

The Business Judgment Rule and the Entire Fairness Doctrine

Executive Summary

Courts rely on two standards of review for assessing disputed business transactions. The “business judgment rule” prevents courts from second-guessing the decisions of independent and disinterested directors who have acted with due care by placing the focus on the reasonableness of a board’s decision-making process. The business judgment rule is a default rule where the plaintiff has the burden of proof. The “entire fairness standard” is triggered where a majority of the directors approving the transaction are interested or where a majority stockholder stands on both sides of the transaction. Once the entire fairness standard is triggered, the corporate board has the burden to demonstrate that the transaction is inherently fair to the stockholders by demonstrating both fair dealing (i.e., process) and fair price (i.e., substance).

Overview of the Business Judgment Rule

The business judgment rule is “a rule of law that insulates an officer or director of a corporation from liability for a business decision made in good faith if he is not interested in the subject of the business [decision], is informed with respect to the subject of the business [decision] to the extent he reasonably believes to be appropriate under the circumstances, and rationally believes that the business [decision] is in the best interests of the corporation.”¹ Thus, the court squarely places the initial burden of proof on the plaintiff in challenging an officer or director’s decision. If the stockholder fails to meet the evidentiary burden, the business judgment rule attaches to protect officers and directors and the decisions they make.²

The business judgment rule is the first line of defense and often the best protection a company has in an action brought against a director for breach of fiduciary duties. Directors or officers owe to the corporation a duty of care to act on an informed basis, an “uncompromising duty of loyalty” to the corporations on whose boards they serve, and a duty of good faith.³ Violation of any of these duties can carry hefty penalties. The court may order the offending fiduciary to pay restitution or impose punitive damages to deter future violations, in addition to any reputational damages incurred. In a recent 2012 case, the Delaware Supreme Court affirmed a judgment of approximately \$2 billion in addition to over \$300 million in legal fees for plaintiff’s counsel for breach of a fiduciary duty claim.⁴ Paramount to the outcome is the standard under which a director’s actions are reviewed. As the Delaware Supreme Court has recognized, the choice of the applicable test to judge director action is critically important because it often determines the outcome of the matter.⁵

The business judgment rule is rooted in a 100-year history in which the courts generally avoid substituting the judgment of a judge for that of the board.⁶ “It is the essence of the business judgment rule that a court will not apply 20/20 hindsight to second guess a board’s decision, except ‘in rare cases [where] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment.’”⁷ Irrationality is the outer limit of the business judgment rule.⁸ A court will not substitute its own notion of what is or is not a sound business judgment, and the approval of a transaction by a majority of independent and disinterested directors “almost always bolsters [the] presumption that the business judgment rule attaches to transactions approved by a board of directors that are later attacked on grounds of lack of due care.”⁹ The business judgment rule has been stated as a presumption not only by the courts applying Delaware law but also by courts applying the laws of a comfortable majority of other jurisdictions.



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Structurally, the business judgment rule has two components. The first component immunizes directors from personal liability if they act in accordance with its requirements while the second component insulates the court from intervening in management decisions made by the directors. The protection that the business judgment rule affords is generous. “It is well established that the mere fact that a company takes on business risk and suffers losses — even catastrophic losses — does not evidence misconduct, and without more, is not a basis for personal director liability.”¹⁰

Special Pleading Requirements

It is the case in Delaware that “courts routinely dismiss complaints pursuant to Rule 12(b)(6) based on the business judgment rule.”¹¹ The presumption of the business judgment rule attaches *ab initio*, and to survive a motion to dismiss, a plaintiff must allege well-pleaded facts to overcome the presumption. However, a minority of courts have held that the business judgment rule is an affirmative defense that cannot be considered in the context of a motion to dismiss.

