

THE BUSINESS JUDGMENT RULE: CHECKING THE AUTOCRACY IN THE BOARDROOM

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OUTLINE

- I. INTRODUCTION
- II. BUSINESS JUDGMENT RULE: A SNEAK PREVIEW
 - Definition*
 - Rationale*
 - Origin*
 - Presumption*
- III. BUSINESS JUDGMENT RULE ABOARD: THE PHILIPPINE SETTING
 - Fiduciary Duties of the Board of Directors and Corporate Officers Under the Code of Corporate Governance*
 - When Board of Directors' Lose Control: Effect of Non-Compliance*
 - Bad Faith In, Business Judgment Rule Out*
- IV. BUSINESS JUDGMENT RULE IN UNCLE SAM'S CORPORATE WORLD
 - Fiduciary Duties of the Board of Directors and Corporate Officers*
 - Losing Control: When the Board of Directors Does Not Comply*
 - The Delaware Courts and Business Judgment Rule Through the Years*
 - The Celebrated Case of Smith v. Van Gorkom*
 - The Glamour and Bustle of Hollywood Down to Prosaic and Tranquil Georgetown, Delaware in In re Walt Disney Co. Derivative Litigation*
 - Business Judgment Rule in Litigation: The Making*
- V. CONCLUSION

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“The search for cases in which directors... have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack.”

Joseph W. Bishop, Jr.⁺¹

I. INTRODUCTION

Declaration of dividends without unrestricted retained earnings; sale of corporate assets by the Board of Directors of an insolvent corporation; merger of corporation when circumstances do not warrant it – these are some of the few risky business ventures undertaken by corporate directors which usually involve millions of pesos.

In a corporate world, it is but a common phenomenon to undertake risks even if its offshoot would be the ultimate downfall of the corporation. Never mind the pitiful fate of stockholders who invested their hard-earned money in the corporation as long as corporate directors are almost always assured of an aegis that will shield them from the aftermath of wrong business decisions. This is the protection provided by the “Business Judgment Rule” – a legitimate defense for the corporate directors and an inexcusable negligence on the eyes of the stockholders.

Business Judgment Rule is a basic principle applicable to business decisions made by the Board of Directors. These decisions made upon reasonable information and with some rationality do not give rise to directorial liability even if they turned out badly or disastrously from the standpoint of the corporation. Such decisions are valid and binding upon the corporation and

¹ Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, *The Yale Law Journal*, Vol. 77, No. 6 (May, 1968), pp. 1078-1103, <http://www.law.yale.edu/cbl/modernera.htm> (last accessed December 30, 2007).

Joseph Warren Bishop, Jr. (1915-85) came to the Law School in 1957, as part of Dean Rostow’s initiative to expand the faculty. Prior to joining the faculty, as General Counsel to the U.S. Army, he defended the Army from charges of communist infiltration during the McCarthy hearings of the early 1950s. He was decorated for exceptional civilian service by the Army in 1953 upon his departure for private practice.

cannot be enjoined, set aside, or attacked by the stockholders.²

The Corporation Code of the Philippines clearly states that “*Unless otherwise provided in this Code, the corporate powers of all corporations formed under this Code shall be exercised, all business conducted and all property of such corporations controlled and held by the board of directors or trustees...*”³ This express provision in the Code manifestly bestows upon the Board of Directors the exercise of corporate powers, thus giving life to the renowned business judgment rule in the Philippines.

The Philippine Supreme Court also justified the corporate power being vested upon the Board of Directors and corporate officers in this wise:

*“Any person ‘who buys stock in a corporation does so with the knowledge that its affairs are **dominated by a majority** of the stockholders and that **he impliedly contracts that the will** of the majority shall govern in all matters within the limits of the act of incorporation and lawfully enacted by-laws and not forbidden by law.’ To this extent, therefore, the stockholder may be considered to have “parted with his personal right or privilege to regulate the disposition of his property which he has invested in the capital stock of the corporation, and surrendered it to the will of the majority of his fellow incorporators. ... It cannot therefore be justly said that the contract, express or implied, between the corporation and the stockholders is infringed ... by any act of the former which is authorized by a majority...”⁴*

Pursuant to the vast power conferred upon the board of directors and corporate officers in handling corporate affairs, it follows that there is a need for an important defense in case of liability due to breach of management obligation to the corporation. Thus, the Business Judgment Rule answers the plight of the board of directors and corporate officers in case of such liability. As cited in Corporate Board Minutes Website, the Business Judgment Rule shields the director or officer from liability for errors of judgment that resulted in the allegedly negligent act or omission provided they acted in good faith in a matter of business policy or business judgment.⁵

The Business Judgment Rule may appear to be simple on its face but

² ROBERT W. HAMILTON, *THE LAW OF CORPORATIONS IN A NUTSHELL*, 5TH Edition (2000), at 453.

³ CORP. CODE § 23.

⁴ *Gokongwei vs. Securities and Exchange Commission*, 97 SCRA 78 (April 11, 1979).

⁵ <http://www.corporateboardminutes.com/index.shtml> (last accessed December 30, 2007).

may be complex in its application. As the Philippine Supreme Court puts it:

“It is a well-known rule of law that questions of policy or of management are left solely to the honest decision of officers and directors of a corporation and **the courts are without authority to substitute their judgment for the judgment of the board of directors** (author’s emphasis); the board is the business manager of the corporation and so long as it acts in good faith its orders are not reviewable by the courts.”⁶

Through the years, the board of directors and corporate officers readily invoke the Business Judgment Rule as a special defense from liability for wrong business decisions. However, the noble objective of the rule which is to leave solely to the honest decision of officers and directors of a corporation questions of policy or of management, is usually brought to abuse by the Board of Directors. As an aftermath, the rights of the minority stockholders who invested their hard-earned money into the corporation are prejudiced.

II. BUSINESS JUDGMENT RULE: A SNEAK PREVIEW

Definition

The Business Judgment Rule is a case law-derived concept in Corporation law whereby a court will refuse to review the actions of a corporation’s board of directors in managing the corporation unless there is some allegation of conduct that violates the directors’ duty of care, duty of loyalty, or duty of good faith; or that the decisions of the directors lacks a rational basis.⁷

It is based on “the presumption that in making business decisions not involving direct self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation’s best interest. This rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, with

⁶ *Montelibano v. Bacolod-Murcia Milling Co.*, 5 SCRA 36 (1962) at 42, citing *Fletcher on Corporations*, Vol. 2, at 390.

⁷ http://en.wikipedia.org/wiki/Business_judgment_rule (last accessed December 23, 2007) citing *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).

due care, and within the directors' or officers' authority."⁸

The business judgment rule protects directors from liability for many types of actions that turn out badly from the standpoint of the corporation. Examples include:⁹

1. a reorganization of a subsidiary company, including a distribution of surplus, reduction of capital, and distribution of a share dividend;
2. election of a manager and president;
3. a sale of part of the assets of the company;
4. acceptance of a note for a judgment rather than enforcing it by execution;
5. the closing down of unproductive mine; and
6. the determination of the adequacy of information and reporting systems.

In effect, the business judgment rule creates a strong presumption in favor of the Board of Directors of a corporation, freeing its members from possible liability for decisions that result in harm to the corporation. It exists so that a Board will not suffer legal action simply from a bad decision. As the Delaware Supreme Court has said, a court will not substitute its own notions of what is or is not sound business judgment if 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.¹⁰

Rationale

The rationale for the Business Judgment Rule is the recognition by courts that, in the inherently risky environment of business, board of directors need to be free to take risks without a constant fear of lawsuits affecting their judgment.¹¹ It seeks to acknowledge that the daily operation of a business can be innately risky and controversial. Therefore, the board of directors should be allowed to make decisions without fear of being prosecuted afterwards. The business judgment

⁸ Black's Law Dictionary 192 (7th ed. 1999).

⁹ HAMILTON, *Supra* note 2, at 455.

¹⁰ http://en.wikipedia.org/wiki/Business_judgment_rule (last accessed December 23, 2007) citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

¹¹ *Id.* See, for instance, *Gagliardi v. TriFoods Int'l Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (setting out rationale for the rule).

rule further assumes that it is unfair to expect those managing a company to make perfect decisions all the time. As long as the courts believe that the board of directors acted rationally in a particular situation, no further action will be taken against them.¹²

Moreover, the policy underlying the business judgment rule is to prevent courts and third parties from “second guessing” business decisions of corporate directors made in good faith and with reasonable information. The business judgment rule is designed to ensure that courts do not in hindsight reverse the judgment of corporate officers and directors who are presumed to have acted in good faith and in the best interests of the company.¹³

In sum, it appears that the major rationales underscoring the validity of the business judgment rule are the following: (1) people make mistakes, and that they should be encouraged to assume directorships without fear of failure; (2) the directors need wide discretion in setting policy and making decisions; (3) courts should be kept out of boardrooms where they have little expertise; and (4) all parties concerned should be assured that directors, not shareholders, will set policy and be accountable to all present and future investors.¹⁴

Origin

Historically, the business judgment rule, as interpreted by state and federal courts in the United States, presume that directors of corporations making decisions on behalf of shareholders were correct if they acted (1) in good faith, (2) on an informed basis, (3) in a disinterested manner, (4) with due care, and (5) without discretion or waste.¹⁵ If these criteria were met, directors' fiduciary obligations were satisfied. To overcome this presumption, challengers

¹² <http://www.investopedia.com/terms/b/businessjudgmentrule.asp> (last accessed December 23, 2007).

¹³ *Aronson v. Lewis, supra, Havens v. Attar, supra* (quoting *Aronson*). See also *Federal Deposit Insurance Corp. v. Stahl*, 89 F.3d 1510, 1517 (11th Cir. 1996).

¹⁴ <http://www.lorandoslaw.com/business-judgment-rule.php> (last accessed December 23, 2007), citing Brennan, 12 Whittier L. Rev. at 302. See also *Reading Co. v. Trailer Train Co.*, 9 Del. J. Corp. L. 223, 229 (Del. Ch. 1984) (unreported).

