 496 NE 2d 959 at 968 (Ohio, 1986).

domination,[59] and then insists that those independent, non executive directors ("INEDs") run the decision-making process from beginning to end, under US law their decision is entitled not only to business judgment rule protection, but also to *heightened* business judgment rule protection.[60] What "heightened" means analytically is hard to say, and it may only be a word added for emphasis. The result though will be clear. The decision made will be unassailable if the rule's other elements are shown to have been present.

C. A rational basis for the decision made

52 Directors could be free of conflicts of interest or any hint of domination by another, gather voluminous amounts of information, digest that information, and then make a decision that not only is unwise but without factual support or nonsensical.[61] Under the ALI version of the business judgment rule, such a decision would not be entitled to business judgment rule protection.[62] A decision to put a man or woman on Mars, or to accept a lower, clearly inferior bid for the company or one of its principal assets, are examples of judgments lacking a rational business purpose.[63]

53 On that score, some judges and commentators say that directors are not liable unless their decision or judgment was manifest folly. Others say "rational" incorporates a gross abuse of discretion standard. Those phrasings may permit directors too much latitude in their

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59 Any experienced attorney would direct the corporation to form an *ad hoc* committee comprised exclusively of independent directors. See, *eg*, Scott V Simpson, "The Emerging Role of the Special Committee: Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest" (1988) 43 Bus Law 665.

60 *Ivanhoe Partnership v Newmont Mining Co* 535 A 2d 1334 at 1343 (Del, 1987).

61 In discussion with his informal consultative group, the American Law Institute's Chief Reporter, Professor Melvin Eisenberg, used the vernacular, "off the wall", as an antonym for rational.

62 American Law Institute Principles of Corporate Governance and Structure §401(c)(3) provides that in order to comport with his duty of care, a court must find that the director "rationally believes that the business judgment is in the best interests of the corporation". Of course, context is important. A decision by an aerospace company's board authorising an effort to put a man on Mars may have a rational basis while the same decision by an agricultural or financial service firm's board of directors would not.

63 See, *eg*, *Gimbel v Signal Cos, Inc* 316 A 2d 599 at 610 (Del Ch), affirmed, 316 A 2d 619 (Del, 1974) ("[t]here are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct and which are based simply on gross inadequacy of price"). *Cf Paramount Communications, Inc v Time, Inc* 571 A 2d 1140 at 1152 (directors' decision to accept and recommend to others a clearly inferior price entitled to business judgment rule protection if the transaction was structured as "a merger of equals" ("MOE")).

decision-making. By contrast, the statement that "all director decisions must have a sound business purpose" goes too far in the opposite direction.

54 One esteemed commentator, and also no less an authority than former Delaware Chancellor William Allen (now a professor of law at New York University), both deny that any rational basis requirement exists, at least as part of the Delaware version of the business judgment rule.[64] Chancellor Allen reached his conclusion based upon his reading of a number of Delaware precedents.[65] Nearly simultaneous Delaware Supreme Court decisions seem to contradict Chancellor Allen,[66] as do pronouncements by other courts.[67]

D. Umbrella requirement of good faith

55 In a transactional setting, an attorney advising a board of directors might run through the business judgment's elements as a checklist: judgment or decision?, absence of disabling conflicts on the part of the decision makers?, care in informing themselves about the matter under consideration?, and a rational (plausible) basis for the decision made? She (the attorney) would then do well to pause, raise her head, and sniff. After all is said and done, all good lawyers apply a "smell test". Even if all the law's formal requirements have been met, if the transaction or deal under consideration does not feel right, or smell right, they do not do the deal, or they advise directors to postpone it until they dig down to discover the source of their olfactory discomfort.

56 In business judgment rule jurisprudence, the umbrella requirement of good faith is a surrogate of sorts for a smell test. It has particular utility in at least three delimited areas.

57 One area is when the decision-making process has been infected by illicit motives other than pecuniary conflicts of interest. Revenge, spite, jealousy or other base motives may be behind a directors' decision.

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64 Lyman Johnson, "The Modest Business Judgment Rule" (2000) 55 *Business Lawyer* 625 at 632–633.

