

First Supplement to Memorandum 95-71

Business Judgment Rule: Blocking Unsolicited Tender Offers

The business judgment rule is applicable to determine whether the standard of care of directors and officers has been satisfied, not only for determining liability of the directors and officers, but also for determining whether the course of action they have decided on can be enjoined or set aside. In the literature on corporate fiduciaries, application of business judgment principles to a decision whether to enjoin or set aside a corporate action is sometimes referred to as the business judgment “doctrine”, as opposed to the business judgment “rule” governing liability of directors and officers. The ALI Principles of Corporate Governance do not make this distinction, and the staff draft of the business judgment rule in Memorandum 95-71 states the rule in terms of satisfaction of the duty of care, not limited to liability issues.

The type of business decision that puts greatest pressure on the business judgment rule is a decision by the directors that will block an unsolicited tender offer for control of the corporation. The ALI commentary notes that “Shareholders normally have the right to sell their shares, free of any restrictions, to any person who wishes to purchase their stock. An action taken by the board that interferes with that right, as by blocking a tender offer, goes well beyond the usual board function of conducting the corporation’s business, and needs special justification — in particular, the justification that in the given case an interference with the right of shareholders to sell their stock is in the best interests of the corporation and shareholders.”

For this reason, the ALI Principles of Corporate Governance take the position that the validity of actions taken by the board to block tender offers cannot be judged by either the business judgment rule or the duty of loyalty or duty of fair dealing. Under Section 6.02, there is a special standard of care — the board may take an action that has the foreseeable effect of blocking an unsolicited tender offer if the action is a reasonable response to the offer. Under this approach, the business judgment rule may not be used to prevent an action that is unreasonable from being enjoined or set aside.

The business judgment rule is not available to prevent an unreasonable response to a tender offer from being enjoined or set aside. However, it may protect a disinterested director from personal liability if the response was rational. Section 6.02(a). The reason for this protection stated in the ALI commentary is that a reasonableness test might unduly discourage directors from taking blocking action even when board action to block a tender offer may be in the best interests of the corporation and shareholders. Moreover, it allows the courts to avoid the dilemma of either being overly harsh in the remedies they impose for what they believe to be an unjustifiable defensive maneuver, or else overly lenient in permitting a transaction to stand in order to avoid imposing substantial liability on the directors.

One might well ask whether a director is ever disinterested in a hostile takeover situation, and therefore able to take advantage of business judgment rule protection from personal liability. The answer given by the ALI Principles of Corporate Governance is that, for purposes of application of the business judgment rule, a limited interest such as usual and customary directors' fees and perquisites (whether or not constituting a significant portion of a particular director's income), or the presence of an agreement to indemnify or continue insurance for a director's actions, is not disqualifying. The pecuniary interest of a director as a shareholder also should not cause the director to be viewed as interested, so long as the director is to be treated the same as other shareholders in the transaction.

On the other hand, if a director receives significant benefits from the corporation other than usual and customary fees and perquisites, or is to receive a substantial severance payment, or has other significant financial interests beyond normal fees and perquisites, the director might be considered interested for purposes of the business judgment rule. The prospective loss of a position as a senior executive, for example, would be viewed as a disabling interest, and therefore a senior executive would not be entitled to the protection of the business judgment rule when taking action to oppose a tender offer that could result in the loss of the executive position.

The staff believes it would go far beyond the scope of the present study to codify a rule prescribing the standards of care and review applicable in corporate control transactions. However, **it would be appropriate to make clear that the business judgment rule as drafted is not intended to govern proceedings to enjoin or set aside actions of the board in hostile takeover situations, even**

though it does govern personal liability of directors. The staff would add the following provision to the business judgment rule draft:

Subdivision (f)

(f) Subdivision (a) [business judgment rule] does not apply in a proceeding to enjoin or set aside an action of the board of directors that has the foreseeable effect of blocking an unsolicited tender offer, but directors who authorize that action are not subject to liability for damages if their conduct meets the standard of subdivision (a).

Comment. Subdivision (f) is drawn from ALI Principles of Corporate Governance § 6.02(d). A director is not “interested” within the meaning of subdivision (a) if the director’s interest is limited. For example, usual and customary directors’ fees and perquisites (whether or not constituting a significant portion of a particular director’s income), or the existence of an agreement to indemnify or continue insurance for a director’s actions, is not disqualifying. The pecuniary interest of a director as a shareholder also should not cause the director to be viewed as interested, so long as the director is to be treated the same as other shareholders in the transaction.

On the other hand, if a director receives significant benefits from the corporation other than usual and customary fees and perquisites, or is to receive a substantial severance payment, or has other significant financial interests beyond normal fees and perquisites, the director might be considered interested for purposes of the business judgment rule. The prospective loss of a position as a senior executive, for example, would be viewed as a disabling interest, and therefore a senior executive would not be entitled to the protection of the business judgment rule when taking action to oppose a tender offer that could result in the loss of the executive position.

Respectfully submitted,

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