RECENT DEVELOPMENTS RELATING TO THE BUSINESS JUDGMENT RULE

BY MEREDITH M. BROWN *

I would like to begin with a little introduction of this segment of the program, which is a discussion of the business judgment rule in the context of tender offers. The term, "tender offer", as you all know, is one of the law's great misnomers. There is nothing tender about tender offers.

The basic question with respect to the application of the business judgment rule in tender offer cases is whether the rule ought to apply at all. What should the test be? Is this an area where the directors have such an interest in the transaction, namely, their own positions as directors, that the business judgment rule ought not be applicable? If so, what should the test be?

I will start with a discussion of some of the differing tests one finds coexisting in the case law, and then will suggest some attempts to provide guidance for the practioner under the different tests. I think the different tests probably vary more in their formulation than in the outcome of the cases. Then I think we can get a panel discussion launched on the question of where the law ought to be, which depends to a large extent on what you think the social utility or lack thereof is of the tender offer.

There have been several different tests announced in the case law, as well as a recent shift in the direction of application of the business judgment rule, in these situations. Background reading can be found not only in Dan Fischel's and Frank Easterbrook's article,[1] but also in Marty Lipton's article on takeover bids.[2] I think there will be the beginnings of a heated interchange of footnotes, if not text, between Dan [Fischel] and Marty Lipton on the application of the law and what the law ought to be.

One of the tests which is not a business judgment test, but which has been set forth in the cases, particularly in Delaware, is the sole

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1. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

2. Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Lipton, *Takeover Bids in the Target's Boardroom: An Update After One Year*, 36 BUS. LAW. 1017 (1981).

or primary purpose test. One sees it particularly in the context of cases involving the repurchase of stock from a dissident. The case law suggests that its proper to do that and also to issue stock, which has an effect on control, unless the sole or primary purpose is to entrench management.

One thinks of the *Cheff v. Mathes*[3] case in 1964 and the *Kaplan v. Goldsamt*[4] case in 1977. The problem with it is that the test is hard to use as a guide to planning. The cases say it is all right if there is an incidental purpose which happens to be the entrenchment of management, but it is not all right if the entrenchment purpose is the sole or primary purpose. It gets back to "The Shadow" (so many in the audience are too young to remember that) and the question about who knows what evil lurks in the hearts of men. But it is that kind of test.

At the other end of the spectrum there have been cases which suggest that, in the context of the takeover bid, if management is going to do something which has the effect of entrenching the management of the target company, then management has the burden of showing a compelling reason for the action that it is taking.

One sees this particularly out on the west coast in Ninth Circuit cases. One case that comes to mind is *Klaus v. Hi-Shear Corp.*[5] A district court case, *Royal Industries v. Monogram Industries, Inc.*,[6] is much to the same effect.

Even in Delaware, I think you can find some cases which put the burden on the management of the target company to justify their actions, and I would direct your attention to *Crane Co. v. Harsco Corp.*,[7] which is a 1981 federal district court case. In that case, the target company management bought stock in the target company which was held by arbitrageurs and which otherwise would have gone to Crane Company, the reputed bad boy. The court said in passing that management had not sustained its burden of showing that the purchase was primarily in the interest of the corporation.

I would like to ask Bob [Payson] or Norm, [Veasey], as eminent Delaware counsel, whether the *Crane Company*[8] case can be reconciled with the *Cheff v. Mathes*[9] and *Kaplan v. Goldsamt*[10] cases,

3. 41 Del. Ch. 494, 199 A.2d 548 (1964).
4. 380 A.2d 556 (Del. Ch. 1977).
5. 528 F.2d 225 (9th Cir. 1975).
6. FED. SEC. L. REP. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976).
7. 509 F. Supp. 115 (D.C. Del. 1981).
8. *Id.*
9. 41 Del. Ch. 494, 199 A.2d 548 (1964).
10. 380 A.2d 556 (Del. Ch. 1977).

or whether we have a change in direction of the Delaware law on repurchases by a corporation of its own stock.

Another test which has been set forth in many cases in the context of defending against takeover bids is that, if the directors conclude that a particular takeover bid is detrimental to the corporation and its shareholders, there is a duty to resist such an offer. This dates back to *Northwest Industries v. Goodrich*[11] in the Northern District of Illinois in 1969, and then *Berman v. Gerber Products*,[12] where Gerber successfully withstood the advances of Anderson Clayton, and the court used the same sort of language. I think the Bar did not put an enormous amount of trust in *Berman v. Gerber Products* as a precedent simply because Judge Fox was regarded as favoring the home team to a certain extent.

In the last few months there has been a strong shift—not in the district court level, but up at the circuit court level—for the first time in considering these kinds of cases and saying that they should be measured by application of the business judgment rule. One such case in the Second Circuit is *Treadway Companies v. Care Corp.*,[13] where the target company found itself with a thirty-one percent stockholder who was talking about a proxy contest. The target company issued a large amount of stock to an alternate suitor, with a view ultimately that there would be a merger, but I do not believe a merger agreement had been worked out at the time.