65 See *Caremark Int'l, Inc Derivative Litigation* 698 A 2d 959 at 967 (Del Ch, 1996).

66 One is *Parnes v Bally Entertainment Corp* 722 A 2d 1243 at 1246 (Del, 1999) ("[t]he presumptive validity of a business judgment is rebutted in those rare cases where the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith").

67 See, *eg*, *Soloman v Armstrong* 747 A 2d 1098 (Del Ch, 1999) (the business judgment rule protected the directors' decision on allocation of assets to a tracking stock as allocation had "a rational basis").

In such a case, many litigation lawyers would attack the decision, alleging lack of good faith.[68]

58 A second area is knowing approval of illegal conduct. Directors who approved forgiveness of indebtedness by a political party when under US law then prevailing such forgiveness was tantamount to an illegal campaign contribution, were not entitled to business judgment rule protection, even though they had no conflicts of interest and they had a rational, indeed reasonable, basis for the decision made (continued good will of the political party now in office). They lacked good faith.[69]

59 A third area, also perhaps an earmark of a base motive such as spite or revenge, is overindulgence in strategic, manipulative behaviour – Machiavellian tactic, if you will. In *Red River Wings, Inc v Hoot, Inc*,[70] the court denied business judgment rule protection to directors' actions, finding that the reasons advanced for their manoeuvering were "concocted after the fact to justify their actions".[71]

60 Yet another US decision stated that directors who knowingly withhold material information from other board members in order to mislead shareholders lack good faith. Under such circumstances, the shroud of protection the business judgment rule affords falls to the ground.[72] Another case held that a cryptic and peremptory refusal of a derivative action plaintiff's demand on the board of directors, in a case of obvious wrongdoing in the corporation, constituted a lack of good faith. The court thus could review the merits of the denial of demand itself.[73]

61 The good faith requirement is thus something of a "catch-all", which demonstrates the flexibility of the business judgment rule. For example, in a dominated directors' case, a court could alternatively find

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68 See, *eg*, *In re RJR Nabisco, Inc Shareholders Litigation* 1989 WL 7036 slip op at 15 (Del Ch, 1989):

> Greed is not the only emotion that can pull one from the path of propriety; so might hatred, envy, lust, revenge, or 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.

69 *Miller v AT & T Co* 507 F 2d 759 (3rd Cir, 1974).

70 751 NW 2d 206 at 222 (ND, 2008).

71 In *Yates v Holt-Smith, Inc* 768 NW 2d 213 (Wisc App, 2009), the Machiavellian plot involved a decision to forego a year's end dividend, a decision ordinarily protected by the business judgment rule, in order to induce another principal shareholder to sell stock.

72 *Potter v Pholad* 560 NE 2d 388 at 395 (Minn App, 1997). See also *Emerald Partners v Berlin* 1995 WL 600881 at 7 (Del Ch, 1995).

73 *Harhen v Brown* 710 NE 2d 224 at 234–236 (Mass App), reversed on other grounds, 730 NE 2d 859 (Mass, 2000).

that the directors had rubber-stamped the decision of a controlling shareholder, thus making no decision or judgment of their own, that directors had a disabling conflict of interest (lacked independence), or that the directors lacked good faith. In most business judgment rule cases, then, judges have a number of "outs", although in their wisdom judges may choose not to use any one of them. This is as it should be because, at least historically, the business judgment rule is a judicial construct, born of judges' realisations about limitations on their abilities, about conservation of judicial resources and about a judge's proper role in business cases.

VII. Particular applications of the rule – Dismissal of derivative litigation

62 In 1979, both the New York Court of Appeals, a highly regarded US state court, and the US Supreme Court dusted off a few older precedents, finding in those cases support for the proposition that a board of directors has power to terminate litigation brought by a shareholder as not in the "corporation's best interest".[74] In theory, the concept is sound. Just as a natural person may do, a corporation should be able to decide not to stand on legal rights it may have. The difficulty is how, as a fictional being, a corporation can find its voice for making that decision. The difficulty is compounded because in the typical derivative action the defendants are certain directors or officers, a subgroup of the group that ordinarily manages the corporation's business and affairs, including its court cases, and which would be its voice for determining whether or not to pursue a particular action. That group is, of course, the board of directors.

