The Business Judgment Rule: What You Thought You Knew

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By Paula J. Dalley

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I. Introduction

Most lawyers, even those who have never had anything to do with corporate law, probably know about the “business judgment rule.” But most lawyers, even those who have been practicing corporate law for decades, would have a hard time stating the business judgment rule in the form of a rule. Instead, most would likely describe the rule as something like “courts won’t interfere with a board’s business judgment” or “a court won’t second-guess a board’s decision.” These statements, while generally true, are not statements of the rule but rather are either statements of the result of the application of the rule or statements of the policy basis for the rule. Once one begins to inquire into the rule itself and how it works, lawyers’ apparent universal knowledge rapidly disappears.

II. The Business Judgment Rule

There are two general ways in which the business judgment rule can be stated. The first is the standard statement of the rule in Delaware: “It 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.” Under this formulation of the rule, a business decision that meets certain prerequisites described below will not be open to challenge on the basis of a lack of due care. As explained below, the rule imposes an almost impossible burden on the plaintiff, unless the plaintiff can establish that the rule does not apply.

The second formulation of the business judgment rule is that adopted by the American Law Institute (ALI) in its Principles of Corporate Governance. The Principles begin with the proposition that a director or officer has a duty to the corporation to act “in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.”

This is the duty of care. The Principles go on to state, however, that “A director or officer who makes a business judgment in good faith fulfills the duty [of care] if the director or officer: (1) is not interested in the subject of the business judgment; (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.” In other words, if the conditions for application of the rule are satisfied, there is no longer any possible claim that the directors breached their duty of care. The Principles go on to state that the person challenging the decision has the burden of showing that the officer or director failed to satisfy the stated requirements.

Both the Delaware and the ALI formulations of the business judgment rule establish certain prerequisites to the rule’s application. First, the rule only protects directors who are “disinterested”—that is, they must not be a party to the transaction or expect to derive a personal financial benefit from it. Second, the rule only protects informed decisions—the directors have a duty to consider “all material information reasonably available to them.” Third, the rule does not protect directors who have “either abdicated their functions, or, absent a conscious decision, failed to act.”
failed to act in good faith. Finally, some cases suggest that the rule will not protect directors who have knowingly engaged in illegal conduct.

In sum, then, the business judgment rule requires a plaintiff seeking to challenge a board’s action to make a preliminary showing that: (1) a majority or substantial portion of the board was interested in the transaction; (2) the board acted without reasonable information; (3) the board failed to act at all or failed to act in good faith; or (4) the board knowingly engaged in or authorized illegal conduct.

There are a number of ways of thinking about the business judgment rule that help explain its function. For instance, the business judgment rule is often said to allow judicial review of the process of a board’s decision, but not the substance of what was decided. This is generally accurate, although even process review is minimal under the business judgment rule, because the burden is on the plaintiff to show that the board failed to act with due care in an informed manner, and the standard is said to be gross negligence. Additionally, the rule can be seen as establishing a standard of review for directors’ actions that is different from the applicable standard of conduct. Thus, while a board is obligated to act with due care in the manner that a reasonably prudent person in the same or similar circumstances would act, a court will not review the board’s actions under that standard. Instead, unless a plaintiff can show that the process of the decision was grossly negligent, a court will review the decision only for waste.

The business judgment rule is clearly a creature of policy, and the number of policy considerations that support the rule are impressive. First, the rule is based on an awareness of the limitations of courts, particularly courts sitting with juries, to identify a valid business decision. Not only do judges and juries not have the business experience of a board, they lack the awareness of the broad range of complex factors going into every business decision. In addition, “hindsight bias” suggests that courts are much more likely to find a decision to have been ill-advised when they know that it turned out badly. Second, it is in the general interest of shareholders and the economy to encourage boards to take business risks. If directors know that their decisions will be scrutinized after the fact, they will be less likely to serve as directors at all, and those that do serve will be overly cautious in their decision-making. Third, directors are chosen by the shareholders to make decisions on behalf of the company. By statute, it is the board and no one else who is empowered to manage the business. Permitting shareholders, through the mechanism of the derivative suit, to challenge board decisions would violate this basic premise of corporate law and permit a small number of shareholders to expend valuable corporate (and judicial) resources challenging decisions authorized by statute.

III. Why Do We Care About the Business Judgment Rule?

The application of the business judgment rule is the most important question in any litigation against a corporate board, because its answer will often determine who will ultimately prevail.

