Washington University Law Review

Volume 64
Issue 2 *Corporate and Securities Law Symposium*

1986

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Karen A. Winn

DUE CARE AS A PREREQUISITE FOR PROTECTION UNDER THE BUSINESS JUDGMENT RULE

Smith v. Van Gorkom,
488 A.2d 858 (Del. 1985).

In *Smith v. Van Gorkom,*[1] the Delaware Supreme Court held the directors of Trans Union Company ("Trans Union") personally liable for gross negligence in approving the sale of Trans Union.

The chairman and chief executive officer of Trans Union, Van Gorkom, called a meeting of the board of directors at which he announced for the first time that he had procured a potential buyer of the company.[2] After meeting for only two hours, the directors approved the sale of Trans Union by means of a cash-out merger, with "New T Company" as the surviving corporation.[3] The directors relied solely on Van Gorkom's representation of the details and desirability of the proposed transaction in reaching their decision.[4] The Merger Agreement provided for a fixed price of fifty-five dollars per share.[5] The directors made no attempt to verify the adequacy of the merger price.[6] After a four-month "market test" period during which Trans Union was allowed to entertain other offers, Trans Union shareholders approved the proposed merger.[7]

Although the merger price represented a substantial premium, a group of Trans Union shareholders brought suit against the board of directors to recover damages based on the alleged inadequacy of the merger price.[8] The Delaware supreme court reversed the lower court's judgment for the defendants and *held*: Before recommending a merger, the board of direc-

1. 488 A.2d 858 (Del. 1985).

2. *Id.* at 866-67.

3. *Id.* at 869. New T Company was a subsidiary of the defendant Marmom Group, Inc., owned by Jay Pritzker and Robert Pritzker. *Id.* at 863-64.

DEL. CODE ANN. tit. 8, § 251(b), (c) (1974) requires the directors to adopt a resolution approving a merger agreement before submitting that agreement to the stockholders for a vote.

4. 488 A.2d at 868-69, 874. An outside lawyer retained by Van Gorkom advised the directors that a fairness opinion was not required by law and that they might be sued for not accepting the offer. *Id.* at 868-69.

5. The $55-a-share price represented a substantial premium. The highest price on the New York Stock Exchange for Trans Union stock during the year that the merger was approved was $38 1/4 per share. *Id.* at 866 n.5.

6. *Id.* at 874-77. Moreover, no member of the board read the Merger Agreement, *id.* at 869, or inquired into Van Gorkom's role in forcing the sale, *id.* at 874, 877.

7. *Id.* at 870.

8. *Id.* at 863. The plaintiffs also asked for the rescission of the merger, an unlikely remedy when monetary damages are available. *Id.*

tors must obtain all reasonably available information to satisfy their duty of due care and to obtain protection from subsequent liability under the business judgment rule.[9]

The business judgment rule protects corporate directors from liability for their honest but informed mistakes of judgment by preventing courts from examining the merits of a business decision.[10] The application of the business judgment rule creates a rebuttable presumption that the directors' decision was proper.[11] Before a director may obtain protection under the business judgment rule, however, the director must first demonstrate that he exercised due care and good faith in the decision-making process.[12] The Delaware courts have inconsistently applied the due care requirement, strictly applying the requirement in some circumstances[13] while apparently ignoring it in others.[14]

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9. *Id.* at 864, 893. The court remanded the case to the Chancery Court to determine the fair value of the shares based on Trans Union's "intrinsic value" at the time the board of directors approved the merger, and to award damages to the extent the value exceeded $55 per share. *Id.* at 893.

10. 3A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (1975).

11. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see also* Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva* Zapata?, 37 BUS. LAW. 27, 33 (1981).

12. Commentators have formulated the standards for the business judgment rule differently. One commentator points out that the due care requirement does not conflict with the business judgment rule; judicial noninterference in matters of business judgment is predicated on the assumption that "judgment—reasonable diligence—has in fact been exercised." 3A W. FLETCHER, CLYCOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 1039 (1975).

Delaware courts have at times explicitly recognized the need for due care before invoking the business judgment rule. *See, e.g.*, Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971) (application of business judgment rule depends on showing that informed directors exercised business judgment). At other times, the courts' recognition of a duty of care has been merely implicit. *See, e.g.*, Schreiber v. Pennzoil Co., 419 A.2d 952, 956 (Del. Ch. 1980) (business judgment rule presumes a "rational business decision").

For an explanation of the significance of the due care element in judicial review, see generally Arsht & Hinsey, *Codified Standard—Same Harbour But Charted Channel: A Response*, 35 BUS. LAW. 947, 961 (1980) (rule mandates inquiry to extent necessary for court to ascertain whether decision was product of reasoned judgment).

13. *See, e.g.*, Lutz v. Boas, 39 Del. Ch. 585, 171 A.2d 381 (1961) (director of mutual fund held liable for failing to discover illegal transactions).

14. *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963).