¹⁵ *Id.* See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), overruled in part on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

The rule is embodied in statutory form in the General Corporation Laws of Delaware (DGCL), which state that “[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.”

were forced to show that a director had acted in a grossly negligent manner or had a conflict of interest, but directors could overcome the latter charge by showing that they had informed the Board of their interest and that their actions had served the best interests of the shareholders. This unwillingness of courts to intervene and overturn the decisions of private boards of directors can be traced in English common law as far back as 1742.¹⁶

In the United States, the business judgment rule as a principle of corporate law was first established in 1829 by the Louisiana Supreme Court.¹⁷ In 1853, the Rhode Island Supreme Court stated the rule succinctly: “We think a board of directors acting in good faith and with reasonable care and diligence, who nevertheless falls into a mistake, either as to law or fact, is not liable for the consequences of such mistake.”¹⁸

Presumption

The business judgment rule is not only a substantial rule of law, but also a rule on evidence.¹⁹ It establishes 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.”²⁰ Whenever any action is brought to question the validity of a board resolution or corporate transaction approved by the board, the general rule is once it has been entered into by the Board by virtue of the exercise of its judgment, it will be presumed to be valid. Thus, directors are presumed to have acted properly and to have satisfied these three basic duties of care if the Business Judgment Rule applies.²¹ As the Philippine Supreme Court in the case of *Ingersoll vs. Malabon Sugar Co.*²² has observed:

“The general rule is that in corporate affairs the will of the majority controls, and that contracts *intra vires* entered into by the board of

¹⁶ *Id.*, citing *Charitable Corp. v. Sutton*, 2 Eng. Rep. 400, 404 (1742).

¹⁷ *Id.* See also *Percy v. Millaudon*, 8 Mart. (ns) 68 (La. 1829).

¹⁸ *Id.*, citing *Hodges v. New England Screw Co.*, 3 RI 9, 18 (1853).

¹⁹ VILLANUEVA, PHILIPPINE CORPORATE LAW, 2001, at 281.

²⁰ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

²¹ VILLANUEVA, *supra* note 19, at 281.

²² 53 Phil. 745 (1927).

directors are binding upon the corporation and that the courts will not interfere unless such contracts are so unconscionable and oppressive as to amount to a wanton destruction of the rights of the minority.”

As explained by prominent Delaware jurists in a 2001 article,²³ “[in] the cases, a standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process. Under those circumstances, the directors’ decision is reviewed not for reasonableness but for rationality.”²⁴ Furthermore, “[w]here the business judgment standard applies, a director will not be held liable for a decision—even one that is unreasonable—that results in a loss to the corporation, so long as the decision is rational.”²⁵

The Delaware Supreme Court further noted that, in order to rebut the business judgment rule presumption, a shareholder plaintiff must effectively provide evidence that the “board of directors, in reaching its challenged decision, breached any *one* of its triad of fiduciary duties of loyalty, good faith, due care.”²⁶ As a rule of evidence, the business judgment presumption places the initial burden of proof on the plaintiff. A plaintiff challenging a board decision has the burden of rebutting the rule’s presumption, and if it fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and their decisions.²⁷

²³ A. Fleischer, Jr & A. Sussman, *Directors’ Fiduciary Duties In Takeovers And Mergers* http://www.ffhsj.com/siteFiles/ffFiles/sri_directors_duties.pdf (last accessed December 30, 2007). See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287 (Aug. 2001). The authors are former Delaware Chancellor Allen, then ViceChancellor and later Delaware Supreme Court Justice Jacobs, and Vice Chancellor Strine.

²⁴ *Id.* at 1298 (footnotes omitted). In that article, the authors also question whether good faith should be treated as a separate one of a triad of directors’ fiduciary duties, suggesting that “it is a subset or ‘subsidiary requirement’ that is subsumed within the duty of loyalty, as distinguished from being a compartmentally distinct fiduciary duty of equal dignity with the two bedrock fiduciary duties of loyalty and due care.”

²⁵ *Id.*

²⁶ *Id.* citing *McMullin v. Beran*, 765 A.2d 910, 917 (Del. 2000) (emphasis in original) (quoting *Emerald Partners v. Berlin*, 726 A.2d 1215, 1221 (Del. 1999); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162-63 (Del. 1995); *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 333 (Del.1993).

²⁷ *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345, 361 (Del.1993).

If the rule is rebutted, the burden shifts to the defendant directors and officers, the proponents of the challenged transaction, to prove to the trier of fact the “entire fairness” of the transaction,²⁸ but burden-shifting does not create *per se* liability on the part of the directors.²⁹ It is only when the transaction involves a conflict of interest or breach of fiduciary duty, the burden shifts to a defendant to prove the “entire fairness” of the transaction.³⁰ If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.³¹

It should also be noted that a plaintiff who fails to rebut the business judgment rule presumptions is not entitled to any remedy unless the transaction constitutes waste.³² To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was “so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”³³ A claim of waste will arise only in the rare, “unconscionable case where directors irrationally squander or give away corporate assets.”³⁴

III. BUSINESS JUDGMENT RULE ABOARD: THE PHILIPPINE SETTING

Almost all corporate laws of the Philippines have been patterned with

²⁸ *Id.* at 361.

²⁹ *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d at 1162-1164 (Del.1995).

³⁰ *Kahn v. Tremont Corp.* 694 A.2d 422, 428-29 (Del.1997); *Kahn v. Lynch Commun. Sys., Inc.*, 638 A.2d 1110, 1115, 1117 (Del.1994); *In re Croton River Club*, 52 F.3d 41, 44 (2nd Cir. 1995); *Williams v. Geier*, 671 A.2d 1368, 1378, fn. 20 (Del.Ch. 1996); *Cinerama, Inc. v. Technicolor, Inc.*, *supra*; *Cede & Co.*, *supra*, 634 A.2d at 361.

³¹ *In re: The Walt Disney Company Derivative Litigation*, 906 A.2d 27, 67 (Del.2006), citing *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001); *Brehm v. Eisner*, 746 A.2d 244, 264 n. 66 (Del. 2000) (“Thus, directors’ decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.”).

³² *In re J.P. Stevens & Co., Inc. S’holders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988).

³³ *Brehm*, 746 A.2d at 263.

³⁴ *Id.*

the provisions of the United States Corporate Laws, including the Business Judgment Rule. While the Business Judgment Rule in the United States has been an active part of an extensive legal discussion in their business world, the contrary appears in the Philippines. Business Judgment Rule only occupied a passive role in the Philippine setting with only a few legal provisions covering it and with only a few jurisprudence dealing with it.

Fiduciary Duties of the Board of Directors and Corporate Officers under the Code of Corporate Governance

Directors and Corporate Officers occupy positions of trust and confidence. They have corresponding duties and obligations towards the corporation and its shareholders. One of which is to perform the duties enjoined on them by law and the by-laws of the corporation. It is a settled principle that a director owes a three-fold duty to the corporation: to be diligent, to be loyal, and to be obedient,³⁵ a principle that has been adopted and broadened under the Philippine Code of Corporate Governance. The general as well as specific duties and functions of the Board of directors are spelled out in the said code as follows:³⁶

General Responsibility

A director's office is one of trust and confidence. He should act in the best interest of the corporation in a manner characterized by transparency, accountability and fairness. He should exercise leadership, prudence and integrity in directing the corporation towards sustained progress over the long term. A director assumes certain responsibilities to different constituencies or stakeholders, who have the right to expect that the institution is being run in a prudent and sound manner.

To ensure good governance of the corporation, the Board should establish the corporation's vision and mission, strategic objectives, policies and procedures that may guide and direct the activities of the company. It should also establish means to attain the same as

³⁵ CAMPOS & CAMPOS, *THE CORPORATION CODE OF THE PHILIPPINES: COMMENTS, NOTES AND SELECTED CASES* (1990 Vol. 2) at 641, citing Ballantine, *op cit*, at 156.

³⁶ The Code of Corporate Governance was adopted by the Philippine Securities and Exchange Commission on April 5, 2002. It is made applicable to corporations whose securities are registered or listed, corporations which are grantees of permits or licenses and secondary franchise from the SEC, public companies and branches and subsidiaries of foreign corporations operating in the Philippines whose securities are registered or listed.

well as the mechanism for monitoring management's performance. While the management of the day-to-day affairs of the institution is the responsibility of the management team, the Board is, however, responsible for monitoring and overseeing management action.

Duties and Functions

To insure a high standard of best practice for the company and its stakeholders, the Board should conduct itself with utmost honesty and integrity in the discharge of its duties, functions and responsibilities which include, among others, the following:

- i.** Install a process of selection to ensure a mix of competent directors, each of whom can add value and contribute independent judgment to the formulation of sound corporate strategies and policies. Select and appoint the CEO and other senior officers, who must have the motivation, integrity, competence and professionalism at a very high level. Adopt a professional development program for employees and officers, and succession planning for senior management.
- ii.** Determine the corporation's purpose and value as well as strategies and general policies to ensure that it survives and thrives despite financial crises and its assets and reputation are adequately protected. Provide sound written policies and strategic guidelines to the corporation that will help decide on major capital expenditures. Determine important policies that bear on the character of the corporation with a view towards ensuring its long-term viability and strength. It must periodically evaluate and monitor implementation of such strategies and policies, business plans and operating budgets as well as management's over-all performance to ensure optimum results.
- iii.** Ensure that the corporation complies with all relevant laws, regulations and codes of best business practices.
- iv.** Identify the corporation's major and other stakeholders and formulate a clear policy on communicating or relating with them accurately, effectively and sufficiently. There must be an accounting rendered to them regularly in order to serve their legitimate interests. Likewise, an investor relations program that reaches out to all shareholders and fully informs them of corporate activities should be developed. As a best practice, the chief financial officer or CEO should have oversight of this program and should actively participate in public activities.
- v.** Adopt a system of internal checks and balances, which may be applied in the first instance to the Board. A regular review of the

effectiveness of such system must be conducted so that the decision-making capability and the integrity of corporate operations and reporting systems are maintained at a high level at all times.

vi. Endeavor to provide appropriate technology and systems rating to account for available resources to ensure a position of a strong and meaningful competitor. Identify key risk areas and key performance indicators and monitor these factors with due diligence.

vii. Constitute an Audit and Compliance Committee.

viii. Properly discharge Board functions by meeting regularly. Independent views during Board meetings should be given due consideration and all such meetings should be duly minuted.

ix. Keep Board authority within the powers of the institution as prescribed in the articles of incorporation, by-laws and in existing institution within the scope of its authority as prescribed in its charter and in existing laws, rules and regulations.

Specific Duties and Responsibilities of a Director

i. To conduct fair business transactions with the corporation and to ensure that personal interest does not bias Board decisions.