A. Result When the Rule Applies

If the business judgment rule applies, the board will not be liable unless the plaintiff can show waste. Waste “entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.” Because it is almost impossible for a plaintiff to meet this standard, the business judgment rule is often considered to be a “no liability” rule. However, there have occasionally been cases where the challenged decision was so irrational that the board was found to be liable (that is, to have breached its duty) despite the application of the business judgment rule. Thus, it is more accurate to say that the business judgment rule raises the standard for liability to an extremely high level.

B. Result When the Rule Does Not Apply

As discussed above, the business judgment rule will not apply if the plaintiff can show that one of its prerequisites has not been met. Most often, the plaintiff succeeds in showing that a majority or substantial portion of the board was interested in the transaction. Such a transaction would necessarily involve a breach of the duty of loyalty (by virtue of the directors’ interest), and the rules relating to the duty of loyalty would apply. Unless the directors can show ratification with full disclosure, the transaction will be judged by the “entire fairness” standard. The more interesting question is,

8. While it is clear that the business judgment rule does not protect directors who fail to act in good faith, it is not entirely clear why. Good faith is not, in Delaware, generally odd to be a prerequisite to application of the business judgment rule. And, as noted below, if the business judgment rule applies, the transaction is generally said to be subject only to attack on waste. However, courts have also stated that lack of good faith (or the implied right to, with form, a reason to hold a board’s liable even if the business judgment rule applies. See generally Lynn Johnson, The Modern Business Judgment Rule, 55 Bus. Law. 625, 634-29 (2000).


11. See, e.g., Del. Code Ann. tit. 8 § 144(a) (1991) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”).


13. At 334.

14. See Johnson v. Manganese Corp., 433 A.2d 595, 598 (Del. Ch. 1981) (noting that defendants’ actions “sufficiently explained” and that the defendants had not offered any explanation for continuing to operate a plant or any plant they knew would cease to be profitable).

15. The burden of proof on fairness generally rests on the party charged with violating the duty of loyalty (the directors), but in some cases both parties will shift to the plaintiff to prove that the transaction was unfair. See Kluh v. Lynch Commn. Sys., (Continued on next page)
what happens when the plaintiff succeeds in showing that the board acted without sufficient information, or failed to act in good faith? The business judgment rule will not apply, but then what?

If the business judgment rule did not exist, officers and directors would be held to the usual fiduciary standard of due care: a reasonably or ordinarily prudent person in similar circumstances. Presumably, then, if the business judgment rule does not protect a transaction, that basic standard of care should apply. Because there have been so few cases in which the business judgment rule did not apply but which did not involve a conflict of interest, however, the law here is a bit murky. It is worth considering the leading (and only) cases in this area.

In Smith v. Van Gorkom, the directors were found liable for failing to become adequately informed in connection with a proposed merger between Trans Union and an entity controlled by Jay Pritzker. The Delaware Supreme Court rejected the trial court’s application of the business judgment rule and held that the board had violated its fiduciary duties (of care) by failing to act in an informed manner and by failing to make complete disclosure in seeking a shareholder vote on the merger. The question of the application of the business judgment rule and the ultimate liability of the board for breach of fiduciary duty were related but were clearly separate: the business judgment rule did not apply because the board failed to satisfy the necessary prerequisite of becoming informed. In addition, the board was so grossly negligent in failing to become informed (according to the court) that it breached its fiduciary duties. Thus, the court applied a gross negligence standard to the board’s conduct, and held the board liable for the difference between the fair value of the shares and the merger price. 18

Following Van Gorkom, the Delaware legislature added section 102(b)(7) to the General Corporation Law, which permits a corporation, in its certificate of incorporation, to eliminate directors’ liability for money damages for breaches of the duty of care. Such “excusable clauses” are not applicable to “acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.” 19 This statute effectively insulates directors from claims such as those in Van Gorkom, if the corporation has an excusable proviso in its charter. Shareholders in such corporations thereafter had to allege duty of loyalty violations or lack of good faith in order to avoid the effect of the excusable clause. 20

In 1993 the Delaware Supreme Court decided Cede & Co. v. Technicolor, Inc., 21 commonly known as Cede II. This case was but one chapter in a long story that finally concluded in May, 2005. 22 The court in Cede II was reviewing a decision by the Court of Chancery that implicitly held that the Technicolor board violated its duty of care in approving the takeover of the company by an entity controlled by Ronald Perelman, and expressly held that two Technicolor directors had conflicts of interest. The Delaware Supreme Court agreed that the conflicts of interest did not adversely affect the entire board, so the “independence” prerequisite of the business judgment rule was satisfied, and there was no duty of loyalty violation. Nevertheless, because of the board’s failure to exercise due care (as found by the Chancellor), the business judgment rule did not apply. The Delaware Supreme Court then went on to state that therefore the transaction would be judged by the entire fairness standard. This ruling is quite surprising. The entire fairness standard is generally applied to transactions involving self-dealing; this is the only case to apply the entire fairness standard to a transaction approved by an independent board. In fact, the entire fairness standard originates in the general duty of loyalty from agency law: An agent with a conflict of interest can in some cases defend against a breach of fiduciary duty claim by her principal by showing that the transaction was fair to the principal. An agent accused of acting carelessly, on the other hand, must only show that she acted with due care.

