TARGET BOARD CONDUCT:

DIRECTORS' DUTY OF CARE AND FIDUCIARY RÔLE DURING CONTESTS FOR CORPORATE CONTROL

BY

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A thesis presented to the
Faculty of Graduate Studies
at the University of Manitoba
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PART I

A. INTRODUCTION

1. NATURE AND SCOPE OF THESIS

The proper role of directors during corporate control contests is one which remains undefined. The answer is dependant upon a number of elements which in themselves provide a framework around which an 'ultimate test' might be developed. This thesis sets forward those key elements which form the sign posts along the road to a complete understanding of this issue.

Without doubt the United States is further advanced than is Canada in the development of an 'ultimate test.' Their experience provides a great deal of practical insight and as such it has been reviewed in considerable detail.

Parts II through VII deal exclusively with U.S. law and its treatment of several fundamental issues central to the director's role during corporate control contests. These include duty of care and fiduciary standards, the business judgment rule, codification, the role of outside directors, non-shareholder interests and the regulatory framework. These elements are then considered in the light of U.S. case law as developed in Delaware, California, New York and New Jersey.

Parts VIII through XI deal primarily with Canadian law,

analyzing many of the same issues as noted above.

Finally, Part XII provides a summary of the key issues involved with a view to devining the 'ultimate test.'

PART II

A. DUTY OF CARE

1. STATUTORY AND COMMON LAW STANDARDS

The duty of care which a Director must exercise is dependant upon the standard dictated by each individual state. This standard is established either through the development of case law or set by the State through statute. To date most states have corporation statutes which have codified the standard of care and of these many follow in substance the provisions of section 8.30 of the Revised Model Business Corporations Act,[1] namely:

> (a) A director shall discharge his duties as a director, including his duties as a member of a committee:
>
> (1) in good faith;
>
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (3) in a manner he reasonably believes to be in the best interests of the corporation.

While the Model Act itself has no inherent authority it is intended to serve as a guide for the "revision of state business corporation statutes, reflecting current views as

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[1] Revised Model Business Corp. Act §8.30; (1984).

to the appropriate accommodation of the various commercial and social interests involved in modern business corporations."[2]

Section 8.30 was not however produced in a vacuum; rather it represents a standard based both on judicial formulation and existing state statutes.[3] The section deals with the manner in which a director performs his duties without addressing the correctness of the decision itself.

In developing the standard codified in s.8.30 the authors considered other state statutes which held a director's duty to a standard which incorporated such words as "care," "skill" and "diligence."[4] They felt however that such an approach was inappropriate

> "as there is very little authority as to what "skill" and "diligence," as distinguished from "care," can be required or properly expected of corporate directors in the performance of their duties. "Skill," in the sense of technical competence in a particular field, should not be a qualification for the office of director. The concept of "diligence" is sufficiently subsumed within the concept of "care.""[5]

As such only the word care was introduced into the section.

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[2] Supra n.1 vol. 1 p. xxiii.

[3] Eg., Cal. Corp. Code s.309, 316; Fla. Stat. Ann. s.607.111; Ohio Rev. Code Ann. s.1701.59(B); Wash. Rev. Code s.23A.08.343, 23A.08.345.

[4] Eg., N.C. Gen. Stat. Ann. s.55-35 (1975). Note that the Canadian Statutory Standard incorporates these words.

[5] Supra n.1 p. 929.

Reference to the "ordinarily prudent person" is intended to reflect the long tradition of the common law and "focuses on the basic director attributes of common sense, practical wisdom, and informed judgment."[6] The phrase "in a like position ... under similar circumstances" may include a consideration of a director's particular background, qualifications and management responsibilities in evaluating compliance with the duty of care standard. However it is not intended as an excuse where a director lacking in business skills does not exercise the common sense, practical wisdom, and informed judgment of an "ordinarily prudent person."

There are however no guidelines within s.8.30 to help directors in their determination of what factors to consider when determining what may be in the best interest of the corporation. Some states have however legislated those considerations which a director may properly address. For example an Ohio statute provides that a director must consider the interest of shareholders and permits him to consider the following:

(1) The interests of the corporation's employees, suppliers, creditors, and customers;

(2) The economy of the state and nation;

(3) Community and societal considerations;

(4) The long-term as well as short-term interests of

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[6] Ibid.

> the corporation and its shareholders, including the possibility that those interests may be best served by the continued independence of the corporation.[7]

It has been suggested however, that it is unclear whether guidelines such as these

> "... provide greater protection for directors or impose greater potential liabilities. The language may afford enforceable rights to the expanded constituencies and may charge the directors with the responsibility of acting in the light of such rights."[8]

Examples of state statutes which legislate a duty of care standard include California, Pennsylvania, and Washington which all require "reasonable inquiry".[9]

> "A director shall perform the duties of a director ... in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."[10]

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[7] Ohio Rev. Code Ann. §1701.59(E). See also comparable statutes: Ind. Code §23-1-35-1(d); Me. Rev. Stat. tit. 13A, §716; Minn. Bus. Corp. Act §302A.251, subd. 5; Mo. Bus. Corp. Law §351.347; N.Y. Bus. Corp. Law §717; 42 Pa. C.S.A. §8363(b). See also discussion infra section 7.08.

[8] Knepper, William E., and Bailey, Dan A., Liability of Corporate Officers and Directors, 4th ed. (Charlottesville: The Miche Company, 1988).

[9] Cal. Corp. Code §309(a); 42 Pa. C.S.A. §8363; Wash. Rev. Code 23A.08.343.

[10] Cal. Corp. Code s.309(a) (West 1977).

New York sets its standard as follows:

> "A director shall perform his duties ... in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."[11]

Absent is the language in the Model Act dealing with a "reasonable belief." Similarly Virginia has foregone the requirement of reasonable belief in relation to the best interests of the corporation and requires only that "[a] director shall discharge his duties ... in accordance with his good faith business judgment of the best interests of the corporation."[12]

In addition to the various State standards the common law has played a major role in determining the appropriate standard of care, where none is prescribed by statute and in determining a breach of duty founded either on statute or case law.

> "Corporations are "creatures of state law" and state law "is the font of corporate directors' powers." Accordingly, state court decisions or federal court decisions under state law provide the sources for determining the common law standard of care for directors."[13]

Delaware relies upon case law to provide its standard of

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[11] N.Y. Bus. Corp. Law s.717 (McKinney Supp. 1984-85).

[12] Virginia Stock Corporation Act, VA Code s.13.1-690 (1985).

[13] Supra n.8 p. 43.

care. In Graham v. Allis-Chalmers Mfg. Co. it was held that "directors of a corporation in managing corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."[14] This standard has in later Delaware decisions dealing with the business judgment rule[15] been held to be one of "gross negligence."[16] There is unfortunately no clear case law formulation of gross negligence. One leading text has described it as "more than ordinary negligence but different in kind from wanton or willful misconduct."[17] In Colorado the standard is also one of gross or willful negligence.[18]

Clearly there is no one common law or statutory standard to which a corporate director may look when seeking guidance in this area of corporate responsibility. Another reason for this may be found in the fact that the degree of care is sometimes driven by the circumstances under scrutiny. In Gadd v. Pearson[19] a director of a bank was held to

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[14] 41 Del. Ch. 89, 188 A. 2d 125, 130 (1963).

[15] This topic is dealt with in detail later in the text.

[16] Aronson v. Lewis, 473 A. 3d 805 (Del. 1984); Smith v. Van Gorkom, 488 A. 2d 858, (Del. 1985).

[17] Supra n.8 p. 45.

[18] Christy v. Cameron, 710 F. 2d 669 672 (10th Cir. 1983), citing Colorado decisions.

[19] 351 F. Supp. 895, 903 (M.D. Fla. 1974).

have a greater duty of care placed upon him than directors of other types of corporations.

To help provide some guidance the Corporate Director's Guidebook sets forth its determination of a director's duty of care.[20] The Guidebook follows s.35 of the Model Act which has been incorporated into s.8.30 of the Revised Model Act.

Adding to the debate in this area is section 4.01 of the American Law Institute's Corporate Governance Project.[21] The ALI sets out in s.4.01(a) its treatment of the broad duty of care owed by directors to the Corporation, namely:

> 4.01(a) A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.[22]

This formulation is intended to be a restatement of existing law, consistent with the duty of care standards set out in most jurisdictions. In addition to these general require-

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[20] Corporate Directors' Guidebook Revised Edition, January 1978, (1978) 33 The Business Lawyer 1595 at 1600.

[21] For a complete history of the ALI Project see William Carney, Section 4.01 of the American Law Institute's Corporate Governance Project; Restatement or Misstatement? (1988) 66 Washington University Law Quarterly 239.

[22] American Law Institute [hereinafter ALI], Principles of Corporate Governance and Structure: Analysis and Recommendations, Tentative Draft No. 4 (1985) s.4.01(a).

ments the ALI has set out a further obligation of inquiry:

> S.4.01(a) (1) This duty includes the obligation to make or cause to be made an inquiry when and only when the circumstances would alert a reasonable director to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.[23]

This duty is set forward for the purposes of emphasis and clarity and is intended to set forth "an "inquiry" obligation that is generally recognized in the case law and commentaries."[24]

In so far as s.4.01(a) deals with the general nature of a director's duty of care it tracks in substantial form the guidelines set forth in section 8.30 of the RMBCA. Where however it poses a duty to inquire the ALI, it has been argued, has departed from existing law which is in fact inconsistent with the ALI's proposed duty of inquiry.[25] To date California is the only state which imposes a statutory duty of inquiry.[26] In addition, the Model Act does not impose a similar obligation.

As a general rule however:

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[23] Ibid. s.4.01(a)(1) as amended May 17, 1985.

[24] Ibid. Comment p. 8.

[25] Carney, supra n.21 p. 255.

[26] Cal. Corp. Code s.309(a). The duty of "reasonable inquiry" arises where it is "indicated by the circumstances."

> "... if a director meets his duties in good faith and in a manner he reasonably believes to be in the best interests of the corporation, and if he exercises free and independent business judgment, it is likely that neither state courts nor federal courts will impose liability upon him because of erroneous judgment. But the state of the law is uncertain, and the wise corporate director or officer will not seek to act as his own lawyer."[27]

2. RELIANCE ON EXPERT ADVICE

A director may rely upon the advice of 'experts' under certain circumstances. These guidelines are found in the Model Act, the ALI Principles, case and statute law. Section 8.30(b) of the RMBCA provides as follows:

> (b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
>
> (1) one or more officers or employees of the corporation whom the Director reasonably believes to be reliable and competent in the matters presented;
>
> (2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; ...

As a caveat to this section 8.30(c) states:

> (c) A director is not acting in good faith if he has knowledge concerning the matter in

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[27] Supra n.8 p. 45.

> question that makes reliance otherwise permitted by subsection (b) unwarranted.

Where legal advice is relied upon in defense of an action claiming lack of due care, certain elements must be in evidence. These include:

> "... the advice relied upon must be legal advice ... that the defendant (1) made a complete disclosure to counsel, (2) requested counsel's advice as to the legality of the proposed action, (3) received advice that the action would be lawful, and (4) proceeded in reliance on that advice."[28]

Counsel must also be competent to render the advice and unbiased as it may impact upon reliability.[29] In determining who is an expert the case law has included in its orbit all fields of expertise where special experience and skills are required.[30] What is essential however is that

> "the director, in good faith and in the exercise of due care, "reasonably believe" that the subject matter of the information or advice is within the area of the expert's professional competence."[31]

In actual fact it is the circumstances which will dictate the outcome. This is most clearly evidenced by the manner in which the courts have dealt with differing fact situa-

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[28] Supra n.8 p. 47.

[29] Supra n.8 p. 48.

[30] Supra n.8 p. 49.

[31] Ibid.

tions. For example in the case of Smith v. Van Gorkom (the Trans Union Case)[32] the Delaware Supreme Court reviewed the director's reliance upon expert legal advice. The Court concluded that counsel's advice that failure to accept the Pritzker offer might result in litigation was no defense to acceptance of an offer to purchase the company at $55.00 a share. Horsey, J. speaking for the majority stated that

> "It is, of course, a fact of corporate life that today when faced with difficult or sensitive issues, directors are often subject to suit, irrespective of the decisions they make. However, counsel's mere acknowledgement of this circumstance cannot be rationally translated into a justification for a board permitting itself to be stampeded into a patently unadvised act... Thus, we cannot conclude that the mere threat of litigation, acknowledged by counsel, constitutes either legal advice or any valid basis upon which to pursue an uninformed course."[33]

Another leading decision provides some further guidance on this issue. In the case of Hanson Trust PLC v. ML SCM Acquisitions, Inc.[34] the Second Circuit Court applying New York law considered the directors' defense that their decisions were based in part upon both the advice of a leading law firm and a prominent firm of investment bankers. Pierce, J. stated that by contenting

> "themselves with their financial advisor's

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[32] 488 A. 2d 858 (Del. 1985).

[33] Ibid. p. 881.

[34] 781 F. 2d 264 (2d Cir. 1986).

> conclusory opinion that the option prices were within the range of par value," although had the directors inquired, they would have learned that Goldman Sacks [investment banker] had not calculated a range of fairness" the directors failed to exercise due care."[35]

The concurring opinion of Oakes, J. demonstrates the point by indicating that: "Due care requires full inquiry ... and to the extent that they are relying on advisers, that the advisers are fully informed and in turn fully inform the directors."[36] It is the director's responsibility to oversee the outside advice on which he is relying. Not to do so is a breach of his duty of care.[37]

A comparison of the common law position to that of s.8.30(b)(2) and (c) indicates that both require more than just a passive reliance upon the statements of experts. The Official Comment to the section at issue states that:

> "Under section 8.30(c), however, a director so relying must be without knowledge concerning the matter in question that would cause his reliance to be unwarranted. Also inherent in the concept of good faith is the requirement that, in order to be entitled to rely on a report, statement, opinion, or other matter, the director must have read the report or statement in question, or have been present at a meeting at which it was orally presented, or have taken other steps to become generally familiar with its contents."[38]

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[35] Ibid. p. 275.

[36] Ibid. p. 284.

[37] Ibid. p. 276.

[38] See "Official Comment" supra n.1 p. 930.

Absent however is the duty to inquire in depth into a report in the manner indicated in the Hanson decision.[39] This area as is the case generally is still unsettled replete with differing points of view. For example, Oesterle J. in a recent article[40] states that "As long as directors select the reporting personnel with care and have no reason to suspect that the reports are in error, they may have no duty to make an independent investigation of the facts."[41]

In addition to the common law and the Model Act various states have enacted legislation to exempt directors from liability where they rely upon the advice of others in the decision making process. For example, Section 141(e) of the Delaware General Corporate Law states that directors shall be "fully protected in relying in good faith upon ... reports made to the corporation by any of its officers, or by an independent certified public accountant, or by an appraiser."[42] These statutes normally limit the category of "others" to officers and employees of the Company, legal counsel, engineers, and accountants. Examples of jurisdictions in which such reliance is acceptable include: Alabama, Delaware, California Colorado, Connecticut, Florida,

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[39] Supra n.34.

[40] Dale Oesterle, The Effect of Statutes Limiting Directors' Due Care Liability on Hostile Takeover Defenses (1989) 24 Wake Forest Law Review 31.

[41] Ibid. p. 39.

[42] Del. Code Ann. tit. 8 §141(e) (1983).

Georgia,Hawaii, Idaho, Indiana, Iowa, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Virginia, Washington and Wyoming. It is significant that the Model Act extends reliance upon outside advisors to groups which fell into fields other than those noted above but which nevertheless involve special skills and experience such as investment bankers, geologists, management consultants, actuaries and real estate appraisers.[43]

The final element in this area is ALI s.40.1(a)(2) which states that:[44]

> (2) in performing any of his functions (including his oversight functions), a director of officer is entitled to rely on materials and persons in accordance with s.4.02-.03.
>
> S.4.02 Reliance on Directors, Officers, Employees, Experts, and Other Persons
>
> In performing his duty and functions, a director or officer who acts in good faith, and reasonably believes that his reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other financial data), and decisions, judgments, or performance (including decisions, judgments, or performance within the scope of §4.01(b)), in each case prepared, presented, made, or performed by:

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[43] See "Official Comment" supra n.1 p. 930-31.

[44] Supra n.22 s.4.01(a)(2).

(a) One or more directors, officers, or employees of the corporation, or of a business organization [§1.03] under joint control or common control [§1.05], whom the director or officer reasonably believes merit confidence; or

(b) Legal counsel, public accountants, engineers, or other persons whom the director or officer reasonably believes merit confidence.

In substance the ALI draft tracks the Model Act both in its requirement that "a director must read or otherwise become familiar with information ... in order to be entitled to rely on it"[45] and its expanded range of "other persons" which would qualify under the Draft.[46] In addition both the Model Act and the ALI draft require the director to have a "reasonable belief" that the information relied upon is based upon professional competence and would thus merit confidence. Both apply the same subjective/objective test to the issue as they did earlier in relation to a director's reasonable belief that his actions were in the best interest of the corporation.[47]

3. RELIANCE ON A COMMITTEE OF THE BOARD

"All of the state corporation codes permit a corporation's board to appoint committees of directors and

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[45] See "Comment" supra n.22 p. 79.

[46] Supra n.22 p. 82.

[47] Ibid.

delegate board powers to them."[48] These substantially track the provisions of the RMBCA s.8.25.[49] These committees may

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[48] Supra n.8 p. 50.

[49] §8.25

(a) Unless the articles of incorporation or bylaws provide otherwise, a board of directors may create one or more committees and appoint members of the board of directors to serve on them. Each committee must have two or more members, who serve at the pleasure of the board of directors.

(b) The creation of a committee and appointment of members to it must be approved by the greater of (1) a majority of all the directors in office when the action is taken or (2) the number of directors required by the articles of incorporation or bylaws to take action under section 8.24.

(c) Sections 8.20 through 8.24, which govern meetings, action without meetings, notice and waiver of notice, and quorum and voting requirements of the board of directors, apply to committees and their members as well.

(d) To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the authority of the board of directors under section 8.01.

(e) A committee may not, however:
  (1) authorize distributions;
  (2) approve or propose to shareholders action that this Act requires be approved by shareholders;
  (3) fill vacancies on the board of directors or on any of its committees;
  (4) amend articles of incorporation pursuant to section 10.02;
  (5) adopt, amend, or repeal bylaws;
  (6) approve a plan of merger not requiring shareholder approval;
  (7) authorize or approve reacquisition of shares, except according to a formula or method prescribed by the board of directors; or
  (8) authorize or approve the issuance or sale or contract for sale of shares, or determine the designation and relative

(continued...)

consist of Executive, audit, nominating, finance and compensation committees. The authority is granted in view of the necessity in many larger corporations to delegate authority.

> "Committees allow a board to divide responsibilities so as to utilize efficiently the expertise of its directors. In addition committees allow a board to engage in an objective, disinterested examination of corporate issues in which some or all non-committee board members are interested parties."[50]

In addition stock exchange requirements often stipulate that publicly traded companies maintain committees.[51] The common law treatment of this area is limited as corporate boards are granted their authority not from case law but as a result of both a general state law grant of power and a

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[49](...continued)
rights, preferences, and limitations of a class or series of shares, except that the board of directors may authorize a committee (or a senior executive officer of the corporation) to do so within limits specifically prescribed by the board of directors.

(f) The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in section 8.30.

[50] Scott Simpson, The Emerging Role of the Special Committee - Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest (1988) 43 The Business Lawyer 665.

[51] See generally the New York Stock Exchange. New York Stock Exchange Listed Co. Manual s.303.000, 802.000 (1987).

specific grant relating to the charter of the corporation.[52] Where it will arise is in relation to the treatment of directors' response to takeover bids. This will be developed through the case analysis dealt with later in the text.

As regards the ALI and the RMBCA this area follows in substantial form the rules governing a director's ability to rely upon the advice and/or reports of professionals. Both speak to a director's liability when he relies upon a committee of the board of directors of which he is not a member. Both the Model Act in s.8.30(b)(3)[53] and the ALI Draft s.4.01(a)(2), s.4.01(b) and s.4.03[54] state that such

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[52] Simpson, supra n.50 p. 666.

[53] **§ 8.30**

(b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

(3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

[54] **§4.01. Duty of Care of Directors and Officers; the Business Judgment Rule**

(a) A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

(2) In performing any of his functions (including his oversight functions), a director or officer is entitled to rely

(continued...)

reliance is acceptable given a reasonable belief that reliance is warranted under the circumstances.

While s.8.30(b)(3) of the Model Act does not specifically deal with the "decisions, judgments or performance" of

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[54](...continued)
on materials and persons in accordance with §§4.02-.03.

(b) Except as otherwise provided by statute or by a standard of the corporation [§1.27] and subject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate, formally or informally by course of conduct, any function (including the function of identifying matters requiring the attention of the board) to committees of the board or to directors, officers, employees, experts, or other persons; a director may rely on such committees and persons in fulfilling his duty under this Section with respect to any delegated function if his reliance is in accordance with §§4.02-.03.

§4.03. Reliance on a Committee of the Board

In performing his duty and functions, a director who acts in good faith, and reasonably believes that his reliance is warranted, is entitled to rely on:

(a) The decisions, judgments, or performance (including decisions, judgments, or performance within the scope of §4.01(b)), of a duly authorized committee of the board upon which the director does not serve, with respect to matters properly delegated to that committee, provided that the director reasonably believes the committee merits confidence.

(b) Information, opinions, reports, or statements (including financial statements and other financial data), in each case prepared or presented by a duly authorized committee of the board upon which the director does not serve, provided that the director reasonably believes the committee merits confidence.

a committee the Comment to the section allows for reliance where such actions are undertaken.[55]

Both the RMBCA and the ALI Draft contemplate that non-committee members exercise the same duty of care in this area as they would otherwise. Hence directors should carefully review the reports and statements of all committees. This duty may be further heightened by the amount of knowledge the non-committee director may have of the area and the relative importance of the subject matter at hand.

4. OVERSIGHT

The issue of what constitutes appropriate oversight must be dealt with in the context of a director's overall function. State statutes for the most part put a positive onus on a board of directors to manage the affairs of the corporation.[56] While they are not expected to manage the conduct of the company on a day to day basis they are required to do more than simply monitor its performance. Some of the Board's most essential functions include the following:[57]

(1) Authorization of major corporation actions.

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[55] See "Official Comment" supra n.1 p. 931.

[56] Eg., Del. Code Ann. tit. 8, s.141; N.Y. Bus. Corp. Law s.701; Ohio Rev. Code Ann. s.1701.59.

[57] Supra n.8 pp. 5-7.

This is an obligation customarily imposed by state statutes.

(2) Advice and counsel to the corporation's management, especially to its chief executive officer.

(3) Providing effective auditing procedures so that the board will be adequately informed of the corporation's financial status. In addition to selecting independent auditors, this function also entails establishing uniformly organized audit committees manned by outside directors. The Commission on Auditor's Responsibilities has concluded that "the board of directors, with outside members and an audit committee when appropriate, is the best vehicle for achieving and maintaining balance in the relationship between the independent auditor and management." The board has the responsibility for adopting sound accounting policies and insisting upon their execution. The board's audit committee may have the primary charge of nominating or recommending dismissal of the independent auditor and of directing its activities.

(4) Serving as a facility or mechanism, which may be used to provide access to corporate decision-making for others than the personnel included in management. Thus employees, suppliers, consumers, financial advisers, social groups, and other client groups may be given representation on a corporation's board.

(5) Review of the corporation's investments at regular intervals, at least annually, to ensure that they comply with all applicable provisions of law. This function may well include approval of written guidelines for such policies, including types of securities, general mix of securities, maximum underwriting positions, reporting of losses, valuation procedures, forbidden transactions, and approvals and review of transactions.

(6) Monitoring the performance of management, setting objectives and measuring management's results against them, evaluating the accomplishments of management and their results, and being responsible for the

> selection and removal of the chief executive officer.

Within these parameters directors as a matter of practicality must delegate certain functions in order to fulfill their duty of care responsibility. With the exception of those functions which may not be delegated by virtue of statute, delegation is a fact of corporate life, and one that has been accepted by the courts.

> An informed decision to delegate a task is as much an exercise of business judgment as any other ... The realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company. This is recognized by the provisions of 8 Del. C. §141(a) that the business and affairs of a Delaware corporation are managed by or under the direction of its board. In setting its agenda as to the matters in which it will be directly involved, and those it will delegate, a board's decision in those areas are entitled to equal consideration as exercises of business judgment.[58]

However the necessity to delegate brings with it the ever present possibility of a breach of the oversight duty. Directors have the duty to supervise officers and employees[59] and are responsible for any lack of knowledge of which they had the means of ascertaining. As such they may be held responsible for ignorance of fact which would have been

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[58] Rosenblatt v. Getty Oil Co., 493 A. 2d 929, 943 (Del. 1985).

[59] Briggs v. Spaulding, 141 U.S. 132, 35 L. Ed. 662, 11 S. Ct. 924 (1891).

overcome through good business diligence.[60] "Directors may commit the details of corporate business to subordinate officers, but they may not thereby divest themselves of their duty of general supervision and control."[61]

The issue arises as to when a director will be held liable for an employee's lapse and what is the general standard to be applied in relation to a director's oversight duty? As to the first question the matter has been dealt with in several jurisdictions but with differing conclusions. In Graham v. Allis-Chambers Manufacturing Co.,[62] a decision of the Delaware Supreme Court, the plaintiffs contended that the directors had a duty to monitor the employee's law compliance program because a consent decree entered into 20 years prior should have provided notice that employees might be in violation of anti-trust laws.[63] The court in speaking to the directors' oversight role stated:

> [A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists ... [W]e know of no rule of law which requires a corporate director to assume ... that all corporate employees are incipient law violators who, but for a

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[60] O'Connor v. Firsts Nat'l. Invs.' Corp., 163 Va. 907, 177 S.E. 852 (1935).

[61] Supra n.8 p. 62-3.

[62] 41 Del. Ch. 78, 188 A. 2d 125 (Del. 1963).

[63] Donald Pease, Outside Directors: Their importance to the Corporation and Protection from Liability (1987) 12 Delaware Journal of Corporation Law 25 p. 58.

> tight checkrein, will give free vent to their unlawful propensities.[64]
>
> [D]irectors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances. ...
>
> ... If [a director] has recklessly reposed confidence in an obviously untrustworthy employee, has refused or neglected cavalierly to perform his duty as a director, or has ignored either willfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.[65]

In order to be found culpable Graham indicates that directors must be warned or 'red flags' must be present. As to the second concern regarding the general standard which directors must meet while exercising their oversight function some cases suggest a negligence standard while others believe it inappropriate and misleading to apply this approach. The former approach is used in the leading Delaware cases when dealing generally with the decision making process.[66] The latter example is found in the Second Circuit case of Joy v. North[67] wherein the court suggested

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[64] Supra n.62 p. 130-31.

[65] Ibid. p. 130.

[66] Aronson v. Lewis, 473 A. 2d 805 (Del. 1985), Smith v. Van Gorkom 488 A. 2d 858 (Del. 1985) where in both cases the standard of 'gross negligence' is applied. See also Lutz v. Boas 39 Del. Ch. 585, 171 2d 381 (1961) where in a case dealing specifically with a director's attention to duty, the court applied the standard of 'gross negligence.'

[67] 692 F. 2d 880 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

that the duty was breached only where there was evidence of "obvious and prolonged failure to exercise oversight or supervision."[68] In general however the case law is suggestive of the fact that directors must not take a passive role but rather should ensure that the corporation provides them with enough relevant information on a timely basis to afford a reasonable review of those functions which have been delegated to others.

The ALI recognizes the directors' oversight function in section 4.01 and in particular s.4.01(b) which states that the board has an 'ultimate responsibility' for oversight. In adopting their standard the ALI, as a result of last minute negotiations, adopted the Delaware approach and amended s.4.01(a)(1) changing the duty to inquire. Whereas the old section incorporated a duty to inquire, "Where a reasonable belief under the circumstances" would suffice the revised section requires inquiry "only when the circumstances would alert a reasonable director or officer to the need for inquiry."[69]

For its part the RMBCA is silent with respect to the duty of inquiry and thus does not provide any guidance in this area aside from the language used in s.8.30 generally.

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[68] Ibid. p. 884.

[69] Supra n.22 s.4.01(a)(1) as amended May 17, 1985.

B. STATUTES PROTECTING DIRECTORS FROM LIABILITY FOR MONETARY DAMAGES

In response to the decision rendered in the Trans Union case[70] the majority of state legislatures have acted to counter judicial initiative in the area of a director's duty of care. "State legislatures are moving en masse to protect directors from personal damage awards."[71]

Primarily these statutes operate in one of three different ways. Thirty states allow their corporations to protect directors from damages for breach of the duty of care.[72] This is known as the charter amendment approach. A

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[70] Supra n.16. This case will be dealt with in detail under the Business Judgment Rule. It was in large measure responsible for a crisis that developed in the market for director and officer liability insurance. The early to mid-1980's saw premiums skyrocket and deductibles increase enormously. In addition coverage shrank and many policies were not renewed.

[71] Oesterle, supra n.40 p. 31.

[72] An amendment to section 102 of the Delaware General Corporations Law, effective July 1, 1986, empowers Delaware corporations to amend their charters to eliminate or limit liability of directors for violations of the duty of care. Del. Code Ann. tit. 8 §102(b) (Supp. 1986). The following states followed suit: Alaska (Alaska Stat. §10.05.255(c) (Supp. 1988)), Arizona (Ariz. Rev. Stat. Ann. §10-054(A)(9) (Supp. 1987)), California (Cal. Corp. Code §204(a)(10) (West supp. 1988)), Colorado (Colo. Rev. Stat. §7-3-101(1)(u) (Supp. 1987)), Georgia (Ga. Code Ann. §14-2-171(b)(3) (Supp. 1988)), Idaho (Idaho Code §30-1-54(2) (Supp. 1987)), Iowa (Iowa Code Ann. §496A.49(13) (West Supp. 1988)), Kansas (Kan. Stat. Ann. §17-6002(b)(8) (Supp. 1988)), Kentucky (Ky. Rev. Stat. Ann. §271A.271(2)(d) (Michie/Bobbs-Merill Supp. 1988)), Louisiana (La. Rev. Stat. Ann. §12-24(C)(4) (West Supp. 1988), Maryland (Md. Corps. & Ass'ns. Code Ann. §2-

(continued...)

further six states directly relax standards to the extent that they exclude the duty of care entirely.[73] Within this last group Virginia has also limited the amount of damages for which any individual director might be liable.[74] While these statutes appear to materially affect the directoral duty of care standard as applied to the everyday affairs of the company, at least one author has argued that "... these statutes may prove to be more procedural than substantive. It is doubtful that the new provisions, as they currently stand, will give any significant relief to directors

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[72](...continued)
104(b)(8) (Supp. 1988)), Massachusetts (Mass. Gen. L. ch.1, §13(b)(1 1/2) (Supp. 1987)), Michigan (Mich. Comp. L. §450.1209(c) (1987)), Minnesota (Minn. Stat. Ann. §302A.251 (subd. 4) (West Supp. 1987)), Montana (Mont. Code Ann. §35-1-202(2)(a)(v) (1987)), Nevada (Nev. Rev. Stat. §78.037 (Supp. 1987)), New Jersey (N.J. Rev. Stat. §14A-2-7(3) (Supp. 1988), New Mexico (N.M. Stat. Ann. §53-12-2(E) (1988), New York (N.Y. Bus. Corp. Law §402(b) (McKinney Supp. 1988)), North Carolina (N.C. Gen. Stat. §55-7(11) (1987)), Oklahoma (Okla. Stat. tit. 18, §1006(B)(7) (Supp. 1988)), Oregon (Or. Rev. Stat. §60 047(2)(c) (1987)), Pennsylvania (Pa. Stat. Ann. tit. 42, §8364 (Purdon Supp. 1987)), Rhode Island (R.I. Gen. Laws §7-1.1-48(6) (Supp. 1988)), South Dakota (S.D. Codified Laws Ann. §47-2-58.8 (Supp. 1988)), Tennessee (Tenn. Code Ann. §48-12-102(b)(3) (1988)), Utah (Utah Code Ann. §16-10-49.1 (Supp. 1988)), Washington (Wash. Rev. Code Ann. §23A.12.020(10)(d) (Supp. 1988) and Wyoming (Wyo. Stat. §17-2-202(c) (1987).

[73] Florida (Fla. Stat. §607.1645 (Supp. 1988)), Indiana (Ind. Code §23-1-35-1(e) (Supp. 1988)), Maine (Me. Rev. Stat. Ann. tit. 13-A, §716 (Supp. 1988)), Ohio (Ohio Rev. Code Ann. §1701.59(C) (Baldwin 1988)), Virginia (Va. Code Ann. §13.1-692.1 (Supp. 1988)) and Wisconsin (Wis. Stat. Ann. §180.307 (West Supp. 1987)).

[74] Va. Code Ann. s.13.1-692.1A (Supp. 1987).

involved in takeovers."[75]

An example of a charter amendment statute is Delaware's s.102(b)(7).[76] That statute allows Delaware corporations to

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[75] Supra n.40 at p. 31-32. But see also Stephen Radin, The Director's Duty of Care Three Years After Smith v. Van Gorkham (1988) The Hastings Law Journal 707 at 753.

> "The drafters of limited liability statutes built them on an unstable and insufficient base of amorphous general terminology. They used concepts and distinctions that, at best, have hazy and elusive contours in the context of takeovers and, at worst, are simply void of substance. As a consequence, the limited liability statutes may not affect courts' discretion in awarding personal damages in takeover cases; that is, courts may not be significantly constrained by the new provisions to reach decisions other than they would have without them. And the result is, perhaps, as it should be; if state legislatures want to readjust judicially crafted definitions of the obligations of managers in takeover contests, they ought to be specific to the unique pressures operating in these contests rather than attempt to address the problem through legislation on general standards of conduct."

[76] Del. Code Ann. tit. 8 s.102(b)(9) (Curr. Supp. 1986).

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:
>
> > (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

(continued...)

include in their certificate of incorporation provisions which serve to limit or even eliminate the personal liability of directors for breach of their duty of care. It is significant that the statute a) does not insulate directors who may be officers of the company; and b) does not affect the availability of equitable relief, ie. injunction. To date eight states have legislated identical sections[77] and several others have modeled their statutes in substantial form to that set out in s.102(b)(7). Following the enactment of this provision many Delaware corporations amended their charters to reflect a reduced duty of care requirement.[78] "Most of the adopted charter amendments waive director liability to the fullest extent allowed by the statute rather than imposing some monetary cap."[79]

Other charter amendment or 'enabling' 'states include

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[76](...continued)
(iii) under §174 of this title, or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective..."

[77] Alaska (Alaska Stat. §10.05.255(c) (1988)), Kansas (Kan. Stat. Ann. §17-602(b)(8) (Supp. 1987)), Louisiana (La. Rev. Stat. Ann. §12-24(C)(4) (West Supp. 1988)), Massachusetts (Mass. Gen. I, ch.1, §13(b)(1 1/2) (Supp. 1987)), Michigan (Mich. Comp. Laws §450.1209(c) (1987)), Minnesota (Minn. Stat. Ann. §302A.251(subd.4) (West Supp. 1987)), Oklahoma (Okla. Stat. tit. 18, §1006(B)(7) (1987)), and South Dakota (S.D. Codified Laws Ann. §47-2-58.8 (1988)).

[78] Oesterle, supra n.40 p. 33.

[79] Ibid.

Louisiana, Nevada and New Jersey which in fact include corporate officers as well as directors.[80] States which have enabling statutes but differ in substance from the Delaware Statute include California, Montana, New Mexico and Pennsylvania, which preclude their firms affording protection for a director's "recklessness."[81] By contrast Delaware corporations may allow their directors to be reckless or inattentive and still have acted in "good faith." Although it can be argued that the good faith provision in the Delaware Act may in fact serve as its broadest exception nevertheless "a director acting recklessly, and perhaps on some occasions negligently, could be said to be acting in bad faith."[82] Only the state of Washington has not incorporated the 'good faith' requirement.

In general states which do not in substantial form follow the Delaware statute drop rather than add an exception.[83]

In summary, the only demonstrable difference in

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[80] See Act of July 3, 1987, Act 261 s.1, 3, 1987 LA. Sess. Law Serv. 131-32 (West 1987) (to be codified at L.A. Rev. Stat. s.12.24(c)(4); Nev. Rev. Stat. Ann. s.78.036(1) (Michie 1987); N.J. Rev. Stat. s.14A: 2-7(3), 14A:6-14(4) (West Supp. 1987).

[81] Cal. Corp. Code §204(a)(10)(A)(iv) (Deering Supp. 1988), Mont. Code Ann. §35-1-202(2)(a)(v)(B) (1987), N.M. Stat. Ann. §53-12-2(E)(2)(a) (Supp. 1988), and Pa. Stat. Ann. tit. 42, §8364(a)(2) (Purdon Supp. 1988).

[82] Oesterle, supra n.40 p. 37.

[83] Ibid. p. 36.

> the coverage of the various limited liability statutes appears to be between those states that do not have exceptions for either lack of good faith or recklessness, like Washington, and those states that have one or the other, which includes almost all other states. The former states have effected limited liability for all but conflict of interest cases, while the latter states may have preserved liability for some kinds of competency cases. Additionally, most of the statutes limit liability for directors' unintentional violations of their duty of care but preserve liability for violations of their duty of loyalty.[84]

As was mentioned six states do not require charter amendment as a precursor to a reduction in the standard of directoral duty of care.[85] These states have, as a matter of public policy, shielded directors from monetary liability to the extent put forward in the statute itself.[86] For the most part these statutes increase the level of culpability enormously before a director may be considered in breach of his duty of care obligation.[87]

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[84] Ibid. p. 38.

[85] Supra n.73.

[86] Radin, supra n.75 p. 751.

[87] Ibid. p. 751-52.

> Florida's statute, for example, provides that a director is not liable for monetary damages for any breach of his duties as a director unless the breach constitutes (1) a violation of criminal law, except when the director "had reasonable cause to believe his conduct was unlawful," (2) "a transaction from which the director derived an improper personal benefit, either directly or indirectly," (3) unlawful payments of dividends or unlawful stock purchases or unlawful sales of assets, (4) in a derivative action, "conscious

(continued...)

The final method of limiting liability is Virginia's monetary ceiling on the damages which may be assessed against a director for breach of duty of care. This ceiling applies only to derivative actions "arising out of a single

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[87](...continued)
disregard for the best interest of the corporation, or willful misconduct," or (5) in a non-derivative action, "recklessness or an act or omission which was committed in bad faith or with malicious purpose or in a manner exhibiting wanton and willful disregard of human rights, safety, or property."

Indiana's statute provides that a director is not liable for monetary damages for failure to act in compliance with his duties as a director unless the conduct constitutes "willful misconduct or recklessness." Virginia's statute precludes director liability for conduct "in accordance with [the director's] good faith business judgment of the best interests of the corporation."

The Ohio and Wisconsin statutes similarly limit director liability, but authorize the corporation to "opt out" of this standard by charter provision (as opposed to the Delaware model, which allows corporations to "opt in"). Ohio's statute limits a director's liability for monetary damages unless it is proven, "by clear and convincing evidence," that the act or omission was "undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation." Wisconsin's statute provides directors with immunity from personal liability unless the person asserting such liability proves (1) "a wilful failure to deal fairly with the corporation or its shareholders in connection with a matter in which the director has a material conflict of interest," (2) a violation of criminal law, except when the director had no reasonable cause to believe his conduct was unlawful, (3) "a transaction from which the director had derived an improper personal profit," or (4) wilful misconduct.

transaction or occurrence or course of conduct."[88] The ceiling is the greater of $100,000 or the amount of compensation received by the officer or director in the previous twelve months. Where willful misconduct or intentional violation of law is involved the ceiling will not apply. In addition, the corporation may set a lower ceiling. This legislation has clearly had its impact in that "some Virginia corporations have reportedly proposed either complete eliminations of liability for monetary damages or caps of $1.00."[89]

A further influence in this area is the work of the ALI as set forward in s.7.17:[90]

> §7.17 Limitation on Damages for Certain Violations of the Duty of Care
>
> (a) If a failure by a director [§1.08] or an officer [§1.22] to meet the standard of conduct specified in §4.01 did not
>
> (1) involve a knowing and culpable violation of law by the director or officer; or
>
> (2) enable the director or officer, or an associate [§1.02], to receive a benefit that was improper under Part V; or
>
> (3) show a conscious disregard for the duty of the director or officer to the

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[88] VA. Code Ann. s.13.1-692. 1A (Supp. 1987).

[89] Radin, supra n.75 p. 752.

[90] American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Tentative Draft No. 7 (Philadelphia: American Law Institute, 1987) s. 7.17.

> corporation under circumstances in which the director or officer was aware that his conduct or omission created an unjustified risk of serious injury to the corporation; or
>
> (4) constitute a sustained and unexcused pattern of inattention that amounted to an abdication of the defendant's duty to the corporation,

damages for the violation should be limited to an amount that is not disproportionate to the compensation received by the director or officer for serving the corporation during the year of the violation.

(b) A limitation on damages complying with §7.17(a) may be implemented by

> (1) an enabling statute that authorizes the inclusion of a limitation on damages in a corporation's certificate of incorporation; or
>
> (2) a provision in a certificate of incorporation that is adopted by a vote of disinterested shareholders [§1.11] after appropriate disclosure concerning the provision.

(c) Any limitation on damages set forth in the corporation's certificate of incorporation

> (1) should require ratification by shareholder vote at periodic intervals and, in the case of a provision not expressly authorized by statute, be subject to repeal by shareholders at the annual meeting; and
>
> (2) should not reduce liability with respect to pending actions or losses incurred prior to its adoption.

A comparison between the Virginia law and the ALI Draft indicates that a) the former precludes liability for conduct "in accordance with [the director's] good faith business

judgment of the best interests of the corporation"[91] whereas the latter does not; b) the Virginia statute relates to a monetary amount and the ALI speaks to "an amount that is not disproportionate to the compensation received ... during the year of violation";[92] c) The ALI's ceiling is not subject to shareholder revision. The ALI proposal has been criticized on the basis that directors may be more exposed to liability because of its "limited" rather than "potentially overwhelming" risk of monetary liability.[93]

While it is as yet too early to estimate the impact of the aforementioned legislation on takeover contests there can be no doubt that the courts will have to address the issue where either plaintiff or defendant may rely on a given statute or corporate standard.

C. REFLECTIONS ON THE REAL WORLD CORPORATE BOARDROOM

Is the duty of care standard as articulated above consistent with what might reasonably be expected of directors given the 'real world' function of the corporate boardroom? For the purpose of this analysis I will leave aside the question of whether outside directors should be treated differently from inside directors. Instead the

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[91] VA. Code Ann. s.13.1-690 A.C. (1985).

[92] Supra n.90 s.7.17(a).

[93] Radin, supra n.75 p. 753.

focus will be on the function of the board itself which may or may not be comprised of a majority of outside directors.

The large publicly traded corporate entity of the 1990's is often a complex and diversified organism. These corporations employ hundreds if not thousands of individuals at all levels within the corporate infrastructure. Within this dynamic 'universe' the board of directors sits in final judgment and carries ultimate responsibility for its welfare. Yet corporate boards meet relatively infrequently. This is as a result of the amount of time that can practically be made available by the outside members of the board. In addition these members can at best only give a marginal amount of their time and effort to the corporate enterprise. A 1982 survey indicates that these directors spent on average less than 3 hours a week or approximately 1.5 working days a month doing board and committee work.[94] Yet these directors form an essential part of any healthy and dynamic corporate board. Thus the limitations and constraints placed on the board in managing the affairs of the company are both inherent and unavoidable.

Within this context the board's decisions are most often made by consensus. Of course many of the matters it deals with are routine and of a housekeeping nature. Three-quarters of the board's time is devoted to reports by

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[94] Bayless Manning, The Business Judgment Rule and the Directors' Duty of Attention: Time for Reality (1984) 39 The Business Lawyer 14776 at 1481.

management, committees and routine matters which are incontentious and passed unanimously. The remaining time is spent dealing with specific business items ie. sale of corporate assets.[95] If the average board meets eight times a year, perhaps only ten to fifteen of these items might be decided upon.[96] The problem may be put this way: "All these realities of directoral life add up to a deeper one. From among an infinite number of useful things that a board of directors might reasonably have done or looked into in a given time period, the number that will not have been done by the most qualified, best men, and most diligent board in the world will always be far greater than the number that were done."[97]

In addition there are many ways in which the process of decision making may take place.[98] Factors such as the dominance of the CEO in setting the board's agenda and the make-up of the board itself impact on this process. The latter element is important in that today's boardroom seats directors from all walks of life, some with extensive business experience and others with none at all. There is then no typical corporate board.

If there is no typical board or typical corporate

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[95] Ibid. p. 1483.

[96] Ibid.

[97] Ibid. p. 1485.

[98] See generally supra n.94.

enterprise, what is a fair yardstick to be used to measure whether or not board X has or has not fulfilled its duty of care obligation? In response to this issue Bayless Manning has put forward a compelling argument. The central point of his thesis is that current common law and statutory (including ALI and RMBCA) formulas focus on a negligence standard and that this standard is inappropriate as a gauge of directoral performance.

> The center of the analytic difficulty is this. In the general field of negligence as we are all able to talk of the "reasonable man" and of the prudent standard performance because we have from our daily experience a clear conception of what the actor is doing and a fairly clear conception of the way in which people normally do it. We know what an automobile driver is doing; he is driving a car. We all know from general experience how one would normally do that in the circumstances-and therefore how he should do it.
>
> The situation with regard to the directors of corporations is totally different. There is no agreed upon roster of functions of a director, analogous to driving the car. We do not have any common standard or experience as to what directors do; and what they do varies from company to company, from situation to situation, and from time to time.
>
> Abandoning all effort to state what directors do, the present law simply announces that they must do it "carefully," like a prudent person. But, once again, we have no external measuring rod for assessing how the directors should do it (whatever "it" is). There is no common experience among courts or juries as to how "it" is normally done, and therefore should be done.
>
> However abstract these statements may sound, the point is not abstract at all. A negligent transgression presupposes a departure from normal behavior. The whole concept of negligence and of "reasonable man" presupposes as a predicate a

> clear conception of what the person is doing, and a community understanding of a standard of normalcy about how he should do it. **Both those pieces are missing in the case of the work of corporate directors.**[99]

In addition to applying this standard to positive acts of the board, the ramifications of its application to errors of omission further complicates matters. The central issue here speaks to the practical inability of corporate boards to deal with but a few substantive matters in any given year. From a takeover context only the first area need be addressed as a takeover bid is unlikely to be left off any board's corporate agenda.

Since Mr. Manning wrote his article there have been few substantive changes in the way the Model Act or the ALI have dealt with the issue. Both the current s.8.30[100] and s.4.01[101] speak in terms of "the ordinarily prudent person" and the proper exercise of discretion "under similar circumstances." Similarly current statutory authority and common law speak to the "ordinarily prudent person" or apply a "negligence" standard.[102] These standards are applied to all significant board functions including oversight and the reliance upon outside advice and committee reports.

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[99] Ibid. pp. 1493-94.

[100] Supra n.1 s.8.30.

[101] Supra n.22 s.4.01.