The lower court barred the voting of this newly issued stock, saying that it had been issued for the sole or primary purpose of retaining control. The court, in other words, was using that line of Delaware cases concerned with sole or primary purpose.

The Second Circuit stated that that was the wrong test, that the issuance was done in the good faith exercise of business judgment. The court found significant the fact that the target company was moving in the direction of a merger with the alternate suitor. To the Second Circuit, this fact showed that the business judgment rule was the right test, and that the plaintiff, the alternate suitor, had the burden of showing a lack of good faith so as to render the business judgment rule inapplicable.

In the Third Circuit, *Johnson v. Trueblood*[14] has Chief Judge Seitz, the former Delaware Chancellor, coming out much the same way in the context of a fight for control and saying that the plaintiff

11. 301 F. Supp. 706 (N.D. Ill. 1969).
12. 454 F. Supp. 1310 (W.D. Mich. 1978).
13. 638 F.2d 357 (2d Cir. 1980).
14. 629 F.2d 287 (3d Cir. 1980).

must make a showing from which a fact-finder might infer that an impermissible motive predominated in the making of the decision in question.

The strongest case in this trend is the Seventh Circuit's decision on April 2 in *Panter v. Marshall Field & Co.*,[15] in which Marshall Field was the target company. It had rebuffed the advances of several suitors, but the particular suitor which led to this action was Carter Hawley Hale, another retailer. In response to the overtures of this bidder, Marshall Field brought antitrust litigation, bought stores which happened to be located in the same towns that Carter Hawley Hale's stores were located in, and used that as an argument in its antitrust litigation against the bidder. Eventually the bidder went away and the stock dropped and the shareholders sued.

The district court directed a verdict for the defendants.[16] The court applied the business judgment rule and found that there had been adequate care and study of all of the measures that were taken. The Seventh Circuit affirmed.[17] The plaintiff argued that the burden should be on the directors to establish the compelling business reason for transactions which would have the effect of retaining the directors' control, citing, I am sure, the Ninth Circuit line of cases. The Seventh Circuit said: "In light of the overwhelming weight of authority to the contrary,"—which may be somewhat of an overcharacterization of the case law—"we refuse to apply such a novel rule to this case." [18]

There is a footnote that goes even further and says it is not enough to show a motive to retain control. That, by itself, does not show bad faith. "We do not believe an evaluation of the fairness or wisdom of the Board's conduct is called for as long as it can be attributed to any rational business purpose," stated the Seventh Circuit.[19]

I think that is going perhaps even further than I would care to go. But, as I said at the outset, I think that the different formulations are farther apart than the results. Let me try, not to come up with a clear bright line test, because there is no such thing, but to suggest some guidelines to the puzzles practitioners face based on variables in traditional business judgment rule analysis: the nature of the board's study, the extent of the perceived likely benefits and detriments to the corporation, and the extent of the conflict of interest.

15. 646 F.2d 271 (7th Cir. 1981).
16. 486 F. Supp. 1168 (N.D. Ill. 1980).
17. 646 F.2d 271 (7th Cir. 1981).
18. *Id.* at 295.
19. *Id.*

Let me try to pull some of these apparently conflicting cases together. First, on the nature of the board's study, as Bob has discussed in the context of the termination of a derivative action, careful study is essential. Has the board as a whole focused on the particular defensive measure? What kind of study has it undertaken? What kind of outside advice has it received? Has it reviewed the target company's own prospects? There may be a different duty if you know your company is going to hell in a hurry than there would be if you think you have a bright future.

Have outside investment bankers who are familiar with the corporation given their opinion as to the adequacy of the transaction? Are the outside directors involved? If one sticks to the traditional Delaware cases involving repurchase of shares, one thinks at the other end of the spectrum of *Bennett v. Propp*,[20] where the president, without consulting the board, rushed out and bought a bunch of stock in the market and afterward came to the board with a fait accompli. The court found that was improper.

Second, in analyzing the likely benefits and detriments to the target corporation, the first question is whether the particular measure under discussion will harm the target company. I mentioned the cases which say that if you determine the offer is harmful you are justified in taking steps to oppose it, but I do not believe that this means one is totally unrestricted in the steps taken to oppose the offer. The steps have to be in some way reasonable, and I do not think that the ends justify the means, despite some of the dicta in the case law.

I would draw your attention to the *Royal* case,[21] where the defense of acquisition was made to create an antitrust problem, and the defensive acquisition, which was of the No. 2 Portable Toilet Company—I think the target company was the No. 1 Portable Toilet Company—was done without any study—a company without negative book value and with no earnings. That was struck down.

As to whether there is harm or not, you sometimes see curious reactions from the courts. In the recent defense by St. Joe's against Seagram's tender offer, the St. Joe board tried to get a better offer, and ultimately was successful in getting a significantly better offer than the $45 a share offered by Seagram. St. Joe's directors adopted, on March 24th a program which included looking for alternate suitors at a better price and a self-tender offer and, if all else failed, liquidation, if that was the means calculated to get a better price.