Why did the court in Cede II apply the entire fairness test? It claimed to be following Van Gorkom, but that court had never stated that it was applying the entire fairness standard. It is therefore not clear if the court intended to make new law by holding that the entire fairness standard would apply to every transaction not protected by the business judgment rule, or if the application of the entire fairness standard was simply an error. 23 On the other hand, if the standard, when the business judgment rule does not apply, is merely “due care,” the decision (as in Van Gorkom and as the Court of Chancery in Cede II ruled) that the board had failed to act with due care would both defeat the business judgment rule and result in liability, a result the Delaware Supreme Court could not accept. The court in Cede II very explicitly stated that the application of the business judgment rule is a decision relating to the standard of review, not a determination of

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18. The case settled before the damages were calculated on remand.
20. Id.
22. 635 A.2d 345 (Del. 1993).
24. The events in the Technicolor cases took place in 1982, before section 102(b)(7) was added to the Delaware statute and thus before any excusable proviso could have existed.
Thus, *Cede II* clarified when the business judgment rule will not apply—when the plaintiff can show either that the board is not independent or that it failed to act in an informed manner with due care. However, the *Cede II* court opened a new issue in the law of directors’ liability by suggesting that all transactions would be judged by the entire fairness standard if the business judgment rule did not apply.

**C. Relevance for Demand Futility in Derivative Suits**

The business judgment rule is important not only because it protects the substance of a board’s decision from judicial review, but because it is a feature of the test for futility in the context of the demand requirement in derivative suits. In a shareholder derivative suit, rules of procedure (and public policy) usually require that the plaintiff first make demand upon the board that the board bring the litigation on behalf of the corporation. If demand would be futile, however, it is “excused” and the plaintiff may proceed with the derivative litigation. The test for demand futility in Delaware is whether the directors are “under an influence which sterilizes their discretion” and therefore “cannot be considered proper persons to conduct litigation on behalf of the corporation.” Directors are under such an influence when there is a likelihood that they will be liable in the litigation in question. Thus, to show that demand would be futile in Delaware, a plaintiff must allege particularized facts that create a reasonable doubt that: (1) the directors are disinterested and independent; or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.

Thus, the very first step for a plaintiff in derivative litigation is to allege sufficient facts to show that the business judgment rule will not apply to the transaction. Otherwise, the litigation will be dismissed for failure to make demand on the board.

**IV. The Good Faith Requirement**

Meanwhile, the Delaware courts have been elaborating upon the so-called duty of good faith. In *Parnes v. Bally Entertainment Corp.*, the Delaware Supreme Court ruled that the plaintiff had adequately overcome the presumption of the business judgment rule where the board permitted the Chairman and Chief Executive Officer (CEO) of Bally to negotiate a merger involving payments to himself and an unfair price for the shareholders. The court adopted the Court of Chancery’s finding that the payments were “so egregious that Board approval could not meet the test of business judgment.” The merger process was so tainted that it was “inexplicable that independent directors, acting in good faith, could approve the deal,” and the plaintiff was permitted to go forward with her claim that the merger “lacked a rational basis.” In *Crescent/Mach 1 Partners, L.P. v. Turner*, the Court of Chancery applied *Parnes* in a similar case and held that the board, by acquiescing in the CEO’s self-interested “side-deals,” was stripped of the protection of the business judgment rule. In both cases, the majority of the board was found to be independent. Nevertheless, the court allowed the plaintiff to proceed with a claim for breach of the duty of loyalty based on the board’s failure to act in good faith in the interests of the shareholders. Thus, “had faith” was treated as a species of breach of the duty of loyalty, and a showing of bad faith (like a showing of lack of independence) was sufficient to rebut the presumption of the business judgment rule. Neither case elaborated on the standard that would apply to the board’s decision as the cases went forward.