[102] See generally footnotes 10-18.

If the current test will not suffice then what will? To explore the issue further I have included Mr. Manning's six propositions in Appendix 'A.'[103]

In my opinion while the application of the current 'tortious' test may have its evidentiary difficulties, the propositions detailed in Appendix A are more profoundly flawed. The focus of my objection lies in the subjective context in which the propositions are couched. Specifically, in proposition A a director may

> "devote to the affairs of the company and the performance of his duties as a director such attention as, in his good faith business judgment, a responsible and diligent director similarly situated should devote thereto in the circumstances ... and generally discharge his responsibilities of judgment ... in such manner as, in his good faith judgment, the circumstances call for."[104]

Similar language is used in proposition D, dealing with reliance upon expert advice and reports of committees of the board.

I object to the subjective nature of the test for the following reasons: For a court to inquire as to whether a particular director in his personal judgment acted appropriately is an impossible task. Without an objective fact oriented approach the assertion that a director did indeed act within the parameters of his best judgment may be

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[103] Manning, supra n.94 pp. 1499-1500.

[104] Ibid.

impossible to rebut. Further, the court is forced to look at each director individually to determine his level of competence. This would exonerate directors who have little business expertise in a particular area and rely on this fact for failing to participate and become fully informed. Clearly shareholders are entitled to a minimum standard and one which is not tied to the particular deficiencies of any or all board members. In addition the court should not be placed in the position of having to deal with each individual directors "similarly situated" circumstances. Again a minimal level of scrutiny and attention should be demanded. Finally I believe that unless a director withdraws or formally objects to a decision his compliance is part and parcel of the board's decision and where it is flawed, he must be held accountable. The shield which a subjective test affords is inappropriate to a business environment where investors should be allowed to insist on an objectively defined level of competence.

What then of the argument that such an objective standard is impossible to define? I cannot accept the proposition that the courts are incapable of providing the necessary yardstick. It is precisely the circumstances themselves which dictate <u>what</u> is reasonable and these same circumstances will determine <u>how</u> the matter should have been dealt with. To state that judges and juries have an enhanced ability to determine reasonable judgment in

automobile accidents because "we have ... a clear conception of the way"[105] it is normally done takes us nowhere. Judges and juries decide each case on its relative merits based on the particular circumstances. Such decisions must be made every day in cases dealing with events no less mysterious than board room meetings, ie. medical procedures. In this example one would hardly expect to seat a jury of doctors presided over by a specialist in the area in order to feel secure in a just result. Nor would one feel it sensible to apply a subjective test and accept as the doctor's defense that he had very little training in the area and thus is not culpable.

Clearly an inexperienced corporate bench may have more difficulty in dealing with duty of care cases but consider the alternative.

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[105] Ibid. p. 1493.

PART III

A. FIDUCIARY DUTY

The intent of this section is to review the concept of fiduciary duty in its broadest sense. The specific application of this duty to the area of corporate control contests is dealt with under the context of the Business Judgment Rule.

In general terms "the duty of loyalty imposes upon the board of directors an obligation to avoid conflict-of-interest transactions and thus to act in the best interests of the corporation and its shareholders."[106] This duty can be traced back 248 years to the English case, The Charitable Corporation versus Sir Robert Sutton & others, 2 Ark. 400 (1742).[107] As a practical matter directors' liability in this area covers four broad areas: conflicting and competing interests, declaration of dividends, the usurpation of corporate opportunity and purchase and sale of control.[108]

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[106] Walter Hinnant, Fiduciary Duties of Directors: How Far Do They Go? (1988) 23 Wake Forest Law Review 163 at 168.

[107] Supra n.8. Note: The nature of the fiduciary relationship will be dealt with in greater detail under the general head of Directors as fiduciaries in Canada.

[108] Supra n.106 at 168. See also Robert Ajemian, Outside Directors and the Modified Business Judgment Rule in Hostile Takeovers: A New Test for Director Liability (1989) 62 No. 2 Southern California Law Review 645 at 655:

(continued...)

The latter relates directly to takeover contests.

The fiduciary duty itself has developed through a marriage of statutory and judicial interpretation. Most state statutes do not however make reference to 'fiduciary' responsibilities. However most states do stipulate a duty of 'loyalty,' which deals primarily with the ways in which directors might benefit personally at the shareholder's expense.[109] Again this follows from a fiduciaries' inherent restriction concerning self-dealing.[110] While most states do not make reference to 'fiduciary' duties they have

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[108](...continued)
The traditional duty of loyalty is composed of four parts:

Conflict of Interest: The director should disclose any material personal interest in any transaction the corporation is dealing with.

Duty of Fairness: A director must never make a profit in his own business dealings at the expense of the corporation. The director must hold the welfare of the corporation above his own interests in the case of a potential conflict of interest.

Corporate Opportunity: When a director knows of any corporate opportunity that might advantage the corporation, the director should not take advantage of it without notifying the corporation first.

Confidentiality: The director should not disclose corporate matters until they have been publicly disclosed or the director has reason to believe that they have become part of the public record.

[109] Supra n.106 p. 168.

[110] Tom Gerke, The Business Judgment Rule and Potential Liability for Defensive Takeover Maneuvers by the Board of Directors (1985) U.M.K.C. Law Review 646 at 647.

attempted to codify the general common law principles. Minnesota provides one such example. Subdivision 1 of Minnesota Statutes section 302A.251 provides that:

> "[a] director shall discharge the duties of the position of director in good faith, in a manner the director reasonably believes to be in the best interests of the corporation..."[111]

While the statutory framework where it exists is important, the case law has provided the substantial rules by which the fiduciary duty has been guided.[112] This is the case "because [as] the issues and facts involved in decisions contemplated by corporate boards are often very complicated, general legislation alone offers little guidance for predicting important outcomes or planning transactions. Case law scrutinizing director's decisions has given meaning to abstract codes.[113] Within the U.S. common law the foundation of the fiduciary principle was set down in Pepper v. Litton[114]: "A director is a fiduciary ...

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[111] Minn. Stat. s.3024.251, subd.1 (1988). Statutes which have designated directors as fiduciaries include: La. Rev. Stat. Ann. s.12.91, N.C. Gen. Stat. s.55-35; 42 Pa. C.S.A. 8363.

[112] Marc Luther, Stakeholder versus Stockholder: The Director's Proper Constituency in a Contest for Corporate Control (1989) 15 William Mitchell Law Review 475 at 482.

[113] Ibid. p. 482. Note: This case law as it applies to control contests will be dealt with under the Business Judgment Rule.

[114] 308 U.S. 295, 306, 84 L.Ed. 281, 60 S.Ct. 238, 245 (1939).

So is a dominant or controlling stockholder or group of stockholders ... Their powers are powers in trust ... Their dealings with the corporation are subjected to rigorous scrutiny ..." Delaware law states that "directors are charged with an unyielding fiduciary duty to the corporation and its shareholders."[115] New York[116] and Michigan[117] speak in terms of "a high fiduciary duty of honesty and fair dealing." Florida[118] sets the standard at "strict fiduciary duties" and the law in Kansas[119] states "very strict fiduciary responsibilities." In other jurisdictions the case law uses the terminology; "fiduciary duty" or "fiduciary relationship."[120] Directors must in general terms

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[115] Guth v. Loft, Inc., 2 A. 2d 225 (Del. Ch. 1938), aff'd., 5 A 2d 503 (Del. 1939).

[116] Chris Craft Industries, Inc. v. Piper Aircraft Corp., 480 F. 2d 341 (2d Cir.), cert. denied sub nom. Bangor Punta Corp. v. Chris Craft Industries, Inc., 414 U.S. 910 (1973).

[117] Berman v. Gerber Prod. Co., 454 F. Supp. 1310 (W.D. Mich. 1978).

[118] City of Miami Beach v. Smith 551 F. 2d 1370 (5th Cir. 1978).

[119] Mid-West Underground Storage, Inc. v. Porter, 717 F. 2d 493 (10th Cir. 1983); Delano v. Kitch, 542 F. 2d 550 (10th Cir., 1976), opinion clarified, 554 F. 2d 1004 (10th Cir. 1977), appeal after remand, 663 F. 2d 990 (10th Cir. 1981), cert. denied, 456 U.S. 946 (1982).

[120] Eg., DePinto v. Landoe, 411 F. 2d 297 (9th Cir. 1969); Jewel Cos. v. Pay Less Drug Stores Northwest, Inc., 741 F. 2d 1555 (9th Cir. 1984); United States v. Gates, 396 F. 2d 65 (10th Cir. 1967); Kidwell ex rel. Penfold v. Meikle, 597 F. 2d 1273 (9th Cir. 1979); Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F. 2d 374 (7th Cir. 1984);

(continued...)

give their "conscientious care" and "best judgment to their tasks."[121]

As is the case with most state statutes the Model Act does not refer to directors as 'fiduciaries' but incorporates in s.8.30(1), (3) the duty to act "in good faith" ... "in the best interests of the corporation."[122] Section 8.31[123] deals in specific terms with a director's conflict of interest.

The American Law Institute speaks to the issue of directoral loyalty in Part V[124] and in s.4.01.[125] As is the case with the Model Act s.4.01(a) speaks to a director's duty to act in "good faith" ... in the best interests of the corporation."[126] However there is no reference to a "fiduciary relationship." Part V deals generally with a breach of duty but the introductory Note indicates that the

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[120](...continued)
Robinson v. Watts Detective Agency, Inc., 685 F. 2d 729 (1st Cir. 1982), cert. denied sub nom. Consolidated Serv. Corp. v. Robinson, 459 U.S. 1105 (1983); Ohio Drill & Tool Co. v. Johnson, 625 F. 2d 738 (6th Cir. 1980); Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F. 2d 707 (5th Cir. 1984); Knauff v. Utah Constr. & Mining Co., 408 F. 2d 958 (10th Cir.), cert. denied, 396 U.S. 831 (1969).

[121] Supra n.8 p. 12-13.

[122] Supra n.1 s.8.30(1), (3).

[123] Ibid. s.8.31.

[124] Principles of Corporate Governance: Analysis and Recommendations: Tentative Draft No. 3, (1989) Part V.

[125] Supra n.22 s.4.01.

[126] Ibid.

duty of loyalty reflects "an underlying obligation ... to act fairly toward the corporation and its shareholders."[127]

In summary only a few state statutes refer to directors as fiduciaries. However as a rule they do recognize a duty of loyalty and provide a statutory framework to deal with a breach where it involves a conflict of interest resulting in personal gain. The fiduciary duty has in fact been developed through the common law on a case by case basis and in this area both the Model Act and the American Law Institute have little more to add.

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[127] Supra n.124 Part V "Introductory Note" p. 85.

PART IV

A. THE BUSINESS JUDGMENT RULE

1. THE TRADITIONAL RULE

The business judgment rule is intimately related to both the duty of care and the duty of loyalty obligations which directors owe to the corporation and its shareholders.[128]

> "The business judgment rule is a specific application of this directorial standard of conduct to the situation where, after reasonable investigation, disinterested directors adopt a course of action which, in good faith, they honestly and reasonably believe will benefit the corporation."[129]

The rule insulates directors from liability, where they act conscientiously but their actions nevertheless result in a loss to the corporation and its shareholders.

Originally developed during the industrial revolution the business judgment rule sought to protect individuals

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[128] Note: The American approach is to couch both duties under the general head of 'fiduciary' duties.

[129] Block, D., Barton, N., and Radin, S., The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers, (Clifton, N.J., Prentice Hall, 1987), p. 2. See also, Brian Wanger, Business Judgment Rule: A Benchmark for Evaluating Defensive Tactics in the Storm of Hostile Takeovers (1986) 31 Villanova Law Review 1439 at p. 1447; "Courts generally recognize two components to the business judgment rule - a duty of care and a duty of loyalty."

from liability where damage was sustained through an honest mistake.[130] The rule as developed through case law has for the past one hundred and fifty years been the judicial yardstick used to measure directoral decisions involving day-to-day business transactions.[131] The case of Percy v. Millandon[132] first enunciated the general proposition:

> [T]he occurrence of difficulties ... which offer only a choice of measures, the adoption of a course from which loss ensues cannot make the [director] responsible, if the error was one into which a prudent man might have fallen. The contrary doctrine seems to us to suppose the possession, and require the exercise of perfect wisdom in fallible beings. No man would undertake to render a service to another on such severe conditions. ... The test of responsibility, therefore, should be, not the certainty of wisdom in others, but the possession of ordinary knowledge; and by showing that the error of the [director] is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it.[133]

This case was followed eighteen years later by Godbold v. Branch Bank.[134] In speaking to the rule the court stated:

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[130] See e.g., Ellerman v. Chicago Junction Rep. & Union Stock Yards Co., 49 N.J. Eq. 217, 232, 23A. 287, 292 (N.J. Ch. 1891) (shareholders "cannot question in judicial proceedings the corporate acts of directors, if the same are within the powers of the corporation and in furtherance of its purposes, are not unlawful or against good morals, and are done in good faith and in the exercise of an honest judgment").

[131] Block, Barton and Radin, supra n. 129 p. 3.

[132] 8 Mart. (N.S.) 68 (La. 1829).

[133] Ibid. p. 77-78.

[134] 11 Ala. 191 (1897).

> [Directors] do not in our judgment undertake, that they possess such a perfect knowledge of the matters and subjects which may come under their cognizance, that they cannot err, or be mistaken, either in the wisdom or legality of the means employed by them. To exact such extreme accuracy of knowledge from this or any other class of agents, to whom of necessity a large discretion in the choice of means must be entrusted, would be manifestly wrong, as it must frequently happen, that after the utmost circumspection and caution, the best possible course would not be pursued, and a loss be sustained, which as the event would show, might have been avoided. The inevitable tendency of such a rule would be hostile to the end proposed by it, as no man of ordinary prudence would accept a trust surrounded by such perils.[135]

In another case the proposition was set forward in the following way: "We think a Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fell into a mistake, either as to law or fact, are not liable for the consequences of such mistake."[136]

The rule operates as a presumption of regularity. As stated in Aronson v. Lewis[137] "The business judgment rule

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[135] Ibid. p. 199.

[136] Hodges v. New England Screw Co., 3 R.I. 9, 18 (1853).

[137] Aronson v. Lewis, 473 A. 2d 805, 812 (Del. 1984). This presumption of regularity has been reaffirmed by several recent Delaware Supreme Court decisions (Smith v. Van Gorkom, 488 A. 2d 858 (Del. 1985), Uvocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946 (Del. 1985), Moran v. Household International, Inc., 500 A. 2d 1346 (Del. 1985), Revlon, Inc. v. Mac Andrews & Forbes Holdings, Inc., 506 A. 2d 173 (Del. 1986) and Polk v. Good, 507 A. 2d 531 (Del. 1986). Other states applying the same presumption; Michigan (Hall v. Aliber, 614 F. Supp. 473, 480 (E.D. Mich. 1985), Nevada (Horwitz v. Southwest Forest Industries, Inc., 604 F. Supp.

(continued...)

... is 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 was taken in the best interests of the company." This presumption is applicable to all decisions of a routine nature including more significant transactions involving large corporate assets, major capital investments and the like.[138]

Why are directors afforded the benefit of such a fundamental presumption? The rationale for the business judgment rule is multifaceted. Central to the issue is that the courts feel "ill-equipped and infrequently called on to evaluate what are and must be essentially business judgments."[139] The difficulty arises in that there is no concrete objective standard that might be applied to every business decision. As such some decisions which may appear 'foolhardy' in one context will appear to be divined by

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[137](...continued)
1130, 1135 (D. Nev. 1985), New Jersey (Asarco Inc. v. MRH Holmes A Court, 611 F. Supp. 468, 473 (D.N.J. 1985), New York (Hanson Trust PLC v. MLSCM Acquisition Inc., 781 F. 2d 264, 273 (2d Cir. 1986), Ohio (Mobil Corp. v. Marathon Oil Co., [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) 98,375, at 92,284 (S.D. Ohio Dec. 7, 1981), rev'd. on other grounds, 669 F. 2d 366 (6th Cir. 1981) cert. denied, 455 U.S. 982 (1982), Pennsylvania (Keyser v. Commonwealth National Financial Corp., No. 85-1853, slip op. at 35 (M.D. Pa. April 7, 1986) and Wisconsin (Wanvig v. Johnson Controls Inc., No. 663-4587, slip op. at 10 (Wis. Cir. Ct. Mar. 29, 1985).

[138] Norman Veasey and Julie Seitz, The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project - a Strange Porridge (1985) 63 Texas Law Review 1483 at 1484.

[139] Supra n. 8 p. 182.

genius in another. However the determination of which is the most plausible is not a function for a court to decide. An example of judicial concern in this area may be observed in the case of Joy v. North[140] wherein it is stated:

> [A]fter-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years late against a background of perfect knowledge.[141]

Further it is the directors and not the judges who must bear the responsibility for business judgments as it is the former whose expertise qualifies them for the carrying out of this duty.[142] Similarly the rule is intended to prevent "Monday morning-quarter backing."[143] It is in fact present to "encourage initiative in enterprise decisions, encourage qualified persons to serve as directors, encourage decision-making by independent directors, and give directors wide

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[140] 692 F. 2d 880 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

[141] Ibid. p. 886.

[142] Auerbach v. Bennett, 47 N.Y. 2d 619, 41 9 N.Y.S. 2d 920, 323 N.E. 2d 994, 1000 (1979).

[143] Panter v. Marshall Field & Co., 646 F. 2d 271, 297 (7th Cir.), cert. denied, 454 U.S. 1092 (1981).

latitude in their handling of corporate affairs."[144] In a recent Delaware tender offer case, Chancellor Allen stated:

> Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith. Thus, for example, a good faith decision by a disinterested board cannot be a source of director liability even if the process by which the decision was made was arguably negligent... Only if the process is grossly negligent may liability for damage resulting from a good faith decision be found.[145]

Another basis for the rule lies in the fact that nearly all states have by statute provided directors with the duty to manage the affairs of the company.[146] "The business judgment rule is, therefore, a judicial acknowledgement of the managerial perogatives conferred upon directors."[147] Further the courts have recognized that shareholders voluntarily accept the risk of bad business judgment[148] and that "the proper role of the courts is not to act as an

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[144] Supra n. 8 p. 183.

[145] Solash v. Telex Corp., Fed. Sec. L. Rep. (CCH) 93,608, at 97,727 (Del. Ch. 1988).

[146] Richard Brown, The Role of the Courts in Hostile Takeovers (1989) 93 Dickinson Law Review 195.

[147] Ibid. p. 218.

[148] Joy v. North, 692 F. 2d 880,886 (2d. Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

insurer of shareholder investments."[149] The rule clearly indicates that rather than applying an overly cautious approach, directors must be free to take risks and as such cannot be held to the same standard as ordinary fiduciaries.[150]

As was noted[151] most jurisdictions afford directors the presumption of regularity when the matter at issue involves managerial decisions impacting on the day-to-day operation of the company.[152] However while the business judgment rule provides a presumption of innocence in favour of the directors it does not offer absolute protection. In Gimbel v. Signal Companies, Inc.[153] Chancellor Quillen, quoting Chief Justice Daniel Wolcott, states:

> "A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment."[154]

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[149] Ajemian, supra n. 108 p. 651.

[150] Ibid. p. 652.

[151] Supra n. 137 and 138.

[152] Note: This presumption is modified in many jurisdictions. When the decision at hand materially affects shareholder control eg. corporate control contests. Where only the day to day affairs are at issue the courts are said to be applying the 'Traditional Rule'; however where control is at issue many jurisdictions apply the 'Modified rule.' The latter will be dealt with in detail later in the text.

[153] 316 A. 2d 599 (Del. Ch. 1979).

[154] Ibid. p. 609.

In reference to the above Chancellor, Quillen says further "This does not mean, however, that the business judgment rule irrevocably shields the decisions of corporate directors from challenge."[155] Hence The presumption is rebuttable but the evidentiary burden can be overwhelming. This is a simple truth, as gathering credible evidence which may serve to vitiate a board's decision may be impossible leaving only the circumstances from which to draw the impugned evidence.

In general terms however, the following facts if proven will reverse the evidentiary burden. That a conflict of interest exists or evidence of self-dealing. That the action is fraudulent or manifestly oppressive.[156] Proof of bad faith or abuse of discretion[157] or where it can be shown that the director's primary purpose was to retain control.[158] However control if only incidental to the decision will not serve to rebut the presumption.[159] It is the particular circumstances of the case which will determine

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[155] Ibid.

[156] Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706,712 (N.D. Ill. 1969).

[157] Whitaker Corp. v. Edgar, 535 F. Supp. 933, 950 (N.D. Ill. 1982).

[158] Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946,955 (Del. 1985).

[159] Johnson v. Trueblood, 629 F. 2d 287,293 (3d Cir. 1980).

when and if the facts support the plaintiff's position to the extent necessary to shift the burden of proof.

> "When the "synergies of evidence" make such a prima facie showing, the "burden of justification" shifts to the directors and good faith alone will not preclude a finding of a breach of the duty of loyalty."[160]

Once it has been shown that directors have engaged in self-dealing, fraud or have acted in bad faith or the plaintiff has met his initial evidentiary onus on other grounds the burden of proof shifts to the directors to prove that the transaction was 'fair and reasonable' to the corporation.[161] This statement of the law was reaffirmed in the Delaware case of AC Acquisitions v. Anderson, Clayton & Co.[162] wherein Chancellor Allen said:

> Where director action is not protected by the business judgment rule, mere good faith will not preclude a finding of a breach of the duty of loyalty. Rather, in most such instances (which happen to be self-dealing transactions), the transaction can only be sustained if it is objectively or intrinsically fair; an honest belief that the transaction was entirely fair will not alone be sufficient.[163]

Thus, it is insufficient proof that the decision was based on an honest belief of its fairness. The decision must be

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[160] Supra n. 8 p. 194.

[161] Ibid. p. 195.

[162] 519 A. 2d 103 (Del. Ch. 1986).

[163] Ibid. p. 115.

"intrinsically fair."[164]

In Delaware unless the circumstances indicate a conflict of interest or bad faith the onus will not shift if the decision can be attributed to "any rational business purpose."[165] This general proposition applies where the issue does not involve control contests and will vary depending upon jurisdiction.[166] Where however a jurisdiction has ruled on point all have maintained the directors burden of justification.[167] Nevertheless the primary burden rests with the plaintiff to establish at first instance a breach of directoral duty.

Of increasing importance is the distinction that has been drawn between the business judgment rule and the business judgment doctrine. In general terms "the business judgment rule shields individual directors from liability for damages stemming from decisions, whereas the business judgment doctrine protects the decision itself."[168] The doctrine applies to cases of "transactional justifica-

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[164] Ibid.

[165] Supra n. 8 p. 196.

[166] Ibid.

[167] Ibid.

[168] Joseph Hinsey IV, Business Judgment And the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality (1984) 52 G.W.L. Rev. 609, 611-12.

tion"[169] which involve actions seeking injunctive relief. It is in these circumstances where the decision itself is at issue and not the liability of the decision maker.[170] In both cases the ground rules remain the same and as such courts for the most part have not drawn the distinction.

However while the judiciary has not in the past drawn the distinction through usage of the above noted terminology it has recognized the duality of the concepts through its decisions.[171] Recently however the Delaware Supreme Court

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[169] Veasey and Saitz, supra n. 138 p. 1487. The writer describes transactional justification as "the use of business judgment principles to shield the decision itself from being enjoined or restrained."

[170] Ibid.

[171] Supra n. 168 p. 613 footnote 23:

> 23. The court did not use the terminology in Consolidated Amusement Co. v. Rugoff, [1978] Fed. Sec. L. Rep. (CCH) § 96,584 (S.D.N.Y. 1978), which arose out of stock issuances engineered by the Chief Executive Officer to perpetuate his management position. Nevertheless, the decision could be analyzed on the basis of the court's refusal to apply the business judgment doctrine to insulate the stock issuance transactions from attack and its use of the business judgment rule to provide exoneration for the outside directors.

See also Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co., 26 Ohio St. 3d 151, 21,496 N.E. 2d 959,964 (1986) wherein the court recognizes the doctrine;

> [6] While the business judgment rule protects directors from personal liability in damages, it also applies to cases of "transactional justification," where an injunction is sought against board action, or against a decision itself, in which case the focus is on the decision as contrasted with the liability of the decision maker. There

(continued...)

has taken judicial notice of the business judgment doctrine in the case of Mills Acquisitions Co. v. Macmillan, Inc.[172] The court in its analysis of the director's conduct, states:

> In this context we speak only of the traditional concept of protecting the decision itself, sometimes referred to as the business judgment doctrine. **Revlon**, 506 A. 2d at 180 n.10. The question of the independent directors' personal liability for these challenged decisions, reached under circumstances born of the board's lack of oversight, is not the issue here.[173]

The difference between the two concepts has a practical application in that "in a given case the doctrine may be unavailable but the rule may shield certain directors from liability."[174] This fact may impact upon judicial reasoning both in takeover and non-takeover cases where directoral conduct is at issue. It has been stated that the decision

> "may ultimately depend on whether the case arises as a damage suit against the directors (thus implicating the traditional business judgment rule), or whether the case arises as a transac-

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[171](...continued)
is a distinction between a "transactional justification" case involving or affecting the decision itself and the protection from personal liability of the decision maker. The former is sometimes referred to as involving the business judgment "doctrine," and the latter the business judgment "rule."

[172] 559 A. 3d 1261 (Del. 1989).

[173] Ibid. n. 32.

[174] Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co., supra n. 171 at 26 Ohio St. 21, 496 N.E. 2d 964 n. 4.

> tional justification analysis in an injunction setting."[175]

This is significant in that where the courts have dealt with the issue they "suggest that even though injunctive relief may be available to avoid a transaction, personal liability of the directors for damages will not necessarily follow."[176]

2. ELEMENTS OF THE BUSINESS JUDGMENT RULE

> "The business judgment rule shields corporate decision-makers and their decisions from judicial second-guessing where the five elements of the rule - a business decision, disinterestedness, due care, good faith, and no abuse of discretion - are present. It is presumed that each of these elements of the rule has been satisfied, and the party challenging the board's decision has the burden of establishing facts rebutting this presumption."[177]

Further Knepper and Bailey indicate that:

> The court decisions suggest that the primary inquiry should relate to the two elements involved in the duty of loyalty: disinterestedness and good faith. If these hurdles are cleared, the inquiry turns to the duty of due care and the three elements related to it (a) that the decision is a "business decision," (b) that the decision was an

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[175] R. Balotti & J. Finkelstein, Delaware Law of Corporations and Business Organizations, § 4.7, 407 (1988 Supp.).

[176] Supra n. 8 1989 Supplement p. 15.

[177] Block, Barton & Radin, supra n. 129 p. 9-10. See also supra, footnotes 151-67.

> informed one made after a reasonable effort to learn the facts, and (c) that there was no abuse of discretion. Actually, "abuse of discretion" may also relate to the duty of loyalty, if it involves fraud or gross overreaching.[178]

a. A Business Decision

There is no pat definition of what is a 'business' decision. Whether or not it exists is determined as a matter of fact under the circumstances in question. However a business decision must nevertheless exist prior to the application of the rule. As stated in Kaplan v. Centex Corporation[179]: "Application of the rule ... depends upon a showing that informed directors did, in fact, make a business judgment authorizing the transaction under review."[180] Further the transaction must be within the corporation's authority and

> "in the lawful and legitimate furtherance of corporate purposes, such as policy of management, expedience of contracts or action, adequacy of considerations, or lawful appropriation of corporate funds to advance corporate interests."[181]

The area becomes somewhat less clear when deciding

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[178] Supra n. 8 p. 184-185.

[179] 284 A. 2d 119 (Del. Ch. 1971).

[180] Ibid. p. 124.

[181] Supra n. 8 p. 185.

whether under the circumstances a failure to act precludes the protection of the rule. The following position was put forward in Aronson v. Lewis:[182]

> [9, 10] However, it should be noted that the business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act. But it also follows that under applicable principles, a conscious decision to refrain from acting may nonetheless be a valid exercise of business judgment and enjoy the protections of the rule.[183]

The difficulty arises in assessing whether or not inaction under the particular circumstances will or will not be considered a "conscious decision to refrain from acting."[184] In the final analysis the court will make this determination based on the particular facts of the case. The warning is clear however, and in a takeover context directors must ensure that any decision not to act is properly documented. This will preclude a finding that no conscious decision was in fact made.

b. Disinterestedness

In the context of the business judgment rule a disin-

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[182] 473 A. 2d 805, (Del. 1984).

[183] Ibid. p. 813.

[184] Ibid. See also Manning, supra n. 94, 1483.

terested director is one who displays an absence of personal interest or self-dealing.[185] This duty is incorporated into the general duty of loyalty and as such is considered a fiduciary obligation.[186] Directors must "possess a disinterested independence and ... not stand in a dual relation which prevents an unprejudicial exercise of judgment."[187] The Delaware Supreme Court has defined the issue this way:

> Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders. The question of independence flows from an analysis of the factual allegations pertaining to the influences upon the directors' performance of their duties generally, and more specifically in

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[185] Supra n. 8 p. 184.

[186] See generally, supra text p. 43-48. See also Guth v. Loft, Inc., 5 A. 2d 503,510 (Del. 1939): Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or enable it to make in the reasonably and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.

[187] Auerbach v. Bennett, 47 N.Y. 2d 619,631, 393 N.E. 2d 994,1001, 419 N.Y.S. 2d 920,927 (1979).

respect to the challenged transaction.[188]

Typically interestedness has been found where the board has had a financial interest.[189] Although there has been dictum to support the view that the interest need not be financial.[190] In order for the court to find a breach the

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[188] Pogostin v. Rice, 480 A. 2d 619, 624 (Del. 1984).

[189] Block, Barton & Radin, supra n. 129, p. 12.

[190] Ibid. p. 13 and at footnote 52:

Thus, for instance, in **Drobbin v. Nicolet Instrument Corp.**, 631 F. Supp. 860 (S.D.N.Y. 1986), the court spoke in broad language, stating that a director not "financially interested" in a challenged transaction may nevertheless "forfeit the saving status of "independent director" for more subtle, less direct entanglements and alliances." **Id.**, at 881 (citing two texts - H. Henn & J. Alexander, **Laws of Corporations and Other Business Enterprises** 638 N.1 (3d ed. 1983) and M. Feuer, **Personal Liabilities of Corporate Officers and Directors** (1st ed. 1962) - but no cases). The facts before the **Nicolet** court, however, involved a director who had no financial interest in the specific transaction under challenge itself, but who the court found had an interest in enjoying the goodwill of another director who was indisputably financially interested, and upon whom the director in question was "entirely dependent ... for an **entree** into the practice of law." 631 F. Supp. at 881-82. Such an interest, of course, is plainly financial in nature.

Likewise, in **Packer v. Yampol**, No. 8432 (del. Ch. Apr. 18, 1986) (available on LEXIS and WESTLAW), the court found four of five directors to be interested due to their "professional, financial and personal relationships" (**id.**, slip op. at 35) with Barry Yampol, the corporation's Chairman and Chief Executive Officer, who was clearly interested in a transaction conferring additional voting power upon him shortly after the commence-

(continued...)

plaintiff must establish personal interest or self dealing by a majority of the corporation's directors."[191]

c. Due Care

The general duty of care which directors must exercise has been dealt with in detail earlier in this text. That duty becomes more focused in the context of the business judgment rule, namely, directors must:

(1) inform themselves, prior to making a business decision, of all material information reasonably available to them, and

(2) having become so informed, must then act with requisite care in the discharge of their duties.[192]

Historically the business judgment rule developed

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[190](...continued)
ment of a proxy contest for control of the corporation. See **id.** at 2-3, 13-23. These four directors included a former officer and present consultant to the corporation, two accountants whose firms had performed accounting work for the corporation, Yampol and Yampol family interests, and a lawyer who represented Yampol and Yampol's family. **Id.** at 5 n.1. Certifying the issue for interlocutory appeal, the Delaware Supreme Court noted that the Chancery Court's decision "may conflict with well settled principles of law established by this Court." Yampol v. Packer, Nos. 115, 116 & 117, slip op. at 2 (Del. Apr. 22, 1986). The case was settled, however, prior to a decision on the merits by the Supreme Court.

[191] Ibid. p. 11. See also Radin, supra n. 75 p. 711.

[192] Supra n. 8 p. 187.

concomitantly with reasonable care standards.[193] The business judgment rule developed as an adjunct to these standards in placing upon directors an obligation to be diligent in their decision making process.[194] Hence the traditional rule operates in such a manner as to preclude second-guessing the merits of a decision where the decision was an informed one. The focus then is on the process of decision making rather than on the substantive merit of the decision itself.[195]

While both the rule and the duty of care standards have a common ancestry the application of one to the other is perhaps the greyest area within the entire scope of directoral duty in the business context. In respect to some earlier cases the commentary has centered upon the courts' lack of focus on what constitutes a breach of the duty of care. It has been suggested that the business judgment rule merged with the duty of care to effect that the latter was obscured by the rule.[196] The result was a lack of focus on what the directors did or should have done to become

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[193] Stuart Cohn, Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule (1983) 62 Texas Law Review 591,603.

[194] Ibid.

[195] This approach is still applied to decisions which do not affect corporate control. However as will be seen later in the text, the courts have become more willing to peer behind the process and rule on the merits of a decision in cases which involve defenses to hostile takeover attempts.

[196] Cohn, supra n. 193 p. 605.

informed with a view only to that part of the rule which deals with improper motives such as "self-dealing, fraud or illegality."[197] The net effect, it was argued, was that the presumption of regularity served to shield directors from their common law and statute based duty of care as the focus was not directed toward the decision making process but dealt rather with the duty of loyalty. This for all intent and purposes often adversely affected the plaintiff's already slim prospects for success on a due care theory.[198]

A review of the case law in this area will provide a context in which to view the landmark case of Smith v. Van Gorkom.[199] In the case of Shlensky v. Wrigley[200] the court

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[197] Ibid.

[198] Ibid.

[199] 488 A. 2d 858 (Del. 1985).

[200] 95 Ill. App. 2d 173,237 N.E. 2d 776 (1968). Facts; Cohn, supra n. 193,167:

> In **Shlensky**, plaintiff filed a derivative action challenging the lighting policy at Wrigley Field, home of the Chicago Cubs baseball team. Because the team played no home games at night, many working people and students were unable to patronize the team. The plaintiff alleged that the lighting policy adversely affected the corporation's primary source of revenue, sale of tickets to home games, and thus caused the corporation to suffer a substantial economic loss. Philip K. Wrigley, controlling shareholder, president, and director of Chicago National League Ball Club, Inc., which owned the Cubs, controlled the election of each of the other eight directors, who were, along with Wrigley, defendants in the suit. Apparently the full board had never seriously considered the policy of playing home

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did not consider whether the directors properly researched the facts before making their decision. Instead the directors were simply given the benefit of the presumption of an action taken in good faith and "designed to promote the best interests of the corporation they serve."[201] There was no concern over the decision making process itself which would perhaps have led the court to a different conclusion based on the question of whether in fact it was an informed decision.

In Panter v. Marshall Field & Co.[202] the court again

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[200](...continued)
games at night, and Wrigley had eschewed the policy because of his belief that baseball was a "daytime sport" and that night games would cause the neighbourhood surrounding the stadium to deteriorate. Although the plaintiff argued that Wrigley's personal opinions were irrelevant to the corporation's business interests and welfare, the trial court granted the defendant's motion to dismiss the complaint, and the dismissal was affirmed on appeal.

[201] Ibid. p. 779 (quoting Davis v. Louisville Gas & Electric Co., 16 Del. Ch. 157,169, 142 A. 654,659 (1928)).

[202] 646 F. 2d 271 (7th Cir.), cert. denied, 454 U.S. 1092 (1981). Facts: supra n. 193, 618:

In **Panter v. Marshall Field & Co.** shareholders initiated litigation after Marshall Field successfully thwarted a hostile tender offer planned by Carter Hawley Hale (CHH). Marshall Field's success denied shareholders the opportunity to tender their shares at the intended offering price of $42, which was well above the market price per share prior to the tender offer announcement. The plaintiffs asserted state and federal claims against the corporation and its directors in an effort to recover their "lost" premium. The principal state law claim related to whether two
(continued...)

ignored the decision making process which led to the defensive measures taken. The focus rather was on whether the directors were predominantly driven by "impermissible motives."[203] The majority in this case presumed that the directors exercised due care in deciding the issue at hand. They did not explore the process itself.

Similarly in Treadway Cos. v. Care Corp.[204] the District Court's decision was reversed "without any consideration of whether the directors had obtained sufficient information..."[205] The court concluded that directors "are called to account for their action only when they are shown to have engaged in self-dealing or fraud, or to have acted in bad faith."[206]

In Shlensky, Panter and Treadway the courts substituted motives for diligence[207] and by narrowing the business judgment rule to issues involving a breach of loyalty the

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[202](...continued)
of Marshall Field's defensive measures, the acquisition of stores in CHH's marketing areas and the prosecution of antitrust claims concerning the proposed CHH takeover, were based on a genuine concern for the merits of the tender offer or were motivated primarily by management's desire for continued corporate control.

[203] Ibid. p. 294.

[204] 638 F. 2d 357 (2d Cir. 1980).

[205] Cohn, supra n. 193 p. 620.

[206] Supra n. 204 p. 382.

[207] Cohn, supra n. 193 p. 621.

courts ignored its other pillar, the duty of care.[208]

Following these decisions the Delaware judiciary began to develop a clear separation between the duty of care and the duty of loyalty in their consideration of the business judgment rule. In the case of Aronson v. Lewis[209] the Plaintiff brought a derivative action to set aside a contract of employment. The Aronson court held that the presumption afforded by the rule will only apply where the decision is an informed decision[210] and that under the business judgment rule director liability is predicated upon concepts of gross negligence."[211] Thus unless in the process of becoming informed the directors were 'grossly negligent' no liability will attach to the decision.

That this distinction was followed in the case of Smith v. Van Gorkom was not surprising. What was a shock however, was the fact that the principles put forward in Aronson had in the result a finding of gross negligence against an entire board with a resultant damage award in the millions of dollars against the directors themselves. As has been noted "before Trans Union, courts rarely found individual directors liable for breaching their duty of care in the

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[208] Supra n. 128. See also Aronson v. Lewis.

[209] 473 A. 2d 805 (Del. 1984).

[210] Ibid. p. 812.

[211] Ibid.

absence of some form of self-dealing."[212] The facts are presented in brief as follows:

> The **Van Gorkom** story begins during the summer of 1980, when Trans Union Corporation's senior management became convinced that the corporation's stock was undervalued (the stock had traded at prices ranging from $24-1/4 to $39-1/2 per share over a five-year period) due to Trans Union's inability to utilize large tax write-offs. Without consulting the corporations' board of directors, Trans Union's Chairman and Chief Executive Officer, Jerome Van Gorkom, who owned 75,000 shares and was approaching mandatory retirement, suggested to Jay Pritzker a $55 per share cash-out merger with a company Pritzker controlled. Following several meetings over the course of a week, Pritzker made the offer Van Gorkom had requested. Pritzker insisted, however, that Trans Union's board act on the proposal, which was made on a Thursday, by the following Sunday evening.
>
> That Friday, Van Gorkom called a special board meeting for Saturday, September 20 without advising the directors of the purpose of the meeting. Van Gorkom told his senior management team about the proposed transaction for the first time one hour before the meeting. Notwithstanding a "completely negative" reaction by all but the two officers with whom Van Gorkom had earlier consulted, Van Gorkom proceeded with the board meeting as scheduled.
>
> The board meeting began with a twenty-minute presentation by Van Gorkom, which outlined the terms of the proposed merger. Van Gorkom stated that the free market would judge whether $55 was a fair price because the proposed agreement permitted Trans Union to receive (but not actively solicit) competing offers for ninety days. He urged that the board give Trans Union's stockholders the opportunity to accept or reject the offer. Van Gorkom never mentioned that he, not

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[212] Craig Hammond, Limiting Director's Duty of Care Liability: An Analysis of Delaware's Charter Amendment Approach (1986-87) University of Michigan Journal of Law Reform 543,547.

> Pritzker, was the one who had suggested the $55 price. One of two officers whom Van Gorkom had consulted prior to September 20 announced his approval. Donald Romans, the corporation's chief financial officer, had opposed the merger at the earlier management meeting, but his recommendation was neither requested by nor given to the board. All that Romans stated at the September 20 board meeting was that he had not learned of the proposal until that morning, that calculations he had done in the past "did not indicate either a fair price for the stock or a valuation of the Company," and that in his opinion "$55 was 'in the range of a fair price,' but 'at the beginning of the range.'" Counsel advised the board that a fairness opinion was not required by law, and that the directors might be sued if they failed to accept the offer.
>
> After about two hours, the directors approved the transaction, and the merger agreement was signed by Van Gorkom at a social event that evening. Neither Van Gorkom nor any other director read the agreement prior to signing. Trans Union announced its "definitive" merger agreement on September 22, omitting any reference to the corporation's limited right to receive higher offers.[213]

The fundamental issue in the case was whether under the circumstances the board's decision could be considered the product of an informed business judgment. To that end the court applied an objective standard and carefully evaluated the way in which the decision was made. In doing so, the court did not digress from its historical position of refusing to rule on the merits of the decision itself. The Van Gorkom court in determining that the Trans Union board could not receive the protection of the business judgment rule stated their reasons as follows:

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[213] Facts as set forward, Radin, supra n. 75 p. 714-16.

> The directors (1) did not adequately inform themselves as to [the CEO's] role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours consideration, without prior notice, and without the exigency of a crisis or emergency.[214]

The decision created a storm of controversy. The Delaware court was said to have "exploded a bomb."[215] The corporate bar considered the decision as 'atrocious.'[216]

Clearly the case was a departure from traditional practice in as much as it resulted in a damage award against the directors themselves of some 23.5 million dollars.[217] It was in fact the first decision to hold that a merger was invalid as a result of an uninformed business judgment solely on the basis of the board's decision making process.[218] It was considered by some as bad law because the court "was rigidly formalistic in concluding that negligent decision making yields decisions which are detrimental to

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[214] Supra n. 199 p. 874.

[215] Bayless Manning, Reflections and Practical Tips on Life in the Boardroom after Van Gorkom (1985) 41 The Business Lawyer 1.

[216] Ibid.

[217] This represented the amount by which the fair value of the shares exceeded the $55 share price.

[218] Ajemian, supra n. 108 p. 659.

shareholders."[219] Not only did the court refuse to recognize the inherent expertise of the board,[220] but there was a concern that by looking solely to the decision making process, decisions might be reversed, albeit they may be inherently fair to the shareholders. Similarly many were worried that unfair decisions might escape scrutiny if the 'paper process' involved was sufficient to pass the informed decision making process test.

The case is important for other reasons as well. The court in its deliberations considered some further issues which are relevant to this review of the business judgment rule. First, the court also considered whether one or more of the defendants were entitled to rely on 8 Del. C. §141(e) in good faith reliance upon "reports" including legal advice. They held that although counsel advised that litigation might follow if the sale was not approved, these comments did not amount to 'legal advice.' In particular reference to this the court stated:

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[219] Ibid.

[220] A good deal of the controversy was centered upon the expertise of the directors themselves. In a vigorous dissent McNeilly J. noted the outstanding background of the five outside directors and made the point that with "78 years of combined experience as chief executive officers, and 53 years cumulative service as Trans Union directors ... these men knew Trans Union like the back of their hands ..." (Supra n. 199 p. 894,895). McNeilly J. in recognizing this expertise had a different view of the facts and felt that rather than being grossly negligent the "directors acted with the utmost care in informing themselves of the relevant and available facts.." (supra n. 199 p. 897).

> ... counsel's mere acknowledgement of this circumstance cannot be rationally translated into a justification for a board permitting itself to be stampeded into a patently unadvised act. While suit might result from the rejection of a merger or tender offer, Delaware law makes clear that a board acting within the ambit of the business judgment rule faces no ultimate liability. **Pogostin v. Rice, supra.** Thus, we cannot conclude that the mere threat of litigation, acknowledged by counsel, constitutes either legal advice or any valid basis upon which to pursue an uninformed course.[221]

In addition the court considered the joint and/or severable liability of the directors. While it is generally the rule that ultimate liability for improper conduct is considered on an individual basis,[222] the court stated:

> (1) that since all of the defendant directors, outside as well as inside, take a unified position, we are required to treat all of the directors as one as to whether they are entitled to the protection of the business judgment rule; and (2) that considerations of good faith ... are irrelevant in determining the threshold issue of whether the directors as a Board exercised an informed business judgment.[223]

In the final analysis the case stands for the presumption that directors will not be granted the protection of the business judgment rule where they make an uninformed business decision. Such will be deemed to be the result where directors are grossly negligent in their decision

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[221] Supra n. 199 p. 881.

[222] Supra n. 8 p. 188.

[223] Supra n. 199 p. 889.

making process. Thus although directors may indeed possess all relevant information to proceed to an informed decision, they must create an appearance or evidence of the fact that the knowledge and informed consideration is in fact present.[224]

Whether for better or for worse the court stayed the course in its application of a negligence standard and in its refusal to review the merits of the decision itself. In my opinion the case did not raise the standard of care but rather focused upon the due diligence portion of this duty. Further the case turns on facts which show an egregious lack of care considering what was at issue.[225] In fact counter to the fears raised at the time, the impact of the Trans Union case on directoral liability for damages has been

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[224] A mere "paper trail" is however insufficient. See for example EAC Industries Incorporated v. Frantz Manufacturing Company 501 A. 2d 401 (Del. 1985).

[225] Delaware Supreme Court Justice Andrew Moore who joined the Von Gorkom majority has since stated that the case "doesn't stand for new Law. The court was just applying old Law to egregious facts." Former Delaware Supreme Court Justice William Quillen put it bluntly when he said:

> "[A] board of directors, without any significant particularized internal or external advanced study, and without prior agenda notice, cannot rely on the protection of the business judgment rule in approving a $700 million sale of 100% of the corporation in a two hour meeting." (supra n. 75 p. 720-71).

limited.[226] During the ensuing three year period twelve courts had rejected claims that directors did not exercise due care. Seven involved preliminary injunctions, two dealt with motions for summary judgment and three followed trials. However, while Van Gorkom may not have raised the common law standard of care, it had a major role in lowering the statutory requirement. As one writer has put it,

> "Perhaps the most significant element of the post-Van Gorkom environment is the enactment of the director-protection statutes by thirty three states in 1985 through 1987 ... one major cause-but by no means the only cause - of these developments was the Delaware Supreme Court's Dramatization in Smith v. Van Gorkom that directors could really be held liable for monetary damages as a result of their conduct as directors."[227]

To date however, the standard of due care is still difficult to determine. Where the business judgment rule does not apply, the standard appears to be 'ordinary care' or 'simple negligence.'[228] This is the standard set out under most state corporate statutes.[229] However, when applying the business judgment rule the Delaware courts

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[226] Radin, supra n. 75 p. 721. This article speaks to limited impact of Von Gorkom vis-a-vis the harm it was perceived to foretell.

[227] Ibid. p. 744-45. See also generally text, supra p. 26-35.

[228] Supra n. 8 p. 188.