63 The manner in which the potential conflict of interest has come to be reconciled is through the use of the Special Litigation Committee ("SLC") of the board of directors. If a shareholder brings colourable claims against the officers or some of the directors, counsel would first instruct the board of directors to amend the corporation's by-laws (articles of association, constitution), thereby increasing the number of directors.[75] Second, the board would appoint "expansion directors" to the new positions who could have no conceivable connection to the wrongdoing alleged. Third, the full board of directors would delegate to

74 *Auerbach v Bennett* 393 NE 2d 994 (NY, 1979); *Burks v Lasker* 441 US 471 (1979) (finding no obstacle in the federal Investment Company Act of 1940 if state law, pursuant to one of which all mutual funds must be formed, authorised the Special Litigation Committee practice).

75 If the claim is not colourable, that is, frivolous or outlandish, the full board may summarily recommend that the claim be dismissed, on the advice of outside or of house counsel. See, *eg*, American Law Institute Principles of Corporate Governance and Structure §7.03.

the SLC all of the board's power to deal with the pending action or with the extra-judicial shareholder demand that an action be brought. Fourth, once convened, the SLC would hire an independent law firm to conduct a factual investigation of the shareholder allegations and to research the applicable law. Fifth, the law firm would report periodically to the SLC and involve the SLC members in the investigation, at least at crucial stages.

64 Sixth, in the typical scenario, eight or ten months after its formation, the SLC promulgates a report, which it files with the court in which the shareholder action is pending. Appended to the report usually will be a voluminous record of the investigation conducted and a memorandum of the law.

65 Seventh, by motion for summary judgment, or similar application, the SLC will ask the court to dismiss the shareholder litigation, not necessarily because the law has not been violated but because the SLC has determined that continuation of the shareholder's action would not be "in the corporation's best interest". Because the SLC has made a decision or judgment, has exercised some care informing itself about the subject of that judgment, possesses demonstrable freedom from conflicts of interest, and sets out a rational basis for its recommendation, the SLC will contend that the court must afford the decision or recommendation the protection of the business judgment rule.[76]

66 Eighth, the court will dismiss the shareholder complaint.

67 The SLC device is accepted everywhere courts have encountered it.[77] Instead, the frontier has been what sort of deference, or how much deference, and what sort of review, courts should give to SLC reports and recommendations. No less than five positions on those questions have been formulated by various US states' appellate courts.

68 In several US jurisdictions, courts afford the SLC recommendation full business judgment rule protection. That is, if the SLC offers affidavit or similar proof establishing the elements of the business judgment rule, then the court never reviews the merits of the SLC's recommendation to dismiss the action. This is the position adopted by the New York court in the seminal case of *Auerbach v Bennett*.[78] The principal difference

76 See, *eg*, Douglas M Branson, *Corporate Governance* (Lexis Law Pub, 1993) at paras 11.31–11.34.

77 See generally Arthur Pinto & Douglas M Branson, *Understanding Corporate Law* (LexisNexis, 3rd Ed, 2009) at pp 488–499.

78 393 NE 2d 994 (1979). See also *Desijoudar v Meyercord* 108 Cal App 4th 173 (California, 2003); *Hirsch v Jones Intercable, Inc* 984 P 2d 629 at 637–638 (Colorado, 1999); *Gray v Manhattan Medical Center* 18 P 3rd 291 at 297 (Kansas

(*cont'd on the next page*)

from a run-of-the-mill business judgment case is that in such an instance elements of the rule (good faith, in the corporation's best interest, *etc*) are presumed while under *Auerbach* and its progeny directors must make adequate showings on those scores.