More recently, in *In re Walt Disney Co. Derivative Litigation*, the lack of good faith was used to rebut not the presumptions of the business judgment rule but the application of an exculpatory clause under section 102(b)(7). The Court of Chancery found that the board was independent, and the plaintiff’s claims were clearly based on the duty of care, not the duty of loyalty. Nevertheless, the court held that the plaintiff had alleged sufficient facts to raise a “reason to doubt whether the board’s actions were taken honestly and in good faith,” as required for the application of the business judgment rule, and therefore the directors were not entitled to the protection of the exculpatory clause in Disney’s charter. The plaintiff alleged that the compensation committee of the Disney board, and the board itself, had failed to adequately consider the employment, compensation, and termination of Michael Ovitz as President of Disney in 1995–1996. According to the complaint, the board and committee had considered Ovitz’s employment and compensation only briefly and had failed to act in his termination at all. This case, like *Van Gorkom*, created considerable consternation in that it was the first case to permit a claim of bad faith (or lack of good faith) to go forward against a board that appeared to be acting in what it thought was the best interests of the company, and in a non-merger context. The trial in that case recently concluded, and the Chancellor ruled in favor of the Board. Nonetheless, *Disney* may represent a
change in the amount of deference the Delaware courts are willing to show boards following the corporate scandals of the last several years. Significantly, the court in Disney allowed the plaintiff to challenge the board's decision-making process and thereby avoid not only the exculpatory provision of Disney's charter but also the business judgment rule.

V. Recent Developments in the Concept of Independence

As noted above, one of the prerequisites for the application of the business judgment rule is an independent board. The presence of one director with a conflict of interest, without more, is not sufficient to destroy the presumption of independence. However, if a majority of the other directors are dominated by the interested director, the board as a whole may lack independence. The question is one of fact, and it is often hotly disputed. Generally, however, the Delaware courts have not been receptive to arguments that social or general business connections with an interested director destroy the independence of the remaining directors. Two recent Court of Chancery decisions involving the independence of special litigation committees indicate that this view may be changing.

In Biondi v. Scrushy, one of the first cases to come out of the scandals surrounding HealthSouth Corporation, the company's special litigation committee moved to dismiss a derivative suit alleging that executives sold shares of stock while they were in possession of material non-public information and thereby injured the company. The committee was initially made up of two directors who had close ties to Scrushy (the CEO and focus of most of the allegations of wrongdoing) through charitable organizations. One of the directors (Hanson) was the Chairman of the National Football Foundation and College Hall of Fame, Inc., and the other (Striplin) was on its board, as was Scrushy. HealthSouth had been an important donor to the NFHCF while Hanson was its chair. Striplin and Scrushy had longstanding personal ties to each other and to college football in Alabama, where one college has a Scrushy-Striplin field.

Meanwhile, HealthSouth's new CEO, while the special litigation committee was supposedly conducting its independent investigation, stated publicly that Scrushy and the directors were not in possession of material information at the time alleged. Thus, the CEO stated the answer to the question the litigation committee was only beginning to investigate. Striplin then resigned from the committee after questions were raised about his independence in light of a large contract his glass company had recently received from HealthSouth. Striplin announced his strong support for Scrushy when he resigned from the litigation committee. A new director, Robert May, was appointed to the board and the litigation committee. Before the committee could proceed, however, the company itself announced, based on an investigation conducted by a law firm hired by the full board, not the committee, that Scrushy had been cleared of wrongdoing.

The Court of Chancery refused to stay the litigation pending completion of the special litigation committee's investigation. According to Vice-Chancellor Strine, "it would be futile and wasteful to issue a stay when the undisputed facts will make it impossible for the court later to accept a decision of the special litigation committee to terminate the derivative litigation because the committee will not be able to satisfy its burden...to show that it exercised an independent business judgment." In other words, there was no way the committee would ever be able to show it had made an independent business judgment in view of the committee members' relationships with the insiders who had allegedly engaged in wrongdoing and their premature statements of support for those insiders.

A few months later, the same court rejected the recommendation of a special litigation committee in In re Oracle Corporation Derivative Litigation. In that case, there was no question that the committee had diligently conducted its investigation in good faith. Nevertheless, the court held that the committee failed to satisfy the test for independence in the derivative litigation context, which asks "whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind." The two members of the Oracle special litigation committee were both professors at Stanford University. The defendants in the litigation included another Stanford professor with professional ties to one of the committee members, a Stanford alumnus who had directed millions of dollars in contributions to Stanford and served on a Stanford advisory board with one of the committee members, and Larry Ellison, the CEO, who had donated millions of dollars to Stanford and was, at one time, reportedly considering donating up to $270 million more. Vice-Chancellor Strine wrote:

It is no easy task to decide whether to accuse a fellow director of insider trading. For Oracle to compound that difficulty by requiring [committee] members to consider accusing a fellow professor and two large benefactors of their university of conduct that is rightly considered a violation of criminal law was unnecessary and inconsistent with the
concept of independence recognized by our law. The possibility that these extraneous considerations biased the inquiry...is too substantial for this court to ignore.48