[229] Ibid.

apply a 'gross negligence standard.'[230] In addition, the standard varies by jurisdiction. For example, New York common law has interpreted the statutory requirement[231] to require good faith and the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.[232] Further as there is no typical corporate director and since corporations vary greatly in the way they operate then when dealing with the "ordinarily prudent person" it has been said that:

> When that mythical person engages in collegial participation in corporate board functions, such phrases as "under similar circumstances" are employed as guides for action. But few, if any, circumstances are sufficiently similar for the guides to lead to a safe harbour.[233]

d. Good Faith

The good faith requirement is part of the overall duty which directors hold as fiduciaries in their governance of the corporate enterprise. Under the business judgment rule in order to satisfy this requirement, a director must act

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[230] Aronson v. Lewis, 473 A. 2d 805 (Del. 1984). Smith v. Von Gorkom 488 A. 2d 858 (Del. 1985).

[231] N. of Bus. Corp. Law § 717.

[232] Norlin Corp. v. Rooney, Pace, Inc., 744 F. 2d 255, 264 (2d Cir. 1984).

[233] Supra n. 8 p. 190.

with a good faith belief that his business judgment is in the best interests of the corporation.[234] In Delaware, while directors may not act "with reckless indifference to" or "in disregard of" the shareholders,[235] the courts will not disturb corporate decisions which can be associated with "any rational business purpose."[236] As in other areas of the rule, this requirement varies by jurisdiction. In California, Arizona and Nevada the Ninth Circuit has applied a test requiring a "compelling business reason"[237] especially when the decision impacts negatively upon minority shareholders.[238]

For almost a century the courts have considered the business judgment rule unavailable to directors where there is evidence of bad faith or some other corrupt motive.[239] At present Delaware requires "at a minimum," that the plaintiff "show some sort of bad faith on the part of the

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[234] Block, Barton & Radin, supra n. 129 p. 14.

[235] Allaum v. Consolidated Oil Co., 147 A. 257, 261 (Del. Ch. 1929).

[236] Sinclair Oil Corp. v. Levien, 280 A. 2d 717, 720 (Del. 1971); Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946, 954 (Del. 1985).

[237] See, e.g., Shivers v. Amerco, 670 F. 2d 826, 832 (9th Cir. 1982); Klaus v. Hi-Shear Corp., 528 F. 2d 225, 233 (9th Cir. 1975); Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P. 2d 464 (1969).

[238] Supra n. 8 p. 192.

[239] Briggs v. Spaulding, 141 U.S. 132, 35 L. Ed. 662, 11 S.Ct. 924 (1891).

defendant" in order to displace the business judgment rule.[240] New York requires more than simple good faith. In order to gain the protection of the rule, directors must exercise their "honest judgment in the lawful and legitimate furtherance of corporate purposes."[241] Where outside directors, independent, or "disinterested" directors, "whose sole interest was the furtherance of the corporate enterprise" concur, such has been held to support the good faith of the board's decision.[242]

Of particular interest in this area has been the development of the Primary Purpose test and its application to a finding of good faith decision making. The primary purpose test asks whether the board acted primarily (a) to further a proper corporate purpose, or (b) to keep itself in office.[243] It has typically been applied to decisions made for the purpose of issuing or repurchasing stock as a

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[240] Johnson v. Trueblood, 629 F. 2d 287, 293 (2d Cir. 1980).

[241] Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F. 2d 264, 274 (2d Cir. 1986).

[242] Puma v. Marriott, 283 A. 2d 693, 695-96 (Del. Ch. 1971); Beard v. Elster, 160 A. 2d 731, 738 (Del. 1960); Warshaw v. Calhoun, 221 A. 2d 487, 493 (Del. 1966); Panter v. Marshall Field & Co., 646 F. 2d 271, 294 (7th Cir.), cert. denied, 454 U.S. 1092 (1981). See also Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946, 955 (Del. 1985), and Moran v. Household Int'l, Inc., 500 A. 2d 1346, 1356 (Del. 1985).

[243] Block, Dennis J., Pitt, Harvey L., Hostile Battles for Corporate Control, Vol. 1 (New York: Practising Law Institute, 1985), 384.

defensive measure to a hostile takeover.

The primary purpose approach was applied in Delaware through a trilogy of cases in which each dealt with the concept in a different way. An analysis of this jurisprudence not only illuminates the doctrine, but provides a context in which to view some of the later Delaware decisions. The first decision along this line is that of Kors v. Carey,[244] in which the plaintiff Koss, a minority shareholder, sued the board of directors for an accounting. In this case in order to avert a takeover, the board had repurchased corporate stock from a raider. This was alleged to have been motivated predominantly by the desire of the board to retain their jobs. The plaintiff alleged that the directors breached their fiduciary duty in that the repurchase was not made in furtherance of a proper corporate purpose. The court held that in the absence of "fraud, misconduct or abuse of discretion,"[245] there could be no breach of fiduciary duty and thus no proof of improper purpose. Further, that it was the plaintiff who held the burden of proving the breach. The plaintiff failed in her action against the board. This case was followed two years later by Bennett v. Propp.[246] The case arose as a suit for corporate waste where the chairman of the board, in response

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[244] 158 A. 2d 136 (Del. Ch. 1960).

[245] Ibid. p. 140.

[246] 187 A. 2d 405 (Del. Ch. 1962).

to a perceived takeover threat, made an unauthorized stock repurchase. This repurchase was later ratified by the board. The court distinguished the Kors case stating that decisions premised upon the desire to retain control are improper unless the directors have "manifestly reasonable grounds" to believe that the takeover "would be injurious to the corporation."[247] Further the court indicated that the careful consideration of facts and threat of immediate harm were not present in this case as they were in Kors. More importantly, the court established an initial burden of proof that had to be met by the defendant directors:

> We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of necessity confronted with a conflict of interest, and an objective decision is difficult. See the comments on the instant case in 62 Col. L. Rev. 1096, 1100. Hence, in our opinion, the burden should be on the directors to justify such a purchase as one primarily in the corporate interest.[248]

Whereas the Kors court never shifted the evidentiary burden to the directors the Bennett decision now placed the initial burden on the board. "Gone, then, was the unequivocal application of the traditional business judgment rule in the takeover context. Kors was not to be the rule but the

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[247] Ibid. p. 409.

[248] Ibid.

exception."[249] In the final case of Cheff v. Mathes[250] a derivative suit[251] was brought by a stockholder against the board as a result of a decision to repurchase shares from a corporate raider. It was alleged that the stock repurchase was a breach of fiduciary duty because the stock was purchased at a premium for the sole purpose of entrenching incumbent management in office.[252] The court restated the principles set forward in the Bennett case.[253] However in deciding the issue the court determined that where directors can demonstrate that perceived "danger to corporate policy and effectiveness" existed and that this belief was based on a "showing of good faith and reasonable investigation," they will have satisfied their initial burden of proof.[254] Thus the burden of proof was greater than that put forward in Kors but

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[249] Stephen Lubega, Kors to Unocal: The Business Judgment Rule Speaks with a Forked Tongue (1986) 16 Southwestern University Law Review 814 at 829.

[250] 199 A. 2d 548 (Del. Ch. 1964).

[251] A derivative suit is one: by a shareholder to enforce a corporate cause of action. The corporation is a necessary party, and the relief which is granted is a judgment against a third person in favor of the corporation. An action is a derivative action when the action is based upon a primary right of the corporation, but is asserted on its behalf by the stockholder because of the corporation's failure, deliberate or otherwise, to act upon the primary right.

[252] Lubega, supra n. 249 p. 829.

[253] Supra n. 248.

[254] Supra n. 50 p. 555.

> it was far short of requiring the directors to demonstrate that they acted almost selflessly, or primarily in the corporate interest. The burden on the directors to show that they investigated the threat is not the same as the burden to prove that their actions were taken primarily in the corporate interest. The former inquiry involves only what the directors did or should have done. The latter inquiry involves their reasons for doing what they did or did not do.[255]

Thus a new standard was set which fell somewhere between that of Kors and Bennett. The good faith component of the business judgment rule, as articulated through the primary purpose test, impacted upon later decisions which in their own way dealt with the issue of the directoral decision making process.[256]

e. No Abuse of Discretion

The final element of the business judgment rule demands that directors act in the good faith[257] belief that their business decision is in the corporation's best interests.[258]

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[255] Lubega, supra n. 249 p. 829.

[256] See eg. Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946 (Del. 1985). This case established an enhanced directoral duty of care and a threshold test for directoral conduct. While it marked a turning point in developing what has been termed 'The Modified Rule' the case incorporated many of the concepts set out in Cheff v. Mathes. The Unocal decision is dealt with at length later in the text.

[257] Supra n. 8 p. 190.

[258] Ibid. See also: Whittaker Corp. v. Edgar, 535 F. Supp. 933, 950 (N.D. Ill. 1982).

While discretion is closely related to the good faith requirement of the rule, a breach in this area need not necessarily amount to a breach of this fiduciary duty. This element of the rule has been described in the following way:

> This particular limitation to the business judgment rule is, perhaps, not a limitation at all, but simply an application of the fundamental principle behind the rule. An honest error in judgment is allowed. But a judgment that cannot be sustained on some rational basis falls outside the protection of the business judgment rule; the transaction's results may often belie the honest, good faith exercise of judgment.[259]

For example in Gimbel v. Signal Companies, Inc.[260] an action was brought against directors alleging that they sold a corporate subsidiary at $280 million less than its true value. The court found an abuse of discretion holding that "there are limits on the business judgment rule which fall short of intentional or inferred fraudulent misconduct and which are based simply on gross inadequacy of price."[261] In another case the court held that the business judgment rule "does not furnish a license ... to make ... contracts so unreasonable ... that the assets of the corporation will

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[259] Samuel Arsht, The Business Judgment Rule Revisited (1979/80) 8 Hofstra Law Review 93, 122.

[260] 316 A. 2d 599 (Del. Cl.), aff'd., 316 A. 2d 619 (Del. 1974).

[261] Ibid. p. 610.

become wasted."[262] This form of judicial review does not undermine the business judgment rule in that

> the courts' intent in such cases is not to second-guess decisions which are within the bounds of reason, but instead to ferret out those decisions which constitute such extreme overreaching that they constitute an "abuse of discretion."[263]

3. THE MODIFIED RULE

As has been stated the traditional business judgment rule was developed to protect directors from losses incurred through honest mistakes in judgment.[264] It developed in the context of providing relief where the loss resulted from decisions which impacted upon the day-to-day operations of the corporation.[265] These business operations issues have been referred to as "enterprise issues."[266] Those decisions which deal with the ownership and distribution of corporate stock have been called "ownership claim issues."[267] Where the decision impacts upon the control of the corporation it

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[262] Ludlam v. Riverhead Bend & Mortgage Corp., 244 A.D. 113, 278 N.Y.S. 487 (N.Y. App. Div. 1935).

[263] Block, Barton & Radin, supra n. 129 p. 17.

[264] Supra n. 130.

[265] Supra n. 135.

[266] Manning, supra n. 215 p. 5.

[267] Ibid.

is closely related to the latter category.

As contests for corporate control became increasingly prevalent the courts found themselves armed with only an ancient tool with which to deal with a very modern phenomenon.

> Contests for corporate control have become ever more frequent phenomena on the American business scene. Waged with the intensity of military campaigns and the weaponry of seemingly bottomless bank rolls, these battles determine the destinies of large and small corporations alike. Elaborate strategies and ingenious tactics have been developed both to facilitate takeover attempts and to defend against them. Skirmishes are fought in the company board rooms, in shareholders meetings, and, with increasing regularity, in the courts.[268]

The challenge which the courts face deals not with the mechanics of the tender offer[269] process but with the

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[268] Norlin Corp. v. Rooney Pace, Inc., 744 F. 2d 255, 258 (2d Cir., 1984).

[269] For an historical perspective on the 'Tender Offer' see Amy Gentile, The Second Circuit's Narrowing of the Term "Tender Offer": Hanson Trust PLC v. SCM Corp. (1986) 20 Suffolk University Law Review 1203. See also James Tarinaro, Target Directors' Fiduciary Duties: An Initial Reasonableness Burden (1986) 61 The Notre Dame Law Review 722 footnote 1:

> Federal "tender offer" legislation fails to define the term. Courts have formulated their own definition. The court in SEC v. Carter Hawley Hale Stores, Inc., 760 F. 2d 945 (9th Cir. 1985), found that the existence of a tender offer is determined by the following factors: (1) active and widespread solicitation of public shareholders for shares of an issuer; (2) solicitation made for a substantial percentage of the issuer's stock; (3) offer to purchase made at a premium over the prevailing market price; (4) terms of the offer

(continued...)

difficult issues which arise out of litigation involving the legitimacy of defensive tactics employed by the target corporation.[270] Exotic tactics have been devised and strategies and counter strategies continue to evolve. The courts have met the challenge with the business judgment rule in hand. However through the process of deciding these cases the judiciary have reshaped and reformed the business judgment rule. This development has by no means been uniform across state borders. However an analysis of three important corporate jurisdictions will provide some considerable guidance in this area.

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[269](...continued)
are firm rather than negotiable; (5) offer contingent on the tender of a fixed maximum number to be purchased; (6) offer open only for a limited period of time; (7) offers subjected to selling pressure; and (8) public announcements of a purchasing program concerning the target company precede or accompany rapid accumulations of a large amount of a target's securities. **Id.** at 950 (citing Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), **aff'd on other grounds,** 682 F. 2d 355 (2d Cir. 1982), **cer. denied,** 460 U.S. 1069 (1983)). **See also** Edgar V. MITE Corp., 457 U.S. 624, 626 n.1 (1982); Hanson Trust PLC v. SCM Corp., 774 F. 2d 47 (2d Cir. 1985) (Hanson I). For a more encompassing definition, see S-G Securities, Inc. v. Fuqua Inv. Co., 466 F. Supp. 1114, 1126-27 (D. Mass. 1978) (a publicly announced intention to acquire a substantial block of a company's stock with the purpose of obtaining control and the subsequent rapid acquisition of large blocks of the stock constitutes a tender offer).

[270] David Schubert, Unocal Corp. v. Mesa Petroleum Co.: A New Era of Fiduciary Duty (1986) 38 Baylor Law Review 687, 688.

4. DELAWARE

In the evolution of this area one case marks a watershed in the transformation of the business judgment rule. Unocal Corp. v. Mesa Petroleum Co.,[271] a decision of the Supreme Court of Delaware, fundamentally modified the business judgment rule. The facts are as follows:

> As of April 8, 1985, Mesa had acquired approximately 13% of Unocal's stock on the open market. On that date, Mesa announced a two-tier "front-loaded" tender offer to acquire another 38% of Unocal's outstanding common stock. After 38%, or a total of 51%, of Unocal's outstanding common stock was acquired in the front-end of the two-tiered offer for cash at a premium, giving Mesa control, the remaining 49% held by the minority stockholders was to be eliminated in a back-end merger through an exchange of "junk bonds." The "junk bonds" were determined by Unocal to be highly subordinated and virtually worthless.
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> After considering the inadequacy of the offer, at least as far as the future 49% of Unocal stockholders were concerned, the Unocal board felt that their fiduciary obligations to stockholders called for action to protect the minority. In response, the Unocal board passed a resolution providing that if Mesa acquired 51% (64 million shares) of the company, Unocal would buy the remaining 49% outstanding at $72 per share as a fair price alternative to Mesa's "junk bonds." However, the self-tender was subject to one important exclusion. The shares held by Mesa, which would amount to 51% of the total if the plan were to go into effect, were not eligible to participate in the self-tender. To include Mesa would defeat the whole intent and purpose of the plan because of the 49% proration aspect. Every Mesa share purchased would displace another share held by a Unocal stockholder. Unocal would, in effect, be financing Mesa's inadequate offer.

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[271] 493 A. 2d 946 (Del. 1985).

> The self-tender by Unocal was announced on April 17, 1985. On April 22, based on advice of its investment bankers, Unocal agreed to waive the condition precedent of Mesa's acquisition of control and immediately to purchase up to 50 million shares. Thereafter, Unocal's board tendered their shares as a show of good faith. Mesa countered by moving for a preliminary injunction enjoining the discriminatory self-tender.
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> On April 29, 1985, the Delaware Court of Chancery temporarily restrained Unocal from proceeding with the exchange offer unless Mesa was included. The court accepted the active board doctrine under which the board can oppose and attempt to defeat a hostile takeover which it considers detrimental to the corporation and its stockholders. It decided, however, that in a selective purchase of the company's stock Unocal bore the burden of showing: (1) a valid corporate purpose; and (2) that the transaction was fair to all stockholders, including Mesa. After a May 8 hearing, the court, in an unreported opinion, granted Mesa a preliminary injunction. While conceding that Unocal's decision to oppose Mesa's tender offer was made in good faith, it held that the business judgment rule did not apply to a selective exchange offer such as Unocal's discriminatory self-tender.[272]

The Supreme Court made several observations of fact which had a great deal of influence in the final determination of the case. First, Unocal's board consisted of fourteen directors of which a majority of eight were outside directors. Second, the full board considered the situation at length during a nine and one half hour meeting during which time detailed presentations were made to the board. Third, the outside directors then met separately with Unocal's financial advisors and attorneys and unanimously agreed to

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[272] Schubert, supra n. 270, p. 700-701.

advise the board to reject Mesa's proposal and pursue a self tender offer. Fourth, before any decision was made to act, the board met again to hear a further presentation concerning the fair value of the self tender offer.

On appeal the court in reversing the court of Chancery addressed these fundamental questions:

> Did the Unocal board have the power and duty to oppose a takeover threat it reasonably perceived to be harmful to the corporate enterprise, and if so, is its action here entitled to the protection of the business judgment rule?[273]

The Unocal court, citing Cheff v. Mathes[274] and Bennett v. Propp[275] applied the primary purpose test insofar as finding that, in the acquisition of its shares, a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office.[276] The court stated that where issues of corporate change are involved the board is not passive; rather it has a fundamental duty and obligation to protect its stockholders from reasonably perceived harm, irrespective of its source.[277] The court,

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[273] Unocal 493 A. 2d p. 953.

[274] 199 A. 2d 548, 554 (Del. Ch. 1964).

[275] 1897 A 2d 405, 408 (Del. Ch. 1962).

[276] Unocal 493 A. 2d p. 954.

[277] Ibid.

citing Pogostin v. Rice[278] found that the business judgment rule was applicable to takeover contests and thus the presumptions entailed therein[279] applied fully in this context. Further they stated that the board's judgment will not be disturbed where their decision can be attributed to "any rational business purpose."[280] The court found that while the board has a duty to determine whether an offer is in the best interests of the corporation and its stockholders, there is a caveat to the exercise of this function. The court identified that caveat as the "omnipresent specter that a board may be acting primarily in its own interests."[281] As a result the Unocal court found there to be an "enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[282] In dealing with this test the court followed the guidelines set down in the Bennett and Cheff cases. Namely that in the face of this inherent conflict "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed ".. and that they satisfy this burden

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[278] 480 A. 2d 619 (Del. 1984).

[279] Supra n. 137.

[280] Unocal 493 A. 2d p. 954 citing Sinclair Oil Corp. v. Levien 280 A. 2d 717, 720 (Del. 1971).

[281] Ibid. p. 954.

[282] Ibid.

by showing good faith and reasonable investigation."[283]

The court then introduced a new element into the business judgment rule by focusing on the nature of the defensive tactic itself. The Unocal court stated that unless a defensive measure is "reasonable in relation to the threat posed" it will not fall under the ambit of the business judgment rule.[284] This was termed the element of "balance." In its analysis of the potential harm to the corporation the directors could consider such 'threats' as:

> inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on "constituencies" other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange.[285]

In applying the facts to the 'test(s)' the court found that the Unocal board was justified in finding that Mesa's bid posed a danger to corporate policy and effectiveness. The court agreed that the bid was both inadequate and

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[283] Ibid. p. 955.

[284] Ibid.

[285] Ibid.

coercive[286] in nature and also considered the raider a

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[286] See Wenger, supra n. 129 p. 1453:

> A two-tier tender offer is a means for a raider to acquire one hundred percent of the shares of a target. ... The raider initiates this type of tender offer by offering to purchase enough of the target's shares to obtain a controlling interest in the target at a price which exceeds the current value of the shares. ... The raider then offers to purchase the remaining shares at a lower price. ... Since the price which the tender offeror is willing to pay in the second tier, the tender offer is considered "front-loaded." ... A front-loaded tender offer gives the target's shareholders an incentive to tender their shares in the first tier, so that they can receive a premium for their shares. ... For instance, in **Unocal**, Mesa offered to pay 54 dollars in cash for every share tendered in the first tier. ... In the second tier, however, Mesa offered only high risk debt securities with a face value of 54 dollars. ... These securities, labeled "junk bonds" by the Delaware Supreme Court, were actually worth far less than 54 dollars.

See also Schubert, supra n. 270:

> A corporation attempting a takeover via a "front-loaded" two-tiered tender offer, if it has fully complied with the requirements of the Williams Act and applicable state law, has an additional element of coercion at its disposal. A two-tiered offer presents stockholders with the fear of unequal economic treatment in the second tier unless they sell in the first tier. The drastic nature of Unocal's actions was primarily due to this unique aspect of the two-tiered "front-loaded" tender offer used by Mesa.
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> A "front-loaded" two-tiered offer has been defined by Justice Goldberg as:
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>> [a] two step acquisition technique in which the first step (front end) is a cash tender offer and the second step (back end) frequently is a merger in which remaining shareholders of the subject company may receive securities of the bidder valued below

(continued...)

'threat' due to his reputation as a "greenmailer."[287] The Supreme Court also affirmed the Court of Chancery's finding of fact, that the Unocal board's action was taken in good faith with due care and on an informed basis.[288] This finding was predicated largely on the input of the outside directors and the careful consideration of professionally prepared reports and presentations by the board as a whole.

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[286](...continued)
the consideration offered in the first step.

> The price offered in the front end may not be totally acceptable to the stockholder, but he will tender his shares anyway based upon the belief that he will fare better than if he holds out and the raider acquires control. Potential back end minority shareholders are put in a "prisoner's dilemma."
>
> The offer in **Unocal** was typical. Mesa offered $54 per share in the first tier up to 51% of Unocal's shares. The remaining 49% minority who held out were to receive the virtually worthless "junk bonds" in the second tier merger of Unocal with Mesa.

[287] Unocal 493 A. 2d p. 956 note 13:

> The term "greenmail" refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover. The Chancery Court noted that "Mesa has made tremendous profits from its takeover activities although in the past few years it has not been successful in acquiring any of the target companies on an unfriendly basis." Moreover, the trial court specifically found that the actions of the Unocal board were taken in good faith to eliminate both the inadequacies of the tender offer and to forestall the payment of "greenmail."

[288] Ibid. p. 959. This finding satisfies the burden of proof as stipulated in the Bennett case, supra n. 293.

The court further indicated that the selective exchange offer was reasonable in relation to the threat posed.[289] Finally having cleared both the requirements of the traditional rule and its modifications, the board stood under the umbrella afforded by the rule. The evidentiary onus then shifted to the plaintiff Mesa to show that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith or being uninformed.[290] Mesa was unable to do so and as such the decision was reversed and the preliminary injunction vacated.

The significance of this case demands further scrutiny both by way of summation and critical analysis.[291] Prin-

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[289] The court found that the board's offer was reasonable in that

> ... the board's decision to offer what it determined to be the fair value of the corporation to the 49% of its shareholders, who would otherwise be forced to accept highly subordinated "junk bonds," is reasonable and consistent with the directors' duty to ensure that the minority shareholders receive equal value for their shares.

This concept of equal value was said to provide an element of 'fairness' in that it would give the minority stockholders the substantial equivalent in value to what they had before Mesa's bid was announced.

[290] Unocal 493 A. 2d p. 958.

[291] Steven Bradbury, Note - Corporate Auctions and Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule (1988) 87 Michigan Law Review 276, 282 footnote #31:

(continued...)

cipally the case stands for the proposition that a selective stock exchange is a valid exercise of directoral power where the decision to employ such a tactic is made in good faith and upon a reasonable investigation pursuant to a clear duty to protect the corporate enterprise. In coming to this conclusion the court set up a two prong test. The first focuses on the decision making process[292] and requires that the board have reasonable grounds to believe that a danger or threat to corporate policy of effectiveness exists. The second centres upon the element of 'balance' and requires that the defensive measure be reasonable in relation to the threat posed.

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[291](...continued)

Unocal is a leading case in or out of Delaware because many states look to Delaware for guidance on questions of fiduciary duty. See, e.g., Dynamics Corp. of Am. v. CTS Corp. (CTS I), 794 F. 2d 250, 253 (7th Cir. 1986), revd. on other grounds, 107 S. Ct. 1637 (1987). Federal law generally does not govern the review of a target board's defensive strategies. See Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985); Santa Fe Indus. v. Green, 430 U.S. 462 (1977). The only federal securities law relevant to mergers and acquisitions is the Williams Act, 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982). See Edgar v. MITE Corp. 457 U.S. 624 (1982). The Williams Act imposes certain disclosure duties in connection with tender offers and sizable open market stock purchases, and provides tendering shareholders the right to withdraw their shares and the right to receive the highest price paid in the tender offer, distributed among all tendered shares on a pro rata basis. Piper v. Chris-Craft Indus., 430 U.S. 1, 23 (1977).

[292] Ibid. p. 285.

The first test reaffirms the Trans Union approach, focusing on the decision making process in determining whether or not there was an informed business decision. A showing of good faith and reasonable investigation[293] will satisfy this test.[294]

The second test is distinctive[295] and appears to be more substantive than the threshold duty of care inquiry.[296] "For the first time the court stated that the severity of the defensive measure must correspond to the potential harm

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[293] Supra n. 283.

[294] Supra n. 291, p. 285-285:

> ... Reasonable investigation usually involves a thorough and detached analysis by the board and generally must include an evaluation of the acquisition proposal by an impartial financial adviser. The presence of objective factors tending to show due care on the part of the target directors operates as a surrogate for proof of good faith. In addition, the court in **Unocal** emphasized that a showing of good faith and reasonable investigation is strengthened where the decision to oppose a tender offer has been made by a committee of outside, independent directors. The independence of the corporate decisionmakers-that is, the extent to which the members of the board who voted to resist the takeover are disassociated from management - is one objective item of evidence directly relevant to whether the primary purpose behind the defensive tactic was entrenchment. In sum, a reasonably cautious board that is aware of its obligations under the duty of care will have little difficulty satisfying this threshold procedural inquiry. The first prong is simply meant to identify some rational business purpose behind the board's actions sufficient to overcome the suspicions of self-dealing.

[295] Supra n. 108 p. 669.

[296] Bradbury, supra n. 291 p. 287.

posed by a takeover."[297] This second requirement now afforded the court the ability to strike down defenses which offered as a 'cure,' were arguably worse than the 'disease.' One commentator has stated that with this new development the Unocal court took a crucial step in the development of a meaningful standard of review.[298]

The case has been criticized primarily for its failure to treat all stockholders equally in allowing the selective self tender of shares. One commentator has stated that the decision has modified the concept of fiduciary duty creating a 'qualified' duty.[299] The duty is qualified in that the interests of some shareholders may be subrogated to those of others where the board finds a threat from within. It is argued that this latitude may lead to the "total abrogation of fiduciary duties"[300] and also ignores the trust relationship between directors and stockholders.[301]

It is significant however that there has not been a heated debate on this issue similar to that evidenced after the Trans Union decision. In fact, the modified business judgment rule in the takeover context has generally been

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[297] Ajemian, supra n. 108 p. 669.

[298] Brown, supra n. 146 p. 246.

[299] Schubert, supra n. 270 p. 707.

[300] Ibid.

[301] Ibid. p. 708.

adopted in other jurisdictions.[302]

Six months following the Unocal decision, the Supreme Court of Delaware decided the case of Moran v. Household Intern., Inc..[303] In an important decision[304] the "Delaware Supreme Court sounded the bugle to end yet another battle in the world of corporate acquisition wars."[305] The court took "the Unocal modified business judgment rule analysis one step further" by legitimizing "a corporate board's decision to implement strategies designed to counteract prospective takeover attempts."[306]

The facts are as follows:

> **Moran v. Household International, Inc.** came to the Delaware Supreme Court from the Delaware Chancery Court which upheld the Household board's adoption of a poison pill plan as a legitimate exercise of business judgment. Household was a holding

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[302] Supra n. 8 p. 486. Note however that some jurisdictions do not allocate the burden of proof in similar fashion, choosing to place the initial burden on the plaintiff. Hanson Trust PLC v. ML SCM Acquisitions Inc., 781 F. 2d 264 (2d Cir. 1986).

[303] 500 A. 2d 1346 (Del. 1985).

[304] While this case is generally considered to have played an important role in the development of the modified rule, one Canadian commentator has stated that "[... Moran adds little to the law but deserves mention because it expressly legitimates the adoption by directors of a poison pill..." John Howard, Takeover Battles and the Business Judgment Rule: Recent American Case Law Development (1986) 11 Canadian Business Law Journal 445, 463.

[305] Ronald Ellen, The Poison Pill Warrant - Apothecary and Antidote: Moran v. Household International, Inc. (1987) 36 Depaul Law Review 413.

[306] Luther, supra n. 112 p. 494-495.

company with its principle subsidiaries in the financial services, transportation, and merchandising industries. Its board was composed of sixteen directors, ten outside directors and six members of management. Appellant Moran, one of Household's outside directors and chairman of the Dyson-Kissner-Moran Corporation, the largest single stockholder of Household stock, began discussions with Household's board about a possible leveraged buy-out after observing that Household's stock was significantly undervalued in the market in relation to its book value. The record showed that Moran never intended a hostile takeover and further, that Moran's suggestion of a buy-out never progressed beyond mere discussion.

Prior to its discussions with Moran, the Household board retained legal counsel to develop an anti-takeover strategy. Several plans, including a fair price provision, were considered by the board but were rejected in favor of the poison pill which was adopted without shareholder approval on August 14, 1984. The record showed that the poison pill was not implemented in response to Moran's overtures or any other impending battle with a corporate raider, but rather, as a precautionary measure to ward off future advances in the uneasy and volatile takeover environment surrounding the financial services industry at the time.

Household's poison pill plan provided that common shareholders would be issued one warrant per common share on the occurrence of one of two specified events. The first was an announcement of a tender offer for at least thirty percent of Household's shares. The second was the acquisition of at least twenty percent of Household's shares by any single entity or group. In the case of a tender offer for thirty percent of Household's shares, the issued warrants would immediately entitle the warrant holders to purchase one-hundredth of a share of Household's new and specially issued preferred stock for $100. The board, without shareholder approval, could redeem these warrants at fifty cents per warrant. If any party acquired twenty percent or more of Household's shares, the issued warrants would again be exercisable to purchase one-hundredth of a share of new preferred stock for $100, but the warrants would automatically become nonredeemable by the board. Most importantly, if a warrant had not previously been exercised and a raider forced a

> merger or consolidation, each warrant would be exercisable to purchase $200 of the common stock of the continuing corporation for $100.[307]

The primary issue in the case was the applicability of the business judgment rule as the standard by which the adoption of the rights plan would be reviewed.[308] The court not only upheld the applicability of the rule to defensive tactics, but stated clearly that poison pills were both benign, and in this case, the product of deliberate decision making rather than a reaction to a specific threat. This was viewed as a benefit rather than a detriment.

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[307] Ellen, supra n. 305 p. 421-423.

[308] Moran 500 A. 2d 1346, 1350 (Del. 1985). Note: The 'rights plan' at issue is also commonly referred to as poison pill.

> Two types of poison pills have gained popularity as defensive tacts: the warrant dividend plan, used by Household, and the convertible preferred stock plan. The warrant dividend plan gives a dividend to shareholders in the form of a warrant to buy target common stock. The warrants are issued when a tender offer is made or when a certain percentage of stock is acquired by a raider. The convertible preferred plan gives a stock dividend in the form of convertible preferred stock which is convertible into common stock when a raider acquires a certain percentage of shares. ... Although a poison pill may deter a raider, it also imposes costs upon the target. The warrants may create a large overhang of stock that may affect the market price of the target's common stock as well as inhibit common stock financing. Moreover, the pill deters friendly takeovers as well as hostile ones unless the pill has a provision, as in **Household**, to render the pill harmless by recalling the warrants. Supra n. 305 footnotes 11 and 17.

> ... here we have a defensive mechanism adopted to ward off possible future advances and not a mechanism adopted in reaction to a specific threat. This distinguishing factor does not result in the Directors losing the protection of the business judgment rule. To the contrary, pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment. Therefore, in reviewing a pre-planned defensive mechanism it seems even more appropriate to apply the business judgment rule.[309]

The rights plan was considered a neutral element vis a vis the stockholder as it did not, in the court's opinion, affect the structure of the company. The plan did not affect share price, destroy assets of the corporation or impair its financial flexibility.[310] As the court stated, "Comparing the Rights Plan with other defensive mechanisms, it does less harm to the value structure of the corporation than do the other mechanisms."[311] However there was another reason why the rights plan was considered neutral and that reason forms an important part of the finding in this case. The court held that the rights plan did not afford directors absolute discretion concerning its implementation. In fact the court indicated that directors would be held "to the same fiduciary standards any other board of directors would

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[309] Moran 500 A. 2d 1346, 1350 (Del. 1985).

[310] Ibid. p. 1354.

[311] Ibid.

be held to in deciding to adopt a defensive mechanism..."[312] That standard is the test set forward in the Unocal case.

In deciding the case the court applied the Unocal test to the facts at hand to determine whether or not the directors were justified in taking the decision to incorporate the Plan. The court found that the directors were informed as to the details of the plan and adopted it in the good faith belief that it was necessary to protect Household from coercive acquisition techniques. Further, Household demonstrated that the plan was reasonable in relation to the threat posed in that the directors had a reasonable concern over the increasing frequency of 'bust-up' takeovers which often had a two tier format.

The case stands for the proposition that in Delaware preemptive anti takeover strategies will be granted the protection of the business judgment rule, where the decision to adopt the strategy passes the Unocal business judgment rule test. Hence a corporation must have demonstrable cause for incorporating a preemptive defense and must pass the same test again before it activates the defensive measure if in doing so this action is to be similarly protected by the rule.

The case of Revlon, Inc. v. McAndrews & Forbes Holdings, Inc.,[313] was decided in November of 1985 as was the

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[312] Ibid.

[313] 506 A. 2d 173 (Del. 1986).

Moran decision. In Revlon the Supreme Court of Delaware considered for the first time the validity of lockups and related agreements when used as a defense to a takeover attempt. The court also addressed the relevance of outside constituencies in takeover contests and the duty of directors when the sale of a company becomes inevitable. The facts are as follows:

> In June, 1985, MacAndrews & Forbes Holdings,Inc. (Pantry Pride) approached Revlon to suggest a friendly takeover by Pantry Pride, which suggestion Revlon flatly rejected. On August 14th the Pantry Pride board authorized an offer to acquire Revlon at a negotiated price of $42-43 per share or, alternatively, by way of a hostile takeover bid at $45 per share. Revlon management responded at once that Revlon was not for sale.
>
> On August 19, 1985, the Revlon board met to discuss the Pantry Pride offer. They decided the offer was inadequate, concluded it would be financed in part by "junk bonds" to be followed by a break-up of Revlon to discharge such bonds, and accordingly authorized two defensive measures:
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> (a) a "poison pill" in the form of a note purchase rights plan, which would be triggered when any person acquired 20% of Revlon's outstanding shares and which would entitle the holder to exchange one share of Revlon for a Revlon note having a $65 principal amount with interest at 12% and a one-year maturity (which implied forced liquidation if the notes were issued), and
>
> (b) an exchange offer under which Revlon would acquire up to 5 million (later expanded to 10 million) of its outstanding shares.
>
> On August 23, 1985, Pantry Pride began a cash takeover bid for all outstanding Revlon shares at $47.50 per share, conditional on financing and on elimination of the note purchase rights plan. On August 26th the Revlon board met, considered the bid, recommended its rejection, and authorized a

competing issuer bid.

On August 29, 1985, Revlon sent out its own exchange offer, which offered in exchange for reach Revlon share a note ($47.50 principal, 11.75% interest, due 1995, and containing covenants restricting further debt issues) and a $9 preferred share redeemable at $100. Revlon thus succeeded in acquiring 10 million of its shares. The aggregate price paid was estimated to be $57.50 per share.

On September 13, 1985, in light of the Revlon competing bid, Pantry Pride terminated its bid of August 23rd. On September 16th it began a new bid at only $42 per share, but conditional only on acquiring at least 90% of the outstanding shares (and thus impliedly accepting the cost of the rights plan). On September 27th Pantry Pride changed its strategy. It offered $50 per share for a merger agreement with Revlon and raised this to $53 per share on October 1st.

On October 3, 1985, the Revlon board considered and unanimously approved a plan to enter into a leveraged buy-out with an investment firm, Forstmann Little: Forstmann Little would assume the $475 million exchange offer notes; Revlon would redeem the rights under the note purchase rights plan, waive the restriction on further borrowing set out in the exchange offer notes, and spin off specified assets for $1.235 billion. Almost at once after waiver of the note restrictions, they dropped in value from $100 to about $87, arousing the ire of shareholders who had exchanged shares for them.

On October 7, 1985, Pantry Pride increased its September 16th cash offer from $42 to $56.25, subject to elimination of the rights and waiver of the note restrictions on issuing further debt.

On October 12, 1985, Revlon voted to approve a new offer of $57.25 per share from Forstmann Little subject to the following conditions:

(a) Revlon would grant Forstmann Little a "lock-up" option on specified assets of Revlon ("crown jewels") for $525 million, to become exercisable if any person acquired 40% of Revlon's outstanding shares;

(b) Forstmann Little would exchange new notes in exchange for the 11.75% exchange offer notes, which would relieve the Revlon directors from the risk of liability for having waived the note restrictions on further debt creation, and

(c) Revlon would pay $25 million into escrow which was to be paid to Forstmann Little in case of unilateral cancellation by Revlon.

On October 14, 1985, Pantry Pride applied for and obtained a temporary restraining order from the Chancery Court of Delaware barring Revlon from transferring any assets pursuant to the Forstmann Little lock-up option and from paying the cancellation fee paid into escrow on that same date. Finally, on October 18, 1985, Pantry Pride increased its cash offer to $58 a share for all Revlon shares and undertook to match Forstmann Little's support for the Revlon notes. This offer of Pantry Pride eventually succeeded.[314]

In deciding the case the court applied the 'threshold' test enunciated in Unocal to the defensive measures undertaken by the Revlon board.[315] This test was applied to each measure in turn. The court held that in undertaking the first defensive strategy the Revlon board had reasonable grounds for believing that there was a danger to corporate policy and effectiveness. This was based upon the good faith and reasonable investigation of facts which indicated that Pantry Pride's offer of $45 was grossly inadequate and that Pantry Pride's intention was to "bust-up" Revlon using "junk bond" financing.[316]

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[314] Howard, supra n. 304 p. 459-461.

[315] Revlon 506 A. 2d 173, 179 (Del. 1986).

[316] Ibid. p. 180.

In addressing the second defensive measure the court felt that the danger to the corporation still existed and that the defense involved was reasonable in relation to the threat posed.[317]

However following this manoeuver when Pantry Pride increased its offer to $50 per share and then to $53 the court indicated that the break up of the company became inevitable.[318] This had the effect of dramatically altering the board's responsibilities.

> The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to a maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the **Unocal** standards. It no longer faced threats to corporate policy and effectiveness, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[319]

The actions taken by the Revlon board following this point in time were to offer Forstmann Little a "lock-up" option, with its emphasis on shoring up the value of the Notes, in the face of possible shareholder litigation. The

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[317] Ibid. p. 181.

[318] Ibid. p. 182.

[319] Ibid.

court found that the directors' primary obligation should have been directed to the stockholders. By considering the interest of the noteholders first, rather than seeking to obtain the highest share price, the directors breached their duty of loyalty to the equity owners.[320] The lock-up option was not illegal per se under Delaware law. However the court found that the use of such a tactic is appropriate only where it operates to stimulate bidding in an auction context. In this case its use had the opposite effect in that it served to restrict bidding, to the shareholders' detriment.[321]

> In reality, the Revlon board ended the auction in return for very little actual improvement in the final bid. The principal benefit went to the directors, who avoided personal liability to a class of creditors to whom the board owed no further duty under the circumstances. Thus, when a board ends an intense bidding contest on an insubstantial basis, and where a significant by-product of that action is to protect the directors against a perceived threat of personal liability for consequences stemming from the adoption of previous defensive measures, the action cannot withstand the enhanced scrutiny which **Unocal** requires of director conduct.[322]

The no-shop provision was held to be subject to the same guidelines as the lock-up option.[323] The court stated that

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[320] Ibid.

[321] Ibid. p. 183.

[322] Ibid. p. 184.

[323] Ibid.

market forces must be allowed to operate freely to bring the target's shareholders the best price available for their equity. Finally, the court indicated that while various corporate constituencies may be considered in addressing a takeover threat, such consideration is only valid where some rationally related benefit accrues to the stockholders.[324]

The case stands as a significant statement of a directors' traditional duty to maximize shareholder wealth in the context of an auction sale.[325] By varying the director's role in this environment, the Revlon court limited the relevance of the Unocal two prong test during the auction phase of a takeover contest.[326] Once a corporate auction has begun, the directors assume the role of auctioneers and may no longer defend the company against threats to the corporate enterprise.[327] However, Revlon did not formulate a new business judgment rule test for evaluating a target board's actions during the auction itself. Neither does it provide guidance to directors in the instance where a sale is inevitable but a lively auction has yet to develop. Indeed the commencement of an auction itself might trigger a judicial review into the substantive

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[324] Ibid. p. 176. The Court was speaking specifically in reference to the Noteholders.

[325] Luther, supra n. 112 p. 487.

[326] Bradbury, supra n. 291 p. 276.

[327] Ibid. p. 277.

fairness of this action.[328] While the area is somewhat unsettled, other jurisdictions have adopted the Revlon analysis.[329]

Recently however, the Delaware Supreme Court has offered further explanation of the role of directors as auctioneers of a target company during the active building process. In the case of Mills Acquisition Co. v. Macmillan, Inc.,[330] the court stated that directors under these circumstances must evidence the most scrupulous adherence to ordinary standards of fairness."[331] Each bidder must be dealt with on an equal basis and all bidders subject to the same restrictions and conditions. This latter point is subject to change where directors can establish that particularized restrictions will benefit shareholders.[332] The emphasis is on the shareholder with "the sole responsibility of the directors in such a sale" directed toward the "shareholders benefit".[333] In evaluating the bid and the bidder, the board may consider the following:

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[328] Ibid. p. 278 and see generally text p. 280-300 for a review of the law with respect to Corporate auctions and the business judgment rule.

[329] See, e.g., Edelman v. Fruehauf Corp., 798 F. 2d 882 (6th Cir. 1986); Hastings-Murtach v. Texas Air Corp., 649 F. Supp. 479 (S.D. Fla. 1986).

[330] 559 A. 2d 1261 (Del. 1989).

[331] Ibid. p. 1285.

[332] Supra n. 8 p. 64.

[333] Mills 559 A. 2d 1261, 1285 (Del. 1989).

> ... the adequacy and terms of the offer, its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegalities; the impact of both the bid and the potential acquisition on other constituencies, provided it bears some reasonable relationship to general shareholder interest; the risk of nonconsummation of the offer; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effect on shareholder interest.[334]

In the final analysis the court stated that:

> "Directors are not required by Delaware law to conduct an auction according to some standard formula, only that they observe the significant requirement of fairness for the purpose of enhancing general shareholder interests."[335]

Further, in order to satisfy the court that shareholders interests have been fairly dealt with, the fulfillment of this duty "requires the intense scrutiny and participation of the independent directors..."[336]

With respect to the issue of when a duty to auction arises, several lower court decisions have examined the area. In the case of Paramount Communications Inc. v. Time Inc.[337] the court stated that a merger agreement alone does

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[334] Supra n. 8 p. 64.

[335] Mills 559 A. 2d 1261, 1287 (Del. 1989).

[336] Ibid. p. 1285.

[337] Fed. Sec. L. Rep. (CCH) § 94.514 (Del. Ch. 1989), aff'd, (Del. July 24, 1989).

not place a target company into the "auction mode." The merger itself in this case did not amount to a change in corporate control.[338] Where a change in corporate control into management's hands is made in response to a hostile takeover bid, the duty to auction the company may arise.[339]

However, once the duty to auction has arisen, the conduct of the auction will be evaluated in the context of the business judgment rule. The directors' duty of care will be satisfied when they exercise their business judgment in good faith with due care and after the receipt of competent information from expert advisors.[340]

The case of Ivanhoe Partners v. Newmont Mining Corp.[341] continued in step with the doctrine laid down in Unocal and Revlon. While it did not modify the business judgment rule further it is authority for the nature and scope of various defensive tactics that are allowable within the context of the rule.[342] These defensive measures include golden para-

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[338] Supra n. 8 p. 65.

[339] Ibid. p. 65.

[340] Supra n. 8 p. 65. See: R.J.R. Nabisco, Inc. Shareholders Litigation, Fed. Sec. L. Rep. § 94,194 (Del. Ch. 1989).

[341] 535 A. 2d 1334 (Del. 1987).

[342] See however Steven Bradbury, supra n. 291 p. 288-289. Mr. Bradbury asserts that Ivanhoe did in fact change the rule by indicating "that the second prong of the Unocal test may simply be a specific application of the first prong to the particular defensive tactics employed by the target board." Mr. Bradbury states that the court indicated that

(continued...)

chutes[343] and various standstill agreements.[344] The case is significant in that it upheld a vigorous and complex defensive campaign launched by target management against the advances of a well known corporate raider (T. Boone Pickens Jr.).[345] In fact, one commentator has suggested that the court went too far in its consideration of what was a 'reasonable' defense in this case.[346]

Concurrent with the development of case law in the area of auction contests is the judiciary's continued application of the business judgment rule as modified in the Unocal

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[342](...continued)
the directors' entire burden of proof under Unocal is satisfied by a single showing: that they exercised good faith and reasonable investigation in analyzing the nature of the takeover bid and its effect on the corporate enterprise. With respect I believe that this analysis is erroneous and that the Ivanhoe court did not undertake to change the rule in any material way. In fact it plainly quoted from its decision in Unocal when applying the business judgment rule to the facts at hand (see Newmont 535 A. 2d 1334, 1341 (Del. 1987)).

[343] Ibid. p. 1338-39 n. 7. The Newmont board approved golden parachutes calling for substantial severance payments to twenty-five key management employees.

[344] These agreements provide for a top end ownership interest which cannot be surpassed. In this case, Newmont had such an agreement with Gold Fields (its major stockholder) where the latter would could purchase up to 49.9% of Newmont stock and limited representation on the board to 40% of the total directors.

[345] Note that Mr. Pickens was similarly responsible for the attempt on Unocal Corp. in his position as President and Chairman of the Board of Mesa Petroleum.

[346] See Elizabeth Adolff, The Business Judgment Rule and Anti-Takeover Defensive Tactics: Ivanhoe Partners v. Newmont Mining Corp. (1988) St. John's Law Review 721.

case.[347] The modified rule has become the new yardstick by which these new and evolving issues are addressed.

