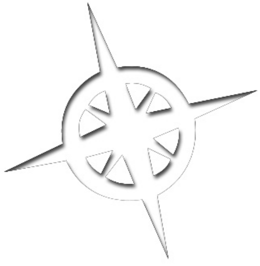

D&O MAPS

THE BUSINESS JUDGMENT RULE: CRACKS IN THE ARMOR?

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by Peter R. Taffae

"... This rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, with due care, and within the directors' or officers' authority."

Black's Law Dictionary, 7th ed., s.v. "business-judgment rule."

The last 2 years have changed the landscape of corporate America in numerous ways. Based on a recent study of 2003 securities litigation, the likelihood of a publicly traded company experiencing a lawsuit over a 5-year period is approximately 10 percent. In the last year we have seen a new ceiling in securities settlement dollars. At one time, a settlement of $200 million made us take notice. Today, that ceiling has risen to $1 billion. Currently, there are seven pending cases in which $1 billion (or more) in damages are claimed.

In addition to shareholders, federal and state regulators are also taking a more aggressive role in investigating and litigating against corporations. Since the Enron debacle, the landscape of corporate governance as well as the public's level of tolerance for management errors and questionable business conduct has shifted dramatically.

One indication of how much the pendulum has swung can be found in recent decisions of the Delaware Chancery Court, which is a key jurisdiction because more than half of the Fortune 500 is incorporated in Delaware. Historically, the Delaware courts have consistently acted in a pro-corporate fashion and reliably issue pro-management opinions concerning corporate decision making.

Over the last 20 years, corporations and their management teams have relied on the business judgment rule to shield themselves from litigation arising out of allegations that they have breached their fiduciary duties of care and loyalty to the corporation. The first part of this article discusses the origins of the business judgment rule. The second part explains how recent court decisions in Delaware are eroding the protection the rule has afforded corporate directors and officers.

Origins of the Business Judgment Rule

Two of the most often cited cases establishing and defining the business judgment rule are

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Guth v Loft, Inc., 23 Del Ch 255, 5 A2d 503, 510 (1939), and *Smith v Van Gorkom,* 488 A2d 858, 874 (1985).

Guth v Loft

Charles G. Guth had been in the candy and soft drink business for more than 30 years. In the early 1930s Guth sold his candy company, "Mavis Candies," to "Loft, Incorporated." Instead of taking cash for his company, he took shares of "Loft, Inc.," stock and became a member of the board of directors and its president. Guth, who had acquired enough voting stock to control the election of directors, quickly changed the composition of and gained control over the Loft board. Loft, Inc., owned and directly operated about 200 candy stores, and most of these had soda fountains. In 1931, these Loft candy stores had sold over 30,000 gallons of Coca-Cola, and Guth tried to convince Coca-Cola to give Loft a wholesale discount. Ultimately, Coca-Cola and Guth could not come to an agreement and Loft, Inc., moved its business to Pepsi Cola.

During the time that Loft, Inc., was negotiating with Coca-Cola, Guth set up a new corporation to acquire the secret formula and trademark of Pepsi Cola. However, this was done without the board's knowledge and Loft, Inc., was never given the opportunity to participate. A shareholder brought a suit against Guth, arguing that the shares of the new corporation should belong to Loft and not to Guth personally. The shareholder prevailed. The court ruled that Guth had usurped a corporate opportunity in violation of his duty of loyalty to the corporation.

The case established the principle that directors owe a duty to the corporation and its shareholders to act in their best interests. The decision in this Delaware court was very clear in holding that a director is required to be loyal to the corporation and must avoid any conflict between his or her duty to the corporation and the director's self-interest. Although it was decided more than 60 years ago, *Guth v Loft, Inc.,* 23 Del Ch 255, 5 A2d 503, 510 (1939), is still relevant today. It stands for the proposition that courts will only second-guess a board's business decisions when such decisions have not been made in good faith.

Smith v Van Gorkom

In 1985, *Smith v Van Gorkom,* 488 A2d 858, 874 (1985), provided the landscape for today's "modern" version of the business judgment rule. Jerome W. Van Gorkom was an officer of Trans Union for more than 24 years. He was chief executive officer for more than 17 years, as well as chairman of the board. Trans Union Corporation was a publicly traded, diversified holding company incorporated in Delaware.

In September 1980, Van Gorkom and Jay A. Pritzker (a corporate raider during the 1980s) met to discuss a possible sale of Trans Union to Pritzker. During this meeting, Van Gorkom suggested a sale of Trans Union at a price of $55 per share (which was trading at $35 at the time). This first meeting concerning the sale took place on a Saturday. Only 2 days later, on Monday, Pritzker told Van Gorkom that he was interested in the $55 cash merger proposal. During the next 2 days, they and some of their associates met to work out the details and began drafting the merger agreement. On Friday (less than 1 week after the first meeting the previous Saturday), Van Gorkom called a special meeting of the Trans Union board for the next day. At the board meeting, Van Gorkom made a 20-minute presentation concerning the merger. At this time, the merger agreement had not yet been distributed to the directors in draft because the final version still had not been finalized. It is also important to recognize that no independent opinion had been sought to evaluate the fairness of the proposed merger price. After only 2 hours of discussion, the board approved the sale of Trans Union to Pritzker at the original $55-per-share price suggested by Van Gorkom. The board also voted not to seek other proposals.