69 Other courts, most notably Delaware's, have stated that a decision to dismiss litigation is qualitatively different from the types of decisions ordinarily entitled to business judgment rule protection, such as directors' decisions to make an acquisition or build a new factory.[79] Courts do not have expertise in the latter but they do have experience – lots of it – on the issue of whether litigation should proceed or be dismissed.[80]

70 In their discretion, then, Delaware judges (Chancellors) may review the merits of an SLC recommendation (known colloquially as a *Zapata* second step, after the leading decision), but only in demand excused cases.[81] Under a North Carolina precedent,[82] in their discretion, trial judges may review recommendations in all cases, demand refused as well as demand excused. The Massachusetts precedent requires that state's trial judges to conduct at least a "smell test" of SLC recommendations in all cases (no discretion).[83] Last of all, the American Law Institute schematic was adopted *in toto* by the Supreme Court of Pennsylvania. The ALI schematic contemplates discretionary review of a SLC recommendation when the lawsuit alleges that directors have committed duty of loyalty violations but non-review when the SLC has recommended that the court dismiss duty of care violations.[84]

App, 2001); *In re United Health Care Group, Inc Shareholder Derivate Litigation* 754 NW 544 (Minnesota, 2008); and *Lewis v Boyd* 838 SW 2d 215 at 224 (Tennessee App, 1992). See also *Bezirdjian v O'Reilly* 183 Cal App 3rd 316 at 323 (Cal App, 2010); and *Blohm v Kelly* 765 NW 2d 147 (Minn App, 2007).

79 *Zapata Corp v Maldonado* 430 A 2d 779 at 787–789 (Del, 1980).

80 Many of the early Special Litigation Committee cases were educated guesses by US federal courts about what they thought states' highest courts, most particularly Delaware's, would do. These guesses are called educated *Erie* guesses, after the 1938 US Supreme Court case *Thomkins v Erie Railway* 305 US 637, which held that in diversity of citizenship cases between citizens of different states, US federal courts must look to and apply state law. In Delaware's case, the early federal cases guessed wrong about how Delaware's highest court might decide. See also *Gaines v Houghton* 645 F 2d 761 (9th Cir, 1981) (California law); *Lewis v Anderson* 615 F 2d 778 (9th Cir, 1979); *Genzer v Cunningham* 498 F Supp 779 at 682 (ED Mich, 1980) (Michigan law).

81 From the caption in the seminal Delaware case, *Zapata Corp v Maldonado* 430 A 2d 779 (Del, 1980).

82 *Alford v Shaw* 358 SE 2d 323 (NC, 1987).

83 *Houle v Low* 556 NE 2d 51 at 56–57 (Mass, 1990). Accord *In re PSE & G Shareholder Litigation* 718 A 254 at 260 (New Jersey, 1998).

84 *Cuker v Milalauskas* 692 A 1042 at 1049 (Pennsylvania, 1997).

VIII. Particular applications of the rule – Review of adoption of takeover defences

71 Another type of corporate decision that differs from typical investment or management questions, such as whether to develop a new product or modernise a plant, is the decision by the board of directors to adopt takeover defences or to prefer one competing bidder for a company over other bidders. Jurisdictions vary as to how much latitude their laws permit in the adoption of takeover defences, ranging from none or very little to wide, if not complete, freedom. The latter is the US position while the European Union, at the urging particularly of Germany, is somewhere between those extremes.

72 Here again, directors should not have complete discretion, as they should have with more routine decisions. Rather than sharing with courts, as in the case of dismissal of litigation, here directors share with shareholders. As owners, shareholders should have more of a say, or some say, with regard to whether the company and its shareholders should be allowed to entertain an offer for their shares, or whether one competing offer is to be preferred over another. At a minimum, on the latter type questions, jurisdiction between directors and shareholders should be concurrent.

73 So, again, US courts began to use the business judgment rule as the yardstick, provided, of course, that the directors who actually voted in favour of the defence tactic were free of conflicts of interest.[85] But, as with review of SLC recommendations to dismiss litigation against the corporation or its directors, courts added refinements to the ordinary business judgment rule. They did so to factor in the differing nature of the judgment or decision under review and the shared power with stockholders. Once again, the Delaware courts led the way.