5. CALIFORNIA

California follows a similar approach to that of Delaware in that the courts recognize that control disputes call into question the directors' fidelity to the corporation and its shareholders.[348]

The case of Jones v. H.F. Ahmanson & Co.[349] represents the controlling precedent in corporate control disputes.[350] The facts are as follows:

> The plaintiff in this case was a minority stockholder of a savings and loan corporation (United Savings and Loan Association of California) who sued the majority stockholders and officers of the corporation for breach of their fiduciary duty to her. The corporation's shares were not actively traded because of their high book value, the closely held nature of the corporation, and the unwillingness of management to promote the shares among investors and brokers.
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> About two years after the first issue of stock by the corporation, investors interest in savings and loan securities increased. Because publicly

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[347] In Re Holly Farms Corporation Shareholders Litig., Fed. Sec. L. Rep. (CCH) § 94,486 (Del. Ch. 1989). This case is a recent application of the Unocal test in the context of an auction scenario.

[348] Lubega, supra n. 249 p. 830.

[349] 1 Cal. 3d 93, 460 P. 2d 464, 81 Col. Rptr. 592 (1969).

[350] Lubega, supra n. 249 p. 830.

> traded savings and loan securities were thriving, the majority stockholders of United Savings and Loan sought a way to cash in on this bonanza. To this end, they created a new corporation (United Financial) whose shares they exchanged for their United Savings and Loan shares pursuant to a prior agreement. They did not offer the minority stockholders an opportunity to exchange their shares, nor did they promote the shares of United Savings and Loan. They did, however, work to create a public market for the new corporation's securities. The resulting offering of these securities provided that more than eighty-five percent of the return on their sale would be distributed immediately, as a return of capital, to the original shareholders of United Financial, who were also the majority stockholders of United Savings and Loan.
>
> Following the creation of United Financial, defendants, the majority stockholders, continued to stimulate the public trading of United Financial Stock but did nothing to support the declining sales of United Savings and Loan shares. They also offered and purchased United Savings and Loan stock through United Financial at a price lower than its book value, notified shareholders that no dividends other than regular dividends would be paid in the near future, and offered the minority an exchange of their shares only if they would accept a grossly low exchange price.[351]

The court placed the initial burden on the "director or [the majority] stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."[352] The court implicitly rejected the traditional business judgment rule in the context of protecting minority interests from abuse of control by either the directors or

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[351] Ibid. p. 830-831.

[352] Jones, 81 Cal. Rptr. 592, 599 (1969).

the minority shareholders.[353]

While the case did not involve corporate governance it set the stage for later cases to abolish the application of the traditional business judgment rule in corporate control dispute cases.

Among these cases is Klaus v. Hi-Shear Corp.[354] wherein a takeover attempt of Hi-Shear Corporation was made by tender offer. In defending against the offer the directors of Hi-Shear made three stock issuances which effectively lessened the raider's ownership interest. The plaintiff sued for breach of fiduciary duty in the three stock issuances. In assessing the actions of the board the court held that the protection afforded by the traditional rule would not apply where the plaintiff alleges a breach of trust.[355] Where this is the case directors have the onus of showing more than that "the corporation derived some advantage from its actions" but that there was a "compelling business purpose."[356] Further, the court stated that a "compelling business purpose suggests a balancing of the good to the corporation against the disproportionate advantage to the majority shareholders and incumbent

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[353] Lubega, supra n. 249 p. 831.

[354] 528 F. 2d 225 (9th Cir. 1975).

[355] Ibid. p. 233.

[356] Ibid. 233-234. The court relied upon the Ahmanson decision for its conclusion.

management."[357]

In Jewel Companies v. Pay Less Drug Stores Northwest[358] the court held that in the case of a negotiated merger no special scrutiny will be required of incumbent management. This will apply even where management obligates itself not to solicit competing merger bids.[359] The decision could however, clearly operate to the detriment of shareholders where a decision not to solicit offers may result in reduced share value and may also be motivated primarily for the purpose of entrenching incumbent management. The decision to apply the traditional business judgment rule under these circumstances is indeed troublesome and would appear to be somewhat inconsistent with previous authority.[360]

6. NEW YORK/NEW JERSEY

Through a series of cases over the past decade the New York District Courts and Courts of Appeal for the 2nd Circuit have developed their own approach to the application of the business judgment rule in control contests.

The first decision along this line is Treadway Co.,

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[357] Ibid. p. 234.

[358] 741 F. 2d 1555 (9th Cir. 1984).

[359] Lubega, supra n. 249 p. 835.

[360] For a critical evaluation of the Jewel case, see Richard Buxbaum, The Internal Division of Powers in Corporate Governance (1985) 73 California Law Review 1671, 1696.

Inc. v. Care Corp..[361] This case arose as an appeal from the District Court for the Southern District of New York applying New Jersey law, wherein the Lower court refused to enjoin voting stock issued to a "white knight"[362] for the purpose of blocking a takeover. In determining whether the issuance of stock to defeat a proxy challenge by Care Corp. was valid, the court placed the burden of proof on the plaintiff to show that the target directors had acted in self-interest, bad faith or for some other improper purpose.[363] The court stated that the business judgment rule applied in this case and put forward the application of the rule as follows:

> Individual stockholders cannot question in judicial proceedings the corporate acts of directors, if the same are within the powers of the corporation and in furtherance of its purposes, are not unlawful or against good morals, and are done in good faith and in the exercise of an honest judgment. Questions of policy of management, of expediency of contracts or action, of adequacy of consideration not grossly disproportionate, of lawful appropriation of corporate funds to advance corporate interests, are left solely to the honest decision of the directors, if their powers are without limitation and

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[361] 638 F. 2d 357 (2d Cir. 1980).

[362] A White Knight represents a business combination partner which is more favourable to existing management than is the raider. Such a relationship is normally formed at the target's bequest once a hostile takeover deal has been undertaken or is about to be instigated. The intent of the manoeuver is to frustrate the control aspirations of the raider.

[363] 638 F. 2d 357, 381 (2d Cir. 1980).

free from restraint.[364]

Further, the court stated that if the burden does shift, then the directors must prove that the transaction was fair and reasonable to the corporation.[365] While the court found that one director did in fact act improperly, his motives were not attributed to those of the rest of the board.

The case has been criticized by some commentators for failing to consider the district court's finding that "no good faith effort was ever made by incumbent management of Treadway to determine whether a takeover by Care would or would not be in the best interests of the corporation or its shareholders."[366] With respect, the criticisms may somewhat overstate the issue. In fact, the appellate court did at least consider the due care element of the business judgment

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[364] Ibid. Note: The case of Auerbach v. Bennett 419 N.Y.S. 2d 920, 926 (1979) puts forward the New York common law definition of the business judgment rule: "[It] bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes."

[365] Ibid. p. 382.

[366] 490 F. Supp. 668, 686 (SDNY), rev'd., 638 F. 2d 357 (2d Cir. 1980). See Cohn, supra n. 193 p. 621 "... the appellate court's use of the business judgment rule to reverse the district court reflects either a misunderstanding of the duty of reasonable care or a rejection sub silentio of a reasonable care standard." See also Mark Barton, The Business Judgment Rule in a Hostile Tender Offer: Tearing at the Seams of a Confusing Doctrine - Norlin v. Rooney Pace, Inc. (1986) 17 Rutgers Law Journal 321, 326; "The Second Circuit ignored the district court's findings which suggested that the board had failed to exercise reasonable care..." See also this text p. 68-71.

rule;

> The record as to what steps the Treadway directors took, and exactly what information they sought, preparatory to the exercise of their judgment is somewhat sparse. Care would have us believe they did nothing. A close reading of the record, however, reveals that they had engaged an investment banking firm to negotiate and help them evaluate proposed mergers; that between meetings of the Treadway board they (other than Browne and deJourno) were informed of negotiations with Fair Lanes; that during the negotiations they sent Swordco to Fair Lanes armed with a number of questions to which they wished answers; that they asked Swordco for pro forma balance sheets for the combined company; that they adjourned their deliberations for one week thereafter to reflect on the information they had received and to obtain more; and that they conditioned their approval of the proposed transactions on obtaining an opinion from Swordco that the transactions were fair to Treadway.
>
> Thus the record provides no adequate basis for finding that Care carried its burden of proving that the directors did not exercise their judgment in good faith, or that any other circumstances make the business judgment rule inapposite.[367]

The case of Crouse-Hinds Co. v. Internorth, Inc.[368] was decided three months after Treadway and arose as an appeal from the District Court for the Northern District of New York. At issue in part was whether an exchange offer made to defeat a hostile takeover attempt would be set aside. The court as it did in Treadway stated that the business judgment rule applied to the case at hand. The focus of the inquiry centred on whether the District Court erred in

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[367] 638 F. 2d 357, 384 (2d Cir. 1980).

[368] 634 F. 2d 690 (2d Cir. 1980).

shifting the burden of proof to the target directors upon the finding that they would retain their positions if their defensive tactic was successful.[369] In reversing the lower court the appellate court found that the presumption of improper motive based solely upon the fact that control was to be retained was an inference with "no basis in either law or logic."[370] In holding that the district court had misinterpreted their decision in Treadway,

> "The court made it clear that just because one can infer from the fact that directors will lose their positions that they do not have as their primary or sole purpose the perpetuation of their control, it cannot be presumed that just because the directors are to remain on the board after the merger that perpetuation of control is their motivation."[371]

The plaintiff had to bring forward evidence of such motive and on the facts the court ruled that no such evidence was forthcoming.

Following the decisions in Treadway and Crouse-Hinds Co. it was widely believed that this particular application of the business judgment rule to control contests placed a very heavy evidentiary onus upon the plaintiff.[372]

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[369] The tactic was a defensive merger pursuant to which the directors would remain in office.

[370] 634 F. 2d 690, 702 (2d Cir. 1980).

[371] Gerke, supra n. 110 p. 656.

[372] Karoly Gutman, Tender Offer Defensive Tactics and the Business Judgment Rule (1983) 58 New York University Law

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Four years after Treadway and Crouse-Hinds Co. were decided the Court of Appeals of the Second District came face to face in Norlin Corp. v. Rooney, Pace Inc.[373] with a fact situation which would allow the court to further define the business judgment rule and the limits under which its protection might be conferred. The facts are as follows:

> **Norlin** arose out of a battle for control of Norlin Corporation (Norlin). The battle was joined when Piezo Electric Products, Inc., in conjunction with the investment banking firm of Rooney, Pace Inc. (jointly "Piezo"), began purchasing large blocks of Norlin stock. Anticipating a takeover attempt, Norlin filed suit on January 13, 1984 seeking to enjoin Piezo from acquiring more Norlin stock, force the divestiture of stock already purchased and bar Piezo from voting any Norlin stock it owned. Norlin's motions for a temporary restraining order and expedited discovery were denied; the judge found that the company had failed to show irreparable harm from Piezo's stock purchases.
>
> On January 20, the same day the judge ruled on the above motions, Norlin launched its out of court defense. Norlin's board transferred a block of shares to a wholly owned subsidiary, Andean Enterprises, Inc. (Andean). Five days later the board made two additional stock transfers, giving it voting control over 49 percent of the corporations outstanding stock. First they transferred more shares to Andean. Second the board created the Norlin Industries, Inc. Employee Stock Option Plan. Three Norlin board members were appointed

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[372](...continued)
Review 621, 655. "Such a stringent application of the business judgment rule creates an almost insurmountable barrier to relief for shareholders who have been denied the opportunity to sell their shares at a substantial premium." See also Barton, supra n. 376 p. 327: "The rule that had developed in the Second Circuit ... placed a nearly insurmountable burden on plaintiffs wishing to challenge defensive tactics taken by target management."

[373] 744 F. 2d 255 (2d Cir. 1984).

> trustees of the ESOP. The board then transferred 185,000 shares of common stock to the plan. The consideration for this transfer was a promissory note for $6,824,945. The only justification given for this transaction was to resist any potential takeover by Piezo. ...
>
> As a result of the board's actions, trading of Norlin common stock was suspended by the New York Stock Exchange (NYSE) on March 15, 1984. The Exchange indicated its intention to delist Norlin's stock. Norlin's board was aware that delisting might result from these actions prior to making the exchange.
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> On February 9, 1984 Piezo filed a counterclaim as a Norlin shareholder alleging that the transfer to the ESOP had no valid business purpose and was "intended solely to further entrench management by placing additional shares of voting stock at management's disposal." Piezo sought to have the issuances to the ESOP declared void in order to prevent delisting from the NYSE.[374]

The District Court granted a preliminary injunction to prevent Norlin Corp. from voting its newly distributed shares. In affirming this judgment the Court of Appeal affirmed the application of the business judgment rule to the facts at hand. However, they did so in light of protecting shareholder interests. In a clear statement the court indicated:

> Our most important duty is to protect the fundamental structure of corporate governance. While the day-to-day affairs of a company are to be managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures.[375]

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[374] Burton <u>supra</u> n. 366 p. 331-332.

[375] 744 F. 2d 255, 258 (2d Cir. 1984).

In fact the stock transactions required stockholder approval under the rules of the New York State Exchange. Further the net effect of the stock issuances was to take voting control away from the shareholders and put it in the hands of the directors.[376] In light of the above and the "precipitous timing of the share issuances,"[377] the court found that the transactions were made "not to benefit the employees but rather to solidify management's control of the company."[378] On the facts there was a prima facie showing of self interest[379] on the board's part. The court stated that such a prima facie showing shifted the burden to Norlin's directors who now had to prove that their actions were fair and reasonable.[380] The board failed to make that showing.

The court further indicated that while it expects target boards to make a "reasoned examination of the situation before action is taken," rather than afterwards, they would not sanction "a board decision to lock up voting power by any means, for as long as directors deem necessary,

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[376] Only the Norlin directors could vote the Andean and ESOP shares.

[377] 744 F. 2d 255, 265 (2d Cir. 1984).

[378] Ibid.

[379] Ibid.

[380] Ibid. p. 266. The transaction must serve the best interests of the corporation and its shareholders.

prior to making decisions that will determine a corporation's destiny."[381]

While the case has been criticized in some quarters,[382] it is clear that the Second Circuit will call into question management schemes which are implemented with questionable timing and which decisions result in a shift in control away from the equity holders into the hands of target management. These circumstances alone may evidence a prima facie breach of the duty of loyalty and thus shift the evidentiary burden to the target directors. However, in this case the evidence impugning directoral conduct was admittedly overwhelming, leading one commentator to suggest that,

> "the substantially different and extreme actions taken by the directors in this case reduce any possible chance that the decision is intended to soften the application of the business judgment rule as set forth in prior cases."[383]

In the case of Minstar Acquiring Corp. v. AMF Inc.[384] the District Court for the Southern District of New York, applying New Jersey law, enjoined certain "scorched earth"

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[381] Ibid. p. 267.

[382] Burton, supra n. 366 p. 336 re the misapplication of the self-interest test and the test for reasonableness.

[383] See Gerke supra n. 110 p. 658.

[384] 621 F. Supp. 1252 (S.D.N.Y. 1985).

tactics.[385] The case is significant in that it expressly followed the test established by Norlin. Again the court focused upon employee benefit versus management control.[386] The court examined the nature and timing of the defensive tactics and held that under the circumstances the inference should be drawn that these tactics were more consistent with entrenchment than with employee welfare. The burden then shifted to the target directors to show that the transaction was fair and reasonable.

Where the emphasis in the Norlin case was on the duty of loyalty, the final case in this line deals with the duty of care. In Hanson Trust PLC v. ML SCM Acquisition, Inc.,[387] the Court of Appeals for the Second Circuit applied the law of New York to a District Court decision refusing to grant a motion for preliminary injunction. The case is an important one as it deals with the same issues as were relevant in both Trans Union and Revlon.

The facts are presented at length to facilitate a complete understanding of the decision.

In August 1985, Hanson Trust announced an un-

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[385] Scorched Earth is a term of art for defensive tactics which when applied effectively leave the target company in a ruinous financial position. Through these tactics, the target directors purposely injure the corporation often by riddling it with debt and exhausting its credit.

[386] 621 F. Supp. 1252, 1261 (S.D.N.Y. 1985).

[387] 781 F. 2d 264 (2d Cir. 1986).

solicited cash tender offer of $60 per share for all of SCM Corporation's stock, which was then trading for less than $50 per share. SCM refused Hanson Trust's offer to enter into negotiations that might lead to an amicable acquisition. Instead, at the urging of the SCM officers and with the concurrence of the SCM board, a leveraged buyout and merger agreement was negotiated by SCM with Merrill Lynch, Pierce, Fenner & Smith, a noted investment banking firm. Under this agreement, Merrill Lynch would make a competing offer, valued at $70 per share, for the SCM stock. It was contemplated that an SCM management group would receive equity participation rights of up to fifteen percent in this leveraged buy-out and merger. When Hanson Trust subsequently increased its tender offer from $60 to $72 per share, SCM and merrill Lynch announced the termination of Merrill Lynch's $70 leveraged buy-out offer.

SCM's management then negotiated a second leveraged buyout agreement with Merrill Lynch in which an offer valued at $75 per share would be made by Merrill Lynch for the SCM stock. As a condition to remaining in the bidding contest, Merrill Lynch insisted upon and was granted a lock-up option. This lock-up option would allow Merrill Lynch to purchase at a very favorable price SCM's two most profitable component businesses, which had generated fifty percent of SCM's net operating revenues in recent years. The option was exercisable by Merrill Lynch if a third party, such as Hanson Trust, acquired one third or more of SCM's outstanding shares. Since New York law required mergers to be approved by a vote of two-thirds of the shareholders, any third party, such as Hanson Trust, acquiring one-third or more of SCM's shares would then be in a position to block the contemplated SCM merger with Merrill Lynch. Thus, if Hanson Trust acquired, under its tender offer, a sufficient amount of SCM stock to block the desired Merrill Lynch merger, Merrill Lynch could still financially benefit by exercising its favorably priced lock-up option. This feature provided Merrill Lynch, as SCM's favored suitor, a strong incentive to remain in the bidding contest. On the other hand, the possibility that SCM might lose, through the exercise of the option, two of its most valuable assets to Merrill Lynch for a minimal consideration rendered SCM a considerably less attractive acquisition candidate from Hanson Trust's point of view. As a result, the lock-up

option might prompt Hanson Trust to withdraw from the bidding contest altogether.

On September 10, 1985, the SCM board, consisting only of the nine outside directors of the twelve member board, met and learned for the first time of the proposed second leveraged buyout and merger agreement with Merrill Lynch and the proposed option. The meeting was convened at nine o'clock in the evening and lasted for three hours. A representative of Goldman Sachs & Company, SCM's investment banker, advised the board that the lock-up option price was "within the range of fair value," although he did not state what that range might be. In fact, unknown to the board, Goldman Sachs had never calculated the fair value of the two businesses covered by the option. No member of the board made any inquiries as to the value of the optioned assets. No documents or even pro forma financial statements were distributed to the directors and none were requested by them. Goldman Sachs did state, however, that SCM could undoubtedly obtain a higher price for each of the two optioned businesses if an orderly sale were conducted. In addition, there was no discussion among the directors as to the effect that the sale of SCM's most profitable businesses would have upon its future operations. Although a week remained before Hanson Trust might actually acquire one-third or more of the SCM stock under its tender offer and thereby be in a position to block a Merrill Lynch merger, none of the SCM directors suggested postponing the decision on the lock-up option for further consideration. SCM's outside directors then voted unanimously to approve both the leveraged buyout by Merrill Lynch at $74 per share and the lock-up option.

The following day, Hanson Trust announced the termination of its $72 cash tender offer. Shortly thereafter, Hanson Trust declared its intention to make a $75 cash tender offer conditioned upon the judicial invalidation of the lock-up option granted to Merrill Lynch. Hanson Trust then sought a preliminary injunction enjoining the exercise of the option. In the evidentiary hearing before the district court, there was considerable evidence that the approval of the option price by the SCM board had been based upon a serious undervaluation of the two businesses to be sold. These businesses, which generated one half of SCM's income, could be purchased by

> Merrill Lynch under its option for $430 million, only one third of the total purchase price of SCM which would be paid by Merrill Lynch under its leveraged buyout offer.[388]

In their assessment of the facts, the court stated that the directors must exercise their duty of care with "at least that degree of diligence that an ordinarily prudent person under similar circumstances would use."[389] Further, that in evaluating this duty, they would adhere to the business judgment rule which "bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes."[390] The court stated that while directors enjoy a wide latitude in the development and deployment of defensive strategies there is a limit to what extent they may go in furtherance of this purpose. Having said this, the court flatly rejected the Unocal approach as a method of engaging the business judgment rule.

> Although in other jurisdictions, directors may not enjoy the same presumptions per the business judgment rule, at least in a takeover context, **see, e.g., Unocal Corp. v. Mesa Petroleum Co.** 493 A. 2d 946, 954-55 (Del. Supp., 1985) (initial burden on directors in takeover context to show reasonable grounds for believing that takeover would endanger corporate policy; satisfied by

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[388] Brown, supra n. 146 p. 229-231.

[389] 781 F. 2d 264, 273 (2d Cir. 1986). Applying N.Y. Bus. Corp.L. § 717.

[390] Ibid. quoting Auerbach v. Bennett 47 N.Y. 2d 619, 629, 419 N.Y.S. 2d 920, 926, 393 N.E. 2d 994, 1000 (1979).

> directors' showing good faith and reasonable investigation), under New York law, the initial burden of proving directors' breach of fiduciary duty rests with the plaintiff. **See Crouse-Hinds,** 634 F. 2d at 702; **see also Auerbach,** 419 N.Y.S. 2d at 926-27, 393 N.E. 2d at 1000-01.[391]

While the burden rests initially with the plaintiff and thus in form the Unocal approach is not followed, one commentator has indicated that the Hanson court was adopting some of Unocal's substantive standards.

> In **Hanson,** the Second Circuit only indicated in very broad terms the duty of care criteria to be employed by a court when examining the substantive merits of a particular defensive tactic adopted by a target board in a takeover struggle. The court initially noted that even if a takeover attempt is found not to be in the best interests of the corporation, the board "does not hold a blank check to use all possible strategies to forestall the acquisition moves." By this caveat, the court appears to implicitly recognize that the particular defensive response selected by a target board must be substantively reasonable in relation to the perceived threat posed by the takeover attempt.[392]

There is however, little to support this theory by way of further dictum in the case.

The court then turned its attention to the issue of whether there was in fact a breach of the duty of care. In doing so they opined that the test was met where directors act with "conscientious fairness."[393]

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[391] Ibid.

[392] Brown, supra n. 146 p. 233-234.

[393] 781 F. 2d 264, 274 (2d Cir. 1986).

> Directors are also held to a standard of due care. They must meet this standard with "conscientious fairness," **Alpert v. 28 Williams St. Corp.**, 63 N.Y. 2d 554, 569, 483 N.Y.S. 2d 667, 674, 473 N.E. 2d 19, 26 (1984) (citing cases). For example, where their "methodologies and procedures" are "so restricted in scope, so shallow in execution, or otherwise so **pro forma** or halfhearted as to constitute a pretext or sham," then inquiry into their acts is not shielded by the business judgment rule. **Auerbach**, 419 N.Y.S. 2d at 929, 393 N.E. 2d at 1002-03.[394]

This focus on process couched in terms of 'fairness' has been criticized in some quarters.

> Due care or due diligence is the inverse of negligence. In this context it relates to **process**, requiring directors to take affirmative action to make or cause to be made a reasonable investigation of the material facts so that they can make what is demonstrably an informed judgment. "Conscientious fairness," in contrast, is the essence of the fiduciary standard, requiring a fiduciary to act objectively to achieve a **result** that is not only fair but seen to be fair to the beneficiaries of the fiduciary duty.[395]

Semantics aside however, the court focused on the process by which the target directors made their decisions. The Hanson court applied a "reasonable diligence" standard in their determination of what might be considered an appropriate decision making process.[396] In doing so, the court made a significant statement in respect to the evaluation of

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[394] Ibid.

[395] Howard, supra n. 304 p. 472.

[396] 781 F. 2d 264, 274 (2d Cir. 1986).

directors' decisions generally.

> "Thus while directors are protected to the extent that their actions evidence their business judgment, such protection assumes that courts must not reflexively decline to consider the content of their "judgment" and the extent of the information on which it is based."[397]

This willingness to gaze into the substantive quality of the decision itself broke new ground.

> Under this view, courts, at least in takeover cases, may examine the substantive content of a directorial decision in order to determine if it may be regarded as an informed decision meeting the standards of the fiduciary duty of care. Prior to **Hanson**, duty of care inquiries had been limited to an examination of the adequacy of the information gathering techniques and the appropriateness of the methodologies employed by the directors in reaching their decision. The substantive content of a decision properly made, however, had not been considered a proper subject for judicial scrutiny.[398]

It has been suggested that the Hanson court was forced to analyze the merits of the defensive measure because the outside directors were not informed and thus could not cure management's disqualifying self interest, as was the case in Unocal.[399] Thus it may be that in this area, the Hanson court has taken a step further than those already taken in the Delaware decisions. The courts' opinion seems to rest

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[397] Ibid. p. 275.

[398] Brown, supra n. 146 p. 233.

[399] Ajemian, supra n. 108 p. 678.

somewhere between describing the procedures by which a reasonable decision could be reached, as in Unocal, "and an assessment of the merits of the defensive measure itself."[400]

As regards the process itself, the Hanson court in finding a breach of the duty of care, considered the following:

> [T]he SCM directors, in a three-hour late-night meeting, apparently contented themselves with their financial advisor's conclusory opinion that the option prices were "within the range of fair value," although had the directors inquired, they would have learned that Goldman Sachs [their investment banker] had not calculated a range of fairness. There was not even a written opinion from Goldman Sachs as to the value of the two optioned businesses. ... Moreover, the Board never asked what the top value was or why two businesses that generated half of SCM's income were being sold for one third of the total purchase price of the company ... or what the company would look like if the options were exercised. ... There was little or no discussion of how likely it was that the option "trigger" would be pulled, or who would make that decision - Merrill, the Board, or management.[401]

The court was similarly unimpressed with the board's defense that it was properly relying on the advice of legal and investment counsel. The court stated that "directors have some oversight obligations to become reasonably familiar with an opinion, report, or other source of advice before

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[400] Ibid.

[401] 781 F. 2d 264, 275 (2d Cir. 1986).

becoming entitled to rely on it."[402]

> [t]he Board failed to read or review carefully the various offers and agreements and instead relied on the advisers' descriptions. ... [T]he directors accepted Goldman Sachs' conclusion that the prices of the optioned assets were fair, without ever inquiring about the range of fair value. .. The directors did not seek any documents in support of Goldman Sachs' conclusory opinion. ... Moreover, the fact that [Goldman Sachs] opined ... that an "orderly sale" could achieve higher prices ... should have led the directors to investigate, rather than rely baldly upon, the oral opinion as to fairness. Finally, Goldman Sachs offered no opinion as to what kind of company SCM would be without its "core" businesses. On this issue, of which there is no evidence of any inquiry by the directors, there is thus not even a conclusory opinion from its advisors on which the directors plausibly might have relied.[403]

In reference to the manner in which the outside directors conducted themselves in evaluating management's proposal (re: the value of the optioned assets), the court stated that they "viewed the board as only minimally fulfilling, if not abdicating, its role."[404] Nonetheless, the court found that the actions of the SCM board did not rise to the level of gross negligence found in Trans Union.

> There [Trans Union] in making its decision after only two hours of consideration, the board relied primarily on a twenty-minute presentation by the chief executive officer who had arranged the proposed merger without informing other Board members or management and despite the advice of

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402 Ibid.

403 Ibid. p. 276.

404 Ibid.

> senior management that the merger price was inadequate. On the other hand, the SCM directors failed to take many of the affirmative directorial steps that underlie the finding of due care in **Treadway, supra,** on which the district court herein relied. In **Treadway,** the directors "armed" their bankers with financial questions to evaluate; they requested balance sheets; they adjourned deliberations for one week to consider the requisitioned advice; and they conditioned approval of the deal on the securing of a fairness opinion from their bankers.[405]

Hence it can be inferred that unlike Delaware, New York will apply "simple negligence" as the level at which directoral liability will be assessed. In real terms however, given the court's finding of how poorly the board fulfilled its role, one might well ask, what then is the difference between simple negligence and gross negligence? In New York, while the issue may be moot, the line must certainly be fine indeed.

Having found the directors' prima facie in breach of their duty of care and thus shifting the burden, the court next considered whether the decision itself was justified. The SCM board now had the burden of establishing the fairness of the lock-up transaction. The Hanson court, citing both New York and Delaware (Revlon) precedent, indicated that lock-ups were not illegal per se but may nonetheless be illegal in particular cases:[406]

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[405] Ibid. p. 275.

[406] Ibid. p. 274.

> "A director's obligation to protect the financial interests of the corporation, and thereby the shareholders ... may not be compromised by a competing interests in other legitimate corporate purposes, such as fending off a hostile takeover bid. When engaging in defensive maneuvers, such as a lock-up option, a director's primary obligation is to ensure the overall fairness, including a fair option price, to the shareholders.[407]

This duty was breached in two major areas. First, the court found that the evidence favoured the opinion that the optioned assets were undervalued. Hence the risk to shareholders that there would be a transfer of one half of the corporation at an inadequate price, should Merrill Lynch be allowed to exercise its option.[408] Secondly the court found that the net effect of optioning the "crown jewels" of the company in effect put an end to all competitive bidding.[409] This effectively "impinged upon shareholder decisional rights regarding corporate governance."[410] In both this case and in Revlon, the court drew the distinction between lock-up options which serve to facilitate bidding and those which effectively end it.

> **Hanson Trust** and **Revlon** proscribe (deny business judgment rule protection for) auction-ending devices because approval of measures that cut off competitive bidding is a breach of the duty of loyalty. But where use of similar devices is

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[407] Ibid. p. 278.

[408] Ibid. p. 280.

[409] Ibid. p. 281.

[410] Ibid.

> auction-generating, the duty of loyalty may be served and no manifest conflict of interest is established.[411]

In enjoining the preliminary injunction the Hanson court cited the Revlon case in holding that the SCM board could renew its defensive efforts "on other legitimate grounds, or on a basis that is beyond challenge."[412] It is submitted that in the view of the Hanson court, such a defense, in order to be held valid, must not interfere with a "shareholder's fundamental right to make the decisions affecting the corporation's ultimate destiny."[413] In fact the shareholders' right to receive takeover bids in precedence to "other legitimate corporate purposes"[414] may be stronger than the Revlon and Unocal language that the defensive tactic must be reasonable in relation to the threat posed.[415]

7. CODIFICATION

There have been several attempts to codify the business

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[411] Bradbury supra n. 301 p. 307.

[412] 781 F. 2d 264, 283 (2d Cir. 1986).

[413] Ibid. p. 277.

[414] Supra n. 401 p. 278.

[415] Peter Brenan, New Cases on the Business Judgment Rule: Defending Defensive Tactics Becomes More Difficult (1986-87) 14 Securities Regulation Law Journal 245, 262.

judgment rule. These have centred around the efforts made by the Committee on Corporate Laws of the Section of Corporation, Banking and Business Law[416] and the American Law institute through their "Principles of Corporate Governance and Structure: Analysis and Recommendations."

In 1983 the former group published an exposure draft which attempted to pin down the business judgment rule. However criticism of the section was so pervasive that these changes to the Act were withdrawn. The committee finally determined that the difficulty in attempting to codify the business judgment rule was simply too great.[417] The Committee settled upon s.8.30 of the Act[418] as the general expression of proper directoral conduct and concluded that since

> "the elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts ... section 8.30 does not try to codify the business judgment rule or to delineate the differences, if any, between that rule and the standards of director conduct set forth in this section. That is a task left to the courts and possibly to later revisions of this Model Act."[419]

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[416] This committee has the responsibility of drafting and updating the Revised Model Business Corporation Act.

[417] Elliot Goldstein, Future Articulation of Corporate Law (1984) 39 The Business Lawyer 1541.

[418] See footnote #1 and corollary test in respect to the Duty of Care: U.S.

[419] Revised Model Business Corp. Act § 8.30, Official Comment p. 928.

The process and rationale behind this decision has been described by a member of the Committee as follows:

> Over the past three years [the ABA's Committee on Corporate Laws] has been engaged in an overall revamping of the entire Model Act. In the course of that exercise, the committee tried ... to grapple with the elements of the business judgment rule in a new section 8.30. After no less than ten drafts and literally hundreds of manhours of struggle, the effort was ... abandoned, and it was decided, **faute de mieux**, to retain [the old language] and not seek to go further.[420]

In the view of the RMCA if a director passes the due care test of s.8.30 he is automatically absolved of liability (absent self-dealing or the like).[421]

> Section 8.30(d) follows former section 35 of the Model Act, which provided that "An individual who performs the duties of his office in accordance with this section is not liable for serving or having served as a director." Thus, both former section 35 and current section 8.30(d) are self-executing, and the individual director's exoneration from liability is automatic. If compliance with the standard of conduct set forth in former section 35 or section 8.30 is established, there is no need to consider possible application of the business judgment rule. The possible application of the business judgment rule need only be considered if compliance with the standard of conduct set forth in former section 35 or section 8.30 is not established.[422]

The question of whether the business judgment rule applies

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[420] Manning, supra n. 94 p. 1479.

[421] Veasey and Seitz, supra n. 138 p. 1496.

[422] Revised Model Business Corp. Act § 8.30, Official Comment p. 932.

if the s.8.30 standard is not met is left unanswered. The issue was put forward by Norman Veasey, another Committee member, in the following manner:

> If a director fails to act in good faith, with the requisite care or in a manner he "reasonably believes" to be in the best interests of the corporation, can it be said that he may never be protected by the business judgment rule? The Committee apparently felt that in this area one should "never say never." ... Rightly or wrongly, the Committee concluded that there were too many imponderables that might arise in future cases to say that the business judgment rule would never protect one who had flunked the standard set forth in section 8.30. For example, a director whose belief in the best interests of the corporation was "honest," if not "reasonable," would not pass section 8.30, but might pass the test of **Aronson.** Similarly, the process of becoming informed might not pass an ordinary negligence test (if section 8.30(a)(2) is to be so interpreted) but might pass the gross negligence test of **Aronson.**[423]

On the other hand the American Law Institute has taken an affirmative step in an effort to codify the business judgment rule. The product of this process is s. 4.01(c) and (d).

> S.4.01
> (c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:
>
> (1) he is not interested [§ 1.15] in the subject of his business judgment;
> (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
> (3) he rationally believes that his business

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[423] Veasey and Seitz, supra n. 138 p. 1496.

> judgment is in he best interests of the corporation.
>
> (d) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of duty of care (and the inapplicability of the provisions as to the fulfillment of duty under Subsection (b) or (c)), and the burden of proving that the breach was the legal cause of damage suffered by the corporation.][424]

In the words of the American Law Institute, the description is intended to be "consistent with present law as it would be interpreted in most jurisdictions today, and each of the rules basis elements ... is supported by substantial precedential authority."[425] This section is intended to apply to all board decisions and is therefore not limited to "risky or economic decisions."[426] Protection is afforded only where a "business judgment" is made and it must therefore have been "consciously made and judgment must, in fact, have been exercised."[427] Further, directors must have acted in good faith as "the business rule is inapplicable to duty of loyalty matters."[428] In addition the decision must be an informed one and "s.4.01(c)(2)

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[424] Supra n. 22 s.4.01(c) and (d).

[425] Ibid. Comment to s.4.01(c) p. 58. Note: This statement was set down prior to the decision in the Unocal case.

[426] Ibid. p. 59.

[427] Ibid. p. 60.

[428] Ibid. p. 64.

focuses on the preparedness of a director or officer in making a business decision as opposed to the quality of the decision itself."[429] The "reasonable belief" element of this section has the same objective and subjective content as is applicable elsewhere in Part IV. Generally stated then, the director's judgment must be consistent with his actual knowledge and or the knowledge that may be reasonably attributed to him given the circumstances at hand. To that end the ALI formulation is intended to take into account the relative pressure that may be present or not given the demands of time in the case at hand.

> Some business decisions must, for example, be made under severe time pressure while others afford time for the orderly marshaling of material information. Section 4.01(c)(2) permits a director or officer to take into account the time that is realistically available in deciding the extent to which he should be informed. The time realistically available may compel risk taking, which includes the risk of not having all relevant facts concerning a proposed transaction as well as the risks related to the economic consequences of the transaction itself. A decision to accept the risk of incomplete information, so long as the director reasonably believes such informational risk taking to be appropriate under the circumstances, will be fully consistent with the application of the business judgment rule to decisions made with respect to the principal transaction.[430]

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[429] Ibid. p. 65.

[430] Ibid.. The ALI have provided some factors that may be taken into account in judging a director's reasonable belief as to what was "appropriate under the circumstances";

(i) the importance of the business judgment to be

(continued...)

The director's rational belief that his "business judgment is in the best interests of the corporation" also has an objective and a subjective content. "A director or officer must actually believe that his business judgment is in the best interests of the corporation and that belief must be rational."[431]

A close look at s.4.01 reveals a somewhat bifurcated approach to the issues of directoral conduct and decision making. While the former is addressed in s.4.01(a) and (b), the latter is set forward in s.4.01(c). However, while the two are related, they are not exactly the same. The difficulty arises in trying to separate the two. One commentator has suggested that the conduct and decisional rules have in fact been merged to the extent at least that the latter is to be read in light of the former.[432] The

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[430](...continued)
made; (ii) the time available for obtaining information; (iii) the costs related to obtaining information; (iv) the director's confidence in those who explored a matter and those making presentations; and (v) the state of the corporation's business at the time and the nature of competing demands for the board's attention. The different backgrounds of individual directors, the distinct role each plays in the corporation, and the general value of maintaining board cohesiveness may all be relevant when determining whether a director acted "reasonably" in believing that the information he had before him was "appropriate under the circumstances." (Ibid. p. 66).

[431] Ibid. p. 67.

[432] Carney, supra n. 21 p. 272.

explanation for this is that s.4.01(c) intends to set out the business judgment rule principally as a set of qualifications to director immunity. On the other hand, another commentator has taken the position that the two follow mutually exclusive routes to the extent that the former applies an objective standard and the latter relies upon a subjective orientation.[433] The objective standard is said to be grounded in the "ordinarily prudent person,"[434] while the subjective standard reflects the decision makers "reasonable belief"[435] in respect to his effort to become informed. Yet another commentator has simply stated that s.4.01 is a "strange porridge" pointing to the fact that while s.4.01(a) and (c) both require a director to have a "reasonable" belief, s.4.01(c)(3) applies a "rationality test."[436]

While the 'correct' interpretation of s.4.01(a)-(c) is a matter of some conjecture, s.4.01(d) leaves no doubt that the burden of proof rests with the plaintiff. This is significant in that this section does not articulate the presumption of regularity normally afforded by the business judgment rule. While the ALI intended to "agree with the observation that directors and officers generally act

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[433] Hinsey, supra n. 168 p. 613.

[434] Supra n. 44 s.4.01(a).

[435] Ibid. s.4.01(c)(2).

[436] Veasey and Seitz, supra n. 138 p. 1497.

properly" they believed that the word 'presumption' was "imprecise and subject to misinterpretation."[437] In its stead they placed the initial burden of proof on the plaintiff. This variation has been criticized;

> "Presumptions and burdens of proof, however, are not identical, and the presumption does provide directors with substantial protection that is not afforded simply by placing the burden of proof on the opposing party."[438]

The ALI have also taken steps recently to codify directoral conduct in the following areas: § 5.15 Transfer of Control in which a Director or Principal Senior Executive or His Associate is Interested,[439] § 6.01 Role of Directors

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[437] Supra n. 22 Official Comment p. 12-13.

[438] Block, Barton and Radin, supra n. 129 p. 21.

[439] American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Tentative Draft No. 9 (1989).

> § 5.15 Transfer of Control in Which a Director or Principal Senior Executive or His Associate Is Interested
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> (a) If directors or principal senior executives [§ 1.25] of the corporation or their associates [§ 1.02] are interested [§ 1.18(a)(2)] in a transaction in control [§ 1.32] or a tender offer that results in a transfer of control [§ 1.05] of the corporation to another person [§ 1.23], then such directors, principal senior executives, or associates have the burden of proving that the transaction was fair to the shareholders of the corporation unless (1) the transaction involves a transfer by a controlling shareholder [§ 1.06(a)(2)], or (2) the conditions of subsection (b) are satisfied.

(continued...)

and Holders of Voting Equity Securities with Respect to Transactions in Control Proposed to the Corporation,[440] and

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[439](...continued)

(b) If in connection with a transaction described in subsection (a):

(1) public disclosure of the transaction is made;

(2) responsible persons who express an interest are provided relevant information concerning the corporation and given a reasonable opportunity to submit a competing proposal;

(3) the transaction is authorized by disinterested directors after the procedures set forth in Subsections (1) and (2) have been complied with; and

(4) the transaction is authorized or ratified by disinterested shareholders [§ 1.11] (or, if the transaction is effected by a tender offer, the offer is accepted by disinterested shareholders [§ 1.11]), after disclosure concerning the conflict of interest [§ 1.09(b)] and the transaction [§ 1.09(a)] has been made;

then a party challenging the transaction has the burden of proving that the transaction constituted a waste of corporate assets [§ 1.34].

(c) The fact that holders of equity securities are entitled to an appraisal remedy with the characteristics provided for in [§§ 7.20-7.23] with respect to a transaction specified in Subsection (a) should not make an appraisal proceeding the exclusive remedy of a shareholder who proposes to challenge the transaction, unless the transaction falls within § 7.26 (Transactions in control involving corporate contributions to which a majority shareholder is a party).

[440] ALI Discussion Draft No. 2 (1989).

§ 6.01. Role of Directors and Holders of Voting Equity Securities with Respect to Transactions in Control Proposed to the Corporation

(a) The board of directors, in the exercise of its business judgment [§ 4.01(c)], may approve, reject, or decline to consider a proposal to the

(continued...)

§ 6.02 Actions of Directors that Have the Foreseeable Effect of Blocking Unsolicited Tender Offers.[441] Section 6 is of

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[440](...continued)
corporation to engage in a transaction in control [§ 1.32].

(b) Any transactions in control of the corporation to which the corporation is a party should require approval by the holders of voting equity securities [§ 1.33a].

[441] ALI Discussion Draft No. 2 (1989).

§ 6.02. Actions of Directors That Have the Foreseeable Effect of Blocking Unsolicited Tender Offers

(a) The board of directors may take an action that has the foreseeable effect of blocking an unsolicited tender offer [§ 1.32a], unless the action would materially disfavor the long-term interests of the shareholders. In determining whether such an action would materially disfavor the long-term interests of the shareholders, the board of directors should consider the nature, timing, and adequacy of the offer, the risk of nonconsummation of the offer, and questions of legality, and may consider the past actions of the bidder and its affiliates in other takeover contests, the impact on groups other than shareholders with respect to which the corporation has a legitimate concern, and other relevant factors.

(b) In reviewing an action of the board of directors under subsection (a), the standard of review should be whether the board of directors reasonably concluded that their action would not materially disfavor the long-term interests of the shareholders. A person who challenges an action of the board on the ground that it fails to satisfy the standard of § 6.02(a) has the burden of proof.

(c) An action that does not meet the standard of subsections (a) and (b) may be enjoined, but directors who authorize such an action are not subject to liability for damages if their conduct meets the standard of the business judgment rule [§ 4.01(c)].

particular interest and is set forward by way of a proposal in Discussion Draft No. 2. In this format the ALI "signifies that the formulations in the Draft have not been approved by the Council, nor have they been submitted to or discussed by the members of the Institute at an Annual Meeting."[442] The role of the Discussion draft is to solicit comments concerning the substance of the material at hand.

Section 6.01 is intended to restate existing law, namely that it is within directoral discretion to "approve, reject, or decline to consider a proposal" which will affect corporate control.[443] The review of that decision would be made under s.4.01(c) for the purpose of determining both entitlement to injunctive relief against the directors' decision and the liability, if any, of the directors for their decision. This section "operates to confirm management's wide discretion in the tactics it selects in negotiating a proposed transaction in control."[444] Notably the ALI comments that a determination of the nature in which directors conduct a negotiated sale is "generally for shareholder, not judicial, review."[445]

Where actions are taken by a board to resist a tender

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[442] ALI Discussion Draft No. 2 (1989), Forward p. ix.

[443] Ibid. Comment p. 7. A transaction in control is defined as "one which causes a change in the control of a corporation or its assets or business" (Comment p. 8).

[444] Ibid. p. 9.

[445] Ibid.

offer made directly to the shareholders, these steps will fall under the ambit of s.6.02. In shaping this section, the ALI reviewed the Delaware authority and their existing modified business judgment rule. The enhanced burden required therein[446] was rejected. In its place, the ALI chose to provide its own 'enhanced' standard. They did so by providing that where injunctive or rescissionary relief is requested, the business judgment rule will not govern review of director action to block a tender offer.

> In this circumstance § 6.02(c) places the burden on the plaintiff to show that the directors did not meet the standards of §§ 6.02(a) and (b): that they reasonably concluded that the long-term interests of the shareholders were not materially disfavored by the directors' action. Accordingly, in reviewing directors' actions in an injunction proceeding (as distinct from a proceeding in which personal liability is an issue), § 6.02 also adopts what might be referred to as an intermediate or enhanced business judgment standard of review.[447]

In effect the ALI is stating that failure to reasonably consider the long term interests of shareholders will not necessarily mean that directors have breached the requirements of the business judgment rule (as set forth in s.4.01(c)). In fact, by stating that this level of review is enhanced, the ALI is implying that the long term interests of shareholders is not a fundamental consideration in

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[446] Reference is made to the Unocal case and others.

[447] Supra n. 439 Comment p. 29.

control transactions where directors' personal liability may be concerned. I am quite certain that this particular orientation will come under some considerable scrutiny.

The ALI also took a close look at the Second Circuit decisions reviewed earlier in this text and at both California and Delaware decisions, where each focused to some degree on the element of motive. In doing so, the ALI flatly rejected use of a motive based test by which to gauge the actions of corporate directors.

> Section 6.02 reflects the view that judicial review of directors' blocking actions against unsolicited tender offers should not be based on inquiry into the directors' motives for their actions. Such a review cannot effectively distinguish between cases in which directors favored themselves and cases in which directors properly looked to the interest of the shareholders. Equally important, a motivational standard of review gives no guidance to directors - particularly independent directors - as to what constitutes appropriate behavior. Accordingly, § 6.02 directs judicial inquiry to the question whether action taken by the directors has the foreseeable effect of precluding holders of voting equity securities from having the opportunity to accept an unsolicited tender offer. If it does, then the court must further inquire as to whether the directors reasonably concluded that their action did not materially disfavor the long-term interests of the shareholders. In making such inquiry, a court may give weight to the board's analysis of the competing considerations involved in arriving at its decision, recognizing that any such analysis is not subject to empirical precision.[448]

It is interesting to note here that many of the

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[448] Ibid. p. 31.

considerations, set out in s.6.02(a), to which directors may give head when considering the long term interests of shareholders, are the same as those enunciated in Unocal in their consideration of the reasonableness of a defensive measure.[449] This concurrence is in fact acknowledged by the ALI.[450] In this application the ALI has foregone any subjective element and states that the test of what is reasonable is to be objectively determined by the courts.[451] However, the ALI here vary their own definition of what constitutes 'reasonableness.' As mentioned earlier the ALI consistently applies both a subject and objective test to this standard however for the purposes of this section **only** the objective standard will meet the test. This inconsistency may be read in light of the ALI's aversion to applying anything that would appear to be a motive-based test of directoral conduct. However, in doing so they stir even further this 'strange porridge.'