The basic principle to be observed is that a director should not use his position to make profit or to acquire a benefit or advantage for himself and/or his related interests. He should avoid situations that may compromise his impartiality. If an actual or potential conflict of interest arises on the part of directors or senior executives, it should be fully disclosed and the concerned director should not participate in the decision making. A director who has a continuing conflict of interest of a material nature should consider resigning.

ii. To devote time and attention necessary to properly discharge his duties and responsibilities. A director should devote sufficient time to familiarize himself with the institution's business. He should be constantly aware of the institution's condition and be knowledgeable enough to contribute meaningfully to the Board's work. He should attend and actively participate in Board and committee meetings, request and review meeting materials, ask questions, and request explanations.

iii. To act judiciously. Before deciding on any matter brought before the Board, every director should thoroughly evaluate the issues, ask questions, and seek clarifications when necessary.

iv. To exercise independent judgment. A director should view each

problem/situation objectively. When a disagreement with other directors occurs, he should carefully evaluate the situation and state his position. He should not be afraid to take a position even though it might be unpopular. Corollarily, he should support plans and ideas that he thinks are beneficial to the corporation.

v. To have a working knowledge of the statutory and regulatory requirements affecting the corporation, including the contents of its articles of incorporation and by-laws, the requirements of the Commission, and where applicable the requirements of other regulatory agencies. A director should also keep himself informed of industry developments and business trends in order to safeguard the corporation's competitiveness.

vi. To observe confidentiality. A director should observe the confidentiality of non-public information acquired by reason of his position as director. He should not disclose any information to any other person without the authority of the Board.

vii. To ensure the continuing soundness, effectiveness and adequacy of the company's control environment.

Duties of Directors, Officers, and Managers to Minority Shareholders

The duties of directors and corporate officers towards majority and minority shareholders are not clearly delineated under the Corporation Code. However, scattered in the Corporation Code are various provisions intended to protect shareholders in general and which were adopted in the Code of Corporate Governance.³⁷ These are:

Stockholders' Rights and Protection of Minority Stockholders' Interests³⁸

The Board shall be committed to respect the following rights of the stockholders:

1. Voting Right

Shareholders have the right to elect, remove and replace directors and vote on certain corporate acts in accordance with the Corporation Code. The Code mandates the use of cumulative voting

³⁷ J. Salvador & O. Isip. *Liability of Directors, Officers, and Managers in the Philippines*. Romulo, Mabanta, Buenaventura, Sayoc & de los Angeles. <http://www.aiu.com/aiu/PDF/Philippines.pdf> (last accessed December 30, 2007).

³⁸ Code of Corporate Governance, Title V, Series of 2002.

in the election of directors. Although directors may be removed with or without cause, the Code prohibits removal without cause if it will deny minority shareholders representation in the Board. Removal of directors requires an affirmative vote of two-thirds of the outstanding capital.

2. Pre-emptive Right

All shareholders have pre-emptive rights, unless there is a specific denial of this right in the articles of incorporation or an amendment thereto. They shall have the right to subscribe to the capital stock of the corporation. The articles of incorporation may lay down the specific rights and powers of shareholders with respect to the particular shares they hold, all of which are protected by law so long as they are not in conflict with the Corporation Code.

3. Power of Inspection

The Corporation Code mandates corporations to allow shareholders to inspect corporate books and records including minutes of Board meetings and stock registries in accordance with the Corporation Code, and to provide them an annual report, including financial statements, without cost or restrictions.

4. Right to Information

The shareholders shall be provided, upon request, with periodic reports which disclose personal and professional information about the directors and officers and certain other matters such as their holdings of the company's shares, dealings with the company, relationships among directors and key officers, and the aggregate compensation of directors and officers. The Information Statement/Proxy Statement where these are found must be distributed to the shareholders before annual general meetings and in the Registration Statement and Prospectus in case of registration of shares for public offering with the Commission.

The minority shareholders should be granted the right to propose the holding of a meeting, and the right to propose items in the agenda of the meeting, provided the items are for legitimate business purposes. The minority shareholders should have access to any and all information relating to matters for which the management is accountable and to those relating to matters for which the management should include such information and, if not included, then the minority shareholders can propose to include such information and, if

not included, then the minority shareholders can propose to include such matters in the agenda of stockholders' meeting, being within the definition of legitimate purposes.

5. Right to Dividends

Shareholders have the right to receive dividends subject to the discretion of the Board. However, the Commission may direct the corporation to declare dividends when its retained earnings are in excess of 100% of its paid-in capital stock, except: a) when justified by definite corporate expansion projects or programs approved by the Board or b) when the corporation is prohibited under any local or foreign creditor from declaring dividends without its consent, and such consent has not been secured; or c) when it can be clearly shown that such retention is necessary under special circumstances obtaining in the corporation, such as when there is a need for special reserve for probable contingencies.

6. Appraisal Right

The Corporation Code allows the exercise of the shareholders' appraisal rights under the following circumstances:

- a) In case any amendment to the articles of incorporation has the effect of changing or restricting the rights of any stockholders or class of shares, or of authorizing preferences in any respect superior to those of outstanding shares of any class, or of extending or shortening the term of corporate existence;
- b) In case of sale, lease, exchange, transfer, mortgage, pledge or other disposition of all or substantially all of the corporate property and assets as provided in the Corporation Code; and
- c) In case of merger or consolidation.

It is the duty of the directors to promote shareholder rights, remove impediments to the exercise of shareholders rights, and allow possibilities to seek redress for violation of their rights. They shall encourage the exercise of shareholders' voting rights and the solution of collective action problems through appropriate mechanisms. They shall be instrumental in removing excessive costs and other administrative or practical impediments to shareholders participating in meetings and/or voting in person. The directors shall pave the way for the electronic filing and distribution of shareholder information necessary to make informed decisions subject to legal constraints.

When Board of Directors' Lose Control: Effect of Non-Compliance

While directors are expected to observe diligence, care, and prudence in the performance of their duties, they are nevertheless protected from mistakes or errors committed in the exercise of their business judgment provided they acted in good faith and with due care and prudence under the "business judgment rule" which has been accordingly adopted in the Philippines.³⁹

Two Aspects of Business Judgment Rule. Business Judgment Rule provides two levels of protection available to the Board of Directors and Corporate Officers, namely:⁴⁰

1. Resolutions and transactions entered into by the Board of Directors within the powers of the corporation cannot be reversed by the courts not even on the behest of the stockholders of the corporation;
2. Directors and officers acting within such business judgment cannot be held personally liable for the consequences of such acts.

The first aspect of the Business Judgment Rule is that it shields good faith management decisions by directors from later court intervention. This aspect of the rule recognizes that directors need flexibility in their decision making process. Hence, even if a decision turns out to have less than ideal consequences, the court will not replace its judgment for that of the directors, if the directors' decision making process was sound.⁴¹

In *Montelibano v. Bacolod-Murcia Milling Co.*,⁴² the Supreme Court enunciated the principle that when a resolution is "passed in good faith by the board of directors, it is valid and binding, and whether or not it will cause losses or decrease the profits of the corporation, the court has no authority to review them."⁴³ It emphasized the rule that board of directors "hold such office charged with the duty to act for the corporation according to their best judgment, and in so doing they cannot be controlled in the reasonable exercise and performance of such duty."⁴⁴ Whether the business of a corporation should be operated at a loss during depression, or close down at a smaller loss, is a purely business and

³⁹ J. Salvador & O. Isip, *supra* note 37.

⁴⁰ VILLANUEVA, *supra* note 19, at 284.

⁴¹ Amanda Owen, *The Legal Perspective*, Volume XII, Number 2, Summer 2003.

⁴² 5 SCRA 36 (1962).

⁴³ *Id.*, at 42.

⁴⁴ *Id.*

economic problem to be determined by the directors of the corporation and not by the court.⁴⁵ It further held that “it is a well-known rule of law that questions of policy or of management are left solely to the honest decision of officers and directors of a corporation and the courts are without authority to substitute their judgment for the judgment of the board of directors; the board is the business manager of the corporation and so long as it acts in good faith its orders are not reviewable by the courts.”⁴⁶

The second aspect of the Business Judgment Rule is that directors and officers cannot be held personally liable for corporate debts or obligations incurred in the exercise of the business judgment. In this jurisdiction, however, this is not an absolute rule. Laws and jurisprudence were adopted to safeguard the rights and interests of the minority stockholders.

A.) Corporation Code of the Philippines

A Board of Director or Corporate Officer cannot seek refuge under the said principle to escape liability for the following acts provided under the Corporation Code:⁴⁷

Section 31. *Liability of directors, trustee or officers.* - Directors or trustees who willfully and knowingly vote for or assent to patently unlawful acts of the corporation or who are guilty of gross negligence or bad faith in directing the affairs of the corporation or acquire any personal or pecuniary interest in conflict with their duty as such directors or trustee shall be liable jointly and severally for all damages resulting therefrom suffered by the corporation, its stockholders or members and other persons.

When a director, trustee, or officer attempts to acquire or acquires in violation of his duty, any interest adverse to the corporation in respect of any matter which has been reposed in him in confidence, as to which equity imposes a disability upon him to deal in his own behalf, he shall be liable as a trustee for the corporation and must account for the profits which otherwise would have accrued to the corporation.

Section 34. *Disloyalty of a director.* - Where a director, by virtue of his office, acquires for himself a business opportunity which should

⁴⁵ *Id.*

⁴⁶ *Id.*, citing Fletcher on Corporations, Vol. 2, p. 390.

⁴⁷ J. Salvador & O. Isip, *supra* note 37.

belong to the corporation, thereby obtaining profits to the prejudice of such corporation, he must account to the latter for all such profits by refunding the same, unless his act has been ratified by a vote of the stockholder owning or representing at least two-thirds (2/3) of the outstanding capital stock. This provision shall be applicable, notwithstanding the fact that the director risked his own funds in the venture.

The above provisions epitomize the scope of Board of Directors and Corporate Officers' liability in the Philippines. The rule presupposes "bad faith" as the missing element under the business judgment rule.⁴⁸ The said provisions likewise name the exception to the general rule that Board of Director, Corporate Officers and Stockholders cannot ordinarily be held personally liable for the debts of the corporation.⁴⁹

b.) Philippine Jurisprudence

It is a well-settled doctrine both in law and in equity that a corporation is a legal entity distinct and separate from its individual stockholders or members. The separate personality of a corporation may be disregarded under the Doctrine of Piercing the Veil of Corporate Fiction. This doctrine is a theory introduced for the purposes of convenience and to serve the ends of justice.⁵⁰ However, "when the veil of corporate fiction is used as a shield to perpetuate fraud, to defeat public convenience, justify wrong or defend crime or used as a mere alter ego, this fiction shall be disregarded and the individuals composing it will be treated identically."⁵¹ Thus, the Philippine Supreme Court ruled:

"With specific regard to corporate officers, the general rule is that the officer cannot be held personally liable with the corporation, whether civilly or otherwise, for the consequences of his acts, if he acted for and in behalf of the corporation, within the scope of his authority and in good faith. In such cases, the officer's acts are properly attributed to the corporation. However, if it is proven that the officer has used the corporate fiction to defraud a third party, or that he has acted negligently, maliciously or in bad faith, then the corporate veil shall be

⁴⁸ J. Salvador & O. Isip, *supra* note 37.

⁴⁹ *Consolidated Bank and Trust Corporation v. Court of Appeals*, 197 SCRA 663 (1991).