One commentator has observed: "In reality the application of the business judgment rule has excised the requirement that directors exercise ordinary care in the exercise of their offices." Comment, *Director Liability Under the Business Judgment Rule: Fact or Fiction?*, 35 SW. L.J. 775, 792 (1981). Similarly, in 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, 591 (1983), the author suggests a number of reasons for the courts' failure to impose sanctions on directors for lack of due care. First, courts are reluctant to damage reputations or to impose financial hardship on defendants who have not acted in bad faith, but simply have failed to meet "ambiguous standards of care." *Id.*

The application of the duty of care has in the past depended largely on the context of the particular business decision. For example, in *Bennett v. Propp*,[15] a chief executive officer undertook an unauthorized stock repurchase as a defensive tactic to a takeover bid.[16] The board of directors ratified the CEO's actions.[17] The court recognized that the time pressure caused by the hostile takeover attempt and the gravity of the situation made the directors' ratification appropriate under the circumstances.[18] In *Graham v. Allis-Chalmers Manufacturing Company*,[19] however, the Delaware Supreme Court examined the duty of care less exactingly. In *Graham*, a shareholder claimed that indictments based on the alleged price-fixing activities of company employees were the result of the directors' failure to consider the company's consent decrees to past price-fixing violations, and to take steps to prevent further violations.[20] The court found that the directors had "satisfied themselves" that the past violations had not actually taken place, and therefore the directors did not have notice of future illegal price fixing.[21] The court held that the directors were entitled to rely on the honesty and integrity of their employees until they had reason to suspect wrongdoing.[22]

In *Gimbel v. Signal Companies, Inc.*,[23] the Delaware Chancery Court appeared to diminish further the duty of care. In *Gimbel*, a shareholder

at 598. Second, courts may recognize the limitations inherent in the director's role, such as the need to rely on corporate officers and consultants for advice and information. *Id.* at 612.

15. 41 Del. Ch. 14, 187 A.2d 405 (1962).

16. *Id.* at 24, 187 A.2d at 410.

17. *Id.*

18. *Id.* at 22-24, 187 A.2d at 409-10.

19. 41 Del. Ch. 78, 188 A.2d 125 (1963).

20. *Id.* at 80, 188 A.2d at 127. Note that the circumstances in *Graham* do not actually present an instance of an affirmative "business judgment." *See* Aronson v. Lewis, 473 A.2d 805, 813 n.7 (Del. 1984).

21. 41 Del. Ch. at 84, 188 A.2d at 129. The court listed some circumstances under which the court would find directors liable:

> If . . . [the 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 wilfully or through inattention obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him.

Id.

22. *Id.* Similarly, in Muschel v. Western Union Corp., 310 A.2d 904 (Del. Ch. 1973), the court presumed that Western Union's board of directors exercised due care in reaching its decision to merge with another corporation. A Western Union shareholder sought to enjoin the merger, claiming that the directors lacked material information about the acquired corporation when they agreed to purchase that company at an allegedly excessive price. *Id.* at 906. The court merely concluded that the directors deserved the presumption of having made an informed judgment. *Id.* at 909.

23. 316 A.2d 599 (Del. Ch. 1974).

sued to enjoin the consummation of the sale of a subsidiary, claiming that personal interests motivated the directors' decision to sell.[24] The court relied on the substantive merits of the board's decision and did not inquire into the directors' exercise of care. The court concluded that the board's decision was protected by the business judgment rule.[25] "[T]he ultimate question," according to the court, "was not one of method, but of value."[26]

In *Smith v. Van Gorkom*,[27] the Delaware Supreme Court clarified the relationship between the due care requirement and the business judgment rule. The court found that insufficient care in the Trans Union board's decisionmaking process precluded the application of the business judgment rule.

The court made several critical findings in reaching its decision. The board acted hastily under no constraints of an emergency.[28] The board failed to obtain opinions from investment bankers, relying instead on the chief executive officer's twenty-minute oral presentation.[29] Finally, the

24. *Id.* at 604.

25. *Id.* at 615. Nevertheless, the court noted that the directors' decision was made in haste without all available information and that the directors failed to seek a higher price. *Id.* at 612. The court found these factors were probably insufficient to overcome the business judgment "standard." *Id.* at 615. They did not justify the conclusion that the directors acted unadvisedly. *Id.*.

26. *Id.* The court did grant the injunction, however, because the plaintiff alleged a gross disparity between the sale price of the company and its fair market value. *Id.*

27. 488 A.2d 858 (Del. 1985).

28. *Id.* at 874. The directors had no prior notice of the purpose of the September 20 meeting called to approve the Merger Agreement, but approved the sale after only two hours.