The ALI are consistent however in their application of the burden of proof. The onus in § 6.02 continues to remain on the plaintiff. Hence the ALI have rejected the Delaware approach and have opted for the Second Circuit application.

In considering the duty to auction the ALI does not place on directors who are responding to an unsolicited

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[449] Unocal 493 A. 2d 946, 955 (Del. 1985).

[450] Supra n. 439 Comment p. 31.

[451] Ibid.

tender offer the duty to conduct an auction of the corporation's business.[452] Further, in recognizing the efficacy of the Moran decision, the ALI through s.6.02 "provides directors with the authority ... to engage in pre-planning actions to respond to future unsolicited tender offers ... if such actions meet the standard specified in s.6.02(a) and (b)."[453]

Sections 6.01 and 6.02 are a timely and credible effort to provide some form of judicial synthesis in this most uncertain area. The relative merit of this product however, is as yet to be determined.

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[452] Ibid. p. 32.

[453] Ibid. p. 33.

PART V

A. OUTSIDE DIRECTORS

Increasingly courts have looked to the role taken by outside directors in the drama often seen played out in struggles for corporate control. These directors have been variously defined. For example, The Corporate Directors Guidebook draws the distinction between "management directors" and "non management directors."[454] Management directors are those which devote substantially their "full time and attention to the affairs of the corporation, one of its subsidiaries, or any other corporation controlling or controlled by the corporation."[455] Similarly former officers or employees of the corporation are considered management directors when acting in that capacity. By exclusion then all others may be considered non management directors. However within this category the Guidebook, concerned with the functional independence of this class, further differentiates between "affiliated non-management directors" and "unaffiliated non-management directors."[456] Such individuals as commercial bankers, investment bankers, attorneys and others who supply services or goods to the

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[454] Supra n. 20 p. 1619.

[455] Ibid.

[456] Ibid. p. 1620.

corporation fall into the former category. The Guidebook further states that a decision as to the affiliated status of a director should be made by the board through its nominating committee with a view to whether that individual "is free from any relationship which would interfere with the exercise of his independent judgment as a member of the board committee on which he is to serve."[457]

The Business Roundtable[458] distinguishes between "inside" and "outside" directors and is similarly concerned with the relative independence of "retired officers, bankers, lawyers and others."[459] Yet another author has identified three classes of directors;

> The inside directors, which includes officers and employees of the company, non-independent outside directors, which include consultants to the company such as attorneys, bankers and investment bankers whose corporations provide the company with regular services and relatives of inside directors; and independent outside directors who have no present direct business relationship with the corporation on whose board they serve.[460]

The American Law Institute does not speak in terms of

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[457] Ibid.

[458] The Business Round Table is an organization of chief executive officers of some 200 large, publicly held corporations.

[459] Statement of the Business Round Table, The Role and Composition of the Board of Directors of the Large Publicly Owned Corporations (1978) 33 The Business Lawyer, 2083, 2107.

[460] Cohan, The Outside Director - Selection, Responsibilities and Contribution to the Public Corporation (1977) 34 Washington & Lee Law Review 837-838.

"inside" or "outside" directors. Rather the ALI have chosen to distinguish "between directors who have a significant economic or professional relationship with the senior executives, and directors who do not.[461] The focus is on

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[461] American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Tentative Draft No. 2 (1984) Comment p. 17. This relationship is defined in s.1.26:

§ 1.26. Significant Relationship

(1) Except as provided in § 1.26(2), a director has a "significant relationship" with the senior executives [§ 1.25] of a corporation if, as of the record date for the annual meeting of shareholders:

(a) He is employed by the corporation, or was so employed with the two preceding years;
(b) He is a member of the immediate family [§ 1.18] of an individual who (a) is employed by the corporation as an officer [§ 1.19], or (b) was employed by the corporation as a senior executive within the two preceding years;
(c) He has made to or received from the corporation, during either of its two preceding fiscal years, commercial payments [§ 1.04] which exceeded **$200,000**, or he owns or has power to vote an equity interest [§ 1.11] in a business organization [§ 1.03] to which the corporation made, or from which the corporation received, during either of its two preceding fiscal years, commercial payments that, when multiplied by his percentage equity interest in the organization, exceeded **$200,000**;
(d) He is a principal manager [§ 1.21] of a business organization to which the corporation made, or from which the corporation received, during either of the organization's two preceding fiscal years, commercial payments that exceed 5 percent of the organization's consolidated gross revenues for that year, or **$200,000**, whichever is more; or
(e) He is affiliated in a professional capacity

(continued...)

the "relationships that may be expected to inhibit ... objectivity ..., not simply on relationships with the corporation."[462]

Outside directors play a crucial role on many select committees of the board where independence is a highly valued commodity. These include audit committees, finance committees and increasingly, special committees chosen to review tender offers and the various defensive schemes manufactured to defeat them. Judicial comment leaves no

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[461](...continued)
with a law firm that was the primary legal adviser to the corporation with respect to general corporate or securities-law matters, or with an investment-banking firm that was retained by the corporation in an advisory capacity or acted as a managing underwriter in an issue of the corporation's securities, within the two preceding years, or was so affiliated with such a law or investment-banking firm when it was so retained or so acted.

(2) A director shall not be deemed to have a significant relationship with the senior executives under § 1.26(1)(c)-(e) if, on the basis of countervailing or other special circumstances, it could not reasonably be believed that the judgment of a person in the director's position would be affected by his relationship under § 1.26(1)(c)-(e).

(3) For purposes of § 1.26 (and § 1.19, to the extent it is incorporated in § 1.26 by reference) the term "the corporation" includes any corporation that controls [§ 1.05] the corporation, and any subsidiary or other business organization that is controlled by the corporation, and the term "year," used without the qualifying term "fiscal," means the preceding twelve months.

[462] Ibid.

doubt of the outside directors' critical role in contests for corporate control. For example in Unocal the court in speaking of the "omnipresent spectre" of a board acting in their own interest stated:

> In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. However, they satisfy that burden "by showing good faith and reasonable investigation..." Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards.[463]

In fact the outside directors played a dominant role in the decision making process. Similarly in Moran the court reiterated its views on outside director participation stating that proof of reasonableness and good faith was materially enhanced "where here [as in UNOCAL] the majority of the board favouring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards."[464] This approach was carried through in the Mills case wherein the court held that in order to ensure that shareholders' interest have been given proper consideration during the auction phase the fulfillment of this duty "requires the intense scrutiny and participation

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[463] Unocal, 493 A. 2d 946, 955 (Del. 1985).

[464] Moran, 500 A. 2d 1346, 1356 (Del. 1985).

of the independent directors..."[465]

Similarly the Second Circuit has commented upon the important role which outside directors must play in control contests. In Hanson the Court of Appeal stated that "in the context of a self-interested management proposing a defensive LBO, the independent directors have an important duty to protect shareholder interests..."[466] Here of course the outside directors remained uninformed. In both Delaware and New York however, disinterested outside directors cannot overcome management self interest unless they are fully informed and act with due care.[467]

Without doubt the prominence of tender offers and the control contests which they have spawned have brought the outside director to the forefront of this corporate battlefield. Along with this pre-eminent role have come questions concerning the relative "independence" of these directors and the standard to which they should be held. These are valid concerns and reflect the real life manner in which directors are nominated and the amount of time they have to dedicate to the corporate enterprise. The tenor of the American decisions suggests that the court will not address the relative independence of each "outside" director.

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[465] Supra n. 336.

[466] 781 F. 2d 264, 277 (2d Circuit 1986).

[467] See Hanson Trust PLC v. ML SCM Acquisition, Inc. 78 F. 2d 264 (2d Circuit 1986). Smith v. Van Gorham 488 A. 2d 858 (Del. 1985).

Further where corporate control is at stake elements of time and resources will not be at issue. Rather the focus is on shareholder interests and whether or not they have been fairly treated. Outside and inside directors are equally charged with the duty to be informed and to that extent they are required to spend as much time and energy as is necessary to fulfill their duty of care commitment.[468]

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[468] For a further discussion of these issues see generally Brown, supra n. 146, Ajhemian, supra n. 108, Pease, supra n. 63 and Baxter, The Fiduciary Obligations of Directors of a Target Company in Resisting an Unsolicited Takeover Bid (1988) 20 Ottawa Law Review 63.

PART VI

A. NON-SHAREHOLDER INTERESTS

Corporate directors as we have seen must address a myriad of complex issues which arise during contests for corporate control. One of these which merits special interest is the concern which may be reasonably given to the interests of those various classes of individuals who are in some way affected by the outcome but do not hold an equity position. These include creditors, customers, employees and in some cases the community in general.

Philosophically one has a choice as to the measure of weight which may be conferred upon any one interest over another. The traditional view places the emphasis upon the shareholder and advocates that directors have a fiduciary relationship to the corporation and its shareholders similar to that of a trustee in his relation to the beneficiary.[469]

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[469] Supra n. 112 p. 479, footnote 21:

The "traditional model" of the corporate enterprise restricts the discretion of corporate boards to those acts which maximize the present return on the shareholder's investment. This view is based upon the legal conception of the corporation as an instrumentality which has as its exclusive purpose the accumulation of wealth for its owners. The following statement by economist Milton Friedman epitomizes the traditional view:

> A corporate executive's responsibility is to make as much money for the stockholders as

(continued...)

While directors are not held to the same strict standards as true fiduciaries,[470] their role vis-a-vis maximizing shareholder wealth is the focus of this approach.

On the other side is the stackholder theory which views shareholders as merely one constituency of the corporation and focuses upon broader social objectives. The interests of employees, consumers, suppliers and the general public are recognized as playing an important role as they are impacted upon by corporate activity and initiative. In addition this theory is influenced by the concession theory or pure political model which widens the scope of directoral

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[469](...continued)

> possible, as long as he operates within the rules of the game. When an executive decided to take action for reasons of social responsibility, he is taking money from someone else - from the stockholders, in the form of lower dividends, from the employees, in the form of lower wages; or from the consumer, in the form of higher prices. The responsibility of a corporate executive is to fulfill the terms of his contract. If he can't do that in good conscience, then he should quit his job and find another way to do good. He has the right to promote what he regards as desirable moral objectives only with his own money. If, on the other hand, the executives of U.S. Steel undertake to reduce pollution in Gary for the purpose of making the town attractive to employees and thus lowering labor costs, then they are doing the stockholders' bidding. And everybody benefits: The stockholders get higher dividends; the customer gets cheaper steel; the workers get more in return for their labor. That's the beauty of free enterprise.

[470] Ibid. p. 488. See also this text, p. 43-48.

responsibility.[471] The concept of increased corporate responsibility has an early origin. In fact America's earliest corporations were established to effect social objectives. For example, in the late eighteenth and nineteenth centuries corporations were established to construct roads and bridges, enhance transportation, establish banks to provide reliable sources of credit and currency and to organize manufacturing concerns to "free the American economy of its dependency on European indus-

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[471] Ibid. p. 489, footnotes 112-115;

> The concession theory essentially demands a **quid pro quo** from the corporation in the form of socially beneficial activity in exchange for citizens' grant, through government, of the special privileged and powers inherent in the corporate form. ...
>
> The pure political" theory views the corporate entity as an institution exercising power over individuals who have no control over its activities. The model considers social responsibility to be the furtherance of social objectives which will benefit the groups affected by the corporation - its employees, suppliers, the local community and society in general. ...
>
> Under the concession theory a corporation must provide public services or undertake activity which is beneficial to society as a whole. For example, it is argued that corporations further the social interest of economic growth by providing an instrumentality for the aggregation of capital. ...
>
> Conversely, corporations must refrain from activities which are detrimental to the public interest and must be accountable for such activities.

tries."[472] However with the replacement of the special charter with general incorporation laws, the corporate connection with public objectives was diminished. A resurgence of the ideal of corporate responsibility took place in the early 1980's as a response to the general concern over social welfare and "the deeply felt need of the American public to limit a corporation's power and to render it socially accountable..."[473] This concern has been heightened by the tremendous impact which takeovers have had upon non shareholder constituents.

While there cannot be any doubt of the impact of hostile takeovers upon non shareholders interests, there is most certainly some doubt over the relative weight which may be allocated to these interests without incurring legal liability. An early case exemplifying the traditional model is the landmark decision in Dodge v. Ford Motor Co..[474] The facts are as follows:

> ... Henry Ford, who owned 58% of Ford Motor Company and controlled its board of directors, announced a tripartite plan to reduce the price of its cars, ban any special dividends to shareholders and expand facilities to employ more workers. The court found that Henry Ford "thinks the Ford Motor Company has made too much money, has had too large profits, and that although large profits might be still earned, a sharing of them with the public, by reducing the price of the

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[472] Ibid. p. 490.

[473] Ibid. p. 491.

[474] 204 Mich. 459, 170 N.W. 668 (1919).

> output of the company, ought to be undertaken. Arguing that Henry Ford had transformed the corporation from a private business institution into a semi-eleemosynary institution, the Dodge brothers, who owned 10% of Ford Motor Company, brought an action in part to compel a large cash dividend and enjoin the proposed expansion project. The Michigan Supreme Court denied the request for an injunction, but affirmed the trial court's order requiring Ford Motor Company to declare a dividend equal to one-half of its cash surplus.[475]

In doing so the court stated:

> A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.[476]

Fords' directors could not operate the business to benefit non shareholder interests where doing so would be at the expense or loss of opportunity to the shareholders.[477]

In a similar holding the Delaware Supreme Court in Guth v. Loth[478] precluded a corporate director from diverting a potentially lucrative business opportunity to himself

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[475] Andre, Tender Offers for Corporate Control: A Critical Analysis and Proposals for Reform (1987) 12 Delaware Journal of Corporate Law 865, 878-879.

[476] Dodge 204 Mich. 459, 170 N.W. 668 at 684 (1919).

[477] Ibid.

[478] 2 A. 2d 225 (Del. Ch. 1938), aff'd., 5 A. 2d 503 (Del. 1939).

stating that "a corporate officer or director [must] ... refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage..."[479]

On the other hand, in the case of Herald Co. v. Seawell[480] the court in finding that a newspaper company was a quasi-public entity held that its investors have a legal duty to its non investor constituents.[481]

> In holding for the defendants, the court determined that a newspaper owes a duty to its shareholders, its employees, and to the public. Because many people read and relied upon the news reported by the Denver Post, the court reasoned, it was a quasi-public institution. Further, the court found a duty running to the employees of the company because many of them were highly skilled workers who had spent much of their lives working for the newspaper. The court stated that placing the public needs and good above the desire for profit was "wholly justified" and assumed that shareholders entrust their money to managers partly in anticipation of furthering the economic well-being of noninvestor constituents.[482]

More recently in the case of GAF Corp. v. Union Carbide Corp.,[483] the court upheld certain defensive tactics among which was an amendment to the Company's retirement plan vesting certain funds in participating employees in the event of a change in control. The court found that:

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[479] Ibid. p. 510.

[480] 472 F. 2d 1081 (10th Cir. 1972).

[481] Ibid. p. 1095.

[482] Andre, supra n. 475 p. 880.

[483] 624 F. Supp. 1016 (S.D.N.Y. 1985).

> The protection of loyal employees, including managers, of the organization is not anathema in the Courthouse. To be compared are the situations in which similar protection to the well-being and security of employees, pensioners, and loyal members of management is regularly accorded when a business is moved or substantially liquidated; they are similarly directly affected by unfriendly raids on control.[484]

In implementing their defensive strategy the court held that the directors were operating within the guidelines of the business judgment rule when they took into consideration both pension benefits and severance payments.[485] Allowing directors the latitude to consider these interests was "necessary in order to maintain balance and serenity in the marketplace and in corporate affairs..."[486]

In Enterra Corp. v. SGS Associates[487] the District Court for the Eastern District of Pennsylvania similarly focused upon employee welfare in upholding the validity of a stand still agreement.[488] In doing so the court stated that

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[484] Ibid. p. 1019.

[485] Ibid. p. 1019-1020.

[486] Ibid. p. 1020.

[487] 600 F. Supp. 678 (E.D. Pa. 1985).

[488] Farinaro, supra n. 269 p. 741 footnote 118;

SGS Associates (SGS) held a substantial percentage of the outstanding shares of Enterra Corp. (Enterra). The Enterra board, as a defense tactic, reached a standstill agreement with SGS. This standstill agreement provided that SGS could not acquire more than 15% of Enterra's outstanding

(continued...)

directors may consider such factors as

> "the retention and recruitment of key employees, allaying the takeover concerns of (and stabilizing relations with) various suppliers, customers and lenders, settling the trading market for Enterra stock..."[489]

While these concerns may be addressed in some jurisdictions the court will not uphold a defensive tactic where such considerations are intended solely to disguise a true motive of entrenchment.[490]

In Delaware both Unocal and Revlon speak to the issue of non shareholder interests. In Unocal the court in its deliberation over the factors which may be considered in determining the reasonableness of a defensive tactic included therein ... "the impact on constituencies other than shareholders (ie., creditors, customers, employees and

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[488](...continued)
shares and could not make a tender offer to Enterra shareholders. The agreement thus prevented SGS from attempting to acquire control of Enterra. SGS subsequently attempted to acquire all the outstanding Enterra shares, subject to board approval. The Enterra board, relying on the advice of its investment bankers, concluded that SGS' tender offer was financially inadequate and refused to amend the agreement. The court found that the board did not breach its fiduciary duties when it entered into the agreement and later rejected SGS' proposal for modification of the standstill agreement.

[489] Enterra, 600 F. Supp. 678, 689 (E.D Pa. 1985).

[490] Eg. Norlin Corp. v. Rooney, Pace Inc., 744 F. 2d 255, 265 (2d Cir. 1984) wherein the court found that an ESOP was not created "to benefit the employees but rather to solidify management's control of the company."

perhaps even the community generally)..."[491] Months later in Revlon the same court further refined its statement thereby significantly limiting the effect.[492] The court stated that non shareholder interests may be considered if "there are rationally related benefits accruing to the stockholders."[493]

In an effort to avoid the narrow constituent base set out in Revlon a number of states have amended their corporation statutes to allow directors greater latitude in considering non shareholder interests when faced with hostile takeover bids. For example Ohio has legislated the following:

> For purposes of this section, a director, in determining what he reasonably believes to be in the best interest of the corporation, shall consider the interests of the corporation's shareholders and, in his discretion, may consider any of the following:
>
> (1) The interests of the corporation's employees, suppliers, creditors, and customers;
> (2) The economy of the state and nation;
> (3) Community and societal considerations;
> (4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.[494]

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[491] Unocal, 493 A. 2d 946, 955 (Del. 1985).

[492] Supra n. 8 p. 497.

[493] Revlon, 506 A. 2d 173, 182 (Del. 1986).

[494] Ohio Rev. Code Ann. § 1701.59(E) (Baldwin Supp. 1986).

In Minnesota §302A.251, subd. 5 states:

> In discharging the duties of the position of director, a director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation.[495]

In addition some corporations have amended their articles of incorporation. An example of the foregoing is Control Data Corp. which implemented such a provision in its corporate charter:

> The Board of Directors of the Corporation, when evaluating any offer of another party to (a) make a tender or exchange offer for any equity security of the Corporation, (b) merge or consolidate the Corporation with another corporation, or (c) purchase or otherwise acquire all or substantially all of the properties and assets of the Corporation, shall, in connection with the exercise of its judgment in determining what is in the best interests of the Corporation and its stockholders, give due consideration to all relevant factors, including without limitation the social and economic effects on the employees, customers, suppliers and other constituents of the Corporation and its subsidiaries and on the communities in which the Corporation and its subsidiaries operate or are located.

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[495] Minn. Stat. § 302A.251, subd. 5 (1988 & Supp. 1989). Ida. Code § 30-1702; Ind. Gen. Corp. Act. § 23-1-35-1(d); Neb. Bus. Corp. Act § 21-2035; N.M. § 1701.59(E); Wisc. Bus. Corp. Law § 180.305. See also Me. Rev. Stat. Ann. tit. 13-A, § 716 (Vernon Supp. 1988); Mo. Ann. Stat. § 351.347 (Vernon Supp. 1989); 42 Pa. Cons. Stat. § 8363 (Supp. 1988) N.Y. Bus. Corp. Law § 1603(a)(19).

The American Law Institute has also dealt with this area, first in broad terms through s.2.01[496] and then with specific reference to unsolicited tender offers in s.6.02.[497] Section 2.01 makes it clear that the governing objective of a corporation is the accumulation of wealth "with a view to enhancing corporate profit and shareholder gain." However this dominant motive is to be tempered in part by other considerations. In a comment to s.2.01 the authors state that "these provisions ((a)-(c)) reflect a recognition that the corporation is a social as well as an economic institution, and accordingly that its pursuit of the economic objective must be constrained by social

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[496] American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Tentative Draft No. 2 (1984):

> § 2.01 The Objective and Conduct of the Business Corporation
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> A business corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain, except that, whether or not corporate profit and shareholder gain are thereby enhanced, the corporation, in the conduct of its business
>
> (a) is obliged, to the same extent as a natural person, to act within the boundaries set by law,
> (b) may take into account ethical considerations that are reasonably regarded as appropriate to the responsible conduct of business, and
> (c) may devote a reasonable amount of resources to public welfare, humanitarian, educational, and philanthropic purposes.

[497] Supra n. 441.

imperatives and may be qualified by social needs."[498] Both s.2.01(b) and (c) are intended to deal with the "ongoing conduct of the corporation's business."[499] Where transactions involving or affecting control of the corporation are concerned this section will not apply and reference is intended to be made to Part VI.

Within Part VI s.6.01[500] gives the board the broad authority with which to act when addressing transactions in control proposed to the corporation. Should the board decide that in their business judgment the offer must be blocked, then s.6.02 applies and in doing so it speaks directly to the a consideration of non shareholder interests:

> § 6.02. Actions of Directors That Have the Foreseeable Effect of Blocking Unsolicited Tender Offers
>
> (a) The board of directors may take an action that has the foreseeable effect of blocking an unsolicited tender offer [§ 1.32a], unless the action would materially disfavor the long-term interests of the shareholders. In determining whether such an action would materially disfavor the long-term interests of the shareholders, the board of directors should consider the nature, timing, and adequacy of the offer, the risk of nonconsummation of the offer, and questions of legality, and may consider the past actions of the bidder

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498 ALI, Tentative Draft No. 2 Comment p. 28.

499 Ibid. p. 42.

500 Supra n. 440. See also text p. 150.

> and its affiliates in other takeover contests, the impact on groups other than shareholders with respect to which the corporation has a legitimate concern, and other relevant factors.

In this regard s.6.02 is intended to be read in conjunction with s.2.01 in as much as the interests of outside constituents may be considered even though they do not advance the long term interests of shareholders.[501] However in doing so "s.6.02(a) does not permit the interests of other groups to be recognized in such a way that would materially disfavour long-term shareholder interests."[502] As such the focus rests on the long term shareholder's interest and is therefore consistent with the Delaware approach.

How far then have we come since the era in which Dodge was decided? From a common law perspective not a great deal has changed. Nor has the governing ideological perspective given the ALI's approach to the matter. Even where authority may exist in support of the consideration of outside interests there is little guidance as to how these concerns may be substantially addressed.[503] Although legislative authority has been granted in some jurisdictions the consideration of non shareholder interests is couched in

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[501] ALI, Discussion Draft No. 2 Comment p. 36.

[502] Ibid.

[503] Luther supra n. 112 p. 500.

permissive terms rather than specifically requiring directors to consider such concerns. In sum then this area is perhaps simply another symptom of what is a very uncertain area of the law. In the words of one commentator:

> "Whether or not one believes that takeovers serve a beneficial or inimical purpose, and whether one endorses the stakeholder model over the traditional view, the current application of the business judgment rule creates an ethical uncertainty for directors. Within their discretion, directors may validly choose from a multitude of strategies and devices to resist or to accept a hostile tender offer. In exercising their judgment in a corporate control transaction, directors must favor the constituency to whom they commit their responsibility. However, to sustain the interests of one is effectively to forsake the interests of the other.[504]

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[504] Ibid. p. 501-502.

PART VII

A. REGULATORY FRAMEWORK

In addition to the common law, the Model Act, ALI Tentative and Discussion Drafts and state legislative interests is the regulatory arena in which battles for corporate control are won and lost. A broad understanding of the regulatory component will bring this area into better focus and will help to more finely tune our understanding of the variant dynamics in play as directors seek to steer the corporate ship through muddy waters in a sea of complex conditions.

In an effort to regulate stock tender offers Congress legislated the Securities Acts of 1933 and 1934.[505] However neither piece of legislation provided for tender offers made through cash transactions. During the 1960s corporate America became cognizant of this void and a shift in takeover mechanisms occurred from the use of proxy contests to the cash tender offer. The latter quickly became the dominant means of acquiring control as it was quicker, more efficient, less expensive and less regulated.[506] As a

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[505] The Securities Act of 1933, 15 U.S.C. Sec. 77a-77bbbb (1982), and The Securities Exchange Act of 1934, 15 U.S.C. Sec. 78a-78kk (1982).

[506] Mark Cronin, State Takeover legislation after CTS: Does It Give States a Free Hand to Regulate Tender Offers? (1988) 13 Delaware Journal of Corporate Law 1029.

response to this unforeseen development individual states took the initiative to legislate their own takeover laws. The first state to do so was Virginia, through its 1968 Virginia Takeover Bid Disclosure Act passed to meet an emergency takeover attempt in this state.[507]

Only a few months later the federal government entered the field through passage of The Williams Act.[508] The Williams Act is intended "to protect a target companies' shareholders by imposing disclosure requirements on the offeror and establishing procedural rules to govern the offer."[509] Further, the Williams Act is intended to serve as a communications conduit by providing "a mechanism to get information [concerning] potential shifts in corporate control to the relevant [securities] market."[510] In drafting this legislation Congress intended that the Act should be neutral in respect to its application to tender contests. Neither the target company nor the tender offeror were to gain any advantage.[511]

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[507] Virginia Takeover Bid Disclosure Act, Virginia Code Sec. 13.1 - 528 to 541 (1978 Supp. 1981).

[508] The Williams Act, 15 U.S.C. Sec. 78m (d)-(e), 78 n (d)-(f), 1982.

[509] Cronin, supra n. 506, p. 1032.

[510] Steve Mather, Symposium: Current Issues in Tender Offers, The Elusive Definition of a Tender Offer (1982) 7 Journal of Corporation Law 503, 504.

[511] See 113 Cong. Rec. 843 (daily ed. Jan. 18, 1967) (statement of Senator Williams).

(continued...)

The Act's disclosure provisions are intended to "ensure that shareholders, after hearing from both the offeror and target corporation, ... would have sufficient information to make informed decisions in determining whether to tender their shares."[512] In the words of former SEC Chairman Cohen, the purpose of the Act was "to provide the investor, the person who is required to make a decision, an opportunity to examine and to assess the relevant facts and to reach a decision without being pressured and without being subject to unwarranted techniques which are designed to prevent that from happening."[513] In light of this view one observer has stated that:

> It follows logically that target management should be permitted under the Williams Act to take defensive actions that do not preclude or materially impede shareholders' ability to tender their stock so long as there is full disclosure. On the other hand, maneuvers by target management that deny shareholders an opportunity to tender their shares would be held to violate the Williams Act, absent evidence that the offeror would inflict some clearly foreseeable harm upon the target

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[511](...continued)

> I have taken extreme care with this legislation to balance the scales equally to protect the legitimate interests of the corporation, management, and shareholders without unduly impending cash takeover bids. Every effort has been made to avoid tipping the balance of regulatory burden in favor of management or in favor of the offeror.

[512] Marc Steinberg, Tender Offer Regulation: The Need for Reform (1988) 23 Wake Forest Law Review 1, 18.

[513] Corporate Takeover Bids, S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967), 15.

corporation.[514]

However in Shrieber v. Burlington Northern, Inc.[515] the Supreme Court in its interpretation of the Williams Act held that the availability of federal law remedies in a tender offer situation was limited to misconduct in the area of disclosure only. Hence the validity of defensive tactics vis a vis shareholder rights may be examined solely under state law and in Mr. Steinberg's opinion:

> "The decision also means that the state of Delaware, being the predominant state of incorporation for publicly held companies, may well have the principle voice in determining the validity of takeover tactics."[516]

In concrete terms disclosure under the Williams Act is triggered in two situations: (1) When a person acquires 50% or more of the equity securities registered under s.12 of the Securities Exchange Act of 1934 or (2) When a person attempts through a tender offer to acquire more than 5% of the equity securities registered under s.12.[517] Upon one or another of these occurrences the offeror must file information which includes his identity, background, source of funds, planned changes regarding the target, present stock

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[514] Steinberg, supra n. 512 p. 18.

[515] 472 U.S. 1 (1985).

[516] Ibid.

[517] Cronin, supra n. 506 p. 1033.

ownership in the target and any contracts or undertakings entered into by the purchaser regarding the target's shares.[518] In addition

> "the target company must disclose any material contract, agreement or understanding between the target ... and the bidder company ... (and must also) state whether it is advising its shareholders to accept or reject the offer, whether it is remaining neutral ... or whether it is unable to take a position regarding the offer."[519]

The SEC will review the adequacy of the disclosure but not the merits of the proposed tender offer. In addition the Williams Act imposes three substantive requirements on the terms of the offer:

> (1) offerees who have tendered their shares must be allowed to withdraw from them within fifteen days of, and after sixty days from, the commencement of the offer; (2) if within ten days of when the offer was made, the offeror has been tendered more shares than he is willing to accept, then the offeror must purchase all the shares on a pro rata basis, and (3) if the offeror increases the price for tendered shares during the offer, the offeror must pay the additional amount to those who have already tendered their shares.[520]

However the Williams Act did not specifically preempt this area of regulation and as such both federal and state

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[518] Steinberg, supra n. 512 p. 17.

[519] Cronin, supra n. 506 p. 1033.

[520] Ibid. p. 1033-1034.

authority have the capacity to legislate in this area.[521] This set the stage for constitutional challenges to various state takeover laws which proceeded the Williams Act.

The first challenge is based on the Supremacy Clause found in the U.S. Constitution. This clause maintains that where states pass laws which either come into conflict with or seek to regulate an area of exclusive federal jurisdiction such laws are null and void as the federal law has supremacy. The second challenge is based on the Commerce Clause argument wherein state laws which unduly burden interstate commerce are deemed to be unconstitutional. Since the inception of the Williams Act these arguments have played a dominant role in court challenges to state takeover laws at both the federal and state court levels.

As was noted, individual states starting with Virginia often took a position which sought to regulate tender offers on a local level. Legislation was passed in response to a perceived threat which a given takeover(s) presented at the state level, eg. relocation, plant closures, layoffs and the like. These 'first generation'[522] statutes were targeted squarely against the acquiring company and focused on protecting existing management by hindering the tender offer

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[521] Lois Yoder, "The Corporate Takeover Regulatory Arena" in David Mikee, ed., Hostile Takeovers, Issues in Public and Corporate Policy (New York: Praeger Publishers, 1989) 85.

[522] The 'First Generation" period began in 1968 and ended on June 23, 1982.

process. This was accomplished through the implementation of numerous restrictive regulations and requirements.

> First generation statutes contained certain core provisions which were based upon the disclosure and substantive provisions of the Williams Act. However, these state statutes differed from the federal law in several important respects. First, the state and federal regulations differed markedly with respect to the timing of disclosure: unless a precommencement notification was filed with an appropriate official prior to a tender offer, a large number of states would not allow a tender offer to commence. In contrast, the Williams Act requires disclosure at the commencement of a tender offer when the offeror files a schedule with the SEC. Second, under the Williams Act, both bidder and the target company are required to disclose information, whereas first generation statutes required only the tender offeror to reveal information. Third, the state statutes generally required more extensive and detailed disclosure than the Williams Act.[523]

These provisions were often drafted in haste and were tailored to meet a specific 'emergency.'[524] In spite of the fact that many of these statutes failed constitutional challenges under the supremacy and commerce clauses [525] such legislation was extremely popular with a total of 37 states passing similar legislation.[526]

On June 23, 1982 the first generation period ended with the decision of the United States Supreme Court in Edgar v.

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[523] Cronin, supra n. 506 p. 1035.

[524] Yoder, supra n. 521 p. 86.

[525] Cronin, supra n. 506 p. 1036.

[526] Yoder, supra n. 521 p. 86.

Mite Corp..[527] In that ruling the court found that the Illinois Business Takeover Act[528] was unconstitutional because it "impos[ed] a substantial burden on interstate commerce which outweigh[ed] the putative local benefits."[529] The court applied the test in Pike v. Bruce Church, Inc.[530] wherein such burden is proved where the burden imposed upon commerce is excessive in relation to the local interests served by the statute.[531] The ruling effectively in-

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[527] 457 U.S. 624, 73 L. Ed. 2d 269, 102 S. Ct. 2629 (1982).

[528] Cronin, supra n. 506 footnote #58:

> Ill. Rev. Stat. ch. 121-1/2, §§ 137.51-.70 (1979) (repealed 1983). The Illinois takeover statute applied to any takeover bid where 10% of the target's shareholders were Illinois residents notwithstanding the fact that the company was not incorporated or headquartered in Illinois. The legislation was typical of many first generation statutes in that it contained: (1) a precommencement notification requirement whereby the offeror had to notify the secretary of state 20 days before the offer; (2) a hearing provision during the 20-day waiting period allowing the secretary of state to adjudicate the fairness of the offer; and (3) a substantive fairness provision allowing the secretary of state to deny tender offer registration when the offer is deemed unfair or where full disclosure has not been made.

[529] Mite, 457 U.S. at 646.

[530] 397 U.S. 137 (1970).

[531] Cronin, supra n. 506 p. 1037:

> The Illinois takeover statute failed the Pike test because the law imposed a nationwide jurisdictional reach which gave Illinois the purported power to determine whether a tender offer might proceed anywhere. This intestate burden, accord-

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validated the takeover laws of all 37 states.[532]

Following this decision concerned states undertook to revise their legislation in an effort to avoid the pitfalls set out in Mite. These new laws were still intended to impede takeovers but with an eye to surviving a constitutional challenge. They were in fact a 'second generation' approach to the concern at hand and were often included as part of the state's general corporation laws.[533] For the most part these laws were of six basic types:

1. **Control Share Acquisition Laws** (The Ohio Approach): This type of statute was initially developed and adopted by the State of Ohio, with Indiana also following this approach. The Ohio statute is a typical example of this type of provision. Under this type of law,

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[531](...continued)
ing to the Court, outweighed the state interest of protecting resident shareholders as well as its interest in regulating the internal affairs of its corporations. Specifically, the MITE Court fond that Illinois had "no legitimate interest in protecting nonresident shareholders"; moreover, the Court was not convinced that the takeover statute significantly enhanced shareholder protection beyond the Williams Act's substantive provisions. The Court also rejected applying the internal affairs doctrine for two reasons: (1) since tender offers intend that stock be transferred to third parties, the internal affairs of the target company are not involved; (2) the takeover statute applies to companies not incorporated in the state or having their principal place of business there. In sum, the Court found that the Illinois statute was overreaching under the commerce clause because it affected foreign corporations and nonresident shareholders.

[532] Supra n. 8 p. 501.

[533] Yoder, supra n. 521 p. 88.

an entity acquiring "control shares" in a corporation subject to this law obtains voting power of those shares only when a majority of all shareholders, excluding the "interested shares," grants this voting power at a shareholders' meeting specially called by the board of directors after the corporation receives an "acquiring person statement" from the acquirer. If voting rights are not granted, the corporation may redeem the acquirer's shares.

2. **Fair Price Laws** (The Maryland Approach): Developed by the State of Maryland, its statute is a typical example of this type. Under this type of statute, any business combination involving a resident corporation and a shareholder owning a minimum percentage (for example; 10 or 20 percent) of the resident corporation stock must be recommended by the board of directors and approved by a high percentage (for example; 80 or 95 percent) of the owners of outstanding shares, unless the minority shareholders are to receive, in the business combination, an amount of compensation for their shares that satisfies the fair-price provision of the statute.

3. **Heightened Appraisal Rights, also known as Control-Share Cash-Out-Laws** (Pennsylvania and Maine Approaches): Both Pennsylvania and maine were on the forefront in developing and adopting this type of regulation, and their statutes are good examples of this type. Under this type of statute, an entity acquiring a certain percentage of the stock of a corporation (for example; 25 or 30 percent) must notify remaining shareholders, who then have a right for a reasonable period of time thereafter, to demand cash payment for their shares at a fair-value amount prescribed by the statute.

4. **Five Year Moratorium Laws** (The New York Approach): Developed and adopted in New York, its statute is typical of this type. This type of statute prohibits an interested shareholder (one who obtains 10 or 20 percent of the corporate stock, for example) from participating in a business combination with the corporation for the five-year period

following achievement of the interested shareholder status unless the board of directors approves either of the following prior to the acquirer becoming an interested shareholder:

a. the business combination; or

b. the stock purchase that created the interested shareholder status.

5. **Expanded Constituency Laws** (Illinois Approach): Adopted by Illinois initially, its statute is a typical example of this type of provision. These permissive statutes give the board of directors the power to consider both short-term and long-term effects, not only on corporate shareholders, but also on corporate employees, customers, communities, and suppliers, in determining the best interests of the corporation in any action taken.

6. **Heightened Disclosure Statutes** (Minnesota Approach): Developed and initially adopted by Minnesota, its statute is typical of this type of provision. This disclosure type of statute requires, for effective offers, that potential acquirers file a registration statement with the State Commissioner of Securities. If the filing is insufficient, the commissioner is empowered to suspend the takeover, with a hearing, and final determination occurring rapidly thereafter.[534]

As a number of states applied various combinations of the above or modified provisions to meet specific needs, the classification of these statutes is both overlapping and complex. However following the Mite decision and during the second generation period hostile takeovers proceeded in a relatively unregulated environment having for the most part only to comply with minimum timing and disclosure require-

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[534] Ibid. p. 88-89.

ments as set out under federal securities laws.[535]

All of this changed suddenly with the United States Supreme Court decision in CTS Corporation v. Dynamics Corporation of America.[536] In a surprising verdict the court held that one of these second generation anti-takeover statutes was constitutional. The Act in question was Indiana's Control Share Acquisition Act of 1986 which provided that

> "an acquiror of 20%, 33% or 50% of shares in an Indiana corporation must obtain approval of the majority of the outstanding shares and a majority of the disinterested outstanding shares before it can exercise the voting rights of the purchased shares."[537]

The court in making its ruling stated that "No principle of corporate law and practice is more firmly established than a state's authority to define the voting rights of shareholders."[538] The Act survived constitutional attacks on both the Commerce and Supremacy grounds. The court chose not to apply the Pike test; rather it focused on the internal affairs doctrine which permits states to define and regulate the corporations it charters.[539] While the Act was

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[535] Supra n. 8 p. 501.

[536] 481 U.S. _____, 95 L. Ed. 2d 67, 107 S. Ct. 1637 (1987).

[537] Supra n. 8 p. 502.

[538] CTS, 109 S. Ct. at 1642.

[539] Cronin, supra n. 506 p. 1049.

found to have some effect on intestate commerce, the court found that this was true only to a "limited extent."[540] Hence there was no perceived violation of the Commerce Clause. Further the court held that the Act was reconcilable with the Williams Act and as such met the Supremacy test. In doing so the court stated that:

> [u]nlike the MITE statute, the Indiana Act does not give either management or the offeror an advantage in communicating with the shareholders about the impending offer. The Act also does not impose an infinite delay on tender offers. ... Nor does the Act allow the state government to interpose its views of fairness between willing buyers and sellers of the target company. Rather, the Act allows **shareholders** to evaluate the fairness of the offer collectively.[541]

The Indiana Act was held to be consistent with the "text and purposes of the Williams Act"[542] in spite of the fact that it altered existing federal laws.[543]

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[540] CTS, 109 S. Ct. at 1652.

[541] Ibid. p. 1646.

[542] Ibid. p. 1648.

[543] Cronin, supra n. 506 p. 1046-1047:

> The Court specifically addressed the Seventh Circuit's finding that the fifty-day delay under the Indiana statute precluded an offeror from purchasing shares as soon as the federal law permitted. Since voting rights may not be conferred until a special stockholder meeting, which must be convened within fifty days after the commencement of the offer, the court of appeals found that the statute conflicted with the twenty-business-day period established by federal law. However, the Court viewed the "alleged conflict

(continued...)

Central to the decision was the theme that individual states had the authority to regulate tender offers within their own jurisdiction. Further that in doing so they act with a valid purpose where the law seeks to protect shareholder interests ... "it is well within the state's role as overseer of corporate governance" to afford "shareholders, when a takeover offer is made, an opportunity to decide collectively whether the resulting change in voting control of the corporation, as they perceive it, would be desirable."[544] Further the court indicated that states have the

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[543](...continued)
illusory" stating that "[i]f an offeror fears an adverse shareholder vote under the Act, it can make a conditional tender offer, offering to accept shares on the condition that the shares receive voting rights within a certain period of time." Moreover, the Court stated that even if there was a delay imposed by the statute, the delay was still within the congressionally determined period of time and therefore not unreasonable.

Finally, the Court found that other devices, such as staggering the terms of directors or cumulative voting, might delay takeovers but rejected the notion that these traditional state controls should be preempted by the Williams Act. The Court viewed the delay of voting control as having longstanding prevalence within the dominion of state regulation. In sum, the Court stated that "if Congress had intended to preempt all state laws that delay the acquisition of voting control, it would have said so explicitly.

[544] CTS, 109 S. Ct. at 1651. Significantly the Indiana Act requires that the corporation have either (a) more than 10% of its shareholders resident in Indiana; (b) more than 10% of its shares owned by Indiana residents; or (c) 10,000 shareholders resident in Indiana. See Ind. Code § 23-1-42-4(a) (Supp. 1986). Hence the Act operates only where there is a substantial state interest involved.

authority to define the nature of their corporations' stock;

> [t]he very commodity that is traded in the securities market is one whose characteristics are defined by state law. Similarly, the very commodity that is traded in the "market for corporate control"' - the corporation - is one that owes its existence and attributes to state law. Indiana need not define these commodities as other States do; it need only provide that residents and nonresidents have equal access to them. This Indiana has done. Accordingly, even if the Act should decrease the number of successful tender offers for Indiana corporations, this would not offend the Commerce Clause.[545]

Thus the Supreme Court through CTS has defined to some extent the parameters under which a Control Share Acquisition statute may validly operate. However the impact of this case on other types of second generation statutes is still very much at issue.[546] To add uncertainty the CTS decision has encouraged other states to enact some form of third generation takeover legislation, again to limit hostile corporate mergers and acquisitions through tender offers.[547] At least thirteen states have done so, including Delaware,[548] whose legislation prevents completion of a takeover for three years once the raider obtains 15% of a

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[545] Ibid. p. 1652.

[546] Supra n. 8 p. 502.

[547] Cronin, supra n. 506, p. 1056.

[548] Delaware's takeover law is entitled "Business Combinations with Interested Shareholders." See Del. Code Am. tit. 8, § 203 (1988). See also N.Y. Bus. Corp. Law § 912; N.Y. Bus. Corp. Act, § 14A:10A; Mich. Comp. Laws Ann. § 450.1775.

publicly held corporation unless

> (1) the target board of directors approves of the merger or acquisition prior to the acquirer becoming an interested stockholder; (2) the acquirer gains control of the board of directors and wins the vote of two-thirds of the shares that it does not own at the annual meeting or in a special election; or (3) the acquirer can buy 85% of the shares in a single transaction, excluding the shares held by directors who are officers and certain employee stock plans.[549]

In addition to the three situations noted above, there are a number of further exemptions incorporated in the legislation.[550]

Due to the dominance of Delaware in this arena the legislation at issue will have some considerable national

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[549] Cronin, supra n. 506 p. 1056-1057.

[550] Ibid. p. 1508, footnote #224:

> There are other situations in addition to the three main exemptions above whereby the moratorium provision will not apply: (1) the corporation's original certificate of incorporation contains a provision exempting itself from the statute; (2) the board of directors elects within 90 days of enactment of the statute to opt out of the statute; (3) a majority of shareholders elect to amend the certificate of incorporation or bylaws to opt out of the statute, but such an amendment will not apply for one year nor will it apply to any interested stockholder of the corporation prior to its adoption; (4) the corporation does not have a class of voting stock listed on a national securities exchange or has 2,000 or less stockholders of record; (5) a stockholder became an interested stockholder inadvertently; (6) an interested stockholder proposes a business combination with a third party who has not been an interested shareholder within three years, and the board of directors approves of the transactions.

impact. However its local effect may be somewhat dampened by the fact of its numerous stated exemptions and that most Delaware corporations have neither their principal assets or principal place of business in the state. No doubt however, this law will inhibit hostile takeovers to some extent. This is due in part to the moratorium provision which in effect prevents the raider from paying off loans used to consummate the takeover through the sale of target assets.

The first constitutional challenges to section 203 came within hours of Governor Michael Castle's signing it into law. Black and Decker filed suit against American Standard, Inc. in the U.S. District Court for the District of Delaware and in the Southern District of New York the Campeau/-Federated Department Stores takeover battle generated another challenge. However neither case decided the constitutionality of the section.[551] The first case to speak to the merits of the statute was BNS Inc. v. Koppers Co.,[552] in which Chief Judge Schwartz upheld the constitutionality of the law. Its ultimate fate is however still undecided as it clearly does not operate in the same manner as does the Indiana Statute considered in CTS. It has been argued that the Delaware statute gives more power to

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[551] N. Veasey, J. Finkelstein, R. Shaughnessy, The Delaware Takeover Law: Some Issues, Strategies and Comparisons (1988) 43 The Business Lawyer 865, 881.

[552] 683 F. Supp. 458 (D. Del. 1988). See also RP Acquisition Corp. v. Staley Continental Inc., 686 F. Supp. 476 (D. Del. 1988) which followed the BNS holding.

directors than to shareholders in determining the ultimate fate of a tender offer. Further that it may in fact violate the neutrality between target and raider relative to the shareholder's interest, as intended in the Williams Act, and thus may be subject to preemption.[553] Equally however it may be compatible with both Mite and CTS because, consonant with the internal affairs doctrine, "it does not seek to extend its scope beyond its incorporated companies" and in regard to neutrality it does "give shareholders some autonomy in determining the outcome of a takeover bid."[554]

In addition to state generated legislation several bills have recently been introduced to Congress. This legislation would amend the Williams Act in response to the flood of takeover bids.[555]

In summary, the impact of the current regulatory environment upon directors is one which must be considered prior to the implementation of any response to a takeover bid. Directors must seek to reconcile the applicable common law and state and federal legislation in addition to Model Act and ALI formulations with the particular facts at hand. As we have seen, there is no single approach which will guarantee a liability free decision. These legal directives

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[553] Cronin, supra n. 506 p. 1061.

[554] Ibid.

[555] Eg. The Tender Offer Disclosure and Fairness Act s. 1323, 10th Cong., 1st Sess. (1987); H.R. 2172, 100th Cong., 1st Sess. (1987) (Tender Offer Reform Act of 1987).

form but a rugged road on a corporate landscape filled with crevices and precipices yet unknown. The corporate director has at best a legal compass with which he might hold a course. Only an unerring sense of fair play, good common sense and a thorough understanding of the law will guide today's director to the legal high ground.