⁵⁰ SUNDIANG & AQUINO, *REVIEWER ON COMMERCIAL LAW*, at 236 (2006).

⁵¹ *Umali vs. Court of Appeals*, 189 SCRA 529 (1990)

lifted and he shall be held personally liable for the particular corporate obligation involved.”⁵²

In *Tramat Mercantile, Inc. v. Court of Appeals*,⁵³ the Philippine Supreme Court provides specific instances when personal liability of a corporate director, trustee or officer along with the corporation may so validly attach, as a rule. These are:

1. when the director willfully and knowingly vote for patently unlawful acts of the corporation;⁵⁴
2. when he is guilty of gross negligence or bad faith in directing the affairs of the corporation;⁵⁵
3. when he is guilty of conflict of interest or when he acquires any personal or pecuniary interest in conflict with his duty as such directors;⁵⁶
4. when he consents to the issuance of watered stock or having knowledge of it, does not file with the corporate secretary his written objection;⁵⁷
5. when he agrees to hold himself solidarily liable with the corporation;
6. when the he is made by specific provision of law to personally answer for his corporate action.

The Supreme Court further held in the same case that a director with the stockholder concerned may also be held personally liable to the corporation and its creditors for the difference between the fair value received at the time of the issuance of the watered stock and the par or issued value when he consented to

⁵² *Francisco vs. Merryland Development Corporation*, G.R. No. 141617, 14 August 2001.

⁵³ 238 SCRA 14, at page 19.

⁵⁴ CORP CODE § 31.

⁵⁵ *Id.*

⁵⁶ Corp Code § 31 and § 34.

⁵⁷ Corp Code § 65 :

“Any director or officer of a corporation consenting to the issuance of stocks for a consideration less than its par or issued value or for a consideration in any form other than cash, valued in excess of its fair value, or who, having knowledge thereof, does not forthwith express his objection in writing, and file the same with the corporate secretary, shall be solidarily liable with the stockholder concerned to the corporation and its creditors for the difference between the fair value received at the time of issuance of the stock and the par or issued value of the same.”

the issuance of watered stocks. Moreover, an officer of the corporation becomes liable for damages if he refuses to allow any director, trustee or stockholder to examine the books and records of the corporation.⁵⁸

C.) Statutes

There are likewise special laws which specifically provide for the liability of Directors or Corporate Officers. To wit:⁵⁹

1. General Banking Act of 2000 (Rep. Act No. 8791)

Section 66. Penalty for Violation of this Act.

Unless otherwise herein provided, the violation of any of the provisions of this Act shall be subject to Sections 34, 35, 36 and 37 of the New Central Bank Act. If the offender is a director or officer of a bank, quasi-bank or trust entity, the Monetary Board may also suspend or remove such director or officer. If the violation is committed by a corporation, such corporation may be dissolved by *quo warranto* proceedings instituted by the Solicitor General.

Section 70. Penalty for Transactions After a Bank Becomes Insolvent.

Any director or officer of any bank declared insolvent or placed under receivership by the Monetary Board who refuses to turn over the bank's records and assets to the designated receivers, or who tampers with banks records, or who appropriates for himself or another party or destroys or causes the misappropriation and destruction of the bank's assets, or who receives or permits or causes to be received in said bank any deposit, collection of loans and/or receivables, or who pays out or permits or causes to be paid out any funds of said bank, or who transfers or permits or causes to be transferred any securities or property of said bank shall be subject to the penal provisions of the New Central Bank Act.

2. Securities Regulation Code of 2000 (Rep. Act No. 8799)

Section 51.3. It shall be unlawful for any director or officer of, or any owner of any securities issued by, any issuer required to file any document, report or other information under this Code or any rule or regulation of the Commission thereunder, without just cause, to

⁵⁸J. Salvador & O. Isip, *supra* note 37.

⁵⁹J. *Id.*

hinder, delay or obstruct the making or filing of any such document, report, or information.

Section 73. Penalties. Any person who violates any of the provisions of this Code, or the rules and regulations promulgated by the Commission under authority thereof, or any person who, in a registration statement filed under this Code, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall, upon conviction, suffer a fine of not less than fifty thousand pesos (P50,000.00) nor more than five million pesos (P5,000,000.00) or imprisonment of not less than seven (7) years nor more than twenty-one (21) years, or both in the discretion of the court. If the offender is a corporation, partnership or association or other juridical entity, the penalty may in the discretion of the court be imposed upon such juridical entity and upon the officer or officers of the corporation, partnership, association or entity responsible for the violation, and if such officer is an alien, he shall in addition to the penalties prescribed, be deported without further proceedings after service of sentence.

3. Trust Receipts Law (Pres. Decree No. 115)

Section 13. Penalty Clause.

The failure of an entrustee to turn over the proceeds of the sale of the goods, documents or instruments covered by a trust receipt to the extent of the amount owing to the entruster or as appears in the trust receipt or to return said goods, documents or instruments if they were not sold or disposed of in accordance with the terms of the trust receipt shall constitute the crime of estafa, punishable under the provisions of Article Three hundred and fifteen, paragraph one (b) of Act Numbered Three thousand eight hundred and fifteen, as amended, otherwise known as the Revised Penal Code. If the violation or offense is committed by a corporation, partnership, association or other juridical entities, the penalty provided for in this Decree shall be imposed upon the directors, officers, employees or other officials or persons therein responsible for the offense, without prejudice to the civil liabilities arising from the criminal offense.

Directors, officers, and managers become also personally bound with the corporation if they agreed to be so bound under contract. The Philippine Supreme Court recognized such an undertaking and upheld the liability of a director who jointly and severally warranted payment of all valid and legitimate corporate liabilities of the corporation. Liability of directors and officers can

likewise cover criminal liability.⁶⁰

Section 144 of the Corporation Code categorically provides so:

Violations of any of the provisions of this Code or its amendments not otherwise specifically penalized therein shall be punished by a fine of not less than one thousand (Php 1,000.00) pesos but not more than ten thousand (Php 10,000.00) pesos or by imprisonment for not less than thirty (30) days but not more than five (5) years, or both, in the discretion of the court. Xxx There are also other special laws which subject guilty directors and officers to penal provisions, including the General Banking Act of 2000, Securities Regulation Code, and the Trusts Receipts Law.

Following the Business Judgment Rule, directors and officers of a corporation as a rule, are not liable for acts of the corporation provided they acted in good faith. It does not matter whether such liabilities arise from contractual obligations, intra-corporate issues, tax matters, labor, or environmental regulations. However, if it has been found that they have been guilty of gross negligence or bad faith in their corporate dealings affecting the corporation, its stockholders, and the public in general, they may be held personally liable for damages and may further be criminally bound.⁶¹

Bad Faith In, Business Judgment Rule Out

As held in *Tramat Mercantile, Inc. v. Court of Appeals*,⁶² one of the instances when personal liability of a corporate director, trustee, or officer may validly attach is when he is guilty of gross negligence or bad faith in directing the affairs of the corporation. This is also the same instance when Business Judgment Rule can no longer be invoked.⁶³

In *Philippine Stock Exchange, Inc. v. Court of Appeals*,⁶⁴ the Supreme Court applied the business judgment rule to justify the decision made by the Philippine

⁶⁰ J. Salvador & O. Isip, *supra* note 37 citing *Francisco De Asis, Co., Inc. vs. Court of Appeals*, 136 SCRA 599 (1985).

⁶¹ J. Salvador & O. Isip, *supra* note 37.

⁶² 238 SCRA 14, at 19.

⁶³ *Republic Telecommunications Holdings, Inc. et..al. vs. Court Of Appeals*, et al., G.R. No. 135074 January 29, 1999.

⁶⁴ 281 SCRA 232 (1997) at 248.

Stock Exchange, Inc. in denying the application for listing in the stock market of Puerto Azul Land, Inc. It emphasized that “notwithstanding the regulatory power of the SEC over the PSE, and the resultant authority to reverse the PSE’s decision in matters of application for listing in the market, the SEC may exercise such power only if the PSE’s judgment is attended by *bad faith*.”

Bad faith as a ground for disqualifying the application of business judgment rule appears to be simple at a first glance but may be complicated in its application. But how is the existence of bad faith established as an exception to the Business Judgment Rule?

While there are a few cases in which the court appears to have imposed liability based on a review of the substantive decision itself, most cases in which liability for damages has been imposed involve an element of self-dealing or egregious misconduct *not consistent with good faith*.⁶⁵

In defining the meaning and coverage of “bad faith” on the part of the Board of Directors of a corporation as to warrant an exemption from the business judgment rule, the Philippine Supreme Court in *Philippine Stock Exchange, Inc. v. Court of Appeals*⁶⁶ cited *Board of Liquidators v. Kalaw*,⁶⁷ thus: “bad faith does not simply connote bad judgment or negligence, but imports a dishonest purpose or some moral obliquity and conscious doing of wrong. It means a breach of known duty through some motive or interest of ill will, partaking of the nature of fraud.”

On the other hand, the American Courts view bad faith in this light: The directors must have “*consciously and intentionally disregarded their responsibilities*, adopting a ‘we do not care about the risks’ attitude concerning a material corporate decision.”⁶⁸ The Delaware Court of Chancery in its 2005 post-trial also defined bad faith in the following manner:

“The concept of *intentional dereliction of duty*, a *conscious disregard for one’s responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the

⁶⁵ Hamilton, *supra* note 2, at 450.

⁶⁶ 281 SCRA 232 (1997) at 248.

⁶⁷ 20 SCRA 987 at 1007.

⁶⁸ *In re Walt Disney Co. Derivative Litigation.*, 825 A.2d 275 (Del. Ch. 2003).

epitome of faithless conduct.”⁶⁹

In 2006, the Delaware Supreme Court in the case of *In re Walt Disney Company Derivative Litigation* extensively discussed the definition and categories of bad faith for purposes of Business Judgment Rule. It upheld the Court of Chancery’s definition in its 2005 post-trial as a legally appropriate, although not the exclusive, definition of fiduciary bad faith. It also set out the **three most salient examples of bad faith: (1) the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, (2) the fiduciary acts with the intent to violate applicable positive law, or (3) the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.**⁷⁰

The court further noted that the Chancellor’s observation of bad faith as “an appropriate (*although not the only*) standard for determining whether fiduciaries have acted in good faith” is accurate and helpful, because as a matter of simple logic, at least three different categories of fiduciary behavior are candidates for the “bad faith” pejorative label.⁷¹

*Three Different Categories of Bad Faith*⁷²

The first category involves so-called “subjective bad faith,” that is, fiduciary conduct motivated by an actual intent to do harm. That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic.

The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent.

