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MODERN CONCEPTION OF BUSINESS JUDGMENT RULE: A CASE STUDY ON DELAWARE JURISPRUDENCE

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ABSTRACT

It is quite a uniform understanding that the Business Judgment Rule (BJR), even though deeply and widely developed, is still a foggy and unclear concept. There seems to be a consensus on the generally formulated rationales of the rule, but their shades, even after more than 25 years of analysis and debate[1], remain undecided.

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1 Just to set an example, in 1984, Bailes Manning, former Dean of Stanford Law School, qualified the state of the discussion as a "confused situation". Symposium:

This paper reflects an analysis grounded on the seminal decisions that the Delaware Courts have produced on the BJR and will set what limits have these courts drawn. It is well known that Delaware jurisdiction is fundamental not only for American corporate law, but also for international corporate law.

Recent world known corporate failures have encouraged the judiciary, if not to reformulate the BJR, at least to suggest a narrower spectrum for its application, which responds to the world new command for corporate security and director's accountability.

In the first part of this work we make a brief exposition on the basics of the BJR, without purporting to cover or even touch all issues and ramifications of the rule. In the second part we review the comments upon current decisions in order to understand the modern conception of the rule. This part, on one side, will focus on describing the seminal decisions of the Delaware Courts regarding the BJR and, on the other, whether the rule, after Enron's crisis is being considered as an abstention rule or as a standard of liability.

Key words: Business Judgment Rule, Duty of Care, Business Judgment Rule as a standard of liability, Business Judgment Rule as a doctrine of judicial abstention, Good Faith, Self Dealing.

RESUMEN

Es casi un entendimiento uniforme que la Regla de la discrecionalidad (o Regla del juicio comercial) (BJR), aunque profunda y ampliamente desarrollada, es un concepto nublado

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Current Issues in Corporate Governance: Conference Panel Discussion: The Business Judgment Rule. *Ohio State Law Journal,* 1984.

y conflictivo. Parece haber consenso en cuanto a las bases generalmente de la regla, pero sus matices, aun después de más de 25 años de análisis y debate, no son claros.
Las mundialmente conocidas recientes fallas corporativas internacionales han llevado al poder judicial, si no a reformular el alcance de la BJR, por lo menos a sugerir un ámbito más restringido para su aplicación, que responde a la nueva directriz del derecho societario que clama por la seguridad corporativa y por la responsabilidad de los administradores.
En la primera parte de este trabajo hacemos una breve exposición de las bases de la BJR, sin pretender cubrir o siquiera abordar todas las inflexiones de la regla. En la segunda parte, con el fin de entender la concepción moderna de la BJR, realizamos algunos comentarios sobre providencias judiciales recientes. Esta parte, se enfocará, por un lado, a enunciar los casos más importantes de las cortes de Delaware en relación con la BJR, y, por el otro, a definir si la regla, después de la crisis de Enron, es considerada como una doctrina de abstención judicial o como una graduación de responsabilidad.

Palabras clave: regla de la discrecionalidad, regla del juicio comercial, deber de cuidado, regla de la discrecionalidad como graduación de responsabilidad, regla de la discrecionalidad como doctrina de abstención judicial.

SUMMARY

Introduction

Part I Basis of the business judgment rule

1. Business judgment rule
   1.1 Definition
   1.2 Context

1.2.1 A business judgment
1.2.2 Director or Officer
1.2.3 Duty of care and diligence
2. The five elements of the rule
2.1 Good faith for a proper purpose
2.2 Absence of Self-dealing
2.3 Informed Basis
2.4 Business decision.

Part II modern conception of the business judgment rule in Delaware

1. Conceptions of the business judgment rule
1.1. BJR as a standard of liability. Mr. SMITH'S point of view
1.2. BJR as a doctrine of abstention: Ms. JONES panorama

2. Cataclysms that have overturned the conception of the business judgment rule
2.1. BJR after the early 1980's: towards a standard of liability
2.2. BJR after Enron

3. State of the business judgment rule

Conclusion

INTRODUCTION

Business success implies that risks must be taken and management directors are the individuals who are asked to decide whether a risk is worth taking or not. In the business world, where so many variables affect the outcome of a decision, it would not be fair that directors were liable for corporation's losses assuming that they have followed the proper steps in their decision making process. In order to protect them, the business judgment rule was created.

This paper reflects an analysis grounded on the seminal decisions that the Delaware Courts have produced on the business judgment rule and will set what limits have these courts drawn.