PART VIII

A. DUTY OF CARE

1. STATUTORY AND COMMON LAW STANDARDS

Canada takes its present day common law standard from a long line of English decisions which can be traced back to the Victorian era.[556] The case law itself set a very low standard in that only "when (a director's) imprudence [had] been so great and so manifest as to amount to gross negligence"[557] would he be called to account for his actions. This standard reflected the times in that during this period directors were often merely figureheads or titled people with time on their hands[558] and if shareholders wished to elect incompetent amateurs to head the corporate enterprise the courts would not intervene.[559]

The 'modern day' common law standard was set forward in

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[556] See, e.g., Turquand v. Marshall (1869) L.R. 4 Ch. App. 376; Re Denham & Co. (1883), 25 Ch. D. 752; and Marquis of Bute's Case, [1892] 2 Ch. 100.

[557] Ferrar, John H., Company Law, (London: Butterworths, 1985) at p. 317.

[558] Ibid.

[559] Turquand v. Marshall (1869) 4 Ch. App. 376 at 386 per Lord Hatherly L.C.

the City Equitable[560] case, again a product of its time, reflecting a relaxed standard of care requirement. This case both summed up the judicial attitude of the day and continues to serve as the background for current statutory stipulations which set out minimum standards of conduct.[561] In City Equitable Mr. Justice Romer set forward this standard as follows:

> In discharging the duties of his position ... a director must, of course, act honestly; but he must also exercise some degree of both skill and diligence. To the question of what is the particular degree of skill and diligence required of him, the authorities do not, I think, give any very clear answer. It has been laid down that so long as a director acts honestly he cannot be made responsible in damages unless guilty of gross or culpable negligence in the business sense. ... If, therefore, a director is only liable for gross or culpable negligence, this means that he does not owe a duty to his company, to take all possible care. It is some degree of care less than that ....
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> There are .. one or two other general propositions that seem to be warranted by the reported cases: (1). A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. ... It is perhaps only another way of stating the same proposition to say that directors are not liable for mere errors of judgment. (2). A director is not bound to give continuous attention to the affairs of his company. ... (3). In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left

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560 Re City Equitable Fire Insurance Company Ltd., [1925] 1 Ch. 407.

561 Corporate Directors' Liability, Institute of Law Research and Reform: Research Paper No. 17 (The Institute of Law Research and Reform, Edmonton, Alberta, Feb. 1989).

> to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly.[562]

The first proposition sets forward a very low subjective test. The less experienced a director the less that is required of him. For example in Re Brazilian Rubber Plantations and Estates Ltd.[563] Neville J. stated:

> A director's duty has been laid down as requiring him to act with such care as is reasonably to be expected from him, having regard to his knowledge and experience. He is, I think, not bound to bring any special qualifications to his office. He may undertake the management of a rubber company in complete ignorance of everything connected with rubber, without incurring responsibility for the mistakes which may result from such ignorance; while, if he is acquainted with the rubber business he must give the company the advantage of his knowledge when transacting the company's business.[564]

In reflecting upon the subjective nature of the test one commentator has expressed the view that "as with many other areas of common law, ignorance may be no defense, but stupidity nearly always is."[565] In stating that directors

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[562] City Equitable [1925] 1 Ch. 407, 427-29.

[563] [1911] 1 Ch. 425.

[564] Ibid.. This statement was affirmed in City Equitable at p. 428.

[565] Welling, B., Corporate Law in Canada (Toronto: Butterworths 1984) at p. 329;

> The subjective nature of the common law duty is well established. Perhaps the best example in

(continued...)

were not liable for 'mere errors in judgment' Romer J. was reflecting the view that business judgments did not lie within the purview of the courts and thus they would not be questioned.[566]

The second proposition recognizes the director's function as intermittent in nature with his attendance at meetings required only when under the circumstances he is reasonably able to do so.[567] In addition directors are under no obligation to become involved with the affairs of the corporation.[568]

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[565](...continued)
English law is **Re Denham & Co.**, in which fraudulent balance sheets were prepared by the defendant's fellow directors and were certified by the auditors. The defendant director was proved to have trusted his fellow directors and auditors, had managed to avoid directors' meetings for four years, and had refrained from looking into the books. Irresponsible as this behaviour may sound the courts were impressed by the fact that the director was "a country gentleman" and they were therefore not willing to require much of a standard of him.

Note however that the test also has an objective component in that once the level of competence has been ascertained, the director will be judged on the basis of what he might reasonably have done under the circumstances at hand. Thus the test for 'skill' is subjective vs. an objective test for 'care.'

[566] This is of course the same position taken by the U.S. courts, however unlike the United States, the Canadian judiciary did not develop a business judgment rule.

[567] City Equitable [1925] 1 Ch. 407, 429.

[568] Re Brazilian Rubber Plantations and Estates Ltd. [1911] 1 Ch. 425, 437 per Neville J. See also Re Cardiff Savings Bank, Marquis of Butes' Case [1892] 2 Ch. 100,
(continued...)

The third proposition reflects the business necessity of delegation but with the caveat that directors retain the duty of oversight where applicable. Thus in City Equitable

> "Romer J. suggested that before declaring a dividend the directors should have a complete list of the company's assets before them and ought not to be guided as to the value of their company's assets merely by the assurances of their chairman, however apparently distinguished and honourable, nor with the expression of belief of the auditor, however competent and trustworthy."[569]

Thus at common law a director's actions will be judged on the basis of his particular skills applying next an objective standard to the care taken by a director with this

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[568](...continued)
Welling, supra n.565:

> The high point for inattention to duty was undoubtedly the **Marquis of Bute's** case, in which the presidency and directorship of a bank were inherited by the six-month old Marquis of Bute. He was found not liable in an action involving irregularities in the bank's lending operations. The Marquis had managed to attend only one board meeting in 38 years, having by chance happened through Cardiff at the time of the meeting. Although we have not managed to come up with a comparable silly Canadian case, it appears clear that the Canadian common law requirement was similar and that a director could discharge his duty by trusting in the honesty and capabilities of corporate officials and fellow directors. The only reported case in English law where a director was held liable for non-attendance is **Charitable Corpn. v. Sutton**, a case which is not only unique, but undoubtedly too old to be of much interest. In a nutshell, the common law rule appears clear: the less a director managed to do, the less likely he was to be found legally responsible.

[569] Farrar, supra n.557, p. 321.

particular knowledge and experience. As to diligence a director may remain uninformed if he chooses but if he does not his actions will be judged in accordance with the knowledge he has obtained in concert with the test of skill and care as set out above.

While the common law forms the foundation this area has come under some considerable change as a direct result of statutory initiative to raise the standard of care at both the provincial and federal levels.

In 1968, Ontario first introduced a legislated standard which was intended to raise the standard of care, skill and diligence required of directors. The language was couched in terms of the "reasonably prudent director." However when the Act was reintroduced in 1970 this was changed to "the reasonably prudent person" as follows;

> S.142. Every director and officer of a corporation shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the corporation, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. R.S.O. 1970, c.53, s.144.[570]

Notably this change is presumed to require a diminished standard when compared to that of the professional direc-

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[570] Ontario Business Corporations Act, R.S.O. 1980, C-54.

tor.[571] While the language of this section is very similar to that used by Romer J. in City Equitable the intent of the section is to raise the standard beyond that set forward in the Common law.

On the federal level s.122(1) sets down the following standard:

> 122. (1) Every director and officer of a corporation in exercising his powers and discharging his duties shall
>
> (a) act honestly and in good faith with a view to the best interests of the corporation; and
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in

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[571] Ivan Feltham and William Rauenbusch, Directors' and Officers' Liabilities in Canada 1975-76 1 Canadian Business Law Journal 321, 328;

> This is generally presumed to require a lesser standard of care than that of the "professional director", a standard of care that was implicit in the recommendation of the Lawrence Committee that preceded the revision of the Act. Moreover, the phrase "in comparable circumstances" in the legislative standard is intended to make relevant all of the circumstances in which a decision is made including the significance of the action to the company, the information reasonably available to the director when making the decision, the time available for making the decision, the alternative open to the company and similar factors affecting the decision-making process. Some commentators take the view that the phrase "in comparable circumstances" is also intended to enable a court to take into account the peculiar knowledge or lack of knowledge of the individual director. It might also be used to apply different standards to a director depending on whether he is an "outside" or an "inside" director, a representative of a special interest group, or a professional adviser to the corporation, such as a lawyer or an accountant.

comparable circumstances.[572]

This section mirrors the Ontario legislation and was similarly intended to raise the standard of care.[573] A number of Provinces including Manitoba have passed similarly worded sections.[574] However, while the intent was to raise the standard of care, there is some considerable doubt as to whether this has been achieved. A closer examination of the three component parts of this duty will provide a suitable framework within which to examine the issue.

Arguably the first component of skill has remained unchanged. If one accepts the fact that the reasonably prudent person may have no particular capacity or knowledge of an area which by circumstance he is addressing as a director then the exercise of his 'skill' may be measured by these particular circumstances. Remember this subjective element may fall squarely within the wording which relates the test to "comparable circumstances." Hence "the level of skill possessed by the particular manager in question is

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[572] Canada Business Corporation Act 1974-75-76, C.33, s.1.

[573] Feltham and Rauenbausch, supra n.571, p. 329; the Federal Task Force Report Vol. I at p. 83: "Recent experience has demonstrated how low the prevailing legal standard of care for directors is and we have sought to raise it significantly."

[574] M.C.A. s.117(1). See also the A.B.C.A., S.B.C.A., B.C.C.A., N.B.B.C.A., O.B.C.A.

part of the circumstances."[575]

Similarly it has been argued that the standard of 'care' set forward is to be evaluated subjectively.

> Note that the concepts of care and diligence are separated in the section. This suggests that the word "care" is to be interpreted in terms of the lawyer's notion of "standard of care" rather than the layman's rather looser idea of "careful." Notwithstanding that some minimal objective notion of "carefulness" might arguably be required, there seems no doubt that business judgment can still not be questioned and that it is the manager's personal knowledge and background or experience, not some objective notion of the "reasonable manager" that is the benchmark. In effect, what is imposed here is a requirement that a director or officer, when he actually does undertake some particular task, do so with the care that "a reasonably prudent person would exercise in comparable circumstances." This, we suggest, primarily requires some degree of attention to detail in performing any particuarl managerial task. A director or officer may be utterly unskilled, but if he does undertake a task he must apply what skills he has to work out in some detail what is to be done. Viewed in this manner, the statutory enactment of a "care" requirement does not seem to have altered the common law.[576]

Happily it would appear that at least in the area of diligence some considerable progress has been made. Whereas at common law almost no diligence was good diligence these statutes provide that directors must exercise the diligence of a 'reasonably prudent person.' Read in this light the steps which a reasonably prudent person acting in the capacity of a director would take in comparable circumstan-

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575 Welling, supra n.565, p. 332.

576 Ibid.

ces, now become objectively defined. It is argued that such a person given today's corporate environment would in fact be diligent.

As a further caution directors may be subject to varying standards of diligence depending primarily upon the nature of the breach where a specific statutory requirement is at issue. For example in the case of Fraser v. MNR[577] the diligence standard was applied against s.227.1(1) of the Income Tax Act.[578] This section seeks to impose personal liability on directors where taxes are deducted but not remitted;

> Where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or section 153 or 215, has failed to remit such an amount of or has failed to pay an amount of tax for a taxation year under Part VII or VIII, the directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally liable, together with the corporation, to pay that amount and any interest or penalties relating thereto.[579]

However a director may avoid personal liability as follows:

> A director is not liable for a failure under subsection (1) where he exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have

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[577] 87 D.T.C. 250 (T.C.C.).

[578] R.S.C. 1952, C.148, as amended by S.C. 1970-71-72, C.63.

[579] Enacted by S.C. 1980-81-82-83, C.140, subsection 124(1); amended by S.C. 1983-84, C.1 subsection 100(1).

exercised in comparable circumstances.[580]

The general corporations standard was intended to apply. The facts are as follows;

> Fraser, the appellant taxpayer, was the director of a recently incorporated company. As vice-president of manufacturing operations, he was responsible both for securing raw materials and for producing and shipping the company's products. Fraser held 15 of the 100 shares of the company's capital, Foster (a director and president of the company) held 48 shares, and Bolton (a director and president of the company) held the remaining 37 shares. Bolton was a chartered accountant who worked full-time with an accounting firm and attended the company's premises about twice a month to sign documents and cheques. He and Foster were primarily responsible for the issuance of cheques. Fraser also had signing authority, but exercised it only once over a two-year period.
>
> About one and one-half years after incorporation, the company started experiencing cash flow problems and had difficulties in securing raw materials and in meeting its payroll. Fraser became aware that the company was experiencing some kind of tax problem, but was assured by the other directors who were responsible for financial matters that the problem was being taken care of and that he should not be concerned. Fraser again raised the matter two months later, just before the closing of the business, and was assured at that time that a company receivable would be used to pay the taxes. At no time did Fraser learn of the exact nature of the indebtedness. He was unaware that, in fact, the company had been failing to remit the amounts withheld from employees' wages. The minister assessed Fraser in his capacity as a director of the company under subsection 227.1(1) for the amounts that the company had failed to remit. Fraser's trustee in bankruptcy appealed to the Tax Court of Canada.
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> The court dismissed the appeal of the trustee in

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[580] Ibid. at subsection 124(3).

> bankruptcy of Fraser's estate. It held that subsection 227.1(1) imposed a duty on directors to ensure that the corporation performed the obligations listed in the subsection by making them vicariously liable for any failure of the corporation to perform such a duty. The court found that Fraser had failed to demonstrate that he "exercised the degree of care, diligence and skill to prevent the failure that a reasonably person would have exercised in comparable circumstances" because he had done absolutely nothing to prevent the failure. The court also held that the presence of other directors who were capable (if so inclined) of preventing the default was not, standing alone, sufficient to afford Fraser the protection of subsection 227.1(3).[581]

In their judgment the court did not specifically deal with the standard of care and skill that should have been applied, rather they turned to the issue of diligence. In holding against Fraser the court did not consider his reliance upon the statements of Foster and Bolton as justified vis a vis s.227.1(1). The court indicated that reliance under this section might be reasonable only where a specific resolution were passed delegating special responsibility to one or other of the directors. This is notable given that the facts indicate that Bolton was in fact responsible internally for the remittance of these taxes and had the requisite expertise and capacity to deal with the issue at hand. The courts' focus was on the lack of a properly defined procedure that might have ensured compliance. Thus the duty of diligence is a flexible principle

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[581] Lynn Campbell, The Fiduciary Duties of Corporate Directors: Exploring New Avenues (1988) Vol. 36, No. 4 Canadian Tax Journal p. 914-915.

whose application is dependent upon the wording of the statute itself.

> The duty to exercise diligence is more exacting than the common law duty to exercise skill and care. The amount of diligence required may be measured by the requirements of the particular statute. These requirements establish the rules of conduct that a director must follow to avoid a breach. Judgment or experience is not an issue in determining whether a director has acted in a reasonable way. The "reasonableness" test is applied to the action taken by the board of directors to ensure that effective procedures and controls have been put in place to ensure compliance with a particular piece of legislation.
>
> Diligence, moreover, must be exercised by each member of the board of directors. A director must take action to make certain that a corporation complies with a statutory requirement. Accordingly, as soon as a director becomes aware of a possible statutory breach, he or she must do everything reasonable to ensure that the corporation puts effective procedures and controls into place to prevent the recurrence of such breaches. If there is no appropriate internal arrangement, an individual director must take action, even though there is another director who is capable and who has the authority to prevent the breach of any specific statutory requirement.[582]

Fraser may be a 'hard' case given the facts but it sends a warning to all corporate directors to be vigilant and informed of their various statutory obligations. Unhappily however the case law continues to give little or no direction concerning the manner in which the judiciary will assess the care and skill required of directors.

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[582] Ibid. p. 918.

2. RELIANCE ON EXPERT ADVICE

The common law standard under which a director may be judged reflects the same lax attitude indicative of the care, skill and diligence requirement. Where by statute this standard has not been elevated the common law will apply.[583] The level of care required is exemplified in the case of Huckerby v. Elliot[584] wherein a director relied upon corporate officials. The court stated:

> [I]t is perfectly proper for a director to leave matters to another director or to an official of the company, and that he is under no obligation to test the accuracy of anything that he is told by such a person, or even to make certain that he is complying with the law.[585]

It has been argued however that even where a statutory diligence requirement is not present the standard of care has in fact been raised somewhat since the era in which the Marquis of Bute case was decided.[586] This position rests upon the analogy that since the level of care has been raised as regards auditors the same might be said for

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[583] Welling, supra n.565 p. 334.

[584] [1970] 1 All E.R. 189 (Eng., D.C.).

[585] Ibid. p. 194.

[586] Welling, supra n.565, p. 334.

directors.[587] However since the level of speculation appears to exceed the level of judicial support for this theory it is quite likely the case that a relatively low standard continues to exist at common law.

This standard may have been raised in some jurisdictions through the passage of legislation. For example the C.B.C.A. sets forward the following:

> S.123(4) A director is not liable under section 118, 119 or 122 if he relies in good faith on
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> (a) financial statements of the corporation represented to him by an officer of the corporation or in a written report of the auditor of the corporation fairly to reflect the financial condition of the corporation; or
>
> (b) a report of a lawyer, accountant, engineer, appraiser or other person whose profession lends credibility to a statement made by him. 1974-75-76, c.33, s.118.[588]

Several other provinces including Manitoba[589] have reformed their legislation to include the same or similar provision. Significantly the legislation affords protection where the director relies in 'good faith' upon the information given to him. The question then becomes what is the standard of good faith required to gain the protection afforded by this section. On the one hand a director may be acting in good

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587 Ibid.

588 Supra n.572, s.123(4).

589 M.C.A.s.184(4).

faith but entirely ignorant of facts which due to his negligence cause damage to the corporation. On another level is he to be held liable for negligent conduct but not for reliance which was based on deficiencies the result of a personal lack of knowledge in the area. Or is the director to be held to an even higher standard equal to that demanded by due diligence. In all likelihood the first proposition is the correct one. It would appear that simple good faith may provide a safe harbour.

Notably Ontario does not have a similar provision in its Business Corporations Act. However it does incorporate a statutory standard for skill, care and diligence.[590] The inference may then be drawn that good faith alone will not exonerate a director who has failed to meet his statutory obligation. The issue then becomes whether the standard should be subjectively oriented as with care and skill or objective as reflected in respect to diligence. Bruce Welling sets forward his belief as follows:

> In sum, those Canadian jurisdictions with a statutory test have imposed a legal duty on directors and officers, requiring them to do the best that they personally can with their own skills and business judgment, but to act reasonably diligently in protecting against their own imperfections by seeking assistance, where appropriate, from seemingly qualified advisors.[591]

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590 Supra n.570.

591 Supra n.565, p. 334.

Thus beyond seeking advice there would appear to be no further duty to ensure as to its merits. In addition directors in Manitoba and those of Federally chartered corporations appear to have an open door in respect of whose advice they may consider. Indeed the word 'profession' is undefined and therefore may include any business or calling which the advisor does in exchange for money.[592]

3. OVERSIGHT

Canadian directors are no less responsible for guiding the corporate enterprise as are their American counterparts. Included therein is the necessity to delegate both tasks and authority. City Equitable puts forward the common law position.[593] This appears to have remained unchanged. Indeed the ability to delegate to other members of the board has been codified. For example the C.B.C.A. provides as follows:

> 115.(1) Directors of a corporation may appoint from their number a managing director who is a resident Canadian or a committee of directors and delegate to such managing director or committee

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592 Ibid.

593 Supra n.562 ... (3) "In respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official a director is in the absence of grounds for suspicion justified in trusting that official to perform such duties honestly."

any of the powers of the directors.[594]

Similar provisions appear in other jurisdictions including Manitoba.[595] It is reasonable to assume that any

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[594] C.B.C.A. supra n.572, s.115(1). Note however that this authority is restricted by s.115(3):

> (3) Notwithstanding subsection (1), no managing director and no committee of directors has authority to
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> (a) submit to the shareholders any question or matter requiring the approval of the shareholders;
> (b) fill a vacancy among the directors or in the office of auditor;
> (c) issue securities except in the manner and on the terms authorized by the directors;
> (d) declare dividends;
> (e) purchase, redeem or otherwise acquire shares issued by the corporation;
> (f) pay a commission referred to in section 41;
> (g) approve a management proxy circular referred to in Part XIII;
> (h) approve a take-over bid circular or directors' circular referred to in Part XVII;
> (i) approve any financial statements referred to in section 155; or
> (j) adopt, amend or repeal by-laws. 1974-75-76, c.33, s.110.

[595] M.C.A. s.110(1). Ontario allows for such delegation through s.131 of the O.B.C.A:

> **131.**-(1) Where the number of directors of a corporation is more than six, and if authorized by a special by-law, the directors may elect from among their number an executive committee consisting of not fewer than three of whom, except where the corporation is a non-resident corporation, a majority shall be resident Canadians and the directors may delegate to the executive committee any powers of the board of directors, subject to the restrictions, if any, contained in the by-law or imposed from time to time by the directors. 1974, c.26, s.5(1).

(continued...)

delegation of authority must be made in good faith and to individuals who by virtue of their professional abilities form a credible choice. Beyond this there is no obligation to ascertain that the work is done honestly in the absence of suspicion to the contrary.

While there is no direct statutory authority permitting directors to rely upon the reports of committees of the board the authority to delegate would include this right. As a result reliance upon these reports would also be subject to the same duty of care.[596]

4. PROTECTION FROM LIABILITY

In general terms a corporation may through its articles, by-laws, or resolutions provide protection against personal liability for a breach of directoral duty subject to any applicable legislative provision to the contrary. In this regard a corporations statute will either explicitly state that its authority may not be diluted or it may be silent. In the latter circumstance the section under

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[595](...continued)
This section is more restrictive in its approach than is Manitoba or the C.B.C.A, however there is no companion section which serves to limit the authority of this executive committee by statute.

[596] Further reference under the general heading of the Duty of Diligence may be found in The Independent Corporate Director, Recommendations and Guidance on Boardroom Practice (Ontario: The Institute of Corporate Directors in Canada 1987).

consideration may be opted out only where its terms do not demand compliance.

The C.B.C.A., M.C.A., A.B.C.A. and the O.B.C.A. will be reviewed for the purpose of examination and by way of example. Section 124 of the C.B.C.A. states:

> 124.(1) Except in respect of an action by or on behalf of the corporation or body corporate to procure a judgment in its favour, a corporation may indemnify a director or officer of the corporation, a former director or officer of the corporation or a person who acts or acted at the corporation's request as a director or officer of a body corporate of which the corporation is or was a shareholder or creditor, and his heirs and legal representatives, against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by him in respect of any civil, criminal or administration action or proceeding to which he is made a party by reason of being or having been a director or officer of such corporation nor body corporate, if
>
> (a) he acted honestly and in good faith with a view to the best interests of the corporation; and
>
> (b) in the case of a criminal or administrative action or proceeding that is enforced by a monetary penalty, he had reasonable grounds for believing that his conduct was lawful.

In effect good faith is again a reasonable excuse regardless of the existence if any of negligence in the decision making process. Such indemnification is a right where compliance with this section is achieved.[597] In

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[597] C.B.C.A. s.124(3):

> (3) Notwithstanding anything in this section, a
> (continued...)

addition the C.B.C.A. allows the corporation to purchase directors and officers insurance which may not provide protection for a breach of fiduciary duty but will protect a director where he is in breach of his duty of care, skill or diligence.[598] The sections referred to are immutable.

Manitoba's legislation follows the C.B.C.A. in similar fashion and is also insulated against dilution.[599]

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[597](...continued)
person referred to in subsection (1) is entitled to indemnity from the corporation in respect of all costs, charges and expenses reasonably incurred by him in connection with the defence of any civil, criminal or administrative action or proceeding to which he is made a party by reason of being or having been a director or officer of the corporation or body corporate, if the person seeking indemnity

(a) was substantially successful on the merits in his defence of the action or proceeding; and
(b) fulfils the conditions set out in paragraphs (1)(a) and (b).

[598] Ibid. s.124(4):

A corporation may purchase and maintain insurance for the benefit of any person referred to in subsection (1) against any liability incurred by him

(a) in his capacity as a director or officer of the corporation, except where the liability relates to his failure to act honestly and in good faith with a view to the best interests of the corporation; or
(b) in his capacity as a director or officer of another body corporate where he acts or acted in that capacity at the corporation's request, except where the liability relates to his failure to act honestly and in good faith with a view to the best interests of the body corporate.

[599] M.C.A. s.113.(1)-(40).

The A.B.C.A. is notable in that it specifically provides in the section concerned, that there can be no exception to its stipulated duty of care requirement:

> 117(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall
>
> (a) act honestly and in good faith with a view to the best interests of the corporation, and
>
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.
>
> (2) Every director and officer of a corporation shall comply with this Act, the regulations, articles, by-laws and any unanimous shareholder agreement.
>
> (3) Subject to section 140(7), no provision in a contract, the articles, the by-laws or a resolution relieves a director or officer from the duty to act in accordance with this Act or the regulations or relieves him from liability for a breach of that duty.
>
> (4) In determining whether a particular transaction or course of action is in the best interests of the corporation, a director, if he is elected or appointed by the holders of a class or series of shares or by employees or creditors or a class of employees or creditors, may give special, but not exclusive, consideration to the interests of those who elected or appointed him.

Even more interesting is subsection 4 which specifically affords directors the right to give special consideration to a given class of individuals who need not be equity holders. This special authority does not have a companion section in any of the legislation presently considered. Further legislation concerning indemnification and insurance fall in

line with those of the C.B.C.A.[600]

Ontario falls outside the norm in that the O.B.C.A. will not offer any safe harbour to directors who violate their duty of care requirements:

> S.145(2) No director or officer of a corporation shall be indemnified by the corporation in respect of any liability, costs, charges or expenses that he sustains or incurs in or about any action, suit or other proceeding as a result of which he is adjudged to be in breach of any duty or responsibility imposed upon him under this Act or under any other statute unless, in an action brought against him in his capacity as director officer, he has achieved complete or substantial success as a defendant.

Thus an honest belief and an action taken in good faith is not exculpatory. Furthermore the Act refuses to allow corporations to provide insurance which would insulate directors from personal loss where directors are in breach of their duty of care.

> S.145(3) A corporation may purchase and maintain insurance for the benefit of a director officer thereof, except insurance against a liability, cost, charge or expense of the director or officer incurred as a result of a contravention of section 142. R.S.O. 1970, c.53, s.147.

While the Act does not specifically state that a corporation may not opt out, the language of s.145 and its content leaves no doubt of its immutability.

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[600] A.B.C.A. s.119(1)-(6).

PART IX

A. FIDUCIARY DUTY

This section will, as was done in respect of the U.S. position, deal with the area of fiduciary duty in a broad sense. The application of this principle to corporate control contests will be dealt with in the next section.

Canadian legal history and jurisprudence have evolved more than a simple semantic dichotomy between duties of care and fiduciary duties. The latter differs both in degree and in substance from the former in that both the level of performance and legal remedies available are dependant upon the nature of the relationship. The fiduciary concept has its origin in equity and was developed by the Court of Chancery in order to afford the court an instrument by which to deal fairly with parties in situations where the common law offered no appropriate relief. Due to the dependence and vulnerability associated with trust situations the courts of equity imposed special duties upon the trustee which came to be known as fiduciary duties.[601] These duties afforded the trustee no opportunity for personal gain or abuse of the special relationship that was deemed to exist between the parties. Over time and in response to other

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[601] Maurice Gautreau, Demystifying The Fiduciary Mystique (1989) 68 The Canadian Bar Review p. 1.

situations the court expanded the reach of this concept and included in its scope such relationships as partnerships, agency and professional associations such as lawyers, doctors, executors and the like. The issue became not who was a fiduciary but under what circumstances would such a relationship exist and to whom was the duty owed. In this sense the scope of the duty and the circumstances under which it will arise continues to be open ended.

In particular reference to directors their position as fiduciaries originated with the decision of the English Lord Chancellor in Charitable Corporation v. Sutton.[602] In that case the court dealt with the particular responsibilities of directors in the context of a charitable organization which had sustained losses due in some degree to the failure of its directors to properly oversee the corporation. In addressing the issue the court stated:

> ... an accumulated charge is made against the whole body of directors or committee-men.
>
> Consider first the foundation of this charge.
>
> I take the employment of a director to be of a mixed nature; it partakes of the nature of publick [sic] office, as it arises from a charter of the crown.
>
> But it cannot be said to be an employment affecting the public government. ...
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> Therefore committee-men [directors] are most properly agents to those who employ them in this trust, and who empower them to direct and superin-

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[602] (1747), 25 E.R. 642.

> tend the affairs of the corporation.
>
> In this respect, they may be guilty of acts of commission or omission, of malfeasance or non-feasance. ...
>
> Now where acts are executed within their authority, as repealing bye-laws [sic] and making orders, in such cases though attended with bad consequences, it will be very difficult to determine that these are breaches of trust.
>
> For it is by no means just in a judge, after bad consequences have arisen from such executions of their power, to say that they foresaw at the time what must necessarily happen; and therefore were guilty of a breach of trust.
>
> Next as to mal-feasance and non-feasance.
>
> To instance in non-attendance; if some persons are guilty of gross non-attendance, and leave the management intirely [sic] to others, they may be guilty by this means of the breaches of trust that are committed by others.
>
> By accepting a trust of this sort, a person is obliged to execute it with fidelity and reasonable diligence; and it is no excuse to say that they had no benefit from it, but that it was merely honorary. ...
>
> [I will never] determine that a court of equity cannot lay hold of every breach of trust, let the person be guilty of it in either a private or public capacity.
>
> ... I will never determine that frauds of this kind are out of the reach of courts of law or equity, for an intolerable grievance would follow from such a determination.[603]

While the court compared the director's role to that of a trustee and agent to the corporation.

"The precision of the legal doctrine which could

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[603] Ibid. p. 644-645.

> have stemmed from the Lord Chancellor's dicta gave way, unhappily, to a haphazard development based on conflicting concepts on the one hand, the freedom of the individual directors to pursue their self-interest under the free enterprise system and, on the other hand, duty of fidelity bridling the pursuit of individual wealth by the director."[604]

However both the common law and statutory authority go hand in glove in support of the proposition that directors must place the best interests of the corporation and its shareholders ahead of personal self interest.[605] While the nature of the position and its concomitant duties do not levy upon them the same demands as those set forward for trustees[606] their efforts must be guided with a view to the best interests of the corporation.

Prior to opening an examination of director's fiduciary duties in the context of takeover bids it is important to focus upon the state of the law in so far as these duties are owed to shareholders generally. It is perhaps no surprise that this area of the law remains unsettled. As

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[604] Ellis, M., Fiduciary Duties in Canada, (Ontario, Richard DeBoo Publishers 1988) at 15-2.

[605] See Regal (Hastings) Ltd. v. Gulliver, [1942] 1 All E.R. 378, Standard Investments Ltd. v. Canadian Imperial Bank of Commerce (1985), 22 D.L.R. 4th 410 and Re Smith & Fawcett Ltd., [1942] Ch. 304 (C.A.). Section C.B.C.. s.122(1)(a) supra n.572 and comparable Provincial legislation ie. A.B.C.A., M.C.A., S.B.C.A., B.C.C.A., N.B.B.C.A., O.B.C.A.

[606] Welling, supra n.565 p. 374. For a thorough review of the specific nature of the fiduciary duties owed to the corporation see Ellis, supra n.604 15-1 to 15-32.

stated by Professor Welling:

> To whom are the directors responsible then? This question has been inconsistently dealt with in the English-based jurisprudence copied in Canada over the past 100 years. It is probably better left unasked. In Canada directors are vested with statutory powers and obligations. Regardless of to whom they are legally responsible, there are other groups involved in the corporate government who have the ability to keep the directors in check or even to topple them from power. Directors may be run out of office through the democratic process, practically ignored by powerful managements, challenged in court by the corporate entity itself, or even brought legally to task by a dissentient minority through the use of statutory representative actions.
>
> In the past, it was necessary to determine to whom the directors were responsible in order to ascertain who had the standing to legally challenge their excesses. Nowadays the typical statutory regime sets up two opposing groups: the management on the one hand, the shareholders on the other hand. The two groups tend to have different political and financial interests and they are given legal remedies to allow them to control one another in appropriate situations. Whether the directors owe a direct obligation to the corporate entity, to the shareholders as a group, to particular groups of shareholders, or to each individual shareholder becomes a moot point, except as specified in the appropriate statute.[607]

With respect I believe that the question must be both confronted and answered. The delineation of this fiduciary duty as it may impact upon both shareholders and outside interests is of vital concern both to these groups and to the corporate directors themselves. In addition the determination of which groups fall within the scope of this

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[607] Ibid. p. 300.

duty has not been adequately dealt with by statutes which by and large are silent as to which interests may/should be considered and in what context. Direction if any must then be found within the case law itself and in this regard Professor Welling's assessment in respect of its inconsistency is most certainly correct.

Early cases such as Percival v. Wright[608] established the principle that directors owed their fiduciary duty to the corporation alone to the exclusion of the shareholders themselves. Since that time several jurisdictions have examined the issue with varying results. The existence of a fiduciary duty to shareholders has been recognized in cases involving a director's surreptitious acquisition of shares,[609] a director's purchase of shares from a share-

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[608] (1902), [1902] 2 Ch. 421, 71 L.J. Ch. 846.

[609] Hyatt v. Allen (1914), 17 D.L.R. 7, 11-12. While concluding that normally a director's fiduciary duty extends solely to the corporation, the court stated:

> The [directors] appear to have been under the impression that the directors of a company are entitled under all circumstances to act as if they owed no duty to individual shareholders. No doubt the duty of the directors is primarily one to the company itself. It may be that in [certain] circumstances ... they can deal at arm's length with a shareholder. But ... their Lordships think that the directors must here be taken to have held themselves out to the individual shareholders as acting for them on the same footing as they were acting for the company itself, that is as agents.

holder[610] and where land in which directors held an interest was conveyed from one company to another.[611] However a decision of the Manitoba Court of Appeal has held that directors do not owe a fiduciary duty to shareholders. In Western Finance Co. v. Tasker Enterprises[612] Justice Huband stated:

> In the present case ... Tasker, as a director of Red River, is in a fiduciary relationship to the company. Even if there had been a breach of the

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[610] Pickford v. Thompson (1920), 40 N.S.R. 632. In this case a director had inside information in respect of the value of the share and purchased same to the detriment of the shareholder. The court found a breach of fiduciary duty in that full disclosure was not made to the shareholder involved.

[611] Roxborough Gardens of Hamilton v. Davis (1919), 52 D.L.R. 572-585. In rescinding the contract the court stated:

> No doubt, when ... they decided to take over the ... company's property at $6 a foot, and to take into their syndicate or into the new company only those who were willing to contribute towards carrying the property, and to leave out those shareholders who were either unable or unwilling to risk new moneys in their land speculation, they reasoned that they should not be called upon to protect those who failed to protect themselves. Such a view is not without merit; it is a position which they might reasonably be expected to take. They desired to protect their own investments but, in doing so, they did not think it was fair, or that they were obliged to assume or to protect and carry the investment of the others. These men, however, were all in a fiduciary position which required them not only to protect themselves, but to protect as well their less fortunate associates, and in a position that required them not to allow their interest to conflict with their duty.

[612] (1980), 106 D.L.R. (3d) 81.

> duty there arising ... the fact remains that Red River has made no claim. ... The claim comes from a different company, which happens to be a creditor of Red River, and whose shareholders were the same two individuals who were the shareholders of Red River.[613]

In this case no fiduciary duty was found in spite of the fact that the director involved made an illicit profit at the expense of the company. A similar finding was made in the case of Pelling v. Pelling.[614] In his judgment Mr. Justice Berger stated:

> Dealing first with the claim at common law: there is no fiduciary obligation as between shareholders, and no agreed fiduciary obligation owed by a director to shareholders. A director's duty is to the company; he has no fiduciary obligation to the shareholders. There are some exceptions to this rule ... but the plaintiff has been unable to persuade me that the case at bar falls within any of them. The common law has not thus far provided a remedy in a case such as this.[615]

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[613] Ibid. p. 89.

[614] (1981), 130 D.L.R. (3d) 761 (B.C.S.C.).

[615] Ibid. p. 762. The case has come under some criticism however;

> "The case at bar" involved the redemption of minority shares by the majority shareholder/director of a closely held corporation. The reason for the redemption was the information known only to the director that an offer for all shares at a higher price had been made. While the trial judge was able to find liability by applying the insider trading prohibition in the corporation's statute, **Pelling** is without doubt a retrograde decision for two reasons. First, there is existing authority (referred to above) for holding a director in a fiduciary relationship with the shareholders. Second, "the categories of fiduciary duty are not

(continued...)

However in Goldex Mines Ltd. v. Revill[616] the Ontario Court of Appeal held that corporate directors owe a fiduciary duty to all shareholders personally as well as to the corporation.[617] In expanding the rule in Charlebois v. Bienvenu[618] the court stated:

> In **Charlebois et al. v. Bienvenu et al. ...** Fraser, J., held that the holding of an annual meeting and election of directors after the sending out of a misleading information circular by the directors was a breach of the directors' fiduciary duty to the company. **We hold that such an act is also a breach of duty to the other shareholders.** If the directors of a company choose, or are compelled by statute, to send information to shareholders, those shareholders have a right to expect that the information sent to them is fairly presented, reasonably accurate, and not misleading.
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> . . .
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> ... Where information is sent to shareholders that is untrue or misleading, the duty to shareholders is breached, whether the senders were required by statute to send out that class of information, or whether they simply chose to do so.[619]

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[615](...continued)
closed"; therefore, Berger J. could have used the appropriate fact circumstances to implement the equitable rule to relieve a most inequitable situation. Ellis, supra n.604, 15-27.

[616] (1975), 7 O.R. (2d) 216.

[617] Ellis, supra n.604, 15-27.

[618] [1967] 2 O.R. 635.

[619] Goldex (1975), 7O.R. (2d) 216, 223-224.

Similar dicta appears in the case of Dusik v. Newton[620] wherein the British Columbia Court of Appeal stated:

> Counsel for [the director] says that the general rule is that ... a director does not owe a fiduciary duty to minority shareholders and only three exceptions have emerged. They are where a director acts as an agent of a minority shareholder; where a director buys shares from a minority shareholders, and where a director has been dishonest with or has misled a minority shareholder. In our view the law is no longer that restrictive. ...

Hence the current state of the law is unresolved. As Mark Ellis indicates:

> It is clear that the decisions on this point are diverse and it remains unclear whether a general proposition to the effect that directors generally owe a fiduciary duty to a company's shareholders can be enunciated. However, certainly the judicial trend has, happily, reflected an enlightened propensity toward a finding that

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[620] (1985) 62 B.C.L.R. 1 (C.A.). In Dusk:

> ... a director, who owned 90% of the shares, was approached by the Alberta Pork Marketing Board with respect to a takeover of the company through a purchase of all of the shares of the company. Six months prior to the takeover offer, the company had agreed to purchase the residual 10% shares in the hands of the only other shareholder for $450,000, but the deal had not closed due to financial complications. Under the takeover offer, the 10% would have a value of $1,500,000. The fact of the offer was not communicated to the minority shareholder; the sale of shares for $450,000 was pressured into completion and, upon learning of the takeover, the minority shareholder sued for breach of fiduciary duty. Ellis, supra n.604, 15-27.

In this case the court found a direct breach of fiduciary duty.

> directors owe a fiduciary duty as much to the shareholders as they do to the corporation itself.[621]

Just how 'enlightened' the judiciary have been in the context of control contests will now be reviewed.

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[621] Ellis, supra n.604, 15-28.

PART X

A. CORPORATE CONTROL CONTESTS

1. THE UNITED KINGDOM

Any analysis in respect of the current Canadian position as it impacts upon directoral duties during control contests demands an historical approach. This inevitably leads to a review of the relevant English authority and other United Kingdom decisions which may cast some light upon the current situation. In this regard an appropriate point of departure is a review and analysis of the "proper purposes" or "collateral purposes" doctrine.

In broad terms a director must exercise his authority within the limits of the powers granted to him. Where a director exceeds his jurisdiction his actions will be deemed improper and unauthorized. Where the decision taken may clearly be in violation of a stated power there is no difficulty in defining the breach. This result is however dependant upon the existence of two factors. First the power granted must be easily interpreted and second, the action taken must be of a nature and quality that it falls squarely in opposition to the authority granted. It is a fact of corporate life however, that often neither of these preconditions are present and rarely do both meet where

directoral decisions made during corporate control contests are later held under review. The inherent difficulty lies in the manner in which the power is described. As Professor Welling points out:

> When a limitation is expressly imposed on a particular power the analysis will be easy. But such situations will be rare. Management powers are more likely to be phrased in open-ended fashion: "the directors may declare dividends"; "the corporate secretary may sign invoices."
>
> Where no particular purpose is stated, two possibilities are open. In some circumstances it may be possible to infer from the corporate constitution that the power has been given for some particular purpose, or at least for a type of purpose wholly unrelated to the purpose the corporate official had in mind. In other circumstances it may be impossible to infer a particular purpose by looking at the terms of the grant of power.[622]

Where the latter is the case the courts have attempted to judge the action on the basis of whether it was undertaken in the best interests of the corporation. However as reading minds is an imprecise 'judicial science' at the best of times, decisions which have used this approach in the past should be read with some caution.

The structural application of the "proper purposes" doctrine involves two steps. "First, the proper purpose for which the power was conferred must be ascertained. Second, it must be determined whether the power was exercised for

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[622] Welling, supra n.565, p. 336.

that proper purpose."[623] As a caution however it must be held in mind that Canadian and English jurisdictions vary in respect of where the power may be found. The former is primarily guided by statute whereas in the latter jurisdiction directoral authority is delegated to the board by the shareholders. The difference is significant in that "the courts' function in the English cases is, therefore, to determine what purposes the shareholders had in mind in delegating a power."[624]

Cases in which the proper purposes doctrine has been applied have for the most part involved efforts by directors to issue shares with the intent of manipulating shareholder votes.[625] The first significant decision in which the doctrine was employed in a takeover context was the English case of Hogg v. Cramphorn Ltd.[626] In this case,

> ... a corporation was faced with a takeover proposal. A majority of the shareholders seemed to favor selling their shares, but the chairman of the board thought that the takeover was not in the corporation's best interest. Consequently, a trustee was appointed on behalf of the corporate employees, the trustee applied for an allotment of preference shares, and the board of directors purported to issue these shares. The intended result was to vest enough votes in the trustee to ensure continuing majority support for the

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[623] Baxter, supra n.468, p. 77.

[624] Welling, supra n.565, p. 337.

[625] See eg. Punt v. Symons and Co. Ltd., [1903] 2 Ch. 506 and Piercy v. S. Mills and Co. Ltd., [1920] 1 Ch. 77.

[626] [1967] 1 Ch. 254.

> incumbent board of directors. One of the shareholders sought to prevent the issue of the shares.[627]

The honest motivation of the directors was not at issue, however the articles were broadly worded stating that "the directors may allot shares to such persons, on such terms and conditions and at such times, as the directors think fit." The court took the opportunity at hand to narrowly define the purpose of the power. They did so by establishing first that the authority to issue shares was a fiduciary power and second, that it was granted primarily for the purpose of raising capital when required. The court found that good intentions aside the shares were issued to retain control and as such the decision was taken for an improper purpose. In his judgment Buckley J. stated:

> It is not, in my judgment, open to the directors ... to say, "We genuinely believe that what we seek to prevent the majority from doing will harm the company and therefore our act in arming ourselves or our party with sufficient shares to outvote the majority is a conscientious exercise of our powers under the articles, which should not be interfered with."
>
> Such a belief, even if well founded, would be irrelevant. A majority of shareholders in general meeting is entitled to pursue what course it chooses within the company's powers, however wrong-headed it may appear to others, provided the majority do not unfairly oppress other members of the company.
>
> Nor will this court permit directors to exercise powers, which have been delegated to them by the

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[627] Welling, <u>supra</u> n.565, p. 339.

> company in circumstances which put the directors in a fiduciary position when exercising those powers, in such a way as to interfere with the exercise by the majority of its constitutional rights.[628]

The court in reaffirming prior judicial principle was not concerned with the relative merit of the offer,[629] but with the issue of whether the power was exercised for a proper purpose. The court's narrow application of the articles has come under considerable scrutiny,[630] however its impact upon Canadian judicial opinion has been significant.[631]

In 1974 the Judicial Committee of the Privy Council faced a similar issue in the New South Wales case of Howard Smith Ltd. v. Ampol Petroleum Ltd..[632] The facts are as follows:

> In **Howard Smith**, Ampol Petroleum acquired thirty percent of the issued shares of R.W. Miller (Holdings) Ltd. ("Miller"). Shortly thereafter, it made a tender offer for all of Miller's issued shares. Its offer was rejected by Miller's directors as being too low. Howard Smith Ltd. then announced its intention to make a competing offer at a higher price. Ampol and another Miller shareholder, Bulkships (which collectively held fifty-five percent of the shares of Miller),

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628 Hogg v. Cramphorn Ltd., [196] 1 Ch. 254, 268-269.

629 Piercy v. S. Mills & Co., [1920] 1 Ch. 77.

630 See eg. L.S. Sealy, Company-Directors' Powers-Proper Motive But Improper Purpose (1967) 25 Cambridge Law Journal 33, Welling supra n.5465, p. 337-338.

631 Infra text p. .

632 [1974] A.C. 821, [1974] 1 All E.R. 1126 (N.S.W., J.C.P.C.).

> declared their intention to act jointly in relation to the future operation of the company and to reject any offer for their shares. The effect of such a joint action would have been to frustrate Howard Smith's tender offer.
>
> A plan was devised between Howard Smith and Miller's management whereby Miller would make an issue of its shares to Howard Smith of a size sufficient to dilute Ampol and Bulkships' collective holdings to a minority position, so that Howard Smith could proceed with its takeover bid. Ampol challenged the validity of the share issue. It was argued by Miller's directors that the share issue was made to satisfy the company's need for capital.[633]

As was the case in Hogg v. Cramphorn Ltd. the court found that the directors were not motivated by personal gain or the desire to retain control. In addition the articles in question were also very similar in nature and content. While the court considered other Commonwealth decisions,[634] they nonetheless found the share distribution to be invalid as per the product of an improper purpose. In coming to this conclusion Lord Wilberforce considered as follows:

> ... it is, in their Lordships' opinion, too narrow

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[633] Baxter, supra n.468, p. 82-83.

