BUSINESS JUDGMENT RULE AND SHAREHOLDER DERIVATIVE ACTIONS: BACKGROUND

BY E. NORMAN VEASEY *

I am not going to do very much of the talking today. I have this distinguished panel of experts from in town and out of town, and I think it would be more of a treat for you to hear them talk.

After a few introductory remarks by me, we will turn to a background discussion of the business judgment rule, followed by a discussion of the changing landscape of stockholder derivative suits by Bob Payson. After that, Dean David S. Ruder will discuss a variety of topics, including implied federal causes of action and the interplay of the state business judgment rule with federal policy.

After these presentations, we will resume with this group for two panel discussions. The first will be led by Meredith Brown on the analysis of the business judgment rule in the context of takeover cases, and the second I will attempt to moderate with respect to the future of stockholder litigation in state and federal courts after *Burks*,[1] *Maldonado*,[2] and the recent *Abramowitz* [3] case.

I have put at the end of these discussions a question-and-answer period before we break for lunch, time permitting. I think it might be helpful to adjust that somewhat and have a brief question-and-answer period after each of the panel discussions, so that there will probably be an opportunity for one after the panel discussion on the business judgment rule in the context of takeover cases and then a final one after the panel discussion on the *Maldonado*-type of situation.

There has been a considerable amount written about the business judgment rule. Scholars and courts have attempted to define it, have attempted to apply it in a variety of contexts—offensively, if you will, and defensively.

The context in which the business judgment rule is applicable is changing, as we all know. There are, of course, a variety of cor-

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1. Burks v. Lasker, 404 F. Supp. 1174 (S.D.N.Y. 1975), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd*, 441 U.S. 471 (1979).

2. Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). The Delaware Supreme Court case had not yet been decided when this discussion took place.

3. Abramowitz v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981).

porate transactions which are the result of a decision-making process by the board of directors, whether it is dividends or acquisitions, mergers, takeovers, etc.

Those cases where such decisions are made or where no decision is made—that is, a decision is made not to take action—should be distinguished from cases in which the business judgment rule does not apply. For example, certain cases involving self-dealing, bad faith, or inattentiveness of directors are instances where the business judgment rule does not apply.

The cases involving inattentive cases are to be distinguished from those cases where the board decides not to take action or takes no action. There is considerable discussion in some of the literature as to when the business judgment rule applies in those situations and when it does not apply.

Of course, the most modern context in which the business judgment rule is discussed and applied is that involving the takeover cases and the dismissal of derivative suits. They will be the subject of our panel discussion.

In the takeover cases, of course, the recent decision of *Panter v. Marshall Field*[4] in the Seventh Circuit is illustrative of the application of the business judgment rule to the decision of the board of the target company to resist a tender offer. The response of the target board is the subject of debate and presents a delicate question. Considerable discussion in the literature suggests different theories and different solutions.

One theory, espoused by my friend Professor Dan Fischel, is being published, along with his co-author Professor Easterbrook, in the April Harvard Law Review, entitled, "The Proper Role of a Target's Management in Responding to a Tender Offer,"[5] and it will be interesting to hear Dan Fischel's thesis of that in his presentation today and in the panel discussion.

With respect to the dismissal of derivative suits, the question is whether or not and to what extent the business judgment rule is applicable. Of course, it starts with the discussion of the demand rules, Rule 23.1 in the Delaware Court of Chancery Rules[6] and the equivalent federal rule.[7] The rules require that the plaintiff allege with particularity the efforts, if any, made by the plaintiff to obtain the

4. Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981).

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

6. DEL. CH. CT. R. 23.1.

7. FED. R. CIV. P. 23.1.

action he desires from the directors or comparable authority, and the reasons for his failure to obtain the action or for simply not making the effort.

The Chancery Rule and the Federal Rule are somewhat different in other respects, but I believe the language that I have just quoted is essentially the same. In this forum we will try to discuss the meaning of this provision, the extent to which it is being enforced, and how it relates to the next topic.

The next topic is "disinterested" committee action. Can a disinterested committee of the board cause the dismissal of a derivative action if it determines that the maintenance of the action is not in the best interests of the corporation? Assuming a truly disinterested committee, what "powers" does it have? Does the stockholder have an independent right, nevertheless, to maintain a derivative action whether or not a disinterested committee, presumed to be truly disinterested, makes an investigation and determines in good faith the action should not be maintained?

In *Burks v. Lasker,*[8] the United States Supreme Court, in remanding the case for an application of the question under state law, seemed to assume that under applicable state law there might be room for the business judgment of the board to be exercised in that context. There were a number of federal and state cases following that decision which applied state law, including Delaware law—cases of other jurisdictions applying Delaware law—on the question of whether or not business judgment applied; it seemed to be the consensus of those opinions that it did and that such cases could be dismissed.

In Delaware, the issue arose in a case called *Maldonado v. Flynn*[9] before Vice-Chancellor Hartnett, and he decided that the business judgment rule was not applicable, that the stockholder had an independent right to maintain the action. That case is on appeal now before the Delaware Supreme Court.[10] While it is pending on appeal, other courts are trying to grapple with the question and trying to apply Delaware law. The Southern District of New York, in the *Abramowitz*[11] case, recently predicted that the Delaware Supreme Court would not follow Vice-Chancellor Hartnett's rule and that it would instead apply the business judgment rule.

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8. 441 U.S. 471 (1979).

9. Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), *rev'd sub nom.* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

10. *See* note 2 *supra.*

11. Abramowitz v. Posner, 513 F. Supp. 120 (S.D.N.Y. 1981).

We are in a situation here today where it is rather delicate to discuss the question of the *Maldonado* case. Some of us are in that case. We do not want to try to predict what the Delaware Supreme Court will do. We talked about how we could present this topic, and I think we all decided that we would say, "Here is Vice-Chancellor Hartnett's decision in *Maldonado v. Flynn,* and here is Judge Haight's decision in *Abramowitz*—isn't that interesting?"

We will see how our friends can discuss the topic and maybe those from out of town will not be quite so inhibited as those of us involved in the case.

I believe that the business judgment rule probably boils down to the question of judicial review, and I think it is appropriate to discuss, in the context of all of these business judgment rule considerations, what the court will do in examining the application of the business judgment rule. Will it look behind the application of that rule to determine more than whether or not the board of directors acted in good faith? Will it determine the "reasonableness" of the decision? And if so, what does that mean?

The language of some of the cases and some of the legislative formulations of the business judgment rule leave room for debate on this topic, which I will not dwell on at this point; perhaps we can deal with it later in the context of the panel discussion.