1. BUSINESS JUDGEMENT RULE – DEFINITION AND CONTEXT

1.1 DEFINITION

One of the fundamental principles in corporate law explains that the business and affairs of a corporation are managed by or under the direction of its board of directors. But, business decisions usually take place in conditions of uncertainty and involve risk taking, while directors are expected to maintain and improve shareholders' return on their investment. Nonetheless, not all decisions of directors will result in benefit to the corporation. As a result, directors could be personally liable for corporate losses. To avoid this situation, the business judgment rule was introduced in corporate law.

The business judgment rule (BJR) is not a new invention; it has been a conception of common law in the United States and had its origins over 160 years ago. "The business judgment rule exists to protect and promote the full and free exercise of the managerial power of directors; the rule ensures that the default is deference to the board of directors' authority as the corporation's central and final decision maker"[2].

Following the above mentioned reason, the BJR has been developing as

> "A presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption"[3].

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2 BAINBRIDGE, STEPHEN M., "*The Business Judgment Rule as Abstention Doctrine*", *Vanderbilt Law Review*, 57 Vand. L. Rev. 83, 2004.

3 ARONSON v. LEWIS, 473 A.2d 805, 812 (Del. 1984).

The fundamental purpose of the rule is to offer a "safe harbor" to directors and officers from their personal liability for breaches of the duty of care and diligence in relation to honest and rational business judgments. The rule is identified as the protection of the authority of directors in exercising their duties.

It operates to shield from court intervention business decisions which have been made honestly, prudently, in good faith and on reasonable grounds. In such cases the board's decisions will not be subject to *microscopic* examination and the court will be reluctant to interfere and to usurp the board director's function in managing the corporation. This rule protects Boards and directors from those that might second guess their decisions, because, the court has to look to see that the directors made a reasonable decision, not a perfect decision[4].

The rule will apply when the following prerequisites are met[5]:

- There must be a business judgment,
- Made by a director or officer,
- Who owes a duty of care and diligence

1.2. CONTEXT

1.2.1. A BUSINESS JUDGMENT

The term business judgment implies

> "any decision to take or not to take action in respect of a matter relevant to the business operation of the corporation"[6].

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4 DIETRICH, NICHOLAS, The "business judgment rule": whose judgment, *Gowlings - Corporate Governance Review*, June/July 2002, Toronto.

5 GREENHOW, ANNETTE, *The Statutory Business Judgment Rule: Putting the Wind Into Directors' Salis*, American practicing law 1991, vol. 1.

6 GREENHOW, ANNETTE, it.

Let's examine this term more closely. First, by "judgment" it is meant the decision whether to do or not to do something or to vote for or against a proposal, without going further. In other words, there must be a judgment in reaching the conclusion but it does not enlarge to the success or the failure of the decision.

Second, the issue matter of the judgment has to be a matter relevant to the business operations of a company. A subject relevant to the business involves different aspects such as planning and budgeting, promotion of the company's business, acquiring and disposing assets, obtaining credits and so on. The nature and extend of the performance of these aspects depend on the size, complexity and nature of the business.

1.2.2. DIRECTOR OR OFFICER

In corporate law, the director is the person who manages the company or its property. It is clearly accepted that the directors are the most appropriate persons to make the decisions in the best interests of the company, because they are the ones who posses the skill, information and judgment to make the decision.

1.2.3. DUTY OF CARE AND DILIGENCE

Courts most commonly defined the due care standard of a corporate director in terms of the conduct of a reasonable and prudent person[7].

The duty of care requires that the director performs his powers and discharges his duties with a degree of care and diligence that a reasonable person would exercise in the same circumstances. The expression "a reasonable person" requires that the standard of care and diligence has to be determined objectively, it implies that factors

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7 HORSEY, HENRY, "The duty of care component of the Delaware Business Judgment Ruke", *Delaware Journal of corporate law* 19 Del. J. Corp. L. 971, 1994.

such as size, nature, state of the financial affairs and the urgency and magnitude of problems must be considered.

Directors are concerned in the enhancement and protection of the interest of the company; their functions are special and different from the other agents. They have to ensure the successful performance of the company.

Under the above mentioned proposal, it can be said that a director must exercise his powers in the way he believes, in good faith, is best calculated under the circumstances, taking into account both the short and long term consequences of his acts, to promote the success of the company for the benefit of its members as a whole.

2. THE ELEMENTS OF THE BUSINESS JUDGMENT RULE

In order to apply the business judgment rule as a defense, directors should have acted properly, in good faith, and with reasonable belief that their conduct legally and legitimately assists in achieving the corporation's benefit. They have also to employ their right-minded business judgment after consideration of what they reasonably believe to be the relevant factors.

