RECONCILIATION OF THE BUSINESS JUDGMENT RULE WITH THE FEDERAL SECURITIES LAWS

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The business judgment rule has long been established under state law. Although there are varying articulations of that rule, it can be characterized as stating that business decisions made by independent directors will not be subject to court scrutiny if they are made in good faith after careful investigation of the underlying facts. This presentation concludes that, with limited exceptions, the business judgment rule is consistent with federal securities law policy.

The starting point for analysis is the fact that a business judgment usually involves the question whether certain action should be taken. That decision can be characterized as a conduct decision and usually does not involve transmission of information.

For instance, in a merger between two corporations, the board of directors of corporation B may decide that a merger with corporation A on the terms presented is in the best interest of corporation B and its shareholders. That decision, including its subsequent implementation, involves conduct by the directors. In contrast, when corporation B seeks a vote of its shareholders approving the merger transaction, it will usually provide them with information about the proposed merger. The latter step involves the transmission of information.

Most of the applicable federal securities laws involve information transmission rather than conduct. These laws make it unlawful to make misrepresentations, to engage in half-truths, and to omit required disclosures in respect to transactions involving purchases and sales of securities. For instance, sections 11 [1] and 12(2) [2] of the Securities Act of 1933 and section 18(a) of the Securities Exchange Act of 1934 [3] deal with such information transmission situations. Business judgments by directors usually become actionable under these sections only when made in connection with information transmission.

Business judgment decisions involving conduct without information transmission may be actionable, however, under two familiar

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1. 15 U.S.C. § 77k (1976).
2. 15 U.S.C. § 77l(2) (1976).
3. 15 U.S.C. § 78r(a) (1976).

federal securities law statutes: section 17(a) of the 1933 Act[4] and rule 10b-5[5] promulgated under section 10(b) of the 1934 Act.[6] Both section 17(a) and rule 10b-5 contain the language, "operates or would operate as a fraud or deceit," which seems to carry a conduct implication. It might be argued that the conduct of directors in making a business judgment is actionable under those sections.

If director conduct under the business judgment rule in connection with the purchase or sale of a security is attacked under rule 10b-5, the suit should fail, because application of the business judgment rule in the first instance requires a showing of good faith. *Ernst & Ernst v. Hochfelder*[7] and *Aaron v. S.E.C.*[8] have taught us that rule 10b-5 will be violated only if the defendant acts with scienter, a standard which cannot be met when the conduct is in good faith.

Another approach to rule 10b-5 is to examine *Schoenbaum v. Firstbrook*,[9] a case decided by the Second Circuit in 1968. In that case the board of directors knew of important, positive corporate events which had not yet been disclosed and which would cause the market price of its securities to rise. The board authorized the corporation's sale of its stock in two transactions, one to controlling shareholders and the other to a third party after arm's-length negotiations. Both of the transactions took place at prices which the board knew were below the price which the stock might reach once the information about the positive corporate events was disclosed. The Second Circuit held that the sale to the controlling shareholders was actionable, but that the sale to outsiders was not actionable.[10]

The holding with regard to the outsiders was that, even if the price was too low, the conduct simply was not actionable under rule 10b-5 because it did not amount to fraud.[11] Notably the *Schoenbaum* decision took place before *Hochfelder* was decided, at a time in which the Second Circuit was uncertain whether there was a *scienter* standard in rule 10b-5. The case thus seems to stand quite directly for the proposition that rule 10b-5 is not actionable in a business judgment conduct situation, because no conflict of interest exists.

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4. 15 U.S.C. § 77q(2) (1976).

5. 17 C.F.R. § 240.10b-5 (1981).

6. 15 U.S.C. § 78j(b) (1976).

7. 425 U.S. 185 (1976).

8. 446 U.S. 680 (1980).

9. 268 F. Supp. 385 (S.D.N.Y. 1967), *aff'd in part and rev'd in part*, 405 F.2d 200 (2d Cir. 1968), *cert. denied*, 395 U.S. 906 (1969).

10. 268 F. Supp. 385 (S.D.N.Y. 1967).

11. 405 F.2d 215, 219-20 (2d Cir. 1968).