[634] Notably Tech Corp. Ltd. v. Millar (1972), 33 D.L.R. (3d) 288 (B.C.S.C.). In deciding the case the Howard Smith court distinguished Teck on the basis that the latter had an "ultimate deal" to look forward to which was not present in the case at hand. Even in this regard however the case has been criticized in that it misconstrued the issue in Teck by focusing on the relevance of "the ultimate deal" rather than on the question of whether the directors honestly attempted (on reasonable grounds) to serve the best interests of the corporation. It has been argued by Professor Welling that in fact the directors in Howard Smith did meet this test. See Welling, supra n.565, p. 349-350.

an approach to say that the only valid purpose for which shares may be issued is to raise capital for the company. The discretion is not in terms limited in this way: the law should not impose such a limitation on directors' powers. To define in advance exact limits beyond which directors must not pass is, in their Lordships' view, impossible. This clearly cannot be done by enumeration, since the variety of situations facing directors of different types of company in different situations cannot be anticipated. No more, in their Lordships' view, can this be done by the use of a phrase - such as "bona fide in the interest of the company as a whole," or "for some corporate purpose." Such phrases, if they do anything more than restate the general principle applicable to fiduciary powers, at best serve, negatively, to exclude from the area of validity cases where the directors are acting sectionally, or partially: i.e. improperly favouring one section of the shareholders against another. ...

. . .

In their Lordships' opinion it is necessary to start with a consideration of the power whose exercise is in question, in this case a power to issue shares. Having ascertained, on a fair view, the nature of this power, and having defined as can best be done in the light of modern conditions the, or some, limits within which it may be exercised, it is then necessary for the court, if a particular exercise of it is challenged, to examine the substantial purpose for which it was exercised, and to reach a conclusion whether that purpose was proper or not. In doing so it will necessarily give credit to the bona fide opinion of the directors, if such is found to exist, and will respect their judgment as to the matters of management; having done this, the ultimate conclusion has to be as to the side of a fairly broad line on which the case falls.

The constitution of a limited company normally provides for directors, with powers of management, and shareholders, with defined voting powers having power to appoint the directors, and to take, in general meeting, by majority vote, decisions on matters not reserved for management. Just as it is established that directors, within their management powers, may take decisions against the wishes of the majority of share-

> holders, and indeed that the majority of shareholders cannot control them in the exercise of these powers while they remain in office (**Automatic Self-Cleansing Filter Syndicate Co. Ltd. v. Cuninghame** [1906] 2 Ch. 34), so it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist. To do so is to interfere with that element of the company's constitution which is separate from and set against their powers. If there is added, moreover, to this immediate purpose, an ulterior purpose to enable an offer for shares to proceed which the existing majority was in a position to block, the departure from the legitimate use of the fiduciary power becomes not less, but all the greater. The right to dispose of shares at a given price is essentially an individual right to be exercised on individual decision and on which a majority, in the absence of oppression or similar impropriety, is entitled to prevail. Directors are of course entitled to offer advice, and bound to supply information, relevant to the making of such a decision, but to use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to be sold cannot be related to any purpose for which the power over the share capital was conferred upon them.

Thus while the court appeared to be less rigid in its application of the proper purpose doctrine by stating that no set purpose exists for the power to issue shares, it nevertheless reaffirmed the validity of the doctrine. They did so in trying to relate the director's actions to some unstated purpose for which the power to issue shares was granted.[635] By refusing to consider as the test or limitation of the grant of power the director's honest belief that

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[635] John Farrar, Business Judgment and Defensive Tactics in Hostile Takeover Bids (1989) 15 Canadian Business Law Journal 15, 28-29. Baxter, supra n.468 p. 83.

they were acting in the best interests of the company, the court had to make reference to some undefined list of proper purposes. Howard Smith then provides little guidance to the corporate bar outside of the particular fact situation with which it had to deal.

The English Court of Chancery in the unreported case of Cayne v. Global Natural Resources PLC,[636] followed Howard Smith but held that the principle of Hogg v. Cramphorn should be restricted. The court indicated that motive to retain control if not the sole purpose, will not necessarily vindicate actions taken in defense of a takeover. Speaking of Hogg v. Cramphorn Ltd., Megarry V.C. said this:

> At the same time, this principle must not be carried too far. If Company A and Company B are in business competition, and Company A acquires a large holding of shares in Company B with the object of running Company B down so as to lessen its competition, I would have thought that the directors of Company B might well come to the honest conclusion that it was contrary to the best interests of Company B to allow Company A to effect its purpose, and that in fact this would be so. If, then, the directors issue further shares in Company B for the purpose of defeating Company A's plans and continuing Company B in competition with Company A, I cannot see why that should not be a perfectly proper exercise of the fiduciary powers of the directors of Company B. The object is not to retain control as such, but to prevent Company B from being reduced to impotence and beggary, and the only means available to the directors for achieving this purpose is to retain control. This is quite different from directors seeking to retain control because they think that they are better directors than their rivals would

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[636] (August 12, 1982, Ch. Div.), aff'd. on other grounds, [1984] 1 All E.R. 225 (C.A.).

be.

The case appears to break new ground and

> "it may be possible to say that if the directors genuinely believe that a significant or potentially significant shareholder will, by virtue of his shareholding, cause actual economic or commercial harm to the company, the directors may legitimately seek by exercise of their powers over unissued shares to preserve existing control so as to countervail the harmful influence of that shareholder."[637]

The preceding cases are not intended to be exhaustive of the English law but rather to form a context within which to read the relevant Canadian decisions. The English authority reviewed has been limited to the area of the proper purpose doctrine as this area of the law is closely associated to our own. However the English regulatory system departs markedly from ours in respect of defensive tactics employed to defeat hostile takeover bids.

> It should be noted that public listed company takeovers are subject to the City of London Takeover Code and this influences the views of the judiciary as to what is appropriate conduct. Once an offer has been made or appears to be imminent the Code requires that all defensive transactions which could frustrate the bid must be approved by shareholders in general meeting. Thus, proposed issues of shares or the grant of options on shares, the issue of convertible securities, the sale of material assets or the entering into contracts otherwise than in the ordinary course of business must be approved in this way. Share-

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[637] R. Barrett, Companies - Issue of shares to preserve existing control - whether breach of directors' fiduciary duties (1982) 56 The Australian Law Journal 600.

holders' approval is also necessary for the purchase or redemption by a company of its own shares.[638]

2. CANADA

Unlike the American position there is a lack of substantive Canadian authority in the area of what may be considered appropriate conduct in the face of unsolicited takeover bids. Beyond that which is mandated through the various Provincial Securities Laws and stock exchange rules there remains precious little judicial guidance for directors seeking either to inhibit or repel anticipated or actual 'attacks' upon the corporate enterprise.

An early case is that of Bonisteel v. Collis Leather Co.[639]:

> There, the plaintiff, a shareholder in a closely-held corporation, arranged to purchase the shares of another shareholder, thus giving him a majority of the outstanding shares of the company. The general manager of the company, who was credited with the company's success, made it known that, if the plaintiff acquired control, he would not be disposed to continue his employment with the company. At a subsequent meeting of the board, the directors resolved to offer the balance of the

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[638] Farrar, supra n.635 p. 31-32. For an indepth review of the area see R. Sappideen, Takeover Bids and Target Shareholder Protection: The Regulatory Framework in the United Kingdom, United States and Australia (1986) 8 Journal of Comparative Business and Capital Market Law 281, Farrar, John H., Company Law (London, Butterworths 1985) at 501-529, Morse, G., Charlesworth's Company Law (London, Stevens & Sons 1987) at 807-829.

[639] (1919), 45 O.L.R. 195, 15 O.W.N. 465 (H.C.).

> authorized but unissued shares to the existing shareholders. Shares were issued to the subscribing shareholders in amounts that bore no relation to each subscribing shareholder's previous holdings. The plaintiff requested his **pro rata** amount but was instead offered a much lesser amount. The effect of the share issue was to dilute the plaintiff's holdings to a minority position.[640]

In setting aside the share issue the court held that:

> Upon the evidence there is no doubt at all that the purpose of the defendant directors in all that they did was to deprive the plaintiff of the controlling position which he had acquired. No doubt they thought that it was not in the best interest of the company that he should control its affairs, and, in that sense, they acted in good faith and in what they believed to be the best interest of the company; but, nevertheless, I think that what they attempted to do was exactly what **Martin v. Gibson** (1907), 15 O.L.R. 623, shews that directors have no right to do: they were making a one-sided allotment of stock with a view to the control of the voting power; they were ignoring, to use the words of the Chancellor (p. 633), "the general principle and guide, in dealing with the distribution of new stock and the claims of existing shareholders, that 'equality is equity.'"

A later case decided in Alberta came to a different conclusion. In Spooner v. Spooner Oils Ltd.[641] A.G. Spooner, a director and president of the defendant Company, entered into a contract with the company under which he was issued 250,000 shares for a certain consideration. The Plaintiff shareholder sued to set aside the agreement on two

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640 Baxter, supra n.468, p. 77.

641 (1936), [1936] 2 D.L.R. 634, [1936] 1 W.W.R. 561.

grounds: "First that its purpose was to give A.G. Spooner control of the company, and, second, that it was in effect a sale of the shares at a discount and as such ultra vires ..."[642] The trial judge found for the plaintiff on both grounds, however on appeal, Harvey C.J.A. stated:

> Mr. Justice Ives, who tried the case, held (**ante** p. 1) in the plaintiff's favour on both grounds. He says:
>
> > "I cannot avoid the conclusion, upon the whole evidence, that this end [i.e. control] was much in the minds of all the directors and a material reason for their assent to the agreement."
>
> While I am by no means satisfied that the evidence warrants the conclusion so stated I am quite satisfied that in itself that is not sufficient to invalidate the contract. The cases cited and relied on by the plaintiff on this branch of the case merely establish that when an issue of shares by the directors for the purpose of giving control cannot be deemed to be intended to be in the interest of the shareholders generally but on the contrary appears to be intended to accomplish some other purpose, then it constitutes a breach of trust on the part of the directors who occupy a fiduciary position in which they must act **bona fide** for the interests of the general body of shareholders. It is simply an instance of the act of the directors being at variance with this duty. There is nothing in the authorities cited that would stand in the way of upholding an issue of shares for the sole purpose of giving someone control of the company if the directors honestly believed on reasonable grounds that it was for the interest of the company that that should be done.[643]

The appeal nevertheless failed but on the basis of the share

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[642] Ibid. p. 562.

[643] Ibid.

issue being ultra vires sec. 16 of The Companies Act, 1934, ch. 33 (Dom) due to inadequate consideration.

These two cases foreshadow current law in their disparate view of what might be considered appropriate fiduciary conduct.[644]

The stage was set for the landmark case of Teck Corpn. Ltd. v. Millar,[645] a 1972 decision of the British Columbia Supreme Court. The facts are as follows:

> The defendant, Millar, was the president and a director of Afton Mines, a junior mining company. Afton was financially unable to carry on an extensive drilling program on its claim, so it sought to interest major mining companies ("majors"). A major usually provides capital, personnel, technical assistance and managerial and marketing assistance in return for an allotment of the junior's shares. Afton raised money through a public underwriting of its shares which enabled it to continue drilling. The assays aroused great interest in Afton and Millar was besieged by majors each seeking to obtain the ultimate deal.
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> At this point, Afton required additional financing. However, the previous underwritings had been unsatisfactory and Millar did not yet want to conclude an ultimate deal. Millar decided to try to issue a bloc of shares to a major because he believed that he could obtain a greater net return to Afton, that he would not have to relinquish control of the company and that the participation of a reputable major would enhance the value of the shares. An agreement was reached between Millar and Placer for the sale of shares with a right of first refusal on any future financing

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644 "However, the judicial prejudice against broad interpretations of the share issue power was well established in Canada, as well as in England, during the first half of the twentieth century." Welling, supra, n.565, p. 341.

645 [1973] 2 W.W.R. 385, 33 D.L.R. (3d) 288 (B.C.S.C.).

> including the ultimate deal.
>
> Another major, Teck, was eager to obtain the ultimate deal. Teck offered to purchase from Afton a bloc of Afton shares at four dollars per share if it received a right of first refusal on future financing. However, even though Placer was willing to pay only three dollars per share, Millar preferred to deal with Placer because of its excellent reputation in the industry and its phenomenal record of successful ventures. Teck had not brought a mine into production in the province and could not match Placer's experience or personnel. Millar rejected Teck's higher offer because he wanted Placer involved in the property.
>
> Teck, having failed to make a deal with Afton, began buying Afton's shares on the market. During this period, Millar and Placer negotiated for an ultimate deal. Millar and the other directors, realizing that Teck was coming close to having control and that they would not be in control of Afton much longer, negotiated an ultimate deal with Canex, Placer's wholly-owned subsidiary, which provided for the issuance of shares to Canex if it elected to put the property into production.[646]

Significantly Placer's 'bonus' for bringing the property under production would see them receive an equity share equal to 30% of the issued shares of the Company. The result would displace Teck as a majority shareholder. As such Teck brought an action under two heads:

> Teck asks for damages on behalf of Afton. Teck says that if the contract of June 1st is set aside, Afton is entitled to damages because, if the contract had not been made, Afton could have proceeded with the development of the property in the meantime. Teck alleges that Afton has lost $200,000 a month by reason of the delay and that its damages ought to run from June 1st to the date of judgment. Then Teck says that even if it fails

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[646] Baxter, <u>supra</u> n.468, p. 79-80.

> to prove that Canex had knowledge that the directors of Afton were actuated by an improper purpose, in which case the contract and the allotment of shares to Canex would stand, Afton would still be entitled to damages against the defendant directors, if the Court found against them. Teck says that the contract of June 1st is improvident from Afton's point of view. If, therefore, it stands, the measure of the damages for which the directors will be liable is the loss to Afton thereby, which Teck alleges is many millions of dollars.[647]

Notably a finding against the defendant directors on the second ground would involve a significant claim against them personally.

The central issue at hand was the question of whether under these circumstances the defendant directors were actuated by an improper motive, and that Canex knew it. The Plaintiffs did not dispute the fact that the directors may have believed that their actions were taken in the best interest of the corporation. Rather they rested their case on facts which they said fell four square within those of Hogg v. Cramphorn Ltd.:

> Counsel for Teck says the reasoning in **Hogg v. Cramphorn Ltd., supra,** is applicable in the case at bar. He says the defendant directors believed Teck would use its dominant position to compel Afton to give Teck the ultimate deal. They believed that under Teck's management the property would not be developed as profitably as it would under Placer's management. They also believed that the value of Afton's shares, including their own, would decline, under Teck's management. Therefore, the argument goes, the defendant directors entered into the contract with Canex so

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647 Ibid. p. 292.

> that shares would be alloted under the contract to defeat Teck's majority. The case then is on all fours with **Hogg v. Cramphorn Ltd.**.
>
> Counsel for Teck says that **Hogg v. Cramphorn Ltd.** offers an elaboration of the rule that directors may not issue shares for an improper purpose. If their purpose is merely to retain control, that is improper. So much may be taken for granted. Counsel then goes on to say that **Hogg v. Cramphorn Ltd.** lays it down that an allotment of shares, and any transaction connected with it, made for the purpose of defeating an attempt to secure a majority is improper, even if the directors genuinely consider that it would be deleterious to the company if those seeking a majority were to obtain control.[648]

The court proceeded on the footing that indeed the facts at hand fell within the scope of those contemplated in Hogg v. Cramphorn Ltd.. This case had to be dealt with head on and in speaking to the issue at hand Berger J. stated that the application of Hogg v. Cramphorn Ltd. "rais[ed] an issue of profound importance in company law."[649] Berger J. decided that he could not accept the reasoning in Hogg v. Cramphorn Ltd.:

> How can it be said that directors have the right to consider the interests of the company, and to exercise their powers accordingly, but that there is an exception when it comes to the power to issue shares, and that in the exercise of such power the directors cannot in any circumstances issue shares to defeat an attempt to gain control of the company? It seems to me this is what **Hogg v. Cramphorn Ltd.** says. If the general rule is to be infringed here, will it not be infringed elsewhere? If the directors, even when they

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[648] Ibid. p. 311.

[649] Ibid.

> believe they are serving the best interests of the company, cannot issue shares to defeat an attempt to obtain control, then presumably they cannot exercise any other of their powers to defeat the claims of the majority or, for that matter, to deprive the majority of the advantages of control. I do not think the power to issue shares can be segregated, on the basis that the rule in **Hogg v. Cramphorn Ltd.** applies only in a case of an allotment of shares.
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> Neither can it be distinguished on the footing that the power to issue shares affects the rights of the shareholders in some way that the exercise of other powers does not. The Court's jurisdiction to intervene is founded on the theory that if the directors' purpose is not to serve the interest of the company, but to serve their own interest or that of their friends or of a particular group of shareholders, they can be said to have abused their power. The impropriety lies in the directors' purpose. If their purpose is not to serve the company's interest, then it is an improper purpose. Impropriety depends upon proof that the directors were actuated by a collateral purpose, it does not depend upon the nature of any shareholders' rights that may be affected by the exercise of the directors' powers.[650]

By making the directors' motive the determining factor Berger J. departed abruptly from Hogg v. Cramphorn Ltd.. He further concluded that he was not bound to follow the reasoning in that case as there was judicial authority on both sides of the issue.[651]

Berger J. defined improper purpose using as a yardstick 'the best interests of the corporation.' He now had to provide a framework within which to define this duty. In

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[650] Ibid. p. 312.

[651] Ibid. p. 313. Berger J. reviewed the decisions in both the Bonisteel and Spooner cases.

doing so he then turned his attention to the scope of a director's fiduciary duty and in the process made some important statements concerning the standing of non-shareholder interests.

> In defining the fiduciary duties of directors, the law ought to take into account the fact that the corporation provides the legal framework for the development of resources and the generation of wealth in the private sector of the Canadian economy: . . .
>
> A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting **bona fide** in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered **bona fide** the interests of the shareholders.
>
> I appreciate that it would be a breach of their duty for directors to disregard entirely the interests of a company's shareholders in order to confer a benefit on its employees: **Parke v. Daily News Ltd.**, [1962] Ch. 927. But if they observe a decent respect for other interests lying beyond those of the company's shareholders in the strict sense, that will not, in my view, leave directors open to the charge that they have failed in their fiduciary duty to the company.[652]

This concept was brought into focus when the court considered the scope of a director's duty in the context of a takeover bid. Berger J. stated:

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[652] Ibid. p. 314.

> My own view is that the directors ought to be allowed to consider who is seeking control and why. If they believe that there will be substantial damage to the company's interests if the company is taken over, then the exercise of their powers to defeat those seeking a majority will not necessarily be categorized as improper.[653]

However the court recognized that where takeovers are concerned directors will almost certainly defend any attempted defense on the basis that they acted in the best interest of the company. There had to be an objective framework in which these actions could be assessed. Berger J. stated the issue and resolved it in this way:

> How can the Court go about determining whether the directors have abused their powers in a given case? How are the Courts to know, in an appropriate case, that the directors were genuinely concerned about the company and not merely pursuing their own selfish interests? Well, a similar task has been attempted in cases of conspiracy to injure. There the question is whether the primary object of those alleged to have acted in combination is to promote their own interests or to damage the interests of others: **Crofter Hand Woven Harris Tweed Co. v. Veitch,** [1942] A.C. 435.
>
> I think the Courts should apply the general rule in this way: The directors must act in good faith. Then there must be reasonable grounds for their belief. If they say that they believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose.[654]

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653 Ibid. p. 315.

654 Ibid. p. 315-316.

In further defining this test, the court looked to American judicial authority for guidance in this area.[655] In the result the court stated that a reasonable belief in substantial harm could be found where on the facts the change in question would have profound consequences to the company's whole way of doing business. The nature of the change must be such as to form a reasonable belief that its consequence would damage the company's interests. In its final form Berger J. put the test as follows:

> I think that directors are entitled to consider the reputation, experience and policies of anyone seeking to take over the company. If they decide, on reasonable grounds, a take-over will cause substantial damage to the company's interests, they are entitled to use their powers to protect the company. That is the test that ought to be applied in this case.[656]

However it is not enough that this objective element be found. Directors must also have an honest belief in that their actions are in the best interests of the corporation. In the case at hand the court took an objective approach in determining this issue. Berger J. found that the directors involved acted in the best interest of the corporation based on an objective evaluation of all actions undertaken by this group. The court recognized that in these situations

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[655] The court studied the following Delaware decisions: Kors v. Carey, Bennett v. Propp, Cheff v. Mathes and Candec Corp. v. Lukenheimer Co. 230 A. 2d 769 (1967).

[656] Teck at p. 317.

directors often face a conflict of interest, that being the inherent conflict between serving their own best interest and those of the shareholders. Indeed the court recognized that many interests are in play during corporate control contests. The court in addressing this issue states:

> So it is necessary, then, to disentangle the directors' primary motive or purpose from subsidiary ones. I do not think it is necessary to distinguish motive, purpose or object. The question is, what was it the directors had uppermost in their minds?[657]

What exactly is uppermost in a director's mind will be objectively gleaned from the facts at hand.

In this case the court held that the directors intended to foreclose Teck's opportunity of obtaining for itself the ultimate deal and that this was not an improper purpose. The court determined that the directors acted with the best interests of the corporation in mind.[658] This was so even though Teck itself was the major shareholder. Further the court held that the directors had reasonable grounds for believing that a takeover by Teck would cause substantial damage to the interests of Afton and its shareholders.[659] Notably the court placed the burden of proof upon the

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[657] Ibid. p. 327.

[658] Ibid. p. 328.

[659] Ibid. p. 330.

plaintiffs.[660]

How determinative of the law is Teck? Professor Welling indicates that the law as stated by Berger J. is applicable throughout Canada:

> "The Canada Business Corporations Act says:
>
> > Subject to the articles, the by-laws and any unanimous shareholder agreement and to section 28 [a special section dealing with preemptive rights provided in the articles], shares may be issued at such times and to such persons and for such consideration as the directors may determine.
>
> Subject therefore to the articles in any particular situation, no particular limitation on the share-issue power is provided. The only limitation would appear to be the requirement in s.117(1) that the directors exercise all their powers in the best interests of the corporation. The letters-patent jurisdictions and British Columbia are similar. The English-model jurisdictions, Nova Scotia and Newfoundland, leave the matter to be determined by the articles. Therefore, it is suggested that Berger J. has correctly stated the Canadian law."[661]

One disquieting note might be sounded however. The following statement is made by Berger J.:

> If I am wrong in rejecting **Hogg v. Cramphorn Ltd.**, [1967] Ch. 254, [1966] 3 W.L.R. 955, [1966] 3 All E.R. 420, it is not applicable here in any event. In **Hogg v. Cramphorn Ltd.** the primary purpose of the directors was to frustrate an attempt to obtain control of the company. In the case at bar

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660 Ibid.

661 Welling, supra, n.565 p. 347-348. Similar provisions exist in other jurisdictions. A.B.C.A., M.C.A. [am. 1978, c.30, s.10], S.B.C.A., s.25(1); B.C.C.A., s.41(6); N.B.B.C.A; O.B.C.A., s.23(1).

> the primary purpose of the directors was to make the best contract they could for Afton. I find that the primary purpose of the directors was to serve the best interests of the company. Their primary purpose was to see that the ultimate deal the company made was a deal with Placer, not Teck. They were not motivated by a desire to retain control of the company. They may have thought the issuance of shares under the contract with Canex would enable them, if they had Canex' support, to regain control from Teck. If they did, that was a subsidiary purpose. On any view of the law, therefore, no allegation of improper purpose can be sustained against the defendant directors.[662]

It is understandable that Berger J. did not, given what was at risk personally to the directors, wish to have his decision disturbed. However with respect the facts at hand fall within the scope of Hogg v. Cramphorn Ltd. and as such cannot be distinguished as easily. The central issue was that of motive[663] and what indeed constituted an improper purpose. Both this case and Hogg v. Cramphorn Ltd. involved a share distribution intended to dilute or prevent a majority interest. Berger J. in attempting to distinguish the two cases focuses upon the fact that in the case at bar the motive was not to secure control but to ensure the ultimate deal with Placer. Again with respect this distinction is irrelevant as the issue is not motivation but for what purpose was the power granted and Hogg v. Cramphorn Ltd. stands for the proposition that the share distribution power may not be used except to raise capital. In my

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662 Teck p. 331.

663 Supra n.647.

opinion Teck broke important new ground in rejecting the approach in Hogg v. Cramphorn Ltd. however Berger J. should not have attempted to distinguish the case on the facts as this may well dilute its impact in the foreseeable judicial future.

Teck has been considered by a number of Canadian and Commonwealth cases[664] including Olson v. Phoenix Industrial Supply Ltd.,[665] a decision of the Manitoba Court of Appeal.

The case involved a closely held private corporation which, from time to time, found itself chronically short of capital. On one such occasion the company was advanced funds by the plaintiff's wife.[666] While this amount was reduced over time $7,473.70 remained outstanding by way of a

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[664] Northern & Central Gas Corp. Ltd. v. Hillcrest Collieries Ltd. (1976), 59 D.L.R. (3d) 533, [1976] 1 W.W.R. 481 (Alta. S.C.) (followed): Shield Development Co. Ltd. v. Snyder and Western Mines Ltd., [1976] 3 W.W.R. 44 (B.C.S.C.) (approved obiter); Re Royal Trustco Ltd. (No. 3) (1981), 14 B.L.R. 307 (Ont. H.C.J.) (referred to); First City Financial Corp. Ltd. v. Genstar Corp. (1981), 125 D.L.R. (3d) 303, 33 O.R. (2d) 631 (H.C.J.) (referred to); Exco Corp. Ltd. v. Nova Scotia Savings and Loan (1983), 59 N.S.R. (2d) 331, 35 C.P.C. 345 (C.A.) (considered); Olson v. Phoenix Industrial Supply Ltd. (1984), 9 D.L.R. (4th) 451, 27 Man. R. (2d) 205 (C.A.) (applied); Dixon v. Merland Explorations Ltd. and Turbo Resources Ltd. (1984), 50 A.R. 353, 509 Alta. L.R. (2d) 310 (Q.B.) (referred to). See Howard Smith Ltd. v. Ampol Petroleum Ltd., [1974] A.C. 821; Cayne v. Global Natural Resources PLC (August 12, 1982, Ch. Div.), affd. [1984] 1 All E.R. 225 (C.A.); Darvall v. North Sydney Brick & Tile Co. Ltd. (1988), 12 A.C.L.R. 537.

[665] (1984), 9 D.L.R. (4th) 451, 27 Man. R. (2d) 205 (C.A.).

[666] The Plaintiff, Mr. Olson, was also the founder of the company. Irene Gibbs, the plaintiff's wife, advanced $17,000 to the company.

loan account. When in early 1970 the company's financial position became acute the directors removed the plaintiff as general manager and in his place appointed new management.[667] Later that year upon the request of the defendant Gibbs, the board issued 1635 common shares and 58 preferred shares to Gibbs in satisfaction of her loan account. The net effect of this disbursement was to effectively eliminate the plaintiff's majority control. The plaintiff sought recission and was successful. At trial, Matas J.A. concluded that:

> ... on the basis that the circumstances warranted depriving Olson of majority control, the directors did not have the legal right to issue the excessive number of shares to Gibbs and to water down Olson's equity capriciously. In issuing the shares to Gibbs, the directors contravened their duty to act reasonably and fairly in their conduct of the company's affairs. The act was an improper exercise of their powers as directors. I find that the issuance of 1635 common shares and 58 preferred shares to Gibbs was invalid and should be set aside.

On appeal the decision of the trial judge was reversed. In doing so the court relied upon the decision in Teck. The Appeal court stated that "the test is whether the directors honestly believed that they were acting in the best interests of the company; and whether there were reasonable grounds for their belief."[668] The court found that under

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[667] Irene Gibbs was appointed a co-manager.

[668] Olson p. 209.

the circumstances the survival of the company was dependent upon control being shifted from the plaintiff. This was due to pressure from corporate creditors to remove the plaintiff and the fact that had the loan account not been satisfied it would have been called. This in turn would mean that the company would not be in the necessary financial footing to ask for and receive additional funding without which it would not survive. As such the Appeal court found that the plaintiff did not meet his burden of proof wherein he had to show that the directors had acted in bad faith.

The case is interesting for a number of reasons. Olson as an Appeal court decision establishes Teck as authoritative in Manitoba. Further the case involved a closely held company which was not publicly traded. In addition it applied Teck to corporate control contests outside the arena of takeover bids. Finally while it adopted Teck it did so without expressly referring to the element of 'substantial damage' as part of the test of fiduciary duty. On the facts however the incorporation of this element may be assumed as the court hinged its decision upon their finding that without a change in control the directors believed on reasonable grounds that the corporation would not survive. That would arguably meet a test for substantial damage. However the difficulty in failing to restate the substantial damage component is twofold. Firstly a narrow interpretation may apply too great a burden upon the board. While the

onus remains on the plaintiff he may only need to show that the company was not in extremis. On the other hand a wider interpretation may make it nearly impossible for the plaintiff to prove his case. In either circumstance the court if it intended to apply Teck should have incorporated the Teck test in its entirety.

Fourteen years after Berger J. and Teck the High Court of Justice of Ontario came to a similar conclusion in the Hiram Walker[669] case. The facts are as follows:

> .. Gulf was a company whose primary business was exploration for and development and production of oil and gas. HWR was a company widely held in both Canada and the United States that controlled three well-known Canadian businesses - the distiller, Hiram Walker-Gooderham & Worts (the distiller); the natural gas distributor, Consumers Gas; and an oil explorer and developer, Home Oil. In addition, HWR controlled thirty four per cent of the Interprovincial Pipe Lines Limited (IPL), which also was the largest shareholder of HWR, with about fifteen per cent of the voting shares. The distiller represented forty-three per cent of HWR's assets at market value, and contributed forty per cent of its annual earnings and thirty per cent of sales. Gulf's parent, O & Y Enterprises, at the beginning of 1986 held in excess of ten per cent of the voting shares of HWR.
>
> On March 19, 1986, and pursuant to the rules of the Toronto Stock Exchange and the Montreal Exchange, Gulf provided notice of its proposal to make a take-over bid through the exchanges for all of one series of voting shares (the Class D Preference Shares, First Series, or the preference shares) of HWR, and part of its common shares, at $28.625 per preference share and $32 per common

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669 Re Olympia & York Enterprises Ltd. and Hiram Walker Resources Ltd. et al., Re Interprovincial Pipeline Ltd. and Hiram Walker Resources Ltd. et al. (1986), 59 O.R. (2d) 254 (Ont. S.C., Ont. Div. Ct.).

share. In an endeavour to avoid having United States federal securities regulation (here the Williams Act) apply to the bid, it was expressed in the way increasingly customary for this purpose, not to be made to residents, citizens or nationals of, nor to be made in, the United States. Both exchanges accepted the bid notice.

The bid represented a low premium (over early March Canadian exchange trading highs) of eight per cent, in the case of the preference shares, and 11.3 per cent in the case of the common. The board of HWR, a majority of whose members were outside directors, strongly opposed the bid on the basis that it represented inadequate value to HWR shareholders. HWR initially asked the exchanges to lengthen the duration of the interval before the bid was to be opened for acceptance, and also expressed its concern about the bid's United States restriction as well as certain disclosures in the bid notice. The exchanges refused to interfere with the bid. An appeal of their acceptance of the bid notice, and of their subsequent refusal to interfere with the bid, to the Ontario Securities Commission and to the Commission des valeurs mobilieres du Quebec was unavailing. So, too, were proceedings in the United States to have the bid arrested for violation of the Williams Act. It was now March 27, 1986, and Gulf's bid was due to be opened for acceptance on the two stock exchanges on April 4, 1986.

On March 31st the transaction which gave rise to the proceedings in the Supreme Court of Ontario took place. On that day HWR entered into an agreement to sell the business of the distiller to Allied-Lyons PLC (Allied), a large British food and drink company, for $2.6 billion. There was then to be an exchange take-over bid to purchase forty-eight per cent of the outstanding voting shares of HWR at forty dollars a share (a two billion dollar expenditure) by a third corporation, Fingas Investment Corporation (Fingas). Fingas was a previously dormant corporation activated as a vehicle to facilitate a bid for HWR shares at a higher price than Gulf's offer. Fingas was to fund the offer by issuing for $200 million non-voting, participating Class A Preference Shares to Allied, and for $1.8 billion non-voting, participating Class B Preference Shares to a subsidiary of HWR. In addition Fingas was to

> issue for a nominal consideration forty-nine percent of its voting shares to HWR, twenty-nine per cent to Allied, eleven per cent to a corporate vehicle of a former director of HWR, and eleven per cent to the corporate vehicle of a former consultant to HWR.
>
> On April 2nd, O & Y Enterprises, which by this time had become formally associated with Gulf in an announced higher priced bid for more of the HWR voting stock, and IPL, which had sided with these two offerors in the battle, applied for interlocutory and final relief under the oppression remedy, compliance order, and derivative action provisions of the Ontario Business Corporation Act (the Act). The main relief sought was the enjoining of the sale of the distiller business to Allied, of HWR's $1.8 billion investment in Fingas, and of Fingas' offer for HWR voting securities. The case was heard over five days, between April 3rd and 9th, 1986, on the basis of affidavit evidence and counsel's arguments. In a judgment delivered orally on April 9, Montgomery J. dismissed all of the proceedings. On the same day, as he acknowledged, an intent to make a bid for all of HWR's common, convertibles and warrants at a price equivalent to $36.50 a common share was announced by Trans Canada Pipe Lines Limited, whose interest in HWR was its Home Oil business, an offer conditional on the support of HWR's directors and the withdrawal of the Fingas offer.
>
> O & Y Enterprises and IPL appealed the decision to the Divisional Court. By the time judgment was rendered, on July 9, 1986, by Reid J. in one opinion, and by Craig and Ewaschuk JJ. in another, Gulf and O & Y Enterprises had succeeded in acquiring all of the voting shares of HWR and the Fingas offer had been withdrawn. The remaining substantial issue was thus the sale of the distiller business to Allied. On that, the court dismissed the appeal.[670]

Prior to analyzing the judgment I will make note of the fact that this was not a trial in the sense that a cross

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[670] R.L. Simmonds, Comment (1987) 66 Canadian Bar Review 626, 627-628.

examination of the facts was available. The case was decided on the basis of affidavit evidence and under the rules governing interlocutory relief. These include the consideration of such issues as "balance of convenience" and "irreparable harm" which will not be dealt with in this review. The nature of the relief sought was equitable[671]

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[671] Olympia & York Enterprises Limited (Olympia & York) brought an application under rules 14.05(2), 14.05(3)(d) and (g), and the Business Corporations Act, 1982 (Ont.), c.4, ss. 247 and 252 (the Act). That application is for:

(a) an injunction restraining Hiram Walker and Fingas Investment (Fingas) from proceeding with a proposed offer whereby Fingas would purchase fifty million company shares of Hiram Walker;
(b) an injunction restraining Hiram Walker from investing two billion dollars in Fingas to enable Fingas to make the proposed offer;
(c) an injunction restraining the directors of Hiram Walker from causing Hiram Walker to invest two billion dollars in Fingas;
(d) an injunction restraining the Toronto Stock Exchange (TSE) and the Montreal Exchange (ME) from accepting a Notice filed by Fingas respecting the proposed offer;
(e) an injunction restraining Fingas from voting any shares of Hiram Walker it may acquire as a result of its proposed offer;
(f) an injunction restraining Hiram Walker from selling, transferring or otherwise disposing of the distilled spirits business to Allied-Lyons PLC (Allied);
(g) an injunction restraining the directors of Hiram Walker from causing Hiram Walker to sell, transfer or otherwise dispose of its distilled spirits business to Allied;
(h) an order directing Hiram Walker to produce its agreement with Allied for the sale of Hiram Walker's distilled spirits business;
(i) an injunction restraining the directors of Hiram Walker from acting in contravention of their duties under section 134 of the Act with respect to the proposed offer by Fingas

(continued...)

and involved the direct consideration of s.134(1) of the Ontario Business Corporations Act.[672]

While a number of issues were dealt with at first instance the primary focus of the court was a determination of the fiduciary principle to be applied to this case and whether any such duty had been breached. The conduct of the directors of Hiram Walker was a central issue.[673] In deciding the issue Montgomery J. noted that of the 18 Hiram Walker directors, only six were "insiders."[674] Of the remaining 12 none were now or ever had been officers or employees of the company. The court paid particular attention to the affidavits of Mr. Downing, the President of Hiram Walker and Mr. Lambert, an "outside director." The

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[671](...continued)
and in connection with their proposed sale to Allied;
(j) an order abridging time; and
(k) interlocutory and interim injunctions.

[672] S.134(1):

134(1) Every director and officer of a corporation in exercising his powers and discharging his duties shall,

(a) act honestly and in good faith with a view to the best interests of the corporation; and
(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Note that this section is the same as s.122(1) of the C.B.C.A., supra fn. 572-574.

[673] Hiram Walker p. 265.

[674] Ibid. p. 257.

latter's evidence was very influential as the court paid deference to his independent stature and business expertise.[675] The evidence of both parties was that expert advice was requested and received at several board meetings concerning the adequacy of the Gulf offer and the fact that the directors had a responsibility to act in the best interests of Hiram Walker and its shareholders.[676] Both affidavits stated that the decisions taken were based on the advice that the offer was inadequate and that "the best way to maximize benefit to the shareholders would be through the sale of the distilled spirits division of Hiram Walker combined with an offer to shareholders of $40 per share for 50 million common shares."[677]

Montgomery J. considered the decisions in Howard Smith, Teck and Norlin and concluded "that the law in Ontario is as

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[675] Ibid. p. 265 per Montgomery J.:

> The "insider" affidavit is supplemented by the affidavit of Allen T. Lambert, an "outside" director. Mr. Lambert is not now, nor has he ever been, an officer or employee of Hiram Walker. The extent of his independence and his business acumen may be drawn from his corporate involvement. Between 1961 and 1978 he was president and/or C.E.O. of the Toronto-Dominion Bank. He is presently chairman and a director of Trilon Financial Corporation, London Life Insurance Company and Hudson Bay Mining and Smelting Company Limited. He is also a director of Dome Mines Ltd., Dome Petroleum Ltd., Longvest Corporation, Royal Trustco Limited and others.

[676] Ibid. p. 266 and 267.

[677] Ibid. p. 267.

stated by Berger, J. in Teck."[678] In doing so he made particular reference to the board's responsibility to maximize share value for the benefit of the shareholders. He further cited First City Financial Corp. Ltd. v. Genstar Corp.[679] for the proposition that directors have an "... obligation to take steps that they honestly and reasonably believe are in the best interests of the company and its shareholders in a takeover contest or in respect of a takeover bid."[680]

Montgomery J. decided that the Hiram Walker board acted in accordance with their fiduciary responsibilities. In doing so he distinguished Howard Smith on the facts and found for the directors on the basis that they "acted prudently, properly, reasonably and fairly upon the advice of their legal and financial advisers and resorting to the opinions of management and their collective store of business acumen."[681] Montgomery J. found that the board acted in the best interests of all shareholders and that this was their sole and primary objective.[682] The appeal was dismissed and while Reid J. commented in part upon Montgomery J.'s analysis as noted above he did not disturb

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678 Ibid. p. 272.

679 (1981), 33 O.R. (2d) 631, 125 D.L.R. (3d) 303.

680 Ibid. 33 O.R. (2d) 631, at 646 as per Reid J.

681 Hiram Walker p. 270-271.

682 Ibid. p. 271.

his reasoning on this point. The matter was eventually resolved as Olympia and York Enterprises and Allied reached an agreement whereby control of the distillery business would be shared on a forty nine to fifty one percent basis.

Hiram Walker is an important decision both in terms of its application of the Teck test to Ontario and the fact that it represented the first time a Canadian court considered a case in which a major corporate asset was used as a defensive to a takeover bid.[683]

The case has come under some criticism:

> The reasoning of the Ontario courts in the **Hiram Walker** case dramatically increases the scope of managerial discretion in the midst of a takeover fight, constituting an invitatio to an incumbent board of directors to engage in almost any sort of defensive tactic imaginable. This represents an unfortunate development, in light of both the evolution of Canadian fiduciary breach law and the empirical evidence showing that defensive manoeuvring by management usually costs shareholders money. The approach taken in the case ought to be reconsidered.[684]

Is this a fair analysis of the case? Prior to approaching this question, there is another issue which should be of concern. Montgomery J. distinguishes Howard Smith on the facts. He also adopts at least in part the test in Teck in order to determine the existence of a fiduciary breach.

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[683] Simmonds, supra n.670, p. 630.

[684] Laurence Grafstein, Whose Company Is It, Anyway?: Recent Developments in Canadian Takeover Law (1988) 46, number 2 Toronto, Faculty of Law Review, 522 at p. 526.

This approach indicates a misunderstanding of Howard Smith. In that case the court refused to part with the underlying doctrine in Hogg v. Cramphorn Ltd. in that the director's actions had to be guided by some unstated purpose for which the power to issue shares was granted. Teck on the other hand rejected this premise and looked to intention of the board in the exercise of their discretion. This intent would be determined upon review of all the facts and a consideration of the impact of the takeover on the equity holders. In other words an objective test. Hence with respect Montgomery J. was incorrect when he accepted the reasoning in Howard Smith and at the same time applied the test in Teck.

To his credit, Montgomery J. reviewed some of the U.S. authority but it was only a partial review. Unocal, Moran and Revlon had all been decided prior to the hearing of this case. Perhaps a review of this authority would have raised some inquiry as to the placement of the burden of proof and the heightened level of concern that should be present in a takeover scenario. Montgomery J. does not make reference to such a concern directly. In addition, arguably the nature of the defensive tactic could have come under some further scrutiny.

The proposed agreement with Fingas involved a sale worth approximately 2.6 billion dollars of which Hiram Walker was to borrow 1.8 billion from a consortium of

Canadian banks. This in my opinion represented a major financial corporate reorganization given the substantial increase in corporate debt required to finance the purchase. Montgomery J. took the opposite view deciding that the sale of a corporate division which accounted for 2.6 billion dollars out of a net worth of six billion, was a fact that should not be considered to any great extent.[685]

In answer to the question of whether Hiram Walker has gone too far[686] the search for the answer is indeed an unsettling one. In addition to the concerns noted above, the court in this instance was too willing to accept the affidavit evidence of Messers. Downing and Lambert. Where was the hard evidence? Where were the affidavits of experts which might show that Gulf's offer was undervalued and by what process was the 'true' value determined? Without this in hand how could Montgomery J. determine if reasonable grounds did indeed exist for the compelling moves made by the board in defense of the company. This case decided as it was upon this type of affidavit evidence unfortunately invites abuse. I will agree with Mr. Grafstein where he states: "If the Teck case stood for the proposition that directors can undertake defensive tactics provided that they meet a strict burden of justification, Hiram Walker seems to suggest that a mere assertion of good faith by the directors

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[685] Hiram Walker p. 276-277.

[686] Supra n.684.

will suffice."[687]

Seven months after the decision in Hiram Walker, the Nova Scotia Supreme Court reviewed the fiduciary conduct of directors in EXCO Corporation et al. v. Nova Scotia Savings & Loan Company et al..[688] The facts are as follows:

> In EXCO, EXCO Corp. made an unsolicited takeover bid of Nova Scotia Savings & Loan Co. ("NSS&L"). Prior to its takeover bid, EXCO had amassed a 49.5 percent bloc of NSS&L common stock. In an attempt to defeat the EXCO takeover bid, the NSS&L management sought a suitor more to their liking. They found one in Halifax Developments Holdings Ltd. ("HDHL"). As a condition of becoming involved, however, HDHL required that, **inter alia**, NSS&L privately place 293,000 shares of its common stock in the hands of parties not unfriendly to HDHL and that stock options, which were to be granted to certain NSS&L officers to facilitate HDHL's competing bid, be exercised and the shares tendered in the HDHL takeover bid. The board of NSS&L agreed to, and complied with, the foregoing conditions, the effect of which was to reduce EXCO's position in NSS&L to approximately thirty-four percent and to increase HDHL's position to approximately twenty-five percent.[689]

At least eight separate actions were commenced of which six were addressed in this proceeding. Unlike Hiram Walker this case incorporated a full trial of the issues and an adjudication of the facts in detail. Unlike Teck personal damages were not sought against the target directors as injunctive relief was primarily at issue. The case was

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[687] Grafstein supra n.684.

[688] (1987), 78 N.S.R. (2d) 91, 35 B.L.R. 149 (S.C.).

[689] Baxter, supra n.468, p. 85.

decided by Richard J. who addressed the matter of fiduciary duty in detail. Prior to determining this issue however, the court held that the share allotments were in contravention of the Nova Scotia Savings and Loan Act.[690] As a result the actions taken by NSS&L directors were ultra vires and therefore the share allotments were void. In the result Richard J.'s comments with respect to directors fiduciary duty is obiter dicta. Nevertheless as has been stated, Canadian case law dealing directly with this issue is sparse and as such careful consideration must be given to this decision.

In speaking to this issue Richard J. acknowledged that there was no single line of authority that clearly defines the limits of a director's fiduciary duty when faced with a takeover bid. However he concluded that:

> ... if there is any principle which can be synthesized out of the cases it is that the Courts are reluctant to condone, let alone approve, any action which appears unfair, unjust or motivated by self-interest to the detriment of other legitimate interests. This appears especially true when dealing with the power of directors to allot and issue shares from the treasury of the company.[691]

The court in considering the common law gave particular attention to Howard Smith in light of the factual parallels that could be drawn between the cases. Richard J. cited

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690 S.C. 1964-65, c.72.

691 EXCO p. 256.

Howard Smith extensively[692] with particular reference to the circumstances under which shares may be legitimately issued:

> The Court in **Ampol** found that the issue of the shares was a function that was clearly intra vires the directors of Miller as per its articles of association but then commented at p. 1133:
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> > "But, intra vires though the issue may have been, the directors' power under this article is a fiduciary power, and it remains the case that an exercise of such a power though formally valid, may be attacked on the ground that it was not exercised for the purpose for which it was granted."
>
> The Court also found that there may well be reasons, other than the raising of capital, which would constitute a legitimate exercise of director's duty. ...
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> In finding that the exercise of the power in **Ampol** was improper the Court said:
>
> > "Directors are of course entitled to offer advice, and bound to supply information, relevant to the making of such a decision, but to use their fiduciary power solely for the purpose of shifting the power to decide to whom and at what price shares are to sold cannot be related to any purpose for which the power over share capital was conferred on them."
>
> The Court also agreed with the trial Judge when he found that the director's disregard of the rules of the stock exchange on which the shares were listed was further evidence that their intentions were directed primarily toward the take-over.[693]

Richard J. then turned to the case at bar and stated:

> Section 38 of the by-laws of NSS&L clearly give

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692 Ibid. p. 256-258.

693 Ibid. p. 257-258.

> the directors power and authority to issue shares from treasury. However, it is clear at law that such power must be exercised in the best interests of the company and not for any collateral purpose. Although there may be reasons for issuing shares other than the raising of capital, that appears to be the principal reason. I find that the share issues of November 1980 and July 1983 from the treasury of NSS&L were not primarily for the purpose of raising capital. There was no demonstrable pressing need for capital on either occasion.[694]

The court cited Hogg v. Cramphorn Ltd. only briefly and then only in contrast to the opinion of Berger J. in Teck. In his analysis Richard J. felt that Berger's "pronouncements in Teck [went] beyond what was required to decide [the] case."[695] Richard J. described Teck's position as follows:

> Berger J. adopted what is generally referred to as the "business purpose doctrine" or "proper purpose doctrine" which is opposite to the approach taken by Buckley J. in the **Hogg**, case supra. As Berger J. said at p. 311:
>
> > "Thus Buckley, J., takes the view that the directors have no right to exercise their power to issue shares, in order to defeat an attempt to secure control of the company, **even if they consider that in doing so they are acting in the company's best interests."**
>
> and then at p. 312:
>
> > "The impropriety lies in the directors' purpose. If their purpose is not to serve the company's interests, then it is an improper purpose. Impropriety depends upon proof that the directors were actuated by a

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694 Ibid. p. 258.