The elements of the BJR, commonly recognized by the jurisprudence are:

2.1. GOOD FAITH

The director must make the decision in good faith. The business judgment rule protects directors if they rationally *believed that the decision was in the best interest of the company*, without being contrary to the law.

The "proper purpose" requires all company power to be exercised for the benefit of the company as a whole, for the purpose for which it was originally conferred[8].

8 See GREENHOW, it. at., 9.

2.2. ABSENCE OF SELF-DEALING

The BJR protects directors or officers who do not have a material, personal interest in the decision. The word "material" means that if a conflict of interest is present, then it must relate to more than an immaterial or insignificant interest[9].

> "A disinterested director neither appears in both sides of the transaction nor expects to derive any personal financial benefit from it, as opposed to benefit which is advantageous to the corporation or all the stockholders generally"[10].

2.3. INFORMED BASIS

This is fundamental to the duty of care. The BJR defends directors if they have informed themselves and measured all relevant information about the theme matter of the challenged decision to the level they rationally consider being suitable to making a decision.

The problem of accurately determining how much information is required depends on the nature of the decision, including the subject matter and complexity. Although, the duty of care institutes an objective standard, a director could look for protection under the rule if the director has reasonable belief that he or she was adequately informed to make the decision.

A director should be informed about[11]:

- The business reasons for the transaction;
- The impact of the transaction on the shareholders, employees, customers and other constituencies;

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9 Id, at, 16.

10 Business Judgment Rule. D&O insurance policy draft. 2004.

11 See GREENHOW it. at, 17.

- Management's view as to the price and factors affecting the price;

- The fairness of the transaction.

A proper application of the BJR would defend those directors who are considered to have taken correctly informed business decisions, and have not breached the duty of care, skill and diligence, but it would not operate where that duty has been infringed.

Directors are protected against claims for wrongful decisions, but not against claims for failure to act. Inaction by directors is sheltered by the rule if that inaction is the consequence of a careful decisions to abstain from acting.

In conclusion, a director can be protected by the BJR only when the above mentioned prerequisites were met.

The BJR will impose an independent evaluation of due care and diligence by the court before the court may proceed to consider whether the elements of the rule —as extracted above— have been satisfied. If the elements are content, the business judgment rule will operate to guard the decision of the directors and officers from judicial scrutiny. It would not operate where duty of care and diligence had been breached.

3. APPLICATION OF THE BUSINESS JUDGMENT RULE BY THE COURT

Business decisions normally take place in situations of uncertainty and implicated risk taking which means that a business judgment rule is not the single subject needed to be considered. It is also essential to assess the way in which the courts are taxing if directors have taken action with the appropriate duties of care and diligence. The courts' evaluation has to be based on fairness and convenience of the directors' decision.

It will lie at all times on the facts of the case for the judge to determine whether a director has or has not breached their duty of care, skill and diligence.

Nevertheless,

> "Directors are only protected to the extent that their actions actually evidence their business judgment. The principle of defense presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions. Courts should be reluctant to substitute its own opinion for that of the directors, but they are entitled to consider the content of directors' decision and the extend of the information on which it was based and to measure this against the facts as they existed at the time the impugned decision was made. Although board decisions are not subject to deep examination with perfect vision of hindsight, they are subject to examination"[12].

Hence, judges should desist from reviewing the substantive qualities of business decision.

PART II. MODERN CONCEPTION OF THE BUSINESS JUDGMENT RULE IN DELAWARE

1. CONCEPTIONS OF THE BUSINESS JUDGMENT RULE

Professor BRAINBRIDGE, in his recent work Business Judgment Rule as an Abstention Doctrine[13], accurately describes the approach that the judiciary has had regarding the BJR. On one side it can be considered as a standard of liability and, on the other, as a doctrine of abstention. We proceed to explain briefly this dichotomy.

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12 DIETRICHT, NICHOLAS, *supra* note 4.

13 BRAINBRIDGE, *supra* note 2.

1.1. BJR AS A STANDARD OF LIABILITY. MR. SMITH'S POINT OF VIEW

In many cases, those who claim for a BJR as a standard of liability may coincide with the colloquial example that was brought in the early 1980's and incarnated the followers of this dimension (as a standard) in the mind of an imaginary character[14]: Mr. Smith. Mr. Smith believes that directors represent the interest of majority shareholders, 'that directors are mainly chosen by the CEO and that while they need not necessarily be his personal cronies, they will not be selected unless they are people who are willing to keep their peace and play along. (…) Mr. Smith believes that members of the board of directors, often to the detriment of shareholders, make a great deal of money out of corporate transactions or from inside information[15].