Shortly after the merger was approved by the board, Alden Smith and additional Trans Union shareholders sued Van Gorkom and the other directors. The Delaware Chancery Court held in favor of the plaintiffs, finding that the board "was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal" and that the shareholders were not fully informed of all the facts material to their vote.

This litigation illustrates the pitfalls for directors who rely on the statements of others and fail to adequately investigate relevant facts when making decisions. In effect, the court found that when a corporate board of directors was derelict in conducting a thorough, well-informed decision-making process, shareholders could challenge the efficacy of a board's decisions.

Cracks in the Business Judgment Rule

Within the past several months, the Delaware Chancery Court has broken the long-held tradition of the judiciary's reluctance to entertain shareholder claims that second-guess a corporate board's decision, provided it was made in good faith and following thorough investigation and deliberation. In the past, the courts have been reticent to hear cases that, by their own admission, they are ill-prepared to analyze and therefore place themselves in a "Monday-morning quarterbacking" position.

Accordingly, the court has agreed to hear two cases that could have a significant effect on the business judgment rule as we know it today. One involves The Walt Disney Company and the other Freeport-McMoRan Sulphur Inc. These cases could produce a dramatic shift in the application of the business judgment rule and, regardless of their outcome, the court has now announced its willingness to entertain claims from disgruntled shareholders that test the protection provided by the business judgment rule.

The *Walt Disney* Case

The Walt Disney case (*The Walt Disney Company Derivative Litigation,* 2003 WL 21267266 (Del Ch May 28, 2003)), arose out of the high-profile hiring and equally high-profile termination of Disney's former president, Michael Ovitz. In this litigation, the shareholders are alleging that the defendant directors knowingly breached their fiduciary duty of care to the corporation by approving the terms of Ovitz's employment agreement that were negotiated exclusively by Ovitz's close friend, Michael Eisner. The allegations state that Ovitz breached his duty by placing his personal monetary gains (both in hiring and termination package) over those of the company. In addition, the board allegedly breached its duty to stockholders by not being more closely involved with the negotiations regarding Ovitz's employment package, instead relying solely on Eisner's participation and report to the board. The complaint stated that both the compensation committee and the board failed to review any drafts of the employment agreement, spent very little time considering the agreement at its respective meetings, and neglected to obtain expert advice concerning the reasonableness of the generous terms granted to Ovitz.

In *Disney,* the court refused to grant a motion to dismiss the shareholders' complaint. The board's allegedly willfully neglectful nature was key to the court's decision to deny the motion to dismiss in its holding that the business judgment rule might have applied if "... the board had taken the time or effort to review [its] options, perhaps with the assistance of expert legal advisors...."

The *Freeport-McMoRan Sulphur* Case

On June 18, 2003, the Delaware court also refused to allow the business judgment rule shield in connection with a pleading to uphold a merger that was negotiated in1998 involving Freeport-McMoRan Sulphur Inc. (FMS) and McMoRan Oil & Gas Co. (MOXY) into a holding company called McMoRan Exploration Company (MEC). The merger was a reunion of two companies that were once divested from Freeport-McMoRan Inc. A number of the directors who negotiated the merger sat on the boards of both FMS and MOXY and were thus clearly conflicted. Only two "independent" directors of FMS made up the special committee that negotiated the merger with MOXY and reported its recommendations to the full board. (It should be mentioned that the committee did retain outside legal counsel and investment bankers to assist in the negotiations.) The issues in this litigation are numerous but include the following.

- Are two directors enough to adequately fulfill the duty of loyalty to the corporation and its shareholders?

- Can a committee of two "independent" directors give board members protection under the business judgment rule?

- Can a board comprised of a majority of "conflicted" directors fulfill its duties to the corporation?

Concluding Thoughts

Based on this brief outline of the circumstances in the *Disney* and *Freeport-McMoRan* litigation, the alleged circumstances seem to mirror *Van Gorkom* and *Loft.* The outcome of these two pending cases has many of us concerned and watching closely. The *Disney* case does more than introduce compensation packages into the business judgment rule environment. It might also indicate that all major corporate compensation packages must be reviewed not only by the compensation committee but also by outside experts as well as the entire board of directors.

In effect, the Delaware court is redefining what is required to obtain protection under the business judgment rule shield. The outcomes of these cases could provide a warning to corporate America that directors and officers might have less protection than was once believed. It will be interesting to observe if courts in other states follow Delaware's lead.

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