695 Ibid. p. 259.

> collateral purpose, it does not depend upon the nature of any shareholders' rights that may be affected by the exercise of the directors' powers."

In attempting to liberalize the strict approach in **Hogg**, Berger J. appears to recognize the inherent danger in such an expanded approach when he said at p. 315:

> "If the directors have the right to consider the consequences of a take-over, and to exercise their powers to meet it, if they do so bona fide in the interests of the company, how is the Court to determine their purpose? In every case the directors will insist their whole purpose was to serve the company's interest. And no doubt in most cases it will not be difficult for the directors to persuade themselves that it is in the company's best interests that they should remain in office. Something more than a mere assertion of good faith is required."

Berger J. then attempts to resolve this dilemma by postulating a test for use in assessing the motives of the directors in any given case. He states, again at p. 315:

> "I think the Courts should apply the general rule in this way: The directors must act in good faith. Then there must be reasonable grounds for their belief. If they say that they believe there will be substantial damage to the company's interests, then there must be reasonable grounds for that belief. If there are not, that will justify a finding that the directors were actuated by an improper purpose."[696]

Richard J. agreed with the decision in Teck on the basis that it was a good business decision, stating that "the fact that the deal included a substantial block of shares was ...

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[696] Ibid. p. 259-260.

incidental to the total package."[697]

Richard J. then put forward his own test of fiduciary duty as follows:

> Even the test laid out by Berger J. in the **Teck** case requires further refinement if it [sic] to be applied generally. When exercising their power to issue shares from treasury the directors must be able to show that the considerations upon which the decision to issue was based are consistent only with the best interests of the company and inconsistent with any other interests. This burden ought to be on the directors once a treasury share issue has been challenged. I am of the view that such a test is consistent with the fiduciary nature of the director's duty, in fact, it may be just another way of stating that duty.[698]

In holding for the plaintiff Richard J. provides the following summary:

> In relating the facts of this case to the law respecting the duty of directors in issuing treasury shares I find that the NSS&L directors made a one-sided allotment of shares for the purpose of "watering down" the commanding share equity position of the so-called EXCO group. The NSS&L directors used their rather substantial power for a wrong purpose, i.e., a purpose which was not demonstrably in the best interests of the company. They used their power to support one group in a take-over, a group which the directors had sought out and which was "not unfriendly" to those directors. What the directors did in this case is more consistent with a finding of self-interest than with bona fide company interest. Or, to put it more in the context of the test which I previously set out, what the directors did was not inconsistent with self-interest. In so doing they breached their fiduciary duty to the

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[697] Ibid. p. 259.

[698] Ibid. p. 261.

general body of the shareholders.[699]

What inference can we or should we draw from this case? Is this decision sound as the product of an informed and reasoned judgment? Has it taken the law a few steps further along a path that might ultimately lead to a realistic and widely accepted judicial approach to this type of fiduciary duty?

With respect I believe that Richard J. failed to consult relevant authority, misunderstood the decision in Teck and generally did not have a grasp of the common law in this area. Further that his revised fiduciary standard is therefore suspect in law and may generally be flawed in substance.

It is wholly unacceptable that in his research Richard J. failed to consider the decision in Hiram Walker. This case was decided only months earlier, applied the law in Teck and stood as the current authority in the province of Ontario. Further where Richard J. makes reference to the "proper purpose doctrine" in light of Berger J.'s application of same as opposite to the approach taken in Hogg v. Cramphorn Ltd.,[700] he is entirely incorrect. In fact as was discussed earlier Hogg v. Cramphorn Ltd. is authority for use of the doctrine in takeover scenarios and Teck is

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[699] Ibid. p. 262.

[700] Supra n.696.

authority for the rejection of this approach. This represents a fundamental error in law and underscores Richard J.'s misunderstanding of the common law. In addition Richard J. does not provide a reasonable explanation for his belief that Teck went too far in its application of Berger J.'s test. To say that Teck could have been decided solely on the basis that it was a good business decision, is to say that this is the guiding principle. If that is the case one may query why it was not a consideration in the case at hand. Further the allotment of shares by way of a "bonus" in Teck would have displaced the majority shareholder. In the case at bar NSS&L attempted a similar strategy which would have reduced EXCO's position from 49.5% to 34.0%. Whereas Richard J. considered this as only an incidental consideration in Teck, he based his judgment in EXCO on the fact that EXCO's majority position would be disturbed in a similar fashion. The two approaches are not reconcilable.

What of Richard J.'s own test? Clearly the court broke with tradition when it placed the initial burden of proof on the target directors. This burden was said to be consistent with the fiduciary principle. It is also consistent with the authority in Delaware although there is no indication that American law was considered. To meet this burden the board must show that their actions are consistent only with the best interests of the company and inconsistent with any

other interests.[701] Four paragraphs later Richard J. appears to modify the test by saying that the board may not act in a manner inconsistent with self interest.[702] The court then looked at whether the actions taken were more consistent with self interest than with bona fide company interests. These tests are not the same. The former leaves no room for inconsistency while the latter appears to be decided on a balance of probabilities. Which one did the court intend? In either case Richard J. appears to be applying the proper purpose test whether he knew it or not. In the case of share issues he directed himself to the enabling section of the NSS&L by-laws and inferred therefrom that the principle reason for issuing shares was to raise capital. With this burden in tow the board could show no other proper purpose and in doing so they breached their fiduciary duty through the share allotment.

In summary this case was decided upon principles which the trial judge misunderstood and consequently misapplied. By failing to canvas all relevant authority and by virtue of internal inconsistencies the case should be approached with the utmost caution. If a shift in the burden of proof represents a step forward then the reasoning upon which it and the remainder of the test is based represents two steps backward.

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[701] Supra n.698.

[702] Supra n.699.

PART XI

A. REGULATORY FRAMEWORK

Both the Government of Canada and the Provinces have the authority to regulate securities. Provincial laws regulate bids for companies where such bids are sent to shareholders resident in the province. Federal legislation applies to bids for federally incorporated companies. Where the two jurisdictions overlap both sets of regulations will apply with the acquiror obliged to comply with the most stringent provisions of each statute.[703] Regardless of the jurisdiction however all takeover bid legislation has the same general intent;

> Take-over bid legislation is thus, in the words of the **Kimber Report**, designed primarily for "the protection of the bona fide interests of the shareholders of the offeree company." This objective is "accomplished in three principal ways: by giving the offeree" (shareholder) "information relevant to his decision whether to accept or reject the offer; by ensuring that he has time to assess the information and make a reasoned decision; and by requiring that he be treated equally with other offerees both in terms of price and in respect to the portion of his securities which will be taken up in an over-subscribed partial bid."[704]

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[703] Hadden T., Forbes R., Simmonds R., Canadian Business Organization Law (Toronto: Butterworths 1984) at p. 511.

[704] Ibid. p. 509.

A takeover bid is itself typically defined as follows:

> "take-over bid" means an offer to acquire outstanding voting or equity securities of a class made to any person or company in Manitoba or to any security holder of the offeree issuer whose last address as shown on the books of the offeree issuer is in Manitoba, where the securities subject to the offer to acquire, together with the offeror's securities, constitute in the aggregate 20% or more of the outstanding securities of that class of securities at the date of the offer to acquire; ("offre publique d'achat") and...[705]

Notably the 20% threshold is a condition precedent to the operation of any takeover bid rules. Hence the legislation is not concerned with whether or not actual control has been asserted prior to or after the 20% bid requirement has been met. After a 20% holding is achieved any offer will by definition amount to a takeover bid. Once these regulations have been activated they require the offeror to notify the relevant shareholders as defined by the applicable Act. The form of notification includes a takeover bid circular in which the acquirer "is required to describe any other material fact concerning the securities of the target company and any other matter known to the acquiror which might reasonably be expected to affect the shareholder's

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[705] The Securities Act R.S.M. 1988 c.S50 s.80(1). The 20% holding stipulation has been widely adopted within provincial jurisdictions. The C.B.C.A. however stipulates in s.194 that a 10% bid will suffice. This bid relates to any class of issued shares and is therefore much broader in scope than the provincial regulations.

decision of whether to accept or reject the offer."[706] In addition the board of the target company is required to send a director's circular. This circular may at the director's discretion include a recommendation to accept or reject the bid. Where the Canada Business Corporations Act applies a circular which does not state an opinion requires an explanation for the lack of a recommendation.[707] As with the offeror's circular the director's circular must set forth all such information which might reasonably affect a shareholder's decision to accept or reject the offer.

Takeover bids must be open for a minimum of twenty-one days and shares tendered may be redeemed within ten days of the date upon which the bid commenced.[708] In addition if significant changes occur during the course of a takeover bid new disclosure and time periods for withdrawal conditions will apply. Acquirors are also required to offer identical consideration to all holders of the same class of securities.

The foregoing provisions are subject in all jurisdictions to exempted situations under which the regulations will not apply. Of primary interest here is the Stock Exchange exemption. This does not mean that takeover bids

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[706] Hadden T., supra n.703, p. 515.

[707] C.B.C.A. Regulations, s.68(f). See also O. Reg. 374/87, s.5.

[708] Hadden, T., supra n.703, p. 521.

which are orchestrated through a stock exchange are unregulated.

> The stock exchange by-laws and policies applicable to take-over bids define a take-over bid, which requires compliance with these rules, in much the same fashion as the provincial securities acts. An offer to purchase shares which, when aggregated with the offeror's presently owned shares, exceeds more than 20 per cent of the outstanding voting shares of the target company is a take-over bid. However, where the law under which the target company is incorporated defines a take-over bid in terms of the acquisition of 10 per cent of the voting shares, the stock exchange's rules applicable to take-over bids are activated at the same level.[709]

In addition most provincial legislation requires that the relevant securities commission be satisfied as to the disclosure and timing requirements of the exchange before it will engage the exemption.

While Provincial, Federal and Stock Exchange rules and regulations have been adopted to further the best interests of stockholders two 1986 cases "offer classic examples of how Ontario's elaborate securities laws designed to give sovereignty to shareholders can be utterly ineffectual in concrete situations."[710] In Southam[711]

> ... a deal was struck in the wake of intense

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[709] Ibid. p. 535. See also TSE By-Law No. 147, ss. 23.01(13) and 23.01(11).

[710] Grafstein supra n.684, p. 533.

[711] In the Matter of Torstar Corporation and Southam Inc. (6 June 1986) 9 O.S.C. Bulletin 3088.

takeover rumours during the summer of 1985. When these grew to a crescendo in late August, the target's directors were advised by their investment banker that a bid was imminent. The board "believed that a dismemberment by a successful bidder would not be in the best interests of the remaining Southam shareholders or Southam's employees and customers" and that "a hostile bidder would treat shareholders unequally." Further, because Southam is predominantly involved in the newspaper business, the directors thought there was a public interest in avoiding the feared break-up of the corporation's assets - although they did not specify why concentration of media ownership would be preferable to diversity of ownership. One member of the board declared, "[I]t would have been a clear betrayal of Southam company policy to allow the dismemberment of the Southam Group by a third party whose primary interest might be in the maximization of profits, rather than in publishing quality newspapers." The board's attitude, in sum, is clear. What is not clear is whether Southam minority shareholders harboured the same priorities - because they never had a chance to be heard.

Southam reacted to the growing pressure in late August by encouraging overtures from rival newspaper publisher Torstar. Over a weekend, the two companies entered into a share swap transaction, whereby Southam sold some of its authorized and unissued common shares to Torstar in exchange for non-voting common shares and convertible preference shares. The net result after the deal was that Southam owned 29.8 per cent of Torstar common and Torstar controlled 20 per cent of Southam. Pursuant to the bargain, Torstar then bought an additional 5 per cent on the open market. In addition, Torstar entered into a 10-year standstill arrangement with the Southam family, in which Torstar also agreed to vote its Southam shares for directors nominated by the Southam control group. As a condition of the share exchange, Torstar required the deal to be executed over the weekend, notwithstanding the TSE pre-notification requirement. As the Southam statement of facts itself admitted: "The Southam board members shared Torstar's concern that a delay in the share exchange could well give a hostile bidder the opportunity to block the Torstar transaction by quickly obtaining an

injunction."[712]

The share swap was a wilful breach of TSE By-Law 19.06 requiring advance notice to shareholders of any issuance of shares and which gives the TSE unlimited discretion to accept or reject the notice. In addition, the TSE may require a shareholder vote as a condition of acceptance if the transaction

> (a) may materially affect control of the company;
> (b) has not been negotiated at arm's length; or
> (c) is of such a nature as to make shareholder approval desirable, having regard to the interests of the company's shareholders and the investing public.

Regardless of these facts the TSE allowed the transaction under its "25 percent rule."[713] The ruling is remarkable in its failure to respond to what was in effect a major corporate reorganization orchestrated to avert a perceived takeover and performed out of view of the shareholders. Upon review the Ontario Securities Commission did not take steps to rectify the situation even though it recognized the severity of the breach. TSE officials however stood by their decision. The only action taken by the OSC was to prevent the directors of both companies from trading in the

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[712] Grafstein, supra n.684, p. 536-537.

[713] TSE Company Manual (1986) s.620. This rule states that private placements do not require shareholder approval unless the transaction involves in excess of 25 per cent of the company's equity.

Ontario capital markets for a period of six months.[714] Given that the transaction had been allowed to proceed and that shareholders had already acted in reliance of this fact, there is arguably nothing else the OSC could have done under the circumstances.

The next case of Canada Malting[715] is similar in nature:

> In the fall of 1985, the chief executive officer of Canada Malting heard of takeover rumours. He immediately contacted the company's investment bankers to discuss options. A decision to issue shares in a private placement to Canada Malting's two largest shareholders, Molson's and Labatt's breweries, was made quickly thereafter. The issuance of common shares increased the combined stake of these two beer-makers from 28.3 per cent to 39.7 per cent. Molson's and Labatt's, although sharp rivals for Canadian beer markets, both have a significant business relationship with Canada Malting. Together, they account for 50 per cent of the company's world-wide malt sales and 80 per cent of its domestic sales. The notice of the share issuance was accepted by the TSE just 9 days after Canada Malting got first wind of takeover talk. The transaction went forward the next day at $24 per share, the approximate market price of the stock during the preceding week but constituting a 15 per cent premium above the trading range during the previous month. Canada Malting's investment banker gave an opinion saying that the price represented fair value.[716]

The case arose upon appeal from a decision of the TSE

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[714] See Re Ontario Securities Act s.124(1).

[715] In the Matter of Canada Malting Co. Limited (27 June 1986) 9 O.S.C. Bulletin 3566; Re Canada Malting Co.; Re Molson Companies Ltd. and Ogivile Mills Ltd. (1986), 33 B.L.R. 1.

[716] Grafstein, supra n.684, p. 538-539.

not to require shareholder approval for the private placement of shares. The appeal was brought by a group of minority shareholders. The case is significant in that it provides an insight into the effective level of control which the TSE has in such cases. As in Southam, TSE By-Law 19.06 was at issue. The Commission first addressed those considerations which form the guidelines under which they would consider their response. These were as follows:

> ... the OSC has indicated five possible grounds on which it might interfere with a decision of the TSE:
>
> (i) the TSE proceeded on some incorrect principle;
> (ii) the TSE erred in law;
> (iii) the TSE overlooked material evidence;
> (iv) new and compelling evidence was presented to the OSC that was not presented to the TSE; and
> (v) that TSE's perception of the public interest conflicts with that of the OSC.[717]

The Commission "given the care with which the TSE's filing committee approaches its responsibilities under By-Law 19.06"[718] placed a heavy burden of proof upon the applicant. Upon reviewing the facts the appeal was dismissed. This is an intriguing result in that it represents somewhat of a green light to target directors who, acting only in response to rumour, are afforded the opportunity to issue shares in an effort to avert some possible future

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[717] Canada Malting p. 15.

[718] Ibid. p. 16.

takeover attempt. The appeal was dismissed even though the Commission found that the initial prime moving factor was to consolidate control and fend off any possible takeover bid.[719] The Commission did not then take the next step and determine whether under some form of guideline this step was justified.

This form of review invites abuse. The TSE while informed of the takeover rumour, did not make any further enquiry.[720] To disregard motive as an element in determining whether share distributions are justified brings more uncertainty to an area of the law which is already adrift in a sea of doubt. While the common law was attempting to define some form of guideline the TSE and the OSC were content to look the other way while acknowledging the other's excellent performance.[721] Mr. Grafstein's point is well taken when he states that "in Hiram Walker, Southam, and Canada Malting a tendency toward both cursory and conclusory reasoning is all too evident."[722]

In addition an in depth evaluation of all relevant facts must be done at the stock exchange level as once the transaction has been approved, Pandora's box has been opened and even a successful appeal several months later will have

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[719] Ibid. p. 13.

[720] Ibid. p. 18.a

[721] Supra n.718.

[722] Grafstein, supra n.684, p. 541.

no consequential effect. In deciding the case the Commission made reference to this ideal but one cannot from this case detect anything but lip service to it.

> We would note, in conclusion, that By-law 19.06 gives a very broad and important power to the TSE. It may be that the TSE should rethink its procedures under By-law 19.06 and perhaps restate By-law 19.06 and s.606 of the TSE's company manual. The 25 per cent limit that is built into s.620 may be too rigid and greater flexibility may be called for. At the same time, more precision may be called for in By-law 19.06, although one can appreciate that the TSE wishes to give itself a degree of discretion in an area where an infinite number of factors come into play.
>
> In exercising its discretion under By-law 19.06, the TSE must be careful to ascertain that it has all the facts before it and that its decision is made in a considered fashion on the basis of all those facts and on the basis of what is in the best interests of all of the shareholders of the company.[723]

Following Southam and Canada Malting and in response to the EXCO case, the Canadian Securities administrators adopted a set of guidelines which represent an attempt on their part to regulate target company defensive tactics. National Policy 38 was adopted on August 1, 1986[724] and was the product of developments which can be traced back to

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[723] Canada Malting p.18. For an update on current developments within the O.S.C. reference may be made to the Ontario Securities Commission Draft Policy Statement 7.1-Disclosure, Valuation and Approval for Insider Bids, Issuer Bids, Going Private Transactions, Significant Asset Transactions and Other Related Party Transactions May 23, 1990.

[724] National Policy No. 38 - Take-over Bids: Defensive Tactics (1986) 9 O.S.C.B. 4255. This policy has been reproduced in Appendix "B."

1973. At that time Ontario's Select Committee on Company Law recommended that the province develop legislation which would be similar in nature to Rule 38 of the United Kingdom City Code on Take-Overs and Mergers ("City Code").[725] While the recommendation was not followed, the intent of the proposal was subsequently adopted in National Policy 38. The intent of the policy is to maximize shareholder interests. This view is engaged through the following maxims which may be gleaned from the policy itself:

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[725] Stanley Beck, Rob Wildeboer, National Policy 38 as a Regulator of Defensive Tactics, 1987 Meredith Memorial Lectures, Faculty of Law, McGill University 119 at 120, footnote 3:

> See 1973 Report on Mergers, Amalgamations and Certain Related Matters by Select Committee on Company Law (the "Merger Report"), at 39. The City Code provision to which the Merger Report referred read as follows:
>
> > "38. During the course of an offer, or even before the date of the offer if the Board of the offeree company has reason to believe that a **bona fide** offer is imminent, the Board mut [sic] not, except in pursuance of a contract entered into earlier, without the approval of the shareholders in general meeting, issue any authorised but unissued shares, or issue or grant options in respect of any unissued shares, create or issue or permit the creation or issue of any securities carrying rights of conversion into or subscription for shares of the company or sell, dispose of or acquire or agree to sell, dispose of or acquire assets of material amount or enter into contracts otherwise than in the ordinary course of business. Where it is felt that an obligation or other special circumstance exists, although a formal contract has not been entered into, the Panel must be consulted and its consent obtained."

(1) Takeover bids have an important role in the economy, for both economic and legal reasons.

(2) Target management is in a conflict of interest situation when facing a hostile bid.

(3) The primary objective of takeover bid legislation is the protection of the **bona fide** interests of target company shareholders. A secondary objective is to provide regulatory neutrality between the offeror and target management.

(4) Target company shareholders have the right to make the takeover bid decision. As such, target management has no valid reason to (unilaterally) deny them that right. Target management motivation effectively becomes irrelevant.

(5) The appropriate regulatory approach to takeover bids is to encourage unrestricted auctions.

(6) It is inappropriate to design a specific set of rules regulating target director conduct, other than those imposed by corporate law fiduciary standards. However, even without specific rules, it is possible to develop presumptions as to what conduct may be proper or improper.[726]

National Policy 38 is a significant development in that while it is not judicially binding, it may be persuasive. In addition, in concrete terms it has an everyday real life impact as critical decisions regarding the outcome of takeover bids are often made by the relevant securities commission or stock exchange rather than the courts.[727]

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[726] Ibid. p. 121. For an indepth discussion of each maxim, see text p. 122-137.

[727] National Policy 38 has been adopted by all stock exchanges.

These facts are telling and warrant a careful evaluation of the policy itself.

National Policy 38 is concerned directly with the Target Board's response to an actual takeover bid or actions taken in consideration of an imminent bid. Once this occurs directors must act in the best interest of the shareholders. Within this context there appears to be little to no room within which to consider non-shareholder interests as the focus is primarily fixed upon profit maximization. While the policy allows directors to take defensive measures to defeat a takeover bid, such steps must not deprive shareholders of the ability to respond to the takeover bid or competing bid. Defensive measures which are intended to promote a better offer will be looked upon favourably with unrestricted auctions representing the best possible scenario.

It is ironic if not in fact inconsistent that while the policy states that it is inappropriate to specify a code of conduct for directors, that is exactly what has been delivered. Arguably National Policy 38 affords target boards no discretion whatsoever to take action to protect corporate interests in the longer term where the test of short term financial gain may be met. It flies in the face of reasoned opinions such as those of Berger J. in Teck wherein the duty of the board to run the corporate enterprise is read more broadly than a simple consideration of

the net asset value of the corporation or some other basis of valuation. This policy conveniently ignores the essential element of corporate governance, the role of directors in providing reasoned direction in times of corporate crisis.

Perhaps just as disconcerting is the language of the policy itself. By framing the commission's response to defensive manoeuvers as one which "may" or may not be challenged and by not limiting the response to any particular defensive manoeuver directors are open to challenge under any and all circumstances. Further, there is every indication that liability will accrue where in the discretion of the Commission defensive measures were undertaken which did not maximize profits even though such actions were taken bona fide in the best interests of the company and its shareholders. This approach again ignores corporate reality. It is wholly inconsistent with current Canadian case law and ignorant of the measures taken in the various American jurisdictions previously documented in this thesis.

This policy reflects what might be considered an easy solution to a most complicated issue. Trade and commerce concerns such as these cannot be dealt with by way of such an insular approach. To ignore the generally accepted approach in the United States and the law in Teck as adopted in Ontario and Manitoba, is a dangerous precedent. In an era of Free Trade and international commerce the Canadian

Securities Commissions stand alone in their adoption of an ill-considered and illogical national strategy. It is too early to judge the impact of this policy but both judges and legislators alike would do well to follow another path and in doing so, provide judicious guidance to both securities commissions and stock exchanges alike.[728] A more thoughtful position was put forward by Reid J. in First City Financial Corp. v. Genstar Corp.:[729]

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[728] Baxter supra n.468, p. 100:

> The Canadian Securities Administrators in National Policy No. 38 appear to take the position that the success of an unsolicited takeover bid should be determined by the target's shareholders, and that the role of the target directors is merely to seek the best available offer. This position, however, essentially relegates target directors to the role of auctioneers and places the target company permanently on the auction block. While such a role is appropriate for the target directors when a sale of the target is inevitable, it is not an appropriate role for target directors who believe, in good faith, that the best interests of the company and its shareholders are better served by the company remaining independent. The position adopted by the Canadian Securities Administrators is inconsistent with both the existing Canadian case law and the fundamental premise of corporate governance that the directors' role is to manage the company. It is too early to tell what effect National Policy No. 38 will have on the fiduciary duties of target directors. It would, however, be unwise for courts to blindly follow the policy without first critically evaluating the assumptions upon which it is based, in light of the existing framework for analysis articulated by such cases as Teck.

See however Beck and Wildeboer supra n.725 at p. 133-134 for a competing view.

[729] 33 O.R. (2d) 631 at 646 citing the position taken in Teck.

The right and indeed the obligation of directors to take steps that they honestly and reasonably believe are in the interests of the company and its shareholders in a take-over contest or in respect of a take-over bid, is perfectly clear and unchallenged.

PART XII

A. SUMMARY

What is a director's proper role during contests for corporate control? That after all is the fundamental question which must be addressed whenever a takeover is underway. Further, how should the board direct itself in advance of such an occurrence whether or not a takeover is perceived to be imminent? The search for an answer to these issues has been the dominant focus of this thesis and has brought into sharp relief the milieu in which target boards operate within the various jurisdictions presented. In this final section I will put forward my personal views with respect to the many issues which form a constituent part of the overall answer to this most important question.

1. DUTY OF CARE

a. General Standard

What is an appropriate test under the duty of care requirement? Arguably directors of U.S. boards must meet a higher test of scrutiny than their Canadian counterparts. Both U.S. statutory and common law guidelines subsume skill and diligence under the general head of 'care' and apply

thereto an objective test. While expertise in a particular area may raise the standard all directors regardless of skill must exercise the common sense, practical wisdom, and informed judgment of an "ordinarily prudent person." A breach will be assessed on the basis of negligence whether 'simple' or 'gross' in nature.

On the other hand Canadian jurisprudence draws a distinction between the duty of care, skill and diligence. Where care and skill are put to the test the law will first apply a subjective analysis with a view to determining the personal attributes of the individual director. Upon making that finding the court will then objectively consider whether this director has met the standard that would be applicable for that type of individual. Where such a director is found to be grossly negligent in his undertaking he will be in breach of his duty of care. Only diligence is tested in an objective fashion oblivious to personal attributes.

In my view all directors should be treated equally and without concern for the nature of the corporation or business activity involved. All directors share equally the burden of managing the corporation and only one vote may be cast by each participant. Directors are chosen from different constituencies with a view to improving the decision making of the whole and not of the part. Hence expertise is a fluid concept, an essential ingredient in the

decision making process, but it is not the process itself. For those reasons, it would be unfair to burden one director more greatly than another on the basis of skill in a particular area. Conversely all directors are equally responsible for a given decision and as such should not be judged more leniently on the basis of a lack of expertise.

This approach also serves the equity holder. While he must accept some risk due to the nature of his investment, he has the right to demand a level of expertise that is consistent with objective standards and inconsistent with the vagaries which may be present due to the subjective failings of particular board members.

Canadian jurisprudence is particularly well suited to the application of this type of approach as it represents an equitable arrangement. In other words, it serves both sides justly with a view to providing a balanced approach to any issue. This is a theme which is central to my approach, one which has a long and rich judicial history and is compatible with existing judicial doctrine. It is particularly applicable here because corporate control contests are ripe in opportunity for the abuse of interests between all participants and most often under circumstances which afford undue opportunity among the parties involved. However equity, balance, fairness ... cannot be achieved without guidelines. Both directors, equity holders, and others must know where they stand if anyone's interests are to be

properly served. It is these very same guidelines which are largely absent from current Canadian law.

b. Reliance on Expert Advice

The advice of experts or the lack thereof often plays a central role in trials or hearings which arise from contests for corporate control. Both Canadian and American jurisdictions recognize the inherent role of such counsel through the common law and by statutory authority including both the ALI and Model Act codifications. Not surprisingly, the U.S. approach is more demanding than its Canadian counterpart. The case law in Delaware and New York demand that expert advice not be taken at face value. To that end, the Hanson decision went so far as to indicate that directors must ensure that the advisors have in fact become fully informed prior to accepting or rejecting their reports.

In contrast Canadian common law sets a very low standard and with the possible exception of Ontario the statutory standard has failed to make any appreciable change. Many jurisdictions require only the test of 'good faith' reliance and as such are unconcerned with the nature of the material relied upon. While Ontario appears to set a higher standard as good faith is not particularized as an absolute defense, in actual fact the decision in Hiram Walker is evidence for the proposition that good faith alone

is indeed exculpatory.

Again, what level of scrutiny is fair as a test of the duty of care? Where corporate control is not at issue, directors must both meet the test of good faith and direct themselves substantially in accordance with RMBCA s.8.30(b)[730] and in doing so they "must have read the report or statement in question, or have been present at a meeting at which it was orally presented, or have taken other steps to become generally familiar with its contents."[731] Further, the director must have a reasonable belief that the information relied upon is based upon professional competence. The latter is intended to be objectively defined. Having done so the director is entitled to rely upon the material presented to him.

Where corporate control is at issue directors should have to meet an enhanced evidentiary test. Under these circumstances directors must take positive steps to ensure that the information presented is based upon judgment which is itself the product of full and complete research and deliberation. Directors must inform themselves of the process by which the advice was determined and be satisfied to the extent that they can reasonably rely upon it. In its inquiry the court would be entitled to objectively consider whether upon the facts such reliance was justified. In most

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[730] Text p. 9.

[731] Ibid. p. 12.

cases the advice at issue concerns share and asset values. Given the present regime, directors and other advisors have precious little time to consider fully their response to a takeover bid. As this response is so often influenced by an evaluation of the proposed monetary consideration directors must have ready access to all current financial data. This must be available at short notice in order to allow for sufficient time in which to consider a reasoned response. In addition the board must have in place procedures which would be followed upon receipt of a takeover bid such that they will have directed themselves in a manner consistent with a full and deliberate evaluation of the issue at hand.

These tests again serve all constituencies. They insure that the equity holder can demand informed leadership and place upon directors a standard which is consistent with both the nature of the task and the time that may be accorded to it.

As a final note to this section I draw reference to the various U.S. statutory regimes which reduce the standard of care to the level of 'good faith' alone.[732] In my opinion these provisions are reactionary and self serving and do not reflect the best interests of shareholders. Exempting professional advice from judicial scrutiny is inconsistent with the reasoned judgment of the common law. As was presented it is precisely the advice of experts which is the

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[732] Ibid. p. 13.

foundation upon which many a defense is launched. Such counsel is often at the core of these contests and as such it must be laid open to the most stringent scrutiny. By exempting directors where they rely only in good faith upon such counsel, these states are doing the equity holders a great disservice.

2. OUTSIDE DIRECTORS

Outside directors sometimes do and always should play a prominent role during the course of a corporate control contest. But who is or should be considered an outside director? In my opinion the determinant factor is the independent status of that individual at the relevant point in time the issue arose. A director is an outside director where at that time he was free from any relationship which could interfere with the exercise of independent judgment.[733] This would in my estimation exclude:

1. Employees or former employees regardless of how much time has elapsed since employment was terminated.

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[733] The New York Stock Exchange defines the position as follows:

> "(an independent) director (is one) who is independent of management and free from any relationship which could interfere with the exercise of independent judgment as a committee member."

2. Immediate family members of any of the above.
3. Board members who have held or have had the power to vote an equity interest in the target company, raider or any related company in the past two years.
4. Board members who have at any time within the previous five years received any remuneration for professional services rendered to the target corporation, raider or any related company.
5. Board members who are or were affiliated in a professional capacity with a law firm, investment banking firm or accounting firm which have advised the target company, raider or related company within the previous five years.
6. Any further relationship whether personal or monetary which under the circumstances could reasonably be expected to interfere with the exercise of independent judgment.

These guidelines should be incorporated under the definition of Outside Directors in all corporation's statutes.

During the course of any proceeding whether for interlocutory relief or in a trial scenario the court must first satisfy itself with respect to the status of each director. This has as yet not been the case in either Canada or the United States where I believe the courts have been unwilling to fully differentiate between independent

and non-independent 'outside' directors. Having established the makeup of the board these outside independent directors still retain the same duty of care burden as does any member of the board. The advantage which the target board has however where a majority of the board consists of outside directors is in the area of establishing good faith.

In my view every corporate board should consist of a minimum of two outside directors for every inside board member. Where corporate control is at issue the outside directors must meet independently to hear and consider all relevant advice and material upon which a decision will be based. This 'outside board' should then vote as a group upon every issue which will affect the outcome of the event at hand. These votes will then be carried back to the board as a whole.

3. FIDUCIARY DUTY/NON-SHAREHOLDER INTERESTS

How much weight should target boards give to the interests of inside vs. outside constituents when considering a takeover bid? The answer to this question takes us to the heart of the determination as to whom directors owe a fiduciary duty and the nature of that duty itself. To answer the question let us first focus on the responsibility of directors when faced with decisions which do not entail corporate control issues. As has been noted, Canadian

authority is mixed with respect to the issue of a director's fiduciary duty to the shareholders themselves. In my view the nature of the relationship falls squarely within the conceptual framework upon which fiduciary duty is based. This is an important consideration in as much as the interest of shareholders and those of the corporate entity itself may not always be synchronous. This is precisely what happens in a takeover contest where the short term gain of shareholders may result in the breakup of the corporation itself. Given that the establishment of a fiduciary link between shareholder and director is not necessarily accepted and in fact rejected in some jurisdictions, what authority exists for asserting a similar relationship for outside interests? We have Berger J.'s obiter dicta in Teck[734] which accepts wholeheartedly the important place employee and community interests hold in respect to the decision making process of directors. In addition, A.B.C.A. s.117(4)[735] gives a director the authority to give "special but not exclusive' consideration to the interest(s) which elected him. However that is the sum total available and in my view neither one is authority for the position that a fiduciary relationship exists.

Does the nature of the relationship change where corporate control is at issue? The answer is no. The issue

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[734] Text p. 244.

[735] Ibid. p. 213-214.

is not one of control. The interests of employees, creditors, community and the like can be severely impacted at any time as with a decision to close an entire plant or mine for any stated purpose. The question is how many masters can a director be expected to serve. Fiduciary principles are intended to prevent conflicts of interest. A fiduciary cannot represent conflicting interests. If he does he serves no one. Furthermore, it is unacceptable to expect directors to properly fulfill their management role without clearly indicating whose fiduciary interests they represent. In this case certainty in the law may not be a state of grace but it is a virtue. Given our competing interests then who do we choose? Where are the ties that bind? In my view the shareholder represents the overriding choice.

Does this mean that non-shareholder interests may be ignored? This is not the case. Doing so would ignore the important social role which corporations play in contemporary society. Thus given any number of strategies or decisions which might be played out or made, directors must consider the impact upon employees, community and other interested constituents in every scenario. However, their fiduciary duty will still be owed to the corporation and its shareholders and the final decision must reflect this fact.

Now, recognizing that the interests of the corporation and its shareholders do not always meet especially where control is at stake, where should the target director focus

his attention? Clearly there is some virtue in siding with the interests of the corporate entity. After all, where it is to be dismembered can the directors have fulfilled their statutory duty to properly manage the company? At the same time, who is the corporation if not the shareholders. Is it not for their benefit that the corporation is to be managed? Again competing interests may not be served if the fiduciary principle is to be followed. In my view directors are elected by and answerable to the shareholders and not to the 'corporation' as an ephemeral concept. Now, within this group there are also competing interests. As has been described, corporate control contests often pit the interests of various classes of shareholders against those of the other and even create rifts within the same class. Thus in the context of a takeover bid some shareholders may wish to sell taking advantage of the premium offered while others will not in the interests of seeking a longer term investment. This is the point where in my opinion certainty must yield to flexibility. Having determined the relative position of non-shareholder interests and corporate interests vis-a-vis shareholder interests, one can but offer guidance to the target director in his deliberations during contests for corporate control. In my view the ALI offers the best approach to the issue in their s.6.02.[736] While the section deals with blocking tender offers the same

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[736] Ibid. p. 172-173.

considerations should apply in deciding whether or not to defend against a takeover bid. This section provides a degree of certainty coupled with the necessity of flexibility and guidance required in takeover scenarios. In addition, it is difficult to conceive of many situations where the corporation's best interest will not be served if the decision favours the long-term interests of shareholders. Thus where directors meet this test they will in my estimation have acted in 'the best interests of the corporation.'

4. DIRECTOR'S LIABILITY FOR MONETARY DAMAGES

This area of the law poses a most interesting dilemma. The economic machinery that drives industrialized countries is made up in large measure by corporate concerns both large and small. By law these entities must be managed by directors who in the final analysis bear the ultimate burden of fault where some damage is occasioned to the corporate entity. While a corporate board is by and large a voluntary collegial affair, the fact remains that society relies upon such people to step forward and take charge. This in many ways is illustrated by the term 'captains of industry' as such individuals are often called. As the term implies, leadership and responsibility must predominate. For the most part these directors or 'volunteers' are then elected

and paid a sum of money which is intended to provide recompense for their time and effort. At this point they have assumed the mantle of responsibility. The dilemma that arises is that given the current difficulty in providing adequate D&O insurance, the legal regime in place cannot afford to alienate necessary candidates but at the same time, it must protect the interest of shareholders by providing for a reasonable standard of care. In addition, the system must marry their respective interests in an effort to provide fairly for all concerned.

This as we have seen is a most difficult task. An analysis of the situation in the United States and Canada has shown that there is no consistent approach. Some jurisdictions have implemented a lax set of standards to continue to attract corporate clientele[737] while others do not share this perspective.[738] In addition U.S. courts have at least implicitly considered different standards in their determination of a breach of duty depending upon the type of relief requested.[739] Is there a middle ground which serves all interests justly?

I believe the answer is dependent upon the standard applied. In Canada the test of duty of care both under statute and common law is very low. Indeed it is hard to

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[737] Supra n. 73.

[738] Ie. Ontario.

[739] The 'Doctrine' vs. the 'Rule.'

imagine a fact scenario which would amount to a breach in anything less than egregious circumstances. Until the test for care and skill is raised to an objective standard and the test of diligence is more clearly defined, one can have little sympathy for the director who fails to meet the mark.

In light of the above, the C.B.C.A. and similar legislation deals far too leniently with directors. As in the area of reliance upon expert advice, this legislation provides relief from liability on the basis of good faith alone. On this point I will object on the same basis as stated earlier with reference to my comments in the area of expert advice. The A.B.C.A. provides a higher standard in as much as it does not allow a corporation to lessen an already low duty of care requirement. Finally the O.B.C.A. both prohibits any 'opting out' of its legislation, does not offer 'good faith' as a defense and forbids corporations from insuring its directors or officers against a breach of their duty of care. In my view, only Ontario provides a level of accountability commensurate with the current test of duty of care.

5. THE ULTIMATE TEST

As in any contest where the stakes are survival itself, whether personal or corporate, such circumstances elicit the best character in some and the worst in others. To ignore

the potential breakdown of the fiduciary duty under these circumstances is to deny human nature itself. In sum then, corporate control contests demand special scrutiny where the decision(s) of the board is at issue.

The difficult question at hand however is the nature and scope of this review. As a first step we must in my view cast aside fossilized notions of primary purposes and the mythical practice of reading minds which this approach has spawned. Such dealings are the stuff of middle age thinking and serve only to muddy the waters of judicial thought. The law must be more practical and observant of the facts rather than content itself with devining the unconscious.

It is significant that in the United States the concept of primary purpose is far different than that of its colonial ancestor. Where in the United Kingdom the focus is inward with a view to the ' true purpose' of a given article or by-law the U.S. approach has been to look outward at the facts with a view to objectively determining the primary purpose of the decision maker. Unlike the United Kingdom, the primary purpose doctrine as developed in the United States has laid the foundation upon which forward thinking has been built. Kors v. Carey, Bennett v. Propp and Cheff v. Mathes developed a reasoned and practical approach to the issue of good faith, concerned not with devining some unstated purpose but rather with the substantial motivation

of the decision makers. This determination was then made on objective grounds. Directors had to demonstrate that they believed a danger to corporate policy and effectiveness existed. This would be achieved where that belief was based on a showing of good faith and reasonable investigation. This set the stage for further refinements and developments as the judiciary were faced with complex and differing fact scenarios.

In Canada only Teck and the few jurisdictions which have adopted its approach have been far sighted enough to concern themselves with facts rather than fiction and have attempted to address key concerns such as good faith from the perspective of what is in the best interests of the corporation in the context of the facts at hand. However, even this approach is in its infancy. Under Teck, directors in seeking to defeat a takeover bid must act in good faith. This is a finding of fact that must be based upon a reasonable belief that there will be substantial damage to the company's interests. Further, there must then be reasonable grounds for that belief. In deciding the issue, directors may consider the reputation, experience and policies of the raider. Where they are justified, directors are entitled to use their powers to protect the company. This case as did the aforementioned trilogy of Delaware decisions provides a conceptual framework upon which to build a 'made in Canada' fiduciary test. However, it is only a beginning. Our

courts have not as yet addressed the issue of diligence as it might apply to a takeover scenario. Clearly we have not adopted anything even closely resembling the level of scrutiny developed in Van Gorkom. In my view we must do so when the opportunity arises as the approach used in this case fairly reflects the necessary standard in corporate control scenarios. At this point I will leave open any consideration of the level of negligence then required to find for the plaintiff. The circumstances themselves will speak to the standard required as has been observed throughout this thesis.

There are other issues as well. What of the burden of proof? Should the directors bear an initial burden and if so, how should it be defined? Further, even if as in Teck the directors are justified in their belief in the threat of substantial damage, should they be subject to further scrutiny by evaluating the nature of the defensive tactic itself?

In addition, there is the area of preemptive manoeuvers such as in Moran and a consideration of how deeply courts should look into the decision itself to determine whether or not it should stand. In Delaware the focus is on the process itself and whether all substantive measures were taken to adequately inform the board. In New York Hanson suggests that this is not good enough. The decision itself will be laid open to review upon its merits. Further what

standard should the court apply in assessing the merits of lock-ups, standstill agreements, sale of 'crown jewels' and other manoeuvers. In addition there is the issue of the auction process. Should we follow a similar route to that of Delaware and if so, under what circumstances is an auction triggered and what is the proper role of directors under these circumstances?

I believe we will find those answers in time and in response to the appropriate fact scenarios so long as we continue along the road constructed by Teck but as yet unfinished. In finding a solution to these difficult questions, we would do well to consider the wealth of authority in the United States. We will find in their varied approach some of the threads required to weave our fabric of decisions into a cloth which suits well our own judicial mosaic.

APPENDIX 'A'

PROPOSITIONS

A. Except as to matters provided for in propositions B and C, a director of a company should devote to the affairs of the company and the performance of his duties as a director such attention as, in his good-faith business judgment, a responsible and diligent director similarly situated should devote thereto in the circumstances, plus such additional attention as may have been agreed upon between him and the company, or may, with his consent, be expected of him by the other members of the board of directors. To that end, he should attend such meetings, be informed, undertake such questioning, make such agenda proposals, participate in the work of the boad, and generally discharge his responsibilities of judgment on issues that are on the agenda of the board in such manner as, in his good-faith judgment, the circumstances call for.

B. A director should have an affirmative responsibility to keep himself generally informed about (including, if necessary, responsibility to take initative to do so), and to take such other action as may in his good-faith business judgment be called for in the circumstances to the end that the company shall at all times have:

(1) a functioning management in place and operating;
(2) a financial reporting system in place and operating that is generally appropriate for an enterprise of its character in the circumstances; and
(3) a similarly appropriate information system in place and operating to acquaint the management and the board with major business developments of the company.

C. If from a source that a reasonable person would find credible, a director is informed of conduct by the company or within the company, that is illegal, or entails significant impropriety, or is aberrational outside the normal course of business, the director should have an affirmative responsibility to take such steps as may in his good-faith business judgment be called for in the circumstances to inquire into the matter, and on

the basis thereof, shall take such other initiatives as may in his good-faith business judgment be called for in the circumstances.

D. In the discharge of his duty of attention, a director may rely upon the officers and employees of the company, outside consultants, committees of the board, and individual members of the board as to whom, in his good-faith business judgment, such reliance is warranted.

E. Notwithstanding propositions A through D, the director's duty of attention to the affairs of the company does not extend beyond the time commitment which is customarily expected of similarly situated directors of the company except to the extent that an agreement between the director and the company or, with the consent of the director, the expectation of the other members of the board, may require a greater time commitment.

F. A director who complies with propositions A through E shall for all purposes be held to have discharged his duty of attention to the company as a director.

APPENDIX 'B'

NATIONAL POLICY NO. 38

TAKE-OVER BIDS - DEFENSIVE TACTICS

1. The Canadian securities administrators recognize that take-over bids play an important role in the economy by acting as a discipline on corporate management and as a means of reallocating economic resources to their best uses. In considering the merits of a take-over bid, there is a possibility that the interests of management of the target company will differ from those of its shareholders. Management may take one or more of the following actions in response to a bid that it opposes:

(i) attempt to persuade the shareholders to reject the offer;

(ii) take action to maximize the return to shareholders including soliciting a higher offer from a third party; or

(iii) take other defensive measures to defeat the bid.

2. The primary objective of take-over bid legislation is the protection of the bona fide interests of the shareholders of the target company. A secondary objective is to provide a regulatory framework within which take-over bids may proceed in an open and even-handed environment. The rules should favour neither the offeror nor the management of the target company, but should leave the shareholders of the offeree company free to make a fully informed decision. The administrators are concerned that certain defensive measures taken by management may have the effect of denying to shareholders the ability to make such a decision and of frustrating an open take-over bid process.

3. The administrators have determined that it is inappropriate at this time to specify a code of conduct for directors of a target company, in addition to the fiduciary standard required by corporate law. Any fixed code of conduct runs the risk of containing rules that might be insufficient in some cases and excessive in others.

However, the administrators wish to advise participants in the capital markets that they are prepared to examine target company tactics in specific cases to determine whether they are abusive of shareholder rights. Prior shareholder approval of corporation action would, in appropriate cases, allay such concerns.

4. Without limiting the foregoing, defensive tactics that may come under scrutiny if undertaken during the course of a bid, or immediately prior to a bid if the board of directors has reason to believe that an offer might be imminent, include:

(i) the issuance, or the granting of an option on, or the purchase of, securities representing a significant percentage of the outstanding securities of the target company;

(ii) the sale or acquisition, or granting of an option on, or agreeing to sell or acquire, assets of a material amount; and

(iii) entering into a contract other than in the normal course of business or taking corporate action other than in the normal course of business.

5. The administrators consider that unrestricted auctions produce the most desirable results in take-over bids and is reluctant to intervene in contested bids. However, the administrators will take appropriate action where they become aware of defensive tactics that will likely result in shareholders being deprived of the ability to respond to a take-over bid or to a competing bid.

6. The administrators appreciate that defensive tactics, including those that may consist of some of the actions listed in paragraph 4, may be taken by a board of directors in genuine search of a better offer. It is only those tactics that are likely to deny or severely limit the ability of shareholders to respond to a take-over bid or a competing bid, that may result in action by the administrators.

7. As a general rule, the administrators or

> their staffs will not advise parties as to the propriety of proposed action in a particular case except in the context of a meeting or proceeding of which interested parties have been given notice.

This policy will come into effect immediately.

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