The understanding of the BJR as a standard of liability has been materialized in classical cases such as Trans Union (SMITH *v*. VAN VORKOM 1985), Cede (1993) and, recently, in Disney (2003) and Oracle (2003), the last two drawing up many expectations since they are currently on appeal and aligned on the mentioned perspective of the rule. According to this view, the BJR empowers judges to review the substance of a business decision of directors exclusively when determined circumstances have proven that their duties have been transgressed, especially when there has been bad faith, self dealing, or uninformed decision making.

1.2. BJR AS A DOCTRINE OF ABSTENTION[16]: MS. JONES PANORAMA

By contrast, there is another character: Ms. Jones[17], who thinks that people inside boardrooms are clever and hardworking individuals

14 *Supra* note 1.

15 Id.

16 One can also refer to this panorama as the 'traditional' rationale. Greenfield, KENT and NILSSON, JOHN, "Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?)", *The Business Judgment Rule*, 63 *Brooklyn L. Rev*. 799, 1997.

17 MANNING see *supra* note 1.

that dedicate many hours in designing and implementing the policy of a company, that they hold high levels of responsibility, and are companies they work for. Ms. Jones also thinks that there is no certainty in business strategy, that risk is always present, and even a bullet proof project might fail. The key point is that a court is not entitled to revise a decision of the board if the presumptions granted in their favor by the BJR are not rebutted. An example of judgments that have held this grounds are Shrelensky *vs*. Wrigley[18] (1968), in which the court sustained that 'absent colorable allegations of fraud, illegality, or conflict of interest, the court must abstain from reviewing the directors' decision'[19].

BRAINBRIDGE explains it this way:

> 'If the business judgment rule is framed as an abstention doctrine, however, judicial review is more likely to be the exception rather than the rule. The court begins with a presumption against review. It then reviews the facts to determine not the quality of the decision, but rather whether the decision-making process was tainted by self-dealing and the like. The requisite questions to be asked are more objective and straightforward: Did the board commit fraud? Did the board commit an illegal act? Did the board self-deal? Whether or not the board exercised reasonable care is irrelevant, as well it should be. The business judgment rule thus builds a prophylactic barrier by which courts pre-commit to resisting the temptation to review the merits of the board's decision[20].

2. CATACLYSMS THAT HAVE OVERTURNED THE CONCEPTION OF THE BUSINESS JUDGMENT RULE

The perspective judges decide to apply when deciding under the BJR has depended highly on the socioeconomic perceptions of the markets, the projection of corporate law, and, of course, the behavior

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18 237 N.E.2d 776 (Ill. App. Ct. 1968) citation from BRAINDBRIDGE, *supra* note 2

19 Shrelensky *vs*. Wrigley, the exact citation in BRAINBRIDGE, note 2.

20 BRAINBRIDGE, it.

of Directors. We will see how the courts have played either as a Mr. Smith or a Ms. Jones following the special trends surrounding the corporate world.

2.1. BJR AFTER THE EARLY 1980'S: TOWARDS A STANDARD OF LIABILITY

The BJR suffered its first cataclysm in the early 1980's.

> '[I]n 1983, STUART R. Cohn, professor of law at University of Florida (…), after a similar study of case law involving claims of director breach of duty of care in the absence of self-interest or self-dealing found what he characterized as "a nearly universal judicial reluctance to apply diligence standards against well-intentioned, non-self-enriching directors and officers"'[21].

This reluctance came to an end with several cases decided by Delaware Courts[22], and a swerve in the *stare decisis* took

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21 STUART R. COHN, Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 TEX. L. Rev. 591, 593 n.7 (1983), taken from HORSEY, HENRY RIDGELY, The Duty Of Care Component Of The Delaware Business Judgment Rule, Delaware Law School of Widner, *Delaware Journal of Corporate Law* 19 Del. J. Corp. L. 971, 1994.