The *Schoenbaum* case was also significant because, at the time it was decided, significant doubt existed regarding the application of rule 10b-5 to conflict of interest cases not involving deception. At the time, the *Schoenbaum* case was viewed by some as holding that majority shareholders may not purchase shares from the corporation at unfair prices even if the entire board approves, thus permitting conflict of interest transactions to be attacked directly under rule 10b-5. The case was also subject to the interpretation that controlling shareholders may not purchase shares from the corporation at an unfair price without disclosure to minority shareholders, because the purchase amounts to a deception as to those shareholders.

In *Santa Fe Industries, Inc. v. Green,*[12] the Supreme Court held that deception was required under rule 10b-5 and characterized the *Schoenbaum* case as being a deception case rather than a conduct case.[13] The *Santa Fe* case is important because it holds that a corporate breach of fiduciary duty will not violate rule 10b-5 unless it is accompanied by deception. Thus, ordinary business judgment transactions not involving deception will not violate rule 10b-5.

Another approach to the *Santa Fe* case involves emphasis on part IV of that decision, in which the Court repeated dicta from its decision in *Superintendent of Insurance of New York v. Bankers Life and Casualty*[14] reasoning that Congress did not seek to regulate transactions under section 10(b) which constitute no more than internal corporate mismanagement. This approach would seem to eliminate attacks on business judgment under rule 10b-5. Nevertheless, by characterizing the *Schoenbaum* case and other cases as involving deception, the Court raised the possibility that a management breach of fiduciary obligations could become actionable if accompanied by deception. In *Goldberg v. Meridor,*[15] the Second Circuit took this hint and held, in effect, that an undisclosed sale of overvalued assets for stock of a controlled subsidiary violated rule 10b-5.

The dissent in *Goldberg* characterized the Second Circuit's holding as creating a federal cause of action for breach of fiduciary duty which will apply in all cases, except for those rare instances where the fiduciary denounces himself in advance.[16] If the dissent is correct, the *Goldberg* case may be seen as holding that conflicts of interest will be actionable unless management discloses that breach,

12. 430 U.S. 462 (1977).

13. *Id.* at 475 n.15.

14. 404 U.S. 6 (1971).

15. 567 F.2d 209 (2d Cir. 1977), *cert. denied,* 434 U.S. 1069 (1978).

16. *Id.* at 221 (Meskill, J., concurring in part and dissenting in part).

turning a fiduciary duty case into a deception case by the failure of disclosure element. If this approach is correct, one may ask whether business judgment cases will become actionable under the Federal Securities Laws because shareholders may wish to learn about business judgments which are poor, even if the decisions are protected under state law by the business judgment rule.

The question is: Does *Goldberg* stand for the proposition that a failure to disclose poor business judgment is actionable under rule 10b-5? Probably not, since the *Schoenbaum* case in effect held that poor business judgment itself is not actionable under rule 10b-5 because it is not fraud. Even if one is willing to admit that the Second Circuit bootstrap argument in *Goldberg* is acceptable as to conflict of interest cases, it is stretching logic beyond bounds to find that the argument is acceptable in business judgment cases. Bad business judgment does not become fraud merely because it is not disclosed. Requiring such disclosures would have the effect of turning most business judgment cases into fraud cases.

Even the Second Circuit in its *Goldberg* case seemed to reject the view that failure to disclose poor business judgment would be actionable. It characterized the Supreme Court's statement in *Superintendent of Insurance* that Congress did not intend to regulate internal corporate mismanagement as "a statement that originally seemed intended only to remove negligent corporate misconduct from the reach of the statute." [17]

What about section 17(a) of the 1933 Act? *Aaron v. SEC* held that, scienter is required in an SEC enforcement action under rule 10b-5 and under section 17(a)(1),[18] but is not required under section 17(a)(3).[19] In that case Justice Stewart stated:

> The language of § 17(a)(3), under which it is unlawful for any person to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit, quite plainly focuses upon the effect of particular conduct on members of the investing public rather than upon the culpability of the person responsible.[20]

Under *Aaron* it appears that, in the context of a business judgment decision involving the sale of a security, a director acting in good faith could violate section 17(a)(3) in making a business judgment.

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17. 567 F.2d at 221.

18. 15 U.S.C. § 77q(a) (1976).

19. *Id.*

20. Aaron v. SEC, 446 U.S. 680, 696-97 (1980).

For instance, if a merger transaction calls for a transfer of shares of corporation A to shareholders of corporation B, a sale of corporation A's shares has taken place. If the business judgment decision by corporation B's directors in recommending the transaction to the stockholders of B is made negligently, it might be argued that the decision was made "in the offer or sale" of securities in violation of section 17(a). Arguably the good faith standard of the business judgment rule would not protect the directors. However, further analysis is necessary.