The third category of fiduciary conduct, which falls in between the first two categories of (1) conduct motivated by subjective bad intent and (2) conduct resulting from gross negligence. This third category is what the Chancellor’s definition of bad faith—intentional dereliction of duty, a conscious disregard for one’s responsibilities—is intended to capture. The question is whether such

⁶⁹ *In re Walt Disney Co. Derivative Litigation*, 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) (unpublished).

⁷⁰ *Supra* note 31.

⁷¹ *Id.*

⁷² *Id.*

misconduct is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith. It was viewed that it must be, for at least two reasons.

First, the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (*i.e.*, preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith. The Chancellor implicitly so recognized in his Opinion, where he identified different examples of bad faith as follows:

“The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.”

Second, the legislature has also recognized this intermediate category of fiduciary misconduct, which ranks between conduct involving subjective bad faith and gross negligence. Section 102(b)(7)(ii) of the Delaware General Corporation Law expressly denies money damage exculpation for “acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.” By its very terms that provision distinguishes between “intentional misconduct” and a “knowing violation of law” (both examples of subjective bad faith) on the one hand, and “acts...not in good faith,” on the other. Because the statute exculpates directors only for conduct amounting to gross negligence, the statutory denial of exculpation for “acts...not in good faith” must encompass the intermediate category of misconduct captured by the Chancellor’s definition of bad faith.

IV. BUSINESS JUDGMENT RULE IN UNCLE SAM'S CORPORATE WORLD

In the United States, the *business judgment rule* is an institution with very deep roots and with a very detailed set of rules and consequences. Designed as a shield to prevent the second-guessing of directors' business decisions, the American business judgment rule is not so much about the standard of care that directors bring to their decisions but focuses more on the procedures that directors will follow. The business judgment rule is considered a "safe harbour" designed to avoid an enquiry into the director's standard of care. If a director can bring herself within the safe harbour, no liability will attach.⁷³

Fiduciary Duties of the Board of Directors and Corporate Officers

[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry.

To whom is he a fiduciary?

What obligations does he owe as a fiduciary?

In what respects has he failed to discharge these obligations?

And what are the consequences of his deviation from duty?

Justice Frankfurter⁷⁴

The director's fiduciary duty to both the corporation and its shareholders has been characterized by the Delaware Supreme Court as a triad comprised of good faith, due care, and loyalty.⁷⁵

A. Duty of Care

Under Delaware law, directors are required to exercise that amount of care which ordinarily careful and prudent men would use in similar circumstances.⁷⁶

⁷³ http://www.masse.org/director_liability.html (last accessed December 30, 2006).

⁷⁴ *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943).

⁷⁵ HAMILTON, *Supra* note 23 citing Rodman Ward, Jr., Edward P. Welch & Andrew J. Turezyn, Esquire, *FOLK on the Delaware General Corporation Law* (4th ed. 1998) (Supp 2003) (Aspen Publishers). "The directors of Delaware corporations have a triad of primary fiduciary duties; due care, loyalty, and good faith."

⁷⁶ M. Littenberg & E. Schauder. *Fiduciary Duties and the Venture Capitalist Director*. NEW YORK LAW JOURNAL, October 15, 2002, <http://www.srz.com/files/Article-October2002-FiduciaryDutiesandtheVentureCapitalistDirector.pdf> (last accessed December 30, 2006), citing *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

the duty of care is comprised of two components, namely:⁷⁷ (i) duty of care in the decision-making process; and (ii) duty of care in overseeing the conduct of employees and advisors.

Duty of Care in the Decision-Making Process. The “decision-making function” refers to specific matters delegated to directors such as authorizing distributions or selecting corporate officers. The decision-making function may also refer to a Board of Directors in a closely-held corporation that is itself performing the management function.⁷⁸

This component of the duty of care has evolved in various cases over the years. Perhaps the most well-known decision in this area is *Smith v. Van Gorkom*.⁷⁹ In this case, the Delaware court held that the duty of care mandates that directors should make *an informed decision* based on all material information reasonably available to them and that they should critically assess information. The court further concluded that the Board Members of Trans Union Corporation were grossly negligent and had thus breached their duty of care. Van Gorkom, the chairman of Trans Union Corporation, had unilaterally negotiated the sale of Trans Union and presented the proposal to the board in a 20-minute presentation. Thereafter, the board deliberated for only 90 minutes before approving the plan. During this process, the board did not consult with outside counsel. Moreover, the only evaluation of the purchase price was made at the last minute by an internal officer of the company. The court concluded that the directors were personally liable for their actions, although the case was settled before damages were determined.⁸⁰

Duty of Care in Oversight. The oversight function refers to the monitoring of decisions by management⁸¹ wherein directors are also permitted to delegate and to rely on corporate officers and experts in other contexts, including the implementation of board decisions. The board must however oversee and investigate the conduct of corporate employees and advisors and exercise

⁷⁷ *Id.*

⁷⁸ HAMILTON, *Supra* note 2, at 448.

⁷⁹ M. Littenberg & E. Schauder, *supra* note 75, citing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

⁸⁰ *Id.*

⁸¹ HAMILTON, *supra* note 2, at 448.

reasonable care to see that management fulfills its responsibilities in compliance with law.

In *In re Caremark International Inc. Derivative Litigation* (Del. Ch. 1996), a heightened standard of good faith in the area of oversight of a corporation's personnel and business activities was imposed. The directors must make a good faith effort to establish procedures to protect the corporation's interests from malfeasance by employees.⁸²

B. Duty of Loyalty

The duty of loyalty is referred to in the American law Institute's *Principles of Corporate Governance* as a duty of "fair dealing." It involves the assessment of the propriety of specific transactions.⁸³ The duty of loyalty requires that directors and officers must refrain from engaging in personal activities which would injure or take advantage of the organization. They are prohibited from using their position of trust and confidence to further their private interests.

This duty requires an undivided and unselfish loyalty to the organization and demands that there be no conflict between one's duty to the organization and self-interest.⁸⁴ Prohibited conducts in this regard include but not limited to the following: 1.) directors and officers may not realize secret profits or unfair gain through personal transactions with or on behalf of the organization; 2.) they may not compete with the organization to its detriment; may not usurp an opportunity of the organization; 3.) they may not realize personal gain from the use of material, non-public information; 4.) they should avoid even the appearance of a conflict of interest.⁸⁵

C. Duty of Good Faith

"The Delaware Supreme Court has expanded its definition of the fiduciary duty of directors into a 'triad,' encompassing not only the duty of loyalty and the duty of care, but a third, independent duty of good faith. Good faith as a

⁸² *Id.*

⁸³ *Id.* at 444.

⁸⁴ General Principles Governing D&O Liability, <http://www.hahnline.com/orgprinc.htm> (last accessed December 30, 2006).

⁸⁵ *Id.*

separate aspect of the performance of a director's fiduciary duty is also suggested by a 1986 amendment to the General Corporation Law. However, it is difficult to see how good faith as a concept is not encompassed within the other legs of the 'triad' - *i.e.*, how a director might be found to have breached his duty of good faith without being either disloyal or insufficiently careful."⁸⁶

Losing Control: When the Board of Directors Does Not Comply

A. Duty of Care

The board will not lose its business judgment rule protection for lack of due care, unless the board's conduct amounts to gross negligence.⁸⁷ As the Delaware Supreme Court has emphasized, "the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."⁸⁸ However, the directors will not be personally liable for damages even for gross negligence if the shareholders of the company have adopted a charter provision, as authorized by Delaware General Corporation Law § 102(b)(7), limiting liability to acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.⁸⁹

In many cases, the Delaware Supreme Court has ruled that "director liability for breaching the duty of care is predicated upon concepts of gross

⁸⁶ FLEISCHER, JR. AND SUSSMAN, *supra* note 23, citing David A. Drexler, Lewis S. Black, Jr., A Gilchrist Sparks, III, Delaware Corporation Law and Practice (1998) (Supp. 2002). (Matthew Bender) citing (See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995); 8 Del. C. §102(b)(7)).

⁸⁷ *Id.* See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). In *Function Over Form*, the jurists complain that *Van Gorkom* and the later *Cede II* ruling improperly diluted the gross negligence standard. See 56 Bus. Law. at 1299-1301. They contend that the alleged failures of process in *Van Gorkom* "may have amounted to ordinary negligence, but it is difficult to argue that they constituted gross negligence, which involves a devil-may-care attitude or indifference to duty amounting to recklessness."

⁸⁸ *Id.* See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del.1984) ("Under the business judgment rule director liability is predicated upon concepts of gross negligence."). *Accord*, *Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53, 66-67 (Del. 1989); *Grobow v. Perot*, 539 A.2d 180, 190-91 (Del. 1988) (dismissing stockholder derivative claim of gross negligence for failure to make pre-suit demand).

⁸⁹ *Id.* See Takeover Defense §3.06[A].

negligence,”⁹⁰ but it has not specifically defined those concepts of gross negligence. In *McMillan v. Intercargo Corp.*,⁹¹ Vice Chancellor Strine gave content to the term in observing that second-guessing about whether a board’s strategy was reasonable or appropriate is not sufficient to show gross negligence; rather a plaintiff must set forth facts from which one could infer that the defendants’ lack of care was so egregious as to meet Delaware’s onerous gross negligence standard.⁹²

B. Duty of Loyalty

The Delaware Supreme Court has held that a claim that a director is self-interested, standing alone without evidence of disloyalty, does not rebut the business judgment rule presumption.⁹³ The self-interest of a single director does not taint the business judgment protection for the board’s action, unless it would have affected the collective decision of the board.⁹⁴ A subjective “actual person” standard applies in determining whether any self-interest was material to the allegedly conflicted director’s decision.⁹⁵

“In *Technicolor*, the Delaware Supreme Court affirmed the Chancery Court’s conclusions that under the subjective test only one of nine directors had

⁹⁰ *Id.* See *Malpiede v. Townson*, 780 A.2d 1075, 1097 n. 76 (Del. 2001) (quoting *McMullin*, 765 A.2d at 921 (quoting *Aronson*, 473 A.2d at 812)).

⁹¹ 768 A.2d 492 (Del. Ch. 2000).

⁹² *Supra* note 23.

⁹³ *Id.*, citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362, 365 (Del. 1993) (“*Cede II*”), *after remand*, *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156 (Del. 1995). See §3.03[A][3] (Independence of the Board).

⁹⁴ *Id.*, citing *Cede II*, 634 A.2d at 363-64.