22 Non American readers might question why the authors have emphasized their analysis in decisions taken by the Delaware Courts. To attend that regard, see BRAINBRIDGE, *supra* note 2, who declared: 'In contrast to judges in other states, however, Delaware chancellors frequently have considerable prior corporate experience as practitioners. Once on the bench, there is a substantial pay-off for Delaware chancellors who continue to master corporate law. Delaware chancellors sit at "the center of the corporate law universe". Unlike other courts, which face corporate cases only episodically, such cases make up a very high percentage of the Delaware chancellors' docket. The frequency with which they face such cases provides a strong incentive for Delaware's chancellors to master both doctrine and the business environment in which the doctrine works. In particular, there is a strong reputational incentive to do so. Sitting without juries in a court of equity, Delaware chancellors put their reputation on the line whenever they make a decision. Because so many major corporations are incorporated in Delaware, chancery court cases are often high profile and the court's decisions therefore are subject to close scrutiny by the media, academics, and

place[23]. The tack was explained because of the evolution of corporate law during the early 80's (propagation of mergers, acquisitions and in general, complex corporate transactions) and litigants who were financially capable of bringing the matters to judicial resolution[24].

a) In *Aroson vs. Lewis* (1984)[25] the court portrayed the rule as 'a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption[26]. Further, 'It is presumed that decisions of disinterested directors are made in good faith for a rational business purpose, with due care, and in the honest belief that they are acting in the best interests of stockholders'. (473 A.2d 805)[27]. This landmark case sets the

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practitioners. The reputation of a Delaware chancellor thus depends on his or her ability to decide corporate law disputes quickly and carefully'.

From a financial point of view 60% of the Fortune 500 corporations and about half of the companies listed on the New York Stock Exchange are incorporated in Delaware. (NORMAN VEASEY, Juxtaposing Best Practices and Delaware Corporate Jurisprudence - Part I Metropolitan corporate council http://www.metrocorpcounsel.com/current.php)

23 See in more particular MORAN, J.P., Business Judgment Rule Or Relic?: Cede V. Technicolor and the Continuing Metamorphosis of Director Duty of Care. *Emory Law Journal Emory University School of Law*, Winter, 1996, for whom 'Starting in the mid-80s, however, and culminating with Cede, the court has allowed its approach to duty of loyalty cases to bleed into duty of care cases. The result has been a twisting of the business judgment rule into a standard that moves away from prior standards of judicial deference.'

24 BLOCK, DENNIS J, BARTON, NANCY E, and RADIN, STEPHEN A., Book Review: Sec-Note-1: The Business Judgment Rule: Fiduciary Duties of Corporate Directors. Delaware Law School of Widener University, Inc. *Delaware Journal of Corporate Law*, 1999 24 Del. J. Corp. L. 589.

25 ARONSON v. LEWIS, 473 A.2d 805, 812 (Del. 1984).

26 MORAN, J.P., *supra* note 23.

27 In VEASEY, NORMAN, *The new incarnation of the business judgment rule in takeover defenses*, 11 Del. J. Corp. L. 503. Delaware Law School of Widener University, Inc. 1987.

starting point for the court to show a particular new requirement that was placed as a base to move the rule to other fields. Directors must have been reasonably informed.

b) Trans Union Case (Smith vs. van Gorkom, 1985): Within the context of a merger, directors of Trans Union adopted a decision without the reasonable information required. They did not make a proper pricing study of their own shares before the merger took place. 'The court held that the Board's September 20 decision approving the proposed cash-out merger "was not the product of an informed business judgment."In so holding, the court found adequate evidence that the directors had not availed themselves of all the information reasonably necessary to make an informed decision. Thus, the presumption of reasonable care was overcome'[28].

The breaking point is that there were no allegations of fraud, bad faith, or self-dealing against the board, but, even so, the court studied the procedure that had preceded the adoption of the decision. Also, the required standard of care was reaffirmed: gross negligence[29]. For WAGNER[30], this case did not imply a turn on the precedent; it only clarified the scope of the rule and the extent of the duty of care. We think that, at least, it opened a

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28 WAGNER, THOMAS C., The Business Judgment Rule Imposes Procedural Requirements on Corporate Directors Smith *v*. van Gorkom, *Florida State University Law Review* 14 Fla. St. U.L. *Rev*. 109 488 A.2d 858 (Del. 1985).

29 It was already clear ever since Aronson v. Lewis, 473 A.2d 805, 812 & n. 6 (Del. 1984), also see MORAN J.P's citation in *supra* note 23. In AROSON, the Delaware Court affirmed: '[T]o invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence' HORSEY, it, *supra* note 7.

30 It. note 28.

breach, notwithstanding good faith, for scrutiny of business decisions[31].

c) Cede (Cinerama, Inc. v. Technicolor, 1995)

Cede continued with the transformation of the BJR. Cinerama, Inc. and Cede Co.'s shareholders sued the directors alleging a breach of their duty of care on the grounds of an imprecise and careless pricing of the shares as a consequence of an uninformed decision taking process. The Chancery Court denied the request concluding that even though the defendants had breached their duty of care the plaintiffs had failed in proving the existence of any damage.