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20. 41 Del. Ch. 14, 187 A.2d 405 (1962).

21. 372 A.2d 171 (Del. 1977).

Judge Pollack in the Southern District of New York granted a temporary restraining order against implementation of the liquidation and self-tender offer aspects of the program.[22] The liquidation struck him as horrible. He thought that it involved—and I believe these are almost his words—destroying the charter of this fine old company and how could directors say they had been brought into office in order to preside over—it is almost like Winston Churchill—the liquidation of the British Empire.

He did not focus on the fact that the only purpose for this liquidation alternative, which would only have been pursued with shareholder approval, would have been to try to get a price significantly better—the estimates that St. Joe had before it were in excess of $60 a share, over $15 per share more than the Seagram offer price—for the shareholders, who were the owners of the business.

Another aspect of likely benefits and detriments is how bad the particular bidder or the bid is. The cases indicate that it is entirely proper to consider whether the bid itself is in violation of the antitrust laws. It may be significant if you also have a bidder who is going to harm the enterprise. I would suggest there may be a distinction if the bidder is going for all the shares or just some of them. If he is going for less than all of the shares, it is even more important to consider who the bidder is, the extent of his financing, the nature of his business activity, and the way in which it may or may not be compatible with the target company's business.

With respect to self-interest, the third variable in my analysis, several factors should be considered. One is whether the board is trying to get the best price for the target company as a whole. That was very important in the Second Circuit's decision in *Treadway v. Care*.[23] The court did not find a conflict of interest because the board was looking for the sale of the company at the best possible price. Under those circumstances, said the court, it cannot be said that the board was seeking to entrench itself.

On the other hand, the *Panter* case[24] goes beyond the *Treadway* situation. In *Panter*, Marshall Field's board was not looking for the best price for the company. It was looking to remain independent, because that was in the best interest of the company and the shareholders.

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22. Joseph E. Seagram & Sons, Inc. v. St. Joe Minerals Corp., No. 81-1419 (S.D.N.Y. March 25, 1981).

23. 638 F.2d 357 (2d Cir. 1980).

24. 646 F.2d 271 (7th Cir. 1981).

I suggest in such a case it is necessary to establish, at the very least, careful case-by-case review of each transaction which presents itself. It is not enough to say, "we're independent" no matter how much is being offered by whomever comes along.

Another factor to be considered on the question of conflict of interest is whether the defensive act in question, which has an effect on management, was planned before the bidder appeared on the scene.

If, before the bidder appears on the scene, the target company had been planning to make an acquisition, for example, which would pump out additional shares, the court will be much less likely to interfere with such an issuance than if, in response to the arrival of the bidder, the target undertakes all sorts of acquisitions which involve issuance of shares.

The Second Circuit had before it, just this past year, such a case in *Crouse-Hinds v. InterNorth*,[25] again upholding under the business judgment rule the issuance of shares in an acquisition which had been planned before the bidder appeared. The court was saying in essence that the target company need not paralyze itself and stop everything it otherwise thought was good for the business once the bidder appears.

Another factor pertinent to the conflict of interest question is the extent of the board's self-interest in the particular transaction. It is a kind of 'smell' test. The employment contracts, for instance, were one such thing in *Royal*[26] that clearly colored the court's thinking, and also colored Judge Pollack's thinking in *Seagram v. St. Joe*[27] in much the same way and with much the same olfactory imagery. Judge Pollack said that, considering the fact that St. Joe's directors had authorized various termination arrangements after Seagram appeared, "it gives an aroma to the whole thing which is a little different than giving business judgment."[28] It appears obvious that this fact colored the thinking of the judge to some extent.

Another aspect of the extent of conflict of interest, which is a basic factor in any business judgment case, is whether the particular transaction has been reviewed by the whole board, including outside directors. It was significant to the Seventh Circuit in *Panter* that a majority of the board were outsiders, and the court stated: "The presumption of good faith the business judgment rule affords is height-

25. 634 F.2d 690 (2d Cir. 1980).

26. FED. SEC. L. REP. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976).

27. Joseph E. Seagram & Sons, Inc. v. St. Joe Minerals Corp., No. 81-1419 (S.D.N.Y. March 25, 1981).

28. *Id.*

ened when the majority of the board consists of independent outside directors." [29]

Some people have suggested, among them former SEC Chairman Williams, that to further the independence and to justify the application of the business judgment rule, the defensive measures should be authorized not by the whole board, but by an independent directors' committee similar to the special litigation committee to which Bob referred.

I suggest that this would invite paralysis and division within the board at a time when there is very little time to act, and prompt action is necessary if anything is to be done and if a better deal is to be obtained for the shareholders. I suggest that it is sufficient that the full board, including the outside directors, focuses as a whole on what the policy of the corporation should be in response to the bid and what the particular program implementing the response should be.

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29. 646 F.2d 271 (7th Cir. 1981).