74 The first refinement of the rule came in *Unocal Corp v Mesa Petroleum Co*[86] ("*Unocal*"), which sets out a "response phase" add-on to the business judgment rule which deals with directors' reactions to hostile or semi-hostile takeover bids. To receive business judgment rule protection, the directors adopting a defence must also have inquired

85 The practice is to delegate the adoption of the defence, or intra-corporate review of it, to a committee comprised exclusively of independent directors, although strictly speaking that may not be necessary. A reviewing court could find, for example, that the presence of an executive director did not infect or taint the workings of a collegial group. Nonetheless, out of an abundance of caution, counsel attempt to utilise the independent committee device. See, *eg*, Scott V Simpson, "The Emerging Role of the Special Committee: Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest" (1988) 43 Bus Law 665.

86 493 A 2d 946 at 954 (1985).

whether a realistic "danger to corporate policy and effectiveness existed because of another person's stock ownership".[87] Any takeover defensive step taken then "must be reasonable in relation to the threat posed".[88] In applying these elements added to the business judgment rule, courts are to apply "enhanced scrutiny" to action directors have taken because of "the omnipresent specter that [in the takeover area] a board may be acting primarily in its own interests".[89]

75 *Shamrock Holdings, Inc v Polaroid Corp*,[90] by Delaware standards now an old chestnut, illustrates well what has come to be known as the "proportionality" add-on of *Unocal*. Potential takeover target Polaroid stalled a proposed meeting with a quasi-friendly acquirer (Roy Disney and Shamrock, his investment company) while it installed an employee stock ownership plan ("ESOP") to which it conveyed a large number of Polaroid shares, which would then be in a pro-management set of hands. Creation of an ESOP and allotment to it of a large number of authorised but as yet unissued shares was a popular takeover defence at the time.

76 Without even knowing what the threat to corporate policy or effectiveness was, the Polaroid directors adopted an expensive and drastic defensive measure. Delaware Vice-Chancellor Carolyn Berger found that the Polaroid directors had neither informed themselves, as the basic business judgment rule requires, nor "undertaken the proportionality analysis mandated by *Unocal Corp*".[91]

77 Another, and third, version of the business judgment rule comes into play in the "auction phase" of a takeover bid. In *Revlon, Inc v McAndrews & Forbes Holdings, Inc*[92] ("*Revlon*"), the Delaware Supreme Court held that when it has become inevitable that a company will be sold or broken up, the directors' "role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price at a sale of the company".[93] Under *Revlon*, in the auction phase, any defensive measures taken by directors must be "a rationally related benefit to shareholders" in order to afford those directors and their decision the protection of the business judgment rule.[94]

87 *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 at 955 (1985).
88 *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 at 287 (1985) (nonetheless finding for the defendants).
89 *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 at 954 (1985).
90 559 A 2d 257 at 271 (Del Ch, 1989).
91 *Shamrock Holdings, Inc v Polaroid Corp* 559 A 2d 257 at 271 (Del Ch, 1989).
92 506 A 2d 173 (Del, 1986).
93 *Revlon, Inc v McAndrews & Forbes Holdings, Inc* 506 A 2d 173 at 182 (Del, 1986).
94 *Revlon, Inc v McAndrews & Forbes Holdings, Inc* 506 A 2d 173 at 184 (Del, 1986).

78 Thereafter, Delaware takeover jurisprudence takes many twists and turns. For example, corporations may structure a combination as a "merger of equals", in which case *Revlon* would not apply and directors may cause the corporation to eschew even a clearly superior offer.[95] On the other end of the spectrum, takeover defences which are determined to be "draconian (preclusive or coercive)", foreclosing any possibility of shareholder choice, are deemed beyond the pale.[96] Such drastic defence measures do not even begin to come within these rules. Both courts and commentators refer to the analysis by shorthand (*Unocal* or *Revlon*).[97]

79 All these twists and turn of Delaware business judgment rule takeover jurisprudence could fill volumes, which is in effect the US national jurisprudence on the subject. They are beyond the scope of an article such as this one.[98] This article must now turn to a brief critique of the statutory codifications of the business judgment rule around the world.