DOCTRINE OF ABSTENTION	STANDARD OF LIABILITY
Self interest (conflict of interest) Fraud	Good faith Informed basis (even alternatives)

The Delaware Court reversed the decision and stated (going against the traditional BJR doctrine and beyond Trans Union) that, notwithstanding the absence of a challenge of directors good faith or self interest, the adoption of the decision was evidence of gross negligence since it was an uninformed decision. Notice that the doctrine of the BJR indicated that only challenges on the duty of loyalty could lift the presumption. However, in this case, the breach of the duty of care had the same effect. In Cede, '(t)he court has moved from a standard in Trans Union that would require directors to have "informed themselves, prior to making a business decision, of all material information reasonably available to them," to a requirement in Cede that directors conduct "a prudent search for alternatives," take an "active and direct role in the context of the sale of a company from beginning to end", and not be "passive instrumentalities during merger proceedings"[32].

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31 In the same line see MORAN, J.P. It, note 23.

32 See MORAN, id, who brings the exact quotation of the Court citing Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989), (Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 368 (Del. 1993).

In sum, after 1985, especially after ARONSON, the doctrine of BJR suffered a redress. Ever since, a director cannot defend himself, at least not to the satisfaction of the court, by proving that he acted in good faith and without self dealing; he must demonstrate that he also acted in an informed manner. That *ratio decidendi* was uniform in Aronson *v*. Lewis, in Smith *v*. van Gorkom, and in Cinerama *v*. Technicolor II; it clearly affected the nature of the rule and directed it towards a standard of liability.

2. BJR AFTER ENRON

Enron is the other cataclysm of corporate history. Hidden losses and inflated earnings reached billions of Dollars. WorldCom, Global Crossing, and Tyco followed Enron's bad luck. The fist to blame: directors[33] . What should be done? Legislate[34] and tighten director's liability standards and accountability? Certainly, the Sarbanes Oxley Act was issued in a rush. It drew new requirements for disclosure and established penalties, even criminally considered, for non-compliance.

Did the courts also entered in that rush and triggered judgments punishing directors and companies? There were enough judgments for a derailment of the precedent far from the original rationale of the rule (or as an abstention rule). One could think so if remembers

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33 Gevurtz, indirectly blames not directors, but a specific judgment, Kamin *vs*. American Express [383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976), aff'd, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).] Gevurtz, Franklin A. Corporate governance and the sarbanes-oxley act: earnings management and the business judgment rule: an essay on recent corporate scandals. William *Mitchell Law Review*, 30 Wm. *Mitchell L. Rev*. 12612004. 2004. Therefore, it was allowed 'under a doctrine known as the business judgment rule, for the directors of American Express to cause the company to lose millions of dollars for the sole purpose of improving reported earnings and thereby maintaining the price at which the company's stock traded'.

34 See LAGUADO, CARLOS, Sarbanes- Oxley Act y el Proyecto de intervención económica sobre estándares internacionales de contabilidad, auditoría y contaduría. superintendencia de valores

http://www.supervalores.gov.co/ley_estandares_contables.htm. 2004

what ARONSON, Trans Union and Cede had achieved and is not per se blameworthy because law is in nature mutable. However that is still to be seen. The press and the media seemed to react fiercely with headlines such us 'The court for most U.S. companies has been toughened up by waves of crime and reform'[35], 'Rush to re-judgment'[36], 'Judges signal boards to take duties seriously'[37], 'What's happening to the business judgment rule'[38], 'Recent shareholder suits may be opening cracks in the protection afforded by the business-judgment rule'[39].

Let us summarize some of the cases that have followed this cataclysm, notwithstanding that their final outcome is still pending.

a) *Disney (2003)* (Brehm *v*. Eisner): This recent case involved The Walt Disney Company's severance payment to its former president MICHAEL OVITZ. The action argued that Disney's directors did not conduct the proper analysis on the termination of OVITZ contract and its high severance payment. The Delaware Supreme Court repeated the traditional formulation of the business judgment rule as "a presumption that in making a business decision the directors … acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation." "The court went on to say that "directors' decisions will be respected by courts unless the directors are

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35 *Businessweek*, March 22, 2004.
http://www.businessweek.com/magazine/content/04_12/b3875070.htm

36 PORCHER L. TAYLOR III, see *infra* note 48.

37 USA, *Today*, March 29 2004, http://www.usatoday.com/money/companies/management/2004-03-29-lawsuits_x.htm

38 BROWN, MEREDITH M. and REGNER, WILLIAM D., What is Happening to the Business Judgment Rule?
http://www.debevoise.com/publications/pubsdetail.asp?pubid=1455206192003-&typeid=4

39 KRIS FRIESWIK. *CFO Magazine* February 01, 2004
http://www.cfo.com/article.cfm/3011471/c_3046605?f=insidecfo

interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available""[40]. And also that the directors "knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss"[41].