⁹⁵ *Id.*, citing *Technicolor*, 663 A.2d at 1167; *accord*, *Orman v. Cullman*, 794 A.2d 5, 24, 29-31 (Del. Ch. 2002) (in shareholder derivative suit challenging a cash-out merger, court found pleading sufficient to overcome the business judgment rule presumptions, when a majority of the Board allegedly lacked independence, four directors being affiliated with the interested controlling shareholder and two directors being interested because they were receiving, respectively, consulting fees and an investment banking fee if the merger were completed); *see also H-M Wexford LLC v. Encorp, Inc.*, C.A. No. 19849, 2003 Del. Ch. LEXIS 54 (Del. Ch. May 27, 2003)

(“the alleged benefit must be significant enough as to make it improbable that the director could perform his fiduciary duties to the shareholders”) (quoting *Orman*, 794 A.2d at 23).

a material conflict of interest and, notwithstanding this self-interest, the board as a whole remained a neutral decision-making body.”⁹⁶

In *Parnes v. Bally Entertainment Corp.*,⁹⁷ the plaintiff challenged the merger of Bally with Hilton Hotels. The court ruled that, to overcome the presumption of the business judgment rule, plaintiff had to prove that a majority of the directors will receive a personal benefit from a transaction that is not equally shared by the stockholders... or where a corporate decision will have a materially detrimental impact on a director but not on the corporation and the stockholders or that a majority of the directors were beholden to an interested party or so under the influence of an interested party that the directors’ discretion would be sterilized.⁹⁸ In this case, the court found that the outside board members were completely disinterested and independent and dismissed the claims.⁹⁹

C. Duty of Good Faith

“The Delaware Supreme Court has expanded its definition of the fiduciary duty of directors into a ‘triad,’ encompassing not only the duty of loyalty and the duty of care, but a third, independent duty of good faith. Good faith as a separate aspect of the performance of a director’s fiduciary duty is also suggested by a 1986 amendment to the General Corporation Law. However, it is difficult to see how good faith as a concept is not encompassed within the other legs of the ‘triad’ - *i.e.*, how a director might be found to have breached his duty of good faith without being either disloyal or insufficiently careful.”¹⁰⁰

The duty to act in good faith has played a prominent role in the case of *In Re The Walt Disney Company Derivative Litigation*¹⁰¹. In this case, the Delaware Supreme Court emphasized the distinction between duty of care and duty to act in good faith as it observed:

“From a broad philosophical standpoint, that question is more complex

⁹⁶ *Id.*

⁹⁷ No. 15192, 2001 Del. Ch. LEXIS 34 (Del. Ch. Feb. 20, 2001).

⁹⁸ *Supra* note 23, quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

⁹⁹ *Id.*

¹⁰⁰ *Id.*, citing David A. Drexler, Lewis S. Black, Jr., A Gilchrist Sparks, III, Delaware Corporation Law and Practice (1998) (Supp. 2002) (Matthew Bender) citing (See *Cinerama, Inc. v. Technicolor, Inc.*), 663 A.2d 1156 (Del. 1995); 8 Del. C. §102(b)(7)).

¹⁰¹ *Supra* note at 31.

than would appear, if only because (as the Chancellor and others have observed) “issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty...” But, in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith. The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law jurisprudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction.”¹⁰²

The issue of whether a violation of the duty to act in good faith serves as a basis for the direct imposition of liability was squarely addressed in the case of *Stone v. Ritter*¹⁰³ where the Supreme Court of Delaware held that:

“The phraseology used in *Caremark*¹⁰⁴ and that we employ here – describing the lack of good faith as a “necessary condition to liability” – is deliberate. **The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability.** The failure to act in good faith may result in liability because the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty. It follows that because a showing of bad faith conduct, in the sense described in *Disney*¹⁰⁵ and *Caremark*¹⁰⁶, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.”

Thus, breach of the duty of good faith alone does not create cognizable action. Bad faith is a necessary, but not sufficient condition in most cases. As such, bad faith must be accompanied by another breach of fiduciary duty of due care or loyalty.

¹⁰² *Id.*

¹⁰³ *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). November 6, 2006

¹⁰⁴ *In re Caremark Int’l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del.Ch.1996).

¹⁰⁵ *Supra* note at 31.

¹⁰⁶ *Supra* note at 104.

In *Stone v. Ritter*¹⁰⁷, the Delaware Supreme Court laid down two additional doctrinal consequences of failure to act in good faith. To wit:

First, although good faith may be described colloquially as part of a “triad” of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.

Second, the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman v. Huang*¹⁰⁸, “a director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”

As a rule, when the board of directors or corporate officers fails to comply with any of their fiduciary duties of care, loyalty, and good faith, the Business Judgment Rule will not apply. Thus, the court will necessarily intrude into the wisdom of the Board’s decision.

This rule has, however, been modified in the case of *Stone v. Ritter*¹⁰⁹ where the Delaware Supreme Court held that “although good faith may be described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly.”¹¹⁰ Succinctly put, under Delaware State jurisdiction, failure of the Board of Directors or Corporate Officers to comply with their fiduciary duties of due care or loyalty is actionable in courts. However, failure to comply with fiduciary duty to act in good faith alone will not necessarily negate the operation of business judgment rule as a strong presumption in favor of the Board of Directors and Corporate Officers.

¹⁰⁷ *Supra* note at 103.

¹⁰⁸ 823 A.32 2d 492, 506 n. 34 (Del.Ch.2003).

¹⁰⁹ *Supra* note at 103.

¹¹⁰ *Id.*

The Delaware Courts and Business Judgment Rule through the Years

In the United States, lawyers often point to the well-established “business judgment rule” in Delaware as a strong incentive for management to choose a Delaware entity.¹¹¹ One popular reason for this preference is the perception that Delaware law is more favorable to management.¹¹² Generally, Delaware courts presume 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.”¹¹³ The business judgment rule protects directors and their decisions unless the presumptions of the rule are rebutted.¹¹⁴

The business judgment rule insulates directors from liability for “negligent” board decisions so long as the board’s information gathering and decision-making process was rational or employed in a good faith effort to advance corporate interests.¹¹⁵ However, notwithstanding the substantial protection of the rule, Delaware law leaves the board vulnerable and restricts its decision-making power in certain circumstances. Board decisions are subject to enhanced scrutiny when: 1.) a board adopts a defensive measure in reaction to a perceived threat to corporate control (the “Unocal”¹¹⁶ test) or, 2.) when the decision concerns the breakup of the company and/or a change of control (the “Revlon”¹¹⁷ test). Delaware courts have concluded that these situations create the opportunity for management to entrench itself despite the best interests of the shareholders. As a result, the courts apply, among other requirements, an objective “reasonable person” analysis to measure whether the actions of the board can be sustained.

The nuances of the business judgment rule that have been explained in numerous Delaware court decisions have “caused a general atmosphere of confusion and uncertainty for courts, academics and, most importantly, directors

¹¹¹ James J. Wheaton, Virginia or Delaware: *No Reason To Leave The Old Dominion, Business & The Law*, Troutman Sanders LLP, Atlanta, Georgia, Fall 2003.

¹¹² *Id.*

¹¹³ *Id.*, citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

¹¹⁴ *Id.*, citing *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959, 967-68 (Del. Ch. 1996).

¹¹⁵ *Id.*

¹¹⁶ *Id.*, citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A. 2d 946 (Del 1985).

¹¹⁷ *Id.*, citing *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173 (Del 1986).

of corporations . . . ”¹¹⁸ The objective nature of the tests applied by Delaware courts in many situations means that directors of Delaware corporations can be found liable, even when they have acted in good faith and followed reasonable procedures, because they fail to satisfy a court’s perception of what a hypothetical “reasonable” director would have done.

The Celebrated Case of Smith v. Van Gorkom

In 1985, the Delaware Supreme Court shocked the corporate world. Van Gorkom was the chief executive officer of Trans Union Corporation, a publicly held corporation. He owned 75,000 shares out of 20,000,000 outstanding. During review of the future of the corporation, it discussed the possibility of taking the company private through a leveraged buyout or selling it outright. Van Gorkom, who was close to mandatory retirement age, declared that he would accept \$55 per share for his shares of stock. He made this assessment based on his knowledge of the corporation’s business. Studies were also made by the management to determine whether the cash flow of the corporation at the present level of operations could support the debt needed to support a \$55 price in a leveraged buyout. On the basis of projections run by the corporation’s chief financial officer, it appeared that the cash flow might be adequate for this purpose.¹¹⁹

Without further investigation into the value of the company, without seeking other possible buyers, and without consulting either his Board or any members of the Senior Management except the Trans Union’s Controller, Van Gorkom decided to meet with Jay A. Pritzker, a well-known corporate takeover specialist and a social acquaintance. However, rather than approaching Pritzker simply to determine his interest in acquiring Trans Union, Van Gorkom assembled a proposed per share price for sale of the Company and a financing structure by which to accomplish the sale. Pritzker promptly offered to buy the corporation in a straight purchase at \$55 per share with a decision required within three (3) days. The board of directors was then presented with the \$55 proposal as an emergency matter with a strict three (3) day deadline. Van Gorkom recommended the approval of the transaction based on the argument that the company would consider other offers for a period of months as a “market test” of the adequacy of the price. The Chief Financial Officer opined that the price was

¹¹⁸ *Id.*, citing Engledow, Structuring Corporate Board Action to Meet the Ever-Decreasing Scope of Revlon Duties, 63 Alb. L. Rev. 505 (1999).

¹¹⁹ HAMILTON, *supra* note 2, at 455-456.

“fair but at the beginning of the range.” The board then approved the transaction without asking questions or without extended discussions.¹²⁰

It is worthy to note that the Merger Agreement was executed by Van Gorkom while attending the Chicago Lyric Opera. Apparently, neither he nor any other director personally reviewed the agreement prior to its signing and delivery to Pritzker. The transaction was subsequently submitted for approval of Trans Union shareholders.

The Delaware Supreme Court found that the directors had not adequately informed themselves about the value of the company and the proposed transaction before approving a takeover, and thus were not entitled to the protection of the business judgment rule. The directors were grossly negligent because they approved the merger after only two hours’ deliberation, without prior notice, and without the existence of an emergency. The court awarded damages consisting of the difference between the fair value of the stock and the offered price.¹²¹

The decision provoked strong criticism and extensive commentary because Delaware Courts rarely second-guessed decisions made by experienced directors. The dissenters argued that the directors should be able to evaluate a proposed sale of the company on the basis of their own financial experience, and in reliance on Van Gorkom’s experience and background.¹²² According to Robert Hamilton, it may be argued that *Van Gorkom* was correctly decided because a decision to sell the business of a publicly held company is such an important decision which should not be made without investigation and in blind reliance on the judgment of a single person who will benefit significantly from the transaction. This should be true no matter how confident the directors are in that person’s abilities and objectivities.¹²³

“The immediate consequences of the *Van Gorkom* decision on the business community were disturbing. Lawyers and law firms sent out memoranda to their clients warning them of the risk of liability in the absence of a careful investigation. The memoranda recommended that experts be hired and a “paper trail” be created to demonstrate that a sufficient investigation was made to comply with the requirements of the business judgment rule. Also, some outside directors began to reassess their decision to be directors, and isolated

¹²⁰ *Id.* at 456.