Rebutting the Presumption

In the case that the party challenging the board’s decision is able to allege and prove facts sufficient to overcome the business judgment rule presumption, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its stockholders.¹²

The Fairness Standard Where the Presumption Is Overcome

Fairness “becomes an issue only if the presumption of the business judgment rule is defeated.”¹³ The fairness test is designed to test whether a self-dealing transaction should be given deference or set aside in equity. The court’s decision does not turn on whether the interested directors acted in good faith but whether, in the absence of arms-length bargaining, the transaction, viewed objectively, is fair and reasonable.¹⁴ In other words, the fairness requirement examines whether the transaction is entirely fair to the stockholders.¹⁵ Thus, the tension and complexity in corporate governance between deference to directors’ decisions and the scope of judicial review is underscored by both the shifting burdens of proof within the business judgment rule and dynamic judicial standards, depending on the nature of the transaction or special circumstances of the case.¹⁶

Entire Fairness Doctrine

If the party challenging the board’s decision is able to allege and prove that those involved in the decision-making process lack independence or otherwise breached any of their fiduciary duties, then the business judgment rule’s presumption is overcome and the court will apply the “entire fairness doctrine.” As a result, the burden shifts to the corporation to prove that both the process that was followed and the price that was achieved are fair to the stockholders of the corporation.

Krasner v. Moffet succinctly details the two-step process whereby this protection is lost. First, “when a majority of the board of directors is the ultimate decision maker and a majority of the board is interested in the transaction, the presumption of the business judgment rule is rebutted.”¹⁷ Second, “when the presumption of the business judgment rule has been rebutted, the entire fairness rule is implicated and defendants bear the burden of proof.”¹⁸ The entire fairness standard is a strict standard meant to apply to



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transactions that have conflicts in which the majority of the board is interested or stands to receive a material benefit, a director has financial incentives adverse to the company, or a conflicted director or stockholder “controls or dominates the board as a whole.”¹⁹ Directors are found to be interested if they “appear on both sides of a transaction or expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.”²⁰

The entire fairness test is the most exacting standard, which requires a judicial determination of whether a transaction is entirely fair to stockholders. The burden of proving that a challenged transaction is entirely fair falls on the defendants, who must show that the transaction was approved either by a special committee of independent directors or by an informed vote of the majority of the disinterested stockholders. In addition, when the board of a target corporation does not consist of a majority of disinterested directors, the entire fairness test applies, and the challenged actions will be upheld only if they are fair to the stockholders.

When the entire fairness test applies, a transaction must be fair as to both process and price.²¹ “Fair dealing” encompasses questions of process, including how the transaction is timed, initiated, structured, negotiated, and disclosed and how the approvals of the directors and the stockholders are obtained. “Fair price” relates to the economic and financial terms of the transaction, including any relevant factors that affect the intrinsic or inherent value of a company’s stock, such as the market value and assets of the company, a pro forma analysis and other valuation metrics, and a fairness opinion.

The fair price and fair dealing components are not viewed in isolation but rather in conjunction. Entire fairness requires the court to strictly scrutinize all aspects of a transaction to ensure fairness, and, as such, “fairness as to one prong will not necessarily sterilize or immunize a defendant from liability.”²² “From a procedural perspective, the breach of any one of the board’s fiduciary duties is enough to shift the burden of proof to demonstrate entire fairness.”²³ Thus, “where the pricing terms of a transaction that is the product of an unfair process cannot be justified to reliable markets or by comparison to substantial and dependable precedent transactions, the burden of persuading the court of the fairness of the terms will be exceptionally difficult.”²⁴

Shifting the Burden Back

Even under the weight of the entire fairness doctrine, defendants may shift the burden of proof back to the plaintiff by utilizing procedural safeguards. The most prominent and frequent of these safeguards is to establish and empower a functioning special committee of independent and disinterested directors to safeguard the interests of all stockholders. However, “the special committee must function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power ‘at an arm’s length.’”²⁵ In other words, the special committee must be empowered with the ability to reject the proposed transaction. Another frequently used safeguard is to obtain a fairness opinion from independent financial advisors stating that the terms of the transaction are fair, from a financial point of view, to the company and/or the minority stockholders, as applicable. Although different methodologies may be employed, the opinions often rely on interviews, research, and other such data in the process of considering financial performance and factors affecting earnings. Although not required, special committees and fairness opinions provide an important shield in deflecting stockholder attacks on business decisions and in helping the board to satisfy its obligation to exercise sound business judgment in approving transactions.