IX. Statutory codifications of the business judgment rule

A. Australia

80 The Australian statutory codification, one of the first, if not the first, in the world, follows ALI Corporate Governance Project s 4.01(c),[99] but is not a slave to it. The section[100] provides:

> A director or officer who makes a business judgment is taken to meet the requirements of [the duty of care and diligence], and their equivalent duties at common law and in equity, in respect of the judgment if they:

95 *Paramount Communications, Inc v Time, Inc* 571 A 2d 1140 (Del, 1989).

96 *Unitrin, Inc v American General Corp* 651 A 2d 1361 at 1387 (draconian defences are not within the range of reasonableness, a prerequisite mandated by *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 (1985); therefore, the decision to adopt them is never protected by the business judgment rule).

97 For a recent digression on *Unocal Corp v Mesa Petroleum Co* 493 A 2d 946 (1985) and the adoption of a takeover defence, see *Yucaipa American Alliance Fund II, LP v Riggio* 2010 WL 3170806 (Del Ch, 2010) (Strine VC) (contest for control of booksellers Barnes & Noble, Inc). See also *Shenker v Laurate Education, Ltd* 983 A 2d 408 at 426–427 (Maryland, 2009) (similar).

98 For further elucidation, *see* Arthur Pinto & Douglas M Branson, *Understanding Corporate Law* (LexisNexis, 3rd Ed, 2009) at pp 377–393.

99 See para 19 of this article. It is important to remember that the American Law Institute codification is not law but an authoritative law reform organisation (author of the Restatements of Law) of what the law would appear to be if it were reduced to "black letter".

100 Corporations Act 2001 (Cth) (Australia) s 180(2).

(a) made the judgment in good faith for a proper purpose; and

(b) do not have a personal interest in the subject matter of the judgment; and

(c) inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

(d) rationally believe that the judgment is in the best interests of the corporation.

81 By way of explanation, the subsection adds at the end that "[t]he director's or officer's belief that the judgment is in the best interest of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold".[101]

82 As originally conceived, or at least as conceived by the ALI, the business judgment rule substitutes three or four relatively closed inquiries as a substitute for the more open ended and somewhat subjective question: did the director or the board comport with their duties of care and diligence? Instead we ask, did they make a judgment?, were they informed about the subject matter of the judgment?, were they free of disabling conflicts of interest?, and did they have a rational basis for the decision made? One principal reason for doing so is to promote the conservation of judicial resources.

83 By going further, inserting a requirement that the court must also find the judgment to have been "for a proper purpose", it seems as though the Australian codification re-introduces an open-ended, somewhat subjective inquiry. Courts will wrestle with discerning the motivation for what directors did or approved. They may have to hold longer hearings to do that. The business judgment rule will fall short of achievement of some of its purposes.

84 On information and belief, the Australian drafters inserted the proper purpose requirement to prevent the business judgment rule's use as a shield for the importation of all manner of takeover defences, as has occurred in the US.

B. Germany

85 The Stock Corporation Act of 1965, as amended in 2009,[102] provides that:[103]

101 Corporations Act 2001 (Cth) (Australia) s 180(2).

102 Norton Rose Translation, dated 1 September 2009.

103 Stock Corporation Act of 1965 (Germany) (Norton Rose Translation, dated 1 September 2009) s 93. Section 116 makes analogous duties and responsibilities, presumably with matters in defence, to members of the supervisory board.

> In conducting business, the members of the management board … shall not be deemed to have violated [the duty to act with 'the care of a diligent and conscientious manager'] if, at the time of making the entrepreneurial decision, they had good reason to assume that they were acting on the basis of adequate information for the benefit of the company.

86 Most, or all, of the elements of the US style business judgment rule seem to be incorporated in the section, albeit perhaps cryptically so. A decision ("entrepreneurial decision") is required. The section requires adequate information but the question of how much information is enough information seems left up to the directors ("good reason to assume they were acting on the basis of adequate information"). Freedom from disabling conflicts of interest seems subsumed in the requirement that they must have been acting "for the benefit of the company". If directors were acting for their own benefit, or the benefit of family, business associates or cronies, they would not be acting for the benefit of the company. Those directors would not then be entitled to the shield the sentence provides. "[G]ood reason" seems akin to, but perhaps more demanding than, the US rational basis requirement.