¹²¹ Jacqueline M. Veneziani, Causation and Injury in Corporate Control Transactions: *Cede & Co. v. Technicolor, Inc.*, WASHINGTON LAW REVIEW, Vol. 69 Nos. 3-4, July-Oct. 1994.

¹²² HAMILTON, *supra* note 2, at 457.

¹²³ *Id.* at 458.

instances of resignations were reported. The number of lawyers serving on the boards of directors of their clients declined. And some people reported that it was becoming increasingly difficult to persuade desirable persons to serve on boards because of the potential risks involved, despite the level of compensation and the availability of indemnification and insurance.”¹²⁴

In 1986, the Delaware General Assembly quickly responded to the decision of *Smith v. Van Gorkom* and adopted Section 102(b)(7) of the Delaware General Corporation Law.¹²⁵ The policy choice reflected in that legislation seems fairly clear: it authorizes corporations to amend their certificates of incorporation to eliminate or limit the personal liability of directors for monetary damages on claims of breach of fiduciary duty brought by stockholders by or in the right of the corporation, with certain limited exceptions. These exceptions are: 1.) Breach of the director’s “duty of loyalty” to the corporation; 2.) Acts or omissions “not in good faith or which involve intentional misconduct or a knowing violation of law,” and 3.) Any transaction from which the director derived an improper personal benefit. Eventually, thousands of Delaware corporations promptly amended their articles of incorporation to take advantage of this new provision, which was quickly copied in many other states.¹²⁶

*The Glamour and Bustle of Hollywood Down
to Prosaic and Tranquil Georgetown,*

Delaware in re Walt Disney Co. Derivative Litigation

Michael Eisner (“Eisner”) and The Walt Disney Company (“Disney”) have provided new grist for the mill.¹²⁷ The case of *In re Walt Disney Co. Derivative Litigation*,¹²⁸ arose out of the hiring and subsequent termination of Michael Ovitz (“Ovitz”) as the President of the Walt Disney Company, “a company that for over half a century has been one of America’s leading film and entertainment enterprise.”¹²⁹

¹²⁴ *Id.* at 458-459.

¹²⁵ 65 DEL. LAWS 544 (1986).

¹²⁶ HAMILTON, *supra* note 2, at 459.

¹²⁷ Lawrence A. Hamermesh, Twenty Years After *Smith v. Van Gorkom: An Essay on the Limits of Civil Liability of Corporate Directors and the Role of Shareholder Inspection Rights*, WASHBURN LAW JOURNAL Vol. 45, page 283, <http://washburnlaw.edu/wlj/45-2/articles/hamermesh-lawrence.pdf> (last accessed December 30, 2007).

¹²⁸ *Supra* note 31.

¹²⁹ *Id.*

In August 1995, Ovitz and Disney entered into an employment agreement which Ovitz would serve as President of Disney for five years. However, in December 1996 or only fourteen months after he commenced employment, Ovitz was terminated without cause, resulting in a severance payout to Ovitz valued approximately \$130 million.

Several Disney shareholders immediately brought derivative actions in the Court of Chancery, on behalf of Disney, against Ovitz and the directors of Disney. They claimed that the \$130 million severance payout was the product of fiduciary duty and contractual breaches by Ovitz, and breaches of fiduciary duty by the Disney directors, and a waste of assets.

The trial in the *Disney* litigation concerning Ovitz was nothing short of extraordinary. The thirty-seven day trial brought Eisner, Ovitz, and a stream of luminaries (Sidney Poitier and others) from the glamour and bustle of Hollywood all the way to Georgetown, Delaware, a small county seat in the rural southern part of the state.¹³⁰ Chancellor Chandler described the event as “something of a public spectacle.”¹³¹ “And a spectacle it was, although not in any way as uplifting for the participants as a Cecil B. DeMille *oeuvre*. It revealed embarrassing excess: a \$2 million renovation of Ovitz’s office, for example,¹³² and personal betrayal and recrimination at the highest corporate levels, with Eisner writing about Ovitz that ‘nobody trusts him, for he cannot tell the truth,’¹³³ and Ovitz testifying that he had been betrayed by fellow executives.”¹³⁴

Notably in 2003, the Court of Chancery allowed the Ovitz employment agreement derivative litigation to go forward to trial.¹³⁵ It did so by interpreting the statutory “good faith” element to permit an inference that the Disney directors had not just acted negligently or grossly negligently, but that they had “*consciously*

¹³⁰ HAMERMESH, *supra* note 127 citing Jesse A. Finkelstein et al., *The Disney Trial: A Perspective from Inside the Courtroom*, INSIGHTS, Sept. 2005.

¹³¹ *Id.*, citing Maureen Milford, *Even a Sequel Could Not Match Drama of Original Disney Show; Sensational Trial Brought Financial Boost, Hollywood Glamour to Sussex County*, NEWS J. (Wilmington, Del.), Oct. 16, 2005.

¹³² *Id.*

¹³³ *Id.*, citing *In re Walt Disney Co. Derivative Litigation.*, No. 15452, slip op. at 50 n.186 (Del. Ch. Aug. 9, 2005).

¹³⁴ *Id.*, citing Milford, *supra* note 17 (“One executive claimed he had to clean up after Ovitz by walking behind him with a shovel. ‘He did walk behind me,’ Ovitz testified last year. ‘But it wasn’t a shovel he was carrying. It was a knife.’”).

¹³⁵ *Supra* note 68.

and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."¹³⁶

In 2005, Chancellor Chandler concluded that Disney Directors did not breach their fiduciary duties or commit waste.¹³⁷ The court made pertinent rulings regarding the business judgment rule and held that the rule's protections will not apply if the directors have made an "unintelligent or unadvised judgment."¹³⁸ The court made a distinction between directorial inaction and a director's conscious decision not to act.¹³⁹ An informed and conscious decision to refrain from acting may be a valid exercise of business judgment and will, accordingly, enjoy the protections of the rule. However, the rule has no role to play where directors have either abdicated their functions or failed to act—clearly, dereliction of duty is not protected. In these circumstances, the appropriate standard for determining liability is widely believed to be "gross negligence."¹⁴⁰

The Chancellor Chandler's opinion after trial, despite granting judgment for the Disney directors, was anything but a vindication of their conduct. According to the chancellor, Eisner "stretched the outer boundaries of his authority as CEO," falling "far short of what shareholders expect and demand from those entrusted with a fiduciary position," to the point that he had "enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom."¹⁴¹ As for the Disney directors, the chancellor simply expressed the "hope that this case will serve to inform stockholders, directors and officers

¹³⁶ HAMERMESH, *supra* note 127 citing *In re Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) at page 289.

¹³⁷ *Supra* note 14 citing *In re Walt Disney Co. Derivative Litigation.*, 2005 Del. Ch. LEXIS 113 (Aug. 9, 2005) (unpublished) ("Disney II").

¹³⁸ *Id.* See also *Mitchell v. Highland-Western Glass Co*, 19 Del. Ch. 326, 329, 167 A. 831 (1933).

¹³⁹ *Id.* See also *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) ("a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment" (emphasis added).

¹⁴⁰ *Id.* See *Seminaris v. Landa*, 662 A.2d 1350 (Del. Ch. 1995); *In re Baxter Int'l*, 654 A.2d 1268 (Del. Ch. 1995). However, a single Delaware case has held that ordinary negligence would be the appropriate standard. See *Rabkin v. Philip A. Hunt Chem. Corp*, 1987 Del. Ch. LEXIS 522, *1-3 (Dec 17, 1987) (unpublished), later proceeding, *Rabkin v. Olin Corp.*, 1990 Del. Ch. LEXIS 500, *aff'd*, 1990 Del. LEXIS 405 (Dec. 20, 1990).

¹⁴¹ HAMERMESH, *supra* note 127 citing *In re Disney*, No. 15452, slip op. at 140.

of how the Company's fiduciaries underperformed."¹⁴² And yet, the Chancellor did not hold the Disney directors personally liable.

The court further held that the business judgment rule presumptions protected the decisions of the compensation committee and the remaining Disney directors, not only because they had acted with due care but also because they had not acted in bad faith. In its Opinion the Court of Chancery defined bad faith as follows:

"Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty*, a *conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct."¹⁴³

In 2006, the Delaware Supreme Court affirmed the judgment of the Court of Chancery that the decisions made by the Disney board to approve the Ovitz's Employment Agreement ("OEA"), to hire Ovitz as President and then to terminate him on a Non-Fault Termination ("NFT") basis were protected by the business judgment rule.

The court clarified that there is no substantive difference between the Court of Chancery's 2003 definition of bad faith—a "conscious and intentional disregard of responsibilities, adopting a 'we don't care about the risks' attitude..."—and its 2005 post-trial definition—an "intentional dereliction of duty, a conscious disregard for one's responsibilities." Rather, both formulations express the same concept, although in slightly different language.¹⁴⁴

This decision again provoked strong criticism as it leaves an impression that to create a definitive and categorical definition of the universe of acts that would constitute bad faith would be difficult if not impossible. The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty but all the actions required by a true, faithful steward of the interests of the corporation and its shareholders.

Professors Rock and Wachter described the duty of care in 2003 as "a concept best understood as a "non-legally enforceable rule or standard ('NLER'),"

¹⁴² *Id.*

¹⁴³ *Supra* note 69.