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In re MFW Shareholders Litigation & Practical Implications

Recent cases continue to shape and refine the parameters of the entire fairness review. The Delaware Chancellor recently held that a merger with a controlling stockholder would be reviewed under the less stringent business judgment rule rather than the entire fairness standard if the merger was structured to include certain procedural safeguards for minority stockholders. The critical outcome is that controlling stockholder transactions are judged under the business judgment rule only if (1) the transaction is approved by both a special committee and a majority-of-the-minority vote; (2) the special committee is independent of the controlling stockholder; (3) the special committee is broadly empowered to reject the proposal and is free to retain independent legal and financial advisors; (4) the special committee meets its duty of care; and (5) the minority vote is fully informed and not coerced. Although already well established before *In re MFW*, it is worth restating that effective use of committees of independent directors may shift the burden of proof back to plaintiff,²⁶ and a stockholder vote approving an interested transaction may obviate the need for judicial review of the substantive fairness of such transactions.²⁷ *In re MFW* serves to reinforce the importance of such a special committee adhering to the procedural safeguards or risking the loss of the business judgment rule protection.

Heightened Standards of Review – Revlon and Unocal

Although a case is ultimately decided under the business judgment rule or the entire fairness doctrine, Delaware courts have crafted heightened standards of review where directors take defensive measures or approve a change in control.

Unocal and the World of Hostile Takeovers

In *Unocal v. Mesa Petroleum*, the court reviewed the reasonableness and proportionality of defensive tactics used by a target board in a hostile takeover and established an enhanced scrutiny standard of review due to concerns about loyalty violations.²⁸ The court held that when a board unilaterally adopts defensive measures it must establish that it has reasonable grounds for believing that a danger to corporate policy and effectiveness exists and that its response to that threat is reasonable. However, this heightened judicial scrutiny does not obviate the need for plaintiffs to plead sufficient facts to support the underlying claims for a breach of fiduciary duty in connection with the sale of the company. The Delaware Supreme Court linked *Unocal*'s result to both the business judgment rule and the entire fairness standard. Assuming that a board's actions are reasonable, its defensive actions are then subject to the highly deferential business judgment rule. Alternatively, if directors are unable to satisfy the enhanced scrutiny under *Unocal*, the defensive measures are invalidated unless the directors can overcome their burden of proof in showing that the transaction was entirely fair.

Revlon Duties for Sale of Control

"Revlon duties" are triggered in the case of a "change of control" and require a general reasonableness standard.²⁹ In *Revlon v. Forbes Holdings, Inc.*, the Delaware Supreme Court developed a modified version of the *Unocal* standard to deal with using takeover defenses to ensure that a white knight would prevail in a control auction with the hostile bidder.³⁰ In response to an unsolicited tender offer, Revlon's board undertook defensive measures, culminating in the board authorizing negotiations with other prospective bidders. The board then entered into a merger agreement with a white knight, which included defensive

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measures such as a lockup arrangement. Revlon's initial defensive tactics were reviewed under the standard *Unocal* analysis, bringing sale of control transactions under the umbrella of heightened judicial review. The intensity of the judicial review applicable to directors' conduct and a judicial examination of the reasonableness of the board's decision-making process translates into less tolerance for a director's unwillingness to maximize the value of the business. While directors have a choice of means, they do not comply with their *Revlon* duties unless they undertake reasonable steps to get the best deal for the stockholders.