E. NORMAN VEASEY, chief justice of the Delaware Supreme Court, argues[42] that the Disney case didn't introduce any turn to the existent doctrine on BJR (AROSON, Trans Union and Cede). What the court has been doing, stressed NORMAN VEASY, is paying attention to the process used by directors in the decision making. But, underneath, the substance of the decision remains untouched.

b) Oracle SLC (2003): Under Delaware law, when a derivative action is to be brought, the Board of Directors may appoint a Special Litigation Committee (SLC) to evaluate the reasonableness of the claim and further if the directors or any other wrongdoer to the Company will be sued. In this case, a SLC was appointed to study a complaint against Oracle's directors, including the CEO LARRY ELLISON, for insider trading. The appointed SLC was composed by individuals closely related to Stanford University and found no motives for bringing the directors to court. The Court of Chancery, denied SLC's resolution noting that its independence was in doubt. To Chancellor Strine, "the

40 Id.

41 Saori Horikawa & John Hempill, Serving on a Nonprofit Board in the Post-Enron World, Morrison & Foerster llp San Francisco, CA http://www.cpbo.org/archive/resources/resource1370.html

42 See CFO Magazine. Judgment Calls, at http://www.abanet.org/buslaw/blt/2003-09-10/nonbindingopinions. html. Citations of the Court's considerations and of Norman Veasy's declarations are not disclosed. September 9 2003.

> connections suggested that 'material considerations other than the best interests of Oracle could have influenced the SLC's inquiry and judgments'"[43]. The Court agreed on this ruling because the two SLC members were professors at Stanford University and three of the four defendants were either major donors to or professors at Stanford, such that the SLC was not independent[44].

According to some scholars, Oracle represents a "'seismic shift' because it indicates the Delaware court's willingness "to look beyond quantifiable measures to go into soft issues—business connections, social relationships—in determining independence""[45].

Accepting the premise that with this decisions the courts have not dramatically overruled the precedent, is clear that an element is unmistakably shining. Courts will enter into criticizing the process that has accompanied the decision making. We think that strict tests on the process of the decision taking drive, indirectly, to an obstruction of the board authority and, in the end, a challenge to the director's business efficiency. The Courts are second guessing the call and the conduct of the directors. The duty of care is under question. In the words of a Delaware Supreme Court Judge (in a non-binding opinion):

> 'What Delaware judges expect from corporate officers and directors when reviewing their conduct retrospectively is a scrupulous adherence to a process of decision making that reflects fidelity to the institution and investors that they serve. Their conduct must also show a dedication to

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43 Brown & Regner, It. see note 38, also see FRIESWIK, CRIS, Recent shareholder suits may be opening cracks in the protection afforded by the business-judgment rule. *CFO Magazine*. Judgment Calls, at http://www.cfo.com/article.cfm/3011471/c_3046605?f=insidecfo. February 1st 2004

44 Id.

45 BOLAND, BRETT, cited by FIESWICK, *supra* note 42, unfortunately without the proper foot note.

spending the time necessary to educate themselves about the business and the facts surrounding a decision that will lead the court to have confidence that the ultimate course of action adopted was the product of a rational and careful decision- making process made in good faith[46].