¹⁴⁴ *Supra* note 31.

carrying hortatory value but no formal legal sanction.¹⁴⁵ “In this conception, formal legal sanctions (notably money damages) are an unnecessary, even counterproductive, tool. In the Rock/Wachter model, rather, the role of the Delaware courts is simply to jawbone and encourage the dissemination of good governance practices. No rational director could seriously wish to imitate the behavior of the Disney directors and face the public exposure, criticism, and even humiliation—although not liability—that they have had to endure as a result of the Ovitz derivative litigation. To the contrary, just as Rock and Wachter suggest, the opinion in *Disney* will undoubtedly be held up as an NLER-reinforcing model of how directors should *not* behave. If shareholder plaintiffs’ lawyers would continue to pursue litigation like the *Disney* case, this hortatory value-generating model of litigation, based on the fiduciary duty of care, might function well. This model, however, has a practical limit. After the *Disney* litigation, it is increasingly hard to believe that rational plaintiffs’ lawyers will be willing to invest the massive amounts of time and money necessary to prosecute duty-of-care claims, at least in the Delaware courts, when the sole reward to plaintiffs’ lawyers is the comfort of having exposed suboptimal management practices, a comfort which obviously involves no monetary benefit. In short, even if duty-of-care litigation in the Delaware courts has had some hortatory (NLER) value, that value is at risk if plaintiffs’ lawyers have no incentive to bring cases that elicit judicial guidance.”¹⁴⁶

As observed by Professor Lawrence A. Hamermesh, “it also seems undeniable—and practicing lawyers generally agree—that invoking cases like *Van Gorkom* to their director-clients gives lawyers a tool with which to encourage director attention and responsibility. With personal liability for lack of care an increasingly remote threat, there may be some concern that this tool will become untenably ineffectual. There may therefore be value in considering whether some alternative means exists, which does not involve monetary sanctions against directors, to achieve the hortatory value provided by cases such

¹⁴⁵HAMERMESH, *supra* note 127 citing Edward B. Rock & Michael L. Wachter, *Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation*, 149 U. PA. L. REV. 1619, 1623, 1695 (2001). In this article, Rock and Wachter suggested that the *Disney* litigation would be dismissed upon repleading following the Delaware Supreme Court’s remand in *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). See Rock & Wachter, *supra*, at 1679-80. Of course, the case was not dismissed at that point, but Rock and Wachter’s overall prediction of non-liability was borne out, at least so far, by the judgment for the defendants in 2005. *In re Disney*, No. 15452, slip op. at 174.

¹⁴⁶ *Id.*

as *Disney*.”¹⁴⁷ In any event, *Van Gorkom*’s significance and *in terrorem* value fade into insignificance.¹⁴⁸

Business Judgment Rule in Litigation: The Making

In the United States, before cases involving Business Judgment Rule are brought to Courts by the stockholders, they should first be delegated to a certain group called the “Litigation Committee”. The Litigation Committee is composed of outside directors, who are not themselves principal defendants or involved in the acts complained of. The Litigation Committee is responsible in conducting an investigation as to the merits of the litigation and the advantages and disadvantages to the corporation of pursuing it.¹⁴⁹

“If decisions by litigation committees are protected by the Business Judgment Rule, the decision to discontinue litigation is binding on the plaintiff shareholder. He is thereafter foreclosed from litigating the merits of the case because of the binding nature of the impartial directors’ business judgment. The plaintiff, however, may litigate issues such as the independence and lack of involvement of the members of the committee recommending the discontinuance of the litigation, or of the adequacy of the underlying investigation.”¹⁵⁰

Early decisions including decisions by the United States Supreme Court and the Court of Appeals of New York, uncritically applied the business judgment rule to litigation committee decisions. On the other hand, the Delaware Courts determined the scope of Business Judgment Rule by establishing whether the case is classified as “*demand required*” or “*demand excused*.”¹⁵¹

“A case is ‘*demand excused*’ if the plaintiff has pleaded ‘particularized facts’ that ‘tend to show that the decision complained of is not protected by the business judgment rule.’ If the decision appears to be protected by the business judgment rule, it is a ‘*demand required*’ case. Otherwise, the case is a ‘*demand excused*’ case.”¹⁵²

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ HAMILTON, *supra* note at 463.

¹⁵⁰ *Id.* at 463-464.

¹⁵¹ *Id.* at 464.

¹⁵² *Id.* at 464-465.

In a “*demand required*” case, the plaintiff must make a demand on the board or his case will be dismissed for failing to exhaust his remedies. If a demand is made, moreover, that is a concession by the plaintiff that the case is in fact a “*demand required*” case, and the plaintiff’s case is lost if the committee determines that the decision is protected by the Business Judgment Rule. The plaintiff cannot thereafter argue that the case was really a “*demand excused*” case all along.¹⁵³

In applying the “*demand excused*” case, the Delaware Supreme Court in its decision in *Zapata Corporation vs. Maldonado* (Del. 1981), considered two factors: (1) a court should consider the independence and good faith of the “Independent Litigation Committee” and; (2) a court should exercise its “own independent business judgment” as to whether the litigation should proceed.¹⁵⁴

However, both the American Law Institute and the ABA Committee on Corporate Laws have been dissatisfied with the Delaware approach. Thus, alternative approaches were made wherein a demand should be made in all cases and then separate standards for the scope of the review of the litigation committee should be provided. Section 7.43 of MBCA (1984) provides that the litigation committee decision is final where the directors making the decision are truly independent.¹⁵⁵

“Most decisions involving litigation committees have arisen under Delaware Law. However, there are several decisions in other states. These decisions have generally not adopted the demand required/demand excused distinction of the Delaware law. While the stated tests vary, most courts appear to judge the validity of litigation committee decision in part on whether the decision appears proper and reasonable on the record before the committee and the court.”¹⁵⁶

¹⁵³ *Id.* at 465.

¹⁵⁴ *Id.* at 465.

¹⁵⁵ *Id.* at 466.

¹⁵⁶ *Id.* at 466-467

V. CONCLUSION

*“Our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs.”*¹⁵⁷

In this age of globalization where trade and commerce transactions have new faces, the concept of limited liability for the Board of Directors and Corporate Officers is still alive. So is the business judgment rule. Its foundation is the desire to promote entrepreneurship. But times have changed. At present, some areas of corporate decision making receive more scrutiny from the courts. However, **the bottom line is that there are no litmus tests with respect to corporate decision making and one should, when making significant decisions, where reasonable minds could differ, stand back from the decision and think like a party who might complain about the decision.**¹⁵⁸ That is to say, one must think like a plaintiff. Every decision should be reviewed for any form of self-interest, as bias may subvert the impartiality of the decision maker. One should be fully informed, seek outside expert opinions and take some time to deliberate.¹⁵⁹

The Business Judgment Rule has occupied an important rule in the American Corporate Law that extensive analysis was made in order to arrive at a standard or guideline before the members of the Board of Directors may validly invoke the protection of this rule. Due to the complexity of Business Judgment Rule in its application, certain elements have emerged in the United States as the core of the business judgment rule.

“First, the rule always includes the following key concepts: (i) a business decision, (ii) made in good faith, (iii) by disinterested parties, (i.e., no self-dealing or self-interest), (iv) based on informed judgment, and (v) with a belief (often described by a subjective or objective qualifier such as “reasonable,” “rational,” or “honest”) that the action taken is in the best interests of the corporation. Second, the rule always has two related and complementary aspects: that directors will be presumed to have acted properly and that a court will not second guess the business merits of a business decision. Finally, the rule operates in two basic contexts: to protect a business decision from attack and to protect individual

¹⁵⁷ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985).

¹⁵⁸ Randall L. Nash, *How strong is the “Corporate Shield” for Officers and Directors?*, <http://www.wilaw.com/newsletter/arch-01.html> (last accessed January 6, 2006).

¹⁵⁹ *Id.*

directors from monetary liability.”¹⁶⁰

Thus, failure to comply with these elements¹⁶¹ will negate the benefits accorded to by the Business Judgment Rule.

The American Courts also focused not only on the substantive but also the procedural aspect of this rule. In *Cinerama, Inc. v. Technicolor, Inc.* (Del. 1995), the Court stated that the business judgment rule has both procedural and substantive aspects. It is “procedural” because it places the initial burden of proof on the defendants to establish that the business judgment rule is applicable. If the defendants establish that the business judgment rule was satisfied, the burden of proof shifts and the transaction is approved unless the plaintiff can

¹⁶⁰ *Supra* note 73.

¹⁶¹ ***Elements of the Business Judgment Rule***

To obtain the benefit of this important defense, directors must act in good faith and with a reasonable basis for believing that their conduct is in the lawful and legitimate furtherance of the organization’s purposes and must exercise their honest business judgment after due consideration of what they reasonably believe to be the relevant factors.

1. Business decision.

The Business Judgment Rule protects directors against claims for wrongful acts, but not against claims for failure to act. Inaction by directors is protected by the Business Judgment Rule only if it is a result of a conscious decision to refrain from acting.

2. Disinterestedness or by Disinterested Parties.

The Business Judgment Rule protects directors who are disinterested and independent with respect to the challenged action. For this purpose disinterested directors are those who neither appear on both sides of the transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which inures to the corporation or all the stockholders generally.

3. Due care or based on Informed Judgment.

The Business Judgment Rule protects directors if they reached an informed decision after making a reasonable effort to ascertain and consider all relevant information reasonably available to them and after reasonably deliberating the decision.

4. Good faith.

The Business Judgment Rule protects directors if they acted in good faith or with a belief that their business decision was in the best interests of the corporation. The protection will not apply if the directors acted solely or primarily to preserve their positions or otherwise to benefit themselves. They must firmly believe that the decision made was in the best interest of the organization.

5. No abuse of discretion.

The Business Judgment Rule protects directors against honest errors of judgment, but does not provide protection for decisions that cannot be supported by some rational basis and are egregious on their face. Decisions made by the Directors must be based upon reasonable information.

Supra note 84.

affirmatively prove the lack of intrinsic fairness. If the business judgment rule was not satisfied, the burden does not shift and the defendants must establish the intrinsic fairness of the transaction.¹⁶²

In the Philippines, however, the Business Judgment Rule is still in its infancy. The rule may still sometimes be brought to abuse by the Board of Directors. Our courts must always examine the substance of directors' decisions in order to determine whether those directors complied with their duties of care, loyalty, and good faith. Where the facts show that a director acted in a rational way in arriving at a decision, courts will not review the substance of that decision. However, where a director made a decision with no evident rational deliberation, courts should examine whether the substance of that decision itself merits the rule's protection.¹⁶³

Moreover, rules and guidelines must still be laid down to guide the bench and the bar to determine the existence of bad faith as a ground to overthrow the application of the Business Judgment Rule in the Philippines. The term "bad faith" is too broad to be applied as an exception to the Business Judgment Rule. The applicability of the rule will all depend upon the appreciation of facts and/or evidence by the courts. Thus, it is deemed best if there be a clear procedural guideline in the determination of circumstances which will constitute "bad faith" to exclude the application of the business judgment rule.

On a final note, the essence of Business Judgment Rule dictates that it cannot be used as a blanket authority for the Board of Directors to make drastic corporate decisions without counting the costs, thereby causing prejudice to the minority stockholders who entrusted their hard-earned money and resources in the hands of the Board of Directors. Neither can it be used as a devise to seal the lips of these minority stockholders who truly have rational grounds to object to the "business judgment" made by the Board of Directors. On the other hand, the Board of Directors must likewise be given reasonable flexibility to make rational business decisions for the welfare of the corporation; otherwise, the essence of corporate governance will put to nil.

¹⁶² HAMILTON, *supra* note at 488.

¹⁶³ David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, Zicklin School of Business, Baruch College, Bepress Legal Series (2006), <http://law.bepress.com/expresso/eps/1067> (last accessed December 23, 2007).