Conclusion

The business judgment rule provides a layer of judicial protection to decisions made by a board acting in an informed manner with full knowledge of the benefits and costs of a given transaction. However, the protections of the deferential business judgment rule are not absolute, and the fairness review of any one particular transaction can undergo a nuanced review by the Delaware courts. Where there exists a heightened potential for diverging interests among directors and stockholders, proving fairness can be a tough burden to overcome. Depending on the nature of the transaction and situational conflict, companies must take appropriate procedural safeguards, such as engaging special committees and obtaining fairness opinions, to thwart a successful verdict based on breach of a director or officer's fiduciary duties.

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Notes

- ¹ *Am. Soc'y for Testing. & Materials v. Corpro Cos.*, No. Civ. A. 02-7217, 2005 WL 1941653 (E.D. Pa. Aug. 10, 2005) (quoting *Cuker v. Mikalauskas*, 547 Pa. 600, 692 A.2d 1042 (1997)).
- ² *Cinerama, Inc. v. Technicolor*, 663 A.2d at 1162 (Del. 1995).
- ³ *Hampshire Group Ltd. v. Kuttner*, C.A. No. 3607-VCS (Del. Ch. July 12, 2010), *Guth v. Loft, Inc.*, 5 A.2d 503 at 510 (Del. 1939).
- ⁴ *Americas Mining Corp. v. Theriault*, Nos. 29, 2012, 30, 3012, 2012 LEXIS 459 (Del. Aug. 27, 2012).
- ⁵ *Stroud v. Grace*, 606 A.2d 75, 90 (Del. 1992).
- ⁶ *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919).
- ⁷ *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 262 (Del. Ch. 1998) (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)).
- ⁸ *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).
- ⁹ *Sinclair Oil Corp. v. Levien*, 280 A.2d at 720, *Grobow v. Perot*, Del.Ch., 526 A.2d 914, 921 (1987).
- ¹⁰ *Gagliardi v. TriFoods, Int'l, Inc.*, 1996 Del. Ch. LEXIS 87, at *11-12.
- ¹¹ *NCS Healthcare, Inc. v. Candlewood Partners, LLC*, 827 N.E.2d 797, 803 n.3 (Ohio Ct. App. 2005), appeal not allowed, 835 N.E.2d 383 (Ohio 2005).
- ¹² *Krasner v. Moffet*, 826 A.2d 277, 287 (Del. 2003).
- ¹³ See *Grobow*, *supra* note 9, at 187.
- ¹⁴ *In re Franklin Nat'l Bank Sec. Litig.*, 2 B.R. 687, 707 (E.D.N.Y. 1979).
- ¹⁵ *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 42 n.9 (Del. 1994).
- ¹⁶ *MM Cos. V. Liquid Audio, Inc.*, 813 A.2d 1118, 1127 (Del. 2003).
- ¹⁷ See *Krasner*, *supra* note 12.
- ¹⁸ *Id.*
- ¹⁹ *Texlon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002).
- ²⁰ *Arson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
- ²¹ *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).
- ²² *In re. TD Banknorth Shareholders Litigation*, 938 A.2d 654 (Del. Ch. 2007).
- ²³ See *Cinerama*, *supra* note 2, at 1164.
- ²⁴ *Valeant Pharm. Int'l v. Jerney*, 921 A.2d 732, 748 (Del. Ch. 2007).
- ²⁵ *Kahn v. Tremont Corp.*, 649 A.2d 422 at 429 (Del. 1997).
- ²⁶ *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110 (Del. 1994), *In re W. Nat'l Corp. S'holders Litig.*, C.A. No. 159727, 100 Del Ch. LEXIS 82 (Del. Ch. May 22, 2000), *Clements v. Rogers*, 790 A.2d 1222 (Del. Ch. 2001), *Leuco Alternative Fund Ltd. v. Reader's Digest Ass'n, Inc.* 803 A.2d 428 (Del. 2002).
- ²⁷ *In re Staples, Inc. S'holders Litig*, 792 A.2d 934, 952 (Del. Ch. June 5, 2001).
- ²⁸ *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)
- ²⁹ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986)
- ³⁰ *Id.*