If section 17(a)(3) is analyzed in order to determine whether a business judgment decision is actionable under the federal securities laws, two additional questions arise: May a shareholder use section 17(a) in a private action? In any event, would an attack upon a business judgment prevail?

In *J.I. Case Co. v. Borak*,[21] the Supreme Court stated that private actions would be implied where they are a necessary supplement to Commission action. For a time, the Supreme Court seemed to be following this approach in later cases. For instance, in *Piper v. Chris-Craft Industries*,[22] in which it found that a private action did not exist for a defeated tender offeror under section 14(e),[23] the Court referred to the *Borak* test with approval.

However, more recently, in *Touche Ross & Co. v. Redington*,[24] Justice Rehnquist announced that the Court would apply a stricter standard than elucidated in *Borak*, holding that no private action can be brought under section 17(a) of the 1934 Act. Subsequently, the Court seems to have abandoned the *Borak* necessary supplement rationale for implied private rights.

The most recent implied rights securities case, *Transamerica Mortgage Advisors, Inc. v. Lewis*,[25] dealing with private remedies under the Investment Advisors Act,[26] approached the implied rights question from the point of view of legislative intent. In his concurring opinion in *Transamerica Mortgage*, Justice Powell stated that he believed the Court had adopted his dissent in the *Cannon* case,[27] in which he said: "Absent the most compelling evidence of affirmative Congressional intent, a federal court should not infer a private cause

21. 377 U.S. 426 (1964).
22. 430 U.S. 1 (1977).
23. 15 U.S.C. § 78n(e) (1976).
24. 442 U.S. 560 (1979).
25. 444 U.S. 11 (1979).
26. 15 U.S.C. § 80b (1976).
27. Cannon v. University of Chicago, 441 U.S. 677 (1979).

of action."[28] If Justice Powell is correct, the Court will not imply a private right of action for damages unless it can find compelling affirmative Congressional intent to create a private cause of action.

A second reason for believing that a showing of affirmative Congressional intent will be required was the Court's treatment of the *Cort v. Ash*[29] analysis in its *Transamerica* decision. The majority referred to *Cort v. Ash,* which had established a four-pronged test, and to a Commission contention that, as a result of *Cort v. Ash,* the Court might "consider the utility of a private remedy."[30] It rejected this contention and seemed to say that the inquiry in a private rights case must stop with the intent of Congress. It found a private right of action, but it did so only under the limited theory that a contract violating the securities laws may be voided. Thus, the *Borak* rationale is gone; the Court will not apply the separate steps of the *Cort v. Ash* test; it will look for an affirmative indication of intent; and it will permit the void contract theory to be a limited rationale for a private right of action. If one looks at section 17(a)(3) as a basis for a cause of action, the search must be either for positive legislative intent or for a contract.

To the extent that one is looking for a positive indication that a private damage action under section 17(a)(3) is contemplated by Congress, none will be found. The legislative history of section 17(a) contains nothing to indicate that Congress intended a private action under section 17(a). In fact, one document indicates quite clearly that Congress intended no private right of action for damages under section 17(a).[31]

However, it may be that in a merger case where there is a contract involved, the contract issue is not entirely foreclosed. Assuming that a contract exists or that an SEC enforcement action may be brought (or arguably a private injunction action), the conduct question still exists. Will the conduct contemplated under the business judgment rule be actionable under the section 17(a)(3) language, "operates or would operate as a fraud or deceit"?

Business judgments are good faith decisions relating to corporate transactions. It is difficult to regard such decisions as "fraud". Even though decisions involve conduct they do not involve the type of over reaching normally considered under fraud concepts. It is hard

28. *Id.* at 731.

29. 422 U.S. 66 (1975).

30. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11, 23 (1979).

31. *See* 78 Cong. Rec. 8711-12 (1934) as quoted in Ruder, *Civil Liability Under Rule 10b-5; Judicial Revision or Legislative Intent?,* 57 NW. U. L. REV. 627, 656 (1963).

to imagine that a Supreme Court which is concerned with legislative intent in the implication of remedies field would turn to section 17(a), which is laden with fraud language, and say that a business judgment would be actionable under rule 17(a).