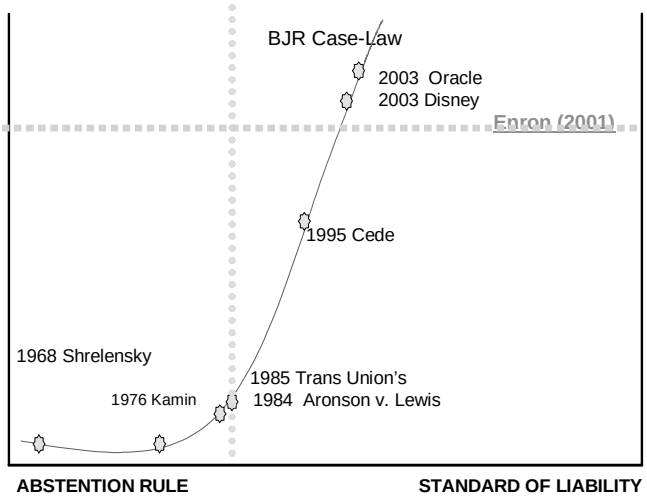
3. STATE OF THE BUSINESS JUDGMENT RULE

We have tried to describe how until 1984-1985 the doctrine keep on the tracks of the traditional conception, that is, as an abstention premise. After then, progressively was targeted to a standard of liability. We saw how the precedent moves away from an abstention rule and becomes a standard of liability. However, after Enron we don't witness a striking distancing. The fear that arose with Enron, according to which the courts would be willing to dramatically overpass the case law boundaries of the BJR, was unjustified and the courts, notwithstanding some slight inclinations to accountability, remained under the fundamental line that was set in the early 80's. It will be just too brave to affirm that the Delaware Courts just forgot about the doctrine. What is true, however, is that the rule elements, as drawn up in the origins of the rule, have not survived. The media erred and the headlines were overestimated. The path shown in Chart 1 suggests that the doctrine has moved from being an abstention rule towards a standard of liability, but still avoiding exaggerated interventions in the substance of the decisions that are under conflict.

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46 MYRON T. STEELE, A Delaware justice writes on judging corporate governance. http://www.abanet.org/buslaw/blt/2003-0910/nonbindingopinions.html, Volume 13, Number 1 - September/October 2003.

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We are too afraid about that a second Enron can turn up. But is that fear justifiable? Isn't it just an exaggerated over estimation of the probability of occurrence of a fact that is truly bizarre? If it is, this is merely a behavior totally justified for a REM[47].

Encouraging the BJR to work as an active standard of liability could be the answer, and Mr. Smith will be glad with the strategy. Nevertheless, we cannot underestimate the effects of a more severe director's responsibility scheme. It can harm deeply corporate structure— the duo of proprietorship and management. In 1985, in the aftermath of the insurance crisis, as stated by Romano[48], 50% of

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47 See M.C. JENSEN & W.H. MECKLING, Nature of Man. *Journal of Applied Corporate Finance*. V. 7 N. 2. Pag. 4-19, and also M.C. JENSEN, Self Interest, Altruism, Incentives, & Agency Theory. Harvard Business School, 1994, in what regards to the PAM Pain Avoidance Model, that suggests that man, due to its rationality, tries to avoid circumstances that previously and throughout his experience he has learned that cause pain. This judgment is to be blamed, partially, says Gevurtz, because it makes part of the leading casebooks used to teach law in New York. See note 32.

48 ROBERTA ROMANO, Corporate Governance in the Aftermath of the Insurance

qualified candidates for directorship either resigned to or not accepted for a position of director. Similar consequences could take place in the XXI century[49]. Judges and legislators must examine this issue with a magnifying glass. Scholars, directors, and legislators must beware of excessively constraining the board's inclination to avoid risky transactions.

CONCLUSION

From this paper some conclusions can be drawn. First of all, The business judgment rule is as doctrine that protects officers and directors of a corporation from personal liability so long as they have acted in good faith, with due care, and within the officer or director's authority. In other words, the substance of a business decision of directors can be reviewed by judges only when determined circumstances have proven that their duties have been transgressed, especially when there has been bad faith, self dealing, or uninformed decision making.

Additionally, the elements of the business judgment rule are identified, Good faith, Absence of self dealing, Informed Basis, Business decision. After these elements were explained, a case study gives further understanding of how the rule has been developed in real life situations.

Crisis, 39 EMORY L.J. 1155, 1155 (1990). n245 Korn & Ferry Int'l, Board Of Directors Fourteenth Annual Study 12 (1987); FAYE A. SILAS, Risky Business: Corporate Directors Bail Out, 72 A.B.A. J. 24, 24 (1986) (discussing 1985 study). Quoted by MORAN, see *supra* notes 13 and 16.

49 As it happened in the 80's, director's liability regime has an effect on insurance availability, specially the D&O policy, which is not only affected by the established standards of valuation of the acts but also by international policies, such as reinsurance covers. In the United States, the market for this products was hardened. PORCHER L. TAYLOR III http://www.thedeal.com/special/sarbanes_oxley/articles/5.html Rush to re-judgment

The study that has been presented revealed that the jurisprudence regarding the BJR in Delaware is based on new elements that were not considered when the doctrine was formulated in the XIX century. It has followed a route throughout two cataclysms, the 1980's boom of corporate transactions, and the Enron's crisis. In 1985, Trans Union's case introduced a prominent ingredient to the jurisprudence that changed it ever since. Enron's debacle, with Disney and Oracle cases, by contrast, has not carried anything but a confirmation and clarification of the BJR as redefined in the 1980's. The path of the case-law suggests that the doctrine has moved from being an abstention rule towards a standard of liability, but still avoiding exaggerated interventions in the substance of the decisions that are under conflict.

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