29. *Id.* Pursuant to DEL. CODE ANN. tit. 8, § 141(e)(1974), directors are "fully protected in relying in good faith upon . . . reports made to the corporation by any of its officers." Although the court noted that the term "report" had been liberally construed in Cheff v. Mathes, 41 Del. Ch. 494, 507-08, 199 A.2d 548, 556 (1964) (term included reports of informal personal investigations by corporate officers), the court considered that Van Gorkom's twenty-minute presentation was not a report under § 141(e), because Van Gorkom was unfamiliar with the Merger Agreement of which he spoke. 488 A.2d at 875. Furthermore, even if Van Gorkom had been familiar with the Merger Agreement, in light of all the surrounding circumstances—the lack of notice, the lack of time constraints, and the absence of supporting documentation—the directors were "duty bound to make reasonable inquiry" about the adequacy of the proposed merger price. *Id.*

The court said explicitly that the board did not need to take any particular measure to ascertain the company's value, such as a fairness opinion or an outside valuation study, but the directors did need to obtain all reasonably available information. If they had done so, they would have learned that the proposed merger price was calculated for buy-out feasibility rather than for valuation, and would have inquired further about its fairness.

Moreover, the original Merger Agreement did not give Trans Union the right to distribute proprietary information to prospective suitors or to solicit competing offers. *Id.* at 878. As finally executed, the Agreement read in pertinent part:

shareholder ratification was ineffective because the proxy materials failed to disclose the method used by the board to determine the merger price.[30]

In *Van Gorkom*, the court reaffirmed the importance of due care as a prerequisite for the protection of the business judgment rule. In the specific context of a merger, the court will defer to the business judgment of a board after assurances that the decision was "informed and deliberate" and that the directors possessed "all reasonably available information."[31]

The *Van Gorkom* standard is consistent with the rationale for the business judgment rule. In protecting shareholder interests, the court should not interfere with the judgments of corporate officers.[32] Instead, the court should determine director liability by reference to the process by which the board acted and not by the merits of the decision made.[33]

The court specifically derived the "informed and deliberate" requirement from the language of the Delaware merger statute.[34] Whether the

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> The Board of Directors shall recommend to the stockholders of Trans Union that they approve and adopt the Merger Agreement ('the stockholders' approval') and to use its best efforts to obtain the requisite vote therefor. GL acknowledges that Trans Union directors may have a competing fiduciary obligation to the stockholders under certain circumstances.

Id. at 879. The defendants relied on this passage to demonstrate both the right to distribute proprietary information and to accept a better offer. The court found that, "on its face," this language incorporated neither condition. *Id.*

Furthermore, the court found the market test period, by which the parties would test the validity of the stock price, inadequate. The first press release announcing the sale of Trans Union described the Merger Agreement as "definitive." *Id.*

30. The proxy materials were "false and misleading" because they stated that the chief financial officer's preliminary report indicated the value of the company was "in the range of $55.00 to $65.00 per share." *Id.* at 891. As the court repeatedly emphasized, that figure was made to determine the feasibility of a leveraged buy-out, and not to ascertain the value of the stock. *Id.*

A dissenting opinion emphasized the directors' longstanding familiarity with the affairs of Trans Union and their ability to make a reasonable decision under the circumstances. *Id.* at 894 (McNeilly, J., dissenting). The dissent, however, failed to address the directors' failure to obtain information on Trans Union's inherent valuation.

31. *Id.* at 873.

32. *See supra* notes 10-12 and accompanying text.

33. The court must also consider the circumstances in which the decision was made. *See supra* notes 15-18 and accompanying text (discussing *Bennett*).

34. 488 A.2d at 873. DEL. CODE ANN. tit. 8, § 251(b) (1974) provides in pertinent part:

> The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation. . . . *Any of the terms of the agreement of merger or consolidation may be made dependent upon facts ascertainable outside of such agreement, provided that the manner in which such facts shall operate upon the terms of the agreement is clearly and expressly set forth in the agreement of merger or consolidation.*

488 A.2d at 873 n.14 (court's emphasis). The court relied on § 251(b) to find that directors have a duty to act in an informed and deliberate manner in approving a merger for submission to stockhold-

requirement will extend to other major business decisions is unclear. For example, in the context of a hostile takeover attempt, the Delaware courts will likely apply a less stringent due care requirement to account for the time pressure placed on directors defending takeover bids.

A probable result of the *Van Gorkom* decision will be to encourage the formalization of the decisionmaking process.[35] Directors should adopt some combination of procedures indicative of deliberate decisionmaking, such as adequate and timely notice to directors of the purpose of meetings and documentation supporting the business reason for the decision.[36] The *Van Gorkom* standard that directors must obtain all reasonably available information may also compel directors to retain, at a considerable cost, investment bankers to assist them with important business decisions accompanying fundamental changes in corporate control.

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ers. The language emphasized by the court, however, merely indicates that the terms of a merger agreement may be conditioned on the performance or occurrence of outside contingencies or facts. The board's mandate to adopt a resolution containing the terms of the merger implies, perhaps, a duty to know what is in the agreement.

35. One commentator has suggested that matters involving corporate structure or personnel in particular require deliberative decision-making. These matters would include mergers, stock issuances, selection of key officers, and sales of considerable assets. *See* Cohn, *supra* note 14, at 616.

36. The court stated that boards must provide "some credible contemporary evidence demonstrating that the directors knew what they were doing." 488 A.2d at 883 n.25.