To review the above discussion, the conclusion advanced here is that cases of negligent business judgment which would be protected under state law by the business judgment rule will also not be actionable under the Federal Securities Laws. The reasoning follows.

1. Sections 11 and 12(2) of the 1933 Act and section 18(a) of the 1934 Act involve information transmission rather than business conduct, and are therefore not applicable to business judgment conduct cases.

2. Although rule 10b-5 might be applicable to conduct cases, it is not available to business judgment conduct cases: (a) rule 10b-5 requires *scienter,* which is not present in a business judgment case; (b) rule 10b-5 requires deception, and deception is, by definition, not present in a business judgment conduct case.

3. In any event, the Supreme Court has stated that Congress did not intend to regulate internal corporate mismanagement under rule 10b-5. Additionally, the Second Circuit held in the *Schoenbaum* case that negligent business conduct not involving conflict of interest does not amount to fraud and is not actionable under rule 10b-5.

4. Although the Second Circuit in *Goldberg v. Meridor* seemed to say that failure to disclose breaches of fiduciary duty would satisfy the deception requirement, it is unlikely that the nondisclosure of poor business judgment would become actionable. Poor business judgment is not a breach of fiduciary duty, and in any event the Supreme Court has seemed to say in its *Superintendent of Insurance* case that negligent corporate misconduct will not be actionable under rule 10b-5.

5. The argument might be advanced that negligent business conduct is actionable under section 17(a)(3) because that section does not require scienter. This argument should also be rejected on the theory that the words of section 17(a)(3), "operates or would operate as a fraud or deceit," have fraud characteristics which may reach conflict of interest transactions, but which should not be stretched to include the type of good faith, independent transactions covered by the business judgment rule.

6. Finally, even if section 17(a)(3) should be interpreted as providing an action challenging business judgment, no private damage action is available, and the section is limited to sale transactions.

For all of these reasons, the business judgment rule is consistent with federal securities law policy.

What about *Burks v. Lasker?*[32] *Burks v. Lasker* dealt with the business judgment rule in the derivative suit context, and the question involved is slightly different. Under *Burks,* the question is whether it is consistent with federal securities law policy for directors to exercise their business judgment to cause the dismissal of a case involving a securities law matter. Here, it is possible to imagine cases in which there are federal interests which could prevail. Stated differently, the question is whether the federal interests should override a valid state law business judgment decision to dismiss a derivative suit involving federal securities law claims.

Federal securities law policy can be contrasted in two types of cases. One type is the *Texas Gulf Sulphur*[33] case, which involved the granting of a stock option to insiders at a time in which the insiders knew about mineral discoveries which were not revealed to the corporation's stock option committee. In that case, the Second Circuit held that federal securities law policy would require cancellation of those stock options even if the board of directors decided after full disclosure that cancellation was not in the corporation's best interest.

That case seems to have been wrongly decided. It involved a business judgment made at the time of suit that the corporation should not seek rescission of the stock options. The Second Circuit seemed to be saying the latter corporate decision should be overridden by a federal interest in preventing corporate officers and directors from accepting stock options without disclosing material corporate information. The reason the case seems wrongly decided is that the corporation is the only injured party. A corporation ought to be entitled to make a business decision as to whether or not it wishes officers and directors to retain stock options originally received in violation of federal law. It may not be in the corporation's best interest to cause rescission of the transactions with the officers or directors. The corporation should be able to relinquish a right to rescind if it wishes to do so.

This situation should be contrasted with cases involving injury to third parties. Consider, for instance, the case in which the corporation offers indemnification to its directors when they have been found liable for negligence in a section 11 case imposing liability for

32. 441 U.S. 471 (1979).

33. SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

misrepresentations contained in a registration statement used to sell securities. In that situation, a derivative suit alleging that the corporation should not be permitted to indemnify the directors should not be dismissed. In the sale of securities context the protected interest is not within the corporation. The protected interests are members of the public who have purchased shares in a public market. The business judgments of the corporation not to sue its directors should be overturned because, if corporations are allowed to indemnify officers and directors who negligently prepare registration statements, the protection for the public provided by section 11 may disappear. In that case there may be a conflict with the federal securities laws.

In summary, it appears that corporate business judgments should not be subject to attack under the federal securities laws, except in those limited situations in which those laws protect third party interests which are injured by the conduct in question.