C. Malaysia

87 The 2007 enactment inserts a separate statutory subsection,[104] the drafting of which seems to follow the Australian statute at the beginning but not carrying through until the end ("reasonably believes" *versus* "rationally believes" in the Australian statute). The subsection provides that:

> A director who makes a business judgment is deemed to meet the requirements of [the duty of care, skill and diligence] under subsection (1A) and the equivalent duties under common law and in equity if the director –
>
> (a) makes the business judgment in good faith for a proper purpose;
>
> (b) does not have a material personal interest in the subject matter of the business judgment;
>
> (c) is informed about the subject matter of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and
>
> (d) reasonably believes that the business judgment is in the best interest of the company.

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104 Companies (Amendment) Act 2007 (Act A1299) (Malaysia) s 7, amending Companies Act [1965] s 132.

88 The use of "reasonably" rather than "rationally" believes a decision to have been in the corporation's best interests, as the American Law Institute and Australian versions provide, makes the Malaysian business judgment rule fall short of its mark. A more complex hearing process is required for a judge to determine if a decision was "reasonable" as opposed to a hearing to determine if a "rational basis" can be advanced for the decision.

D. Nevada

89 Nevada's corporation law provides that "[d]irectors and officers, in deciding upon matters of business, are presumed to act in good faith, on an informed basis and with a view to the best interests of the corporation".[105] The codification is similar but not identical to the Delaware judicial phrasing that 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 was taken in the best interests of the company".[106] Yet all the elements are essentially the same: presumption (which can be upset); requirement for a judgment or decision ("in deciding"); good faith (which would subsume a requirement for an absence of disabling conflicts of interest); and rational basis ("in the best interest of the corporation [company]"). Of course, the law can take many twists and turns in the future, and the interpretations of the two versions diverge, but currently they seem much the same.[107]

E. South Africa

90 Companies Act, No 71 of 2008, replaces both the Companies Act of 1973 and Corporate Laws Amendment, Act No 24 of 2006. Tshediso Matona, Director General of the South African Department of Trade and Industry said of the new Act: "This is the most fundamental reform of company law for over 30 years." Annexure C to the new Act contains the South African version of a statutory business judgment rule:[108]

> [T]he director's judgement as to whether an action or decision is in the best interests of the company is reasonable (i) if the director has taken diligent steps to become informed about the subject matter of the decision and (ii) does not have a material personal financial interest in the subject matter of the decision (nor does a related person) (and it is a decision that a reasonable person in a similar

105 Nevada Revised Statutes §78.138(3) (2001).

106 *Aronson v Lewis* 473 A 2d 805 at 812 (Del, 1984).

107 The Supreme Court of Nevada parsed the Nevada statutory business judgment rule in *Shoen v SAC Holdings Corp* 137 P 3rd 1171 at 1179 (Nev, 2006).

108 Companies Act 2008 (South Africa) s 76(3)(c).

> position could hold in comparable circumstances) … and (iii) the director made a decision or supported the decision of a committee and had a rational basis for believing that the decision was in the best interests of the company.

91 What the right hand giveth the left hand taketh away. Reading backwards, under (iii), directors need only to have a rational basis but then (ii) seems to bring back in a full blown duty of care (standard of conduct): "a decision that a reasonable person in a similar position could hold in comparable circumstances". The South African pronouncement seems to roll the business judgment rule and the standard of conduct into one.

X. Conclusion

92 Strictly speaking, a statutory codification may not be necessary. There exists in the English company law cases sufficient raw material which make out a business judgment rule or business judgment doctrine. Those cases (*In re Brazilian Rubber Plantations & Estates Ltd*,[109] *Re City Equitable Fire Insurance Co Ltd*,[110] and the like) are beyond the scope of an article such as this one. This article hopefully has set out enough about the US business judgment rule, the policies behind it and how it works in practice so that academics and practitioners elsewhere can evaluate their own jurisdiction's proposed codifications and compare them to the several set forth in the preceding section of this article.

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109 [1911] 1 Ch 425.
110 [1925] Ch 407.