The Oracle court spent considerable time discussing the connections between the defendants and the committee members and the effect those connections were likely to have, "[h]uman nature being what it is."49 The committee was charged with deciding whether to accuse fellow directors of serious wrongdoing and potentially exposing the directors to large damage awards and great reputational harm. This burden would fall, moreover, not on the entire board but on only two directors. The court concluded that it was impossible to find that the special committee was independent because "material considerations other than the best interests of Oracle could have influenced the [committee's] inquiry and judgments."50 This was not because the court believed the committee members would have favored the defendants, but because the court believed that their connections with the defendants "would be on the mind[s]" of the committee members as they conducted their investigation.51

In both Biondi and Oracle, the question under consideration was the independence of a special litigation committee. It is not necessarily the case that similar rulings would be made with respect to the independence of one or more board members in determining whether a board should be excused or in evaluating a business transaction. In fact, the Delaware Supreme Court has indicated that it considers that question to be still open.52 Nevertheless, Biondi and Oracle are unusual both for their willingness to consider non-pecuniary bases for finding a lack of independence and for their discussions of the subtle but pervasive effects that social and professional relationships can have on the decision-making process. Whether similar considerations are applied to the determination of independence in connection with whether a decision should be protected by the business judgment rule is now an important question in Delaware law.

48. Id. at 921.

49. Id. at 943. See also id. at 938 ("Delaware law should not be based on a reductionist view of human nature that simplistic human motivations on the lines of the most sophisticated notions of the law and economics movement.").

50. Id. at 947.

51. Id. at 943.

52. See, e.g., Marvin Schooler, Living Debtorhood, Inc. v. Schooler, 852 A.2d 1040, 1055 (2004) (The court also noted that the Oracle decision might eventually come before it on appeal). Id. at 1055 n. 44.

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Third Circuit Orders Arbitration of Chapter 13 Borrower’s Claims Against Lender

By Hank Reichner*

The issue of a lender’s right to arbitration against a consumer debtor in bankruptcy was addressed head-on by the U.S. Court of Appeals for the Third Circuit on January 10, 2006, in Mintze v. American General Financial Services Inc (In re Mintze).1 The Third Circuit held that a bankruptcy court does not have the discretion to deny enforcement of an otherwise valid arbitration clause in a consumer loan simply because the bankruptcy court might be exercising core jurisdiction. The decision will have broad implications for all disputes subject to an arbitration clause where one party to the contract is in bankruptcy.

In this case, Ethel Mintze and American General Consumer discount Company entered into a loan agreement. The agreement contained an arbitration clause. Mintze subsequently filed a voluntary Chapter 13 bankruptcy petition in the U.S. Bankruptcy Court for the Eastern District of Pennsylvania. After American General filed a proof of claim, Mintze filed a complaint in the bankruptcy court seeking, inter alia, to enforce a purported prepetition recission of the loan and asserting federal and consumer protection law claims. American General then filed a motion to compel arbitration, which the bankruptcy court denied and the U.S. District Court for the Eastern District of Pennsylvania affirmed.

The decision involves the interplay of the Federal Arbitration Act with the Bankruptcy Code. In refusing to compel arbitration, the bankruptcy court determined that the proceeding before it was a core proceeding and that it therefore had discretion to deny enforcement of the arbitration clause. The bankruptcy court then decided that the matter was best resolved in the bankruptcy court because the outcome of the rescission claim would affect the debtor's bankruptcy plan and the distribution of funds to her other creditors.

Bankruptcy proceedings are divided into two categories: core and non-core. The distinction between the two categories is relevant because the type of proceedings may determine the ultimate authority of the bankruptcy court. In a core proceeding, a bankruptcy court has comprehensive power to hear, decide, and enter final orders and judgments. In contrast, in a non-core proceeding, the bankruptcy court is allowed only to propose findings of fact and conclusions of law which are then submitted to the district court for approval.

On appeal, American General argued that a determination that a proceeding is core does not automatically give the bankruptcy court discretion to deny arbitration. Up until now, the leading case on the issue of arbitration in bankruptcy was the Third Circuit’s decision in Hays & Co. v. Merrill Lynch Pierce, Fenner & Smith, Inc.2 In Hays, the Third Circuit held, in the context of a non-core proceeding, that a bankruptcy court does not have discretion to deny enforcement of arbitration of a debtor-derivative core-petition contract claim.

(Continued on page 63)

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48. 454 F.3d 227 (3d Cir. 2006).

2. 885 F.2d 1140, 1156 (1989).

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