

THE BUSINESS JUDGMENT RULE (PART 1)

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SUMMARY

The office of director, by its very nature, imposes duties and responsibilities on its bearer. Taking into account the characteristics and nature of companies, it is inevitable that the scope of directors' activities varies from company to company. A director, irrespective of the individual personality of the company, owes the company the duty of care and skill. Coupled with the duty of care and skill much emphasis, particularly in the 21st century, has been placed on the concept of corporate governance. It is within this context that the personal liability of company directors for mere errors of judgment must be considered.

The object of part one of this article is to examine the characteristics of the American business judgment rule. Part 1 explores the origin of the rule and takes into account the various purposes that the rule fulfills in American law. The law relating to director liability in America is examined and the place of the business judgment rule in an American context is considered. Attention is paid to the rule's basic requirements, the application of the rule and the subsequent consequences of the application thereof. Where possible, the requirements of the rule are illustrated through a discussion of case law.

In part 2 the South African position relating to the director's common-law duty of care and skill is considered. The Companies Act, recommendations of the King Committee, and the Department of Trade and Industry's report on corporate law reform are taken into account. The efficiency of the current law in South Africa is evaluated in light of the advantages and disadvantages of the importation of a foreign legal rule into South African law. In the conclusion an assessment is made of whether it is indeed desirable or necessary to import the business judgment rule into South African law.

1 INTRODUCTION

A company is a juristic person that exists separately from its management and shareholders.¹ Due to the fact that it cannot act on its own, it conducts its affairs through representatives.² The company representatives consist of a board of directors who are entrusted with the management of the company's affairs.³ It is crucial that the board of directors be granted limited freedom in order to perform its tasks effectively. Directors must be given "limited" freedom in order to ensure that control is exercised over the board in the interest of the company, its creditors and, importantly, the shareholders.⁴ The primary function of corporate law is to impose controls on persons vested with authority and to regulate the organs concerned with the governance of a company.⁵

Directors are tasked with duties that are a legal consequence of holding the office of director.⁶ The effect of the duties that are imposed on directors is ultimately to set parameters within which they must act.⁷ One of these duties is that of the duty of care and skill.⁸ This duty entails that a director must carry out the functions of his or her office and exercise the powers of that office *bona fide* and for the benefit of the company and in so doing it is required that the director exercise the requisite degree of care and skill.⁹

There is an overlap between the duty of care and skill and that which is known as the business judgment rule.¹⁰ There has been debate, particularly since the publication of the King Report on Corporate Governance,¹¹ as to whether it is necessary and desirable to introduce the American business judgment rule into South African law in order to protect honest directors from being held personally liable for sincere mistakes that led the company to incur losses.

Essentially the business judgment rule, which is a standard of judicial review,¹² entails that courts should exercise restraint in holding directors

¹ *Hülse-Reutter v Gödde* 2001 4 SA 1336 (SCA) 1346A-B; Visser, Pretorius, Sharrock and Van Jaarsveld *Gibson South African Mercantile & Company Law* 8ed (2003) 259-262; and Williams *Concise Corporate Law* (1994) 19.

² Havenga "Corporate Opportunities: A South African Update (Part 1)" 1996 8 *SA Merc LJ* 66.
³ *Ibid.*

⁴ Havenga 1996 8 *SA Merc LJ* 40.

⁵ Mongalo *Corporate Law & Corporate Governance – A Global Picture of Business Undertakings In South Africa* (2003) 151.

⁶ Van Dorsten *The Law of Company Directors in South Africa* 2ed (1999) 214.

⁷ Beuthin and Luiz *Beuthin's Basic Company Law* 2ed (1992) 223.

⁸ Cilliers, Benade, Henning, Du Plessis, Delpont De Koker and Pretorius *Corporate Law* 3ed (2000) 147; and Benade, Henning, Du Plessis, Delpont, De Koker and Pretorius *Entrepreneurial Law* 3ed (2003) 129.

⁹ *Ibid.*

¹⁰ Mongalo 170.

¹¹ The Institute of Directors in Southern Africa "The King Report on Corporate Governance" November 1994.

¹² Schneeman *The Law of Corporations and Other Business Organizations* 3ed (2002) 253.

accountable for business decisions which produce poor results.¹³ Coupled with the duty of care¹⁴ the result is that if a director made a decision in good faith, with care and on an informed basis, which the director reasonably believed was in the interest of the company, the director cannot incur liability in respect of that decision.¹⁵

A closer examination of the characteristics of the business judgment rule and the South African law relating to director liability will reveal whether it is essential to implement the rule in South Africa.

2 ORIGIN AND PURPOSE OF THE BUSINESS JUDGMENT RULE

Directors exercise a measure of judgment in their daily decision-making on behalf of companies. A possibility exists that a particular decision taken can turn sour, be it due to unexpected events or merely because the directors made an honest mistake. The question arises as to what happens to the directors when their actions are clearly to the detriment of the company? The answer to this question has led to jurisprudential debate since the 1800s.

2.1 Origin of the business judgment rule

The business judgment rule was developed in the United States of America alongside the duty of care. The rule relates to one aspect of the duty of care, namely that of decision-making. The rule was founded more than 170 years ago¹⁶ and it is apparent that an objective of the rule is to limit litigation and judicial scrutiny in respect of decisions that are taken within the private business sector.¹⁷

Ultimately the rule entails that if a decision was made in good faith, lacking fraud, the director cannot be held liable for the loss suffered. Personal liability may be incurred in cases of gross negligence.¹⁸

¹³ Gevurtz *Corporation Law* (2000) 278-279; and Hinsey "Business Judgment and the American Law Institute's Corporate Governance Project: The Rule, the Doctrine, and the Reality" 1984 52 *The George Washington Law Review* 610.

¹⁴ Gevurtz 274; Schneeman 251; Sniffen *The Essential Corporation Handbook* (1992) 56; and Subak "A Snapshot of the Law Being Carved in Stone" 1987 42 *The Business Lawyer* 763-764.

¹⁵ For a different description of the rule see *Panter v Marshall Field & Co* 646 F.2d 271 (7th Cir. 1981) 102.

¹⁶ Gevurtz 278; and Lee "The Business Judgment Rule: Should it Protect Nonprofit Directors?" 2003 103 *Columbia Law Review* 939.

¹⁷ The American Law Institute *Principles of Corporate Governance and Structure: Analysis and Recommendations* Vol 1 (1994) 135.

¹⁸ Block and Prussin "The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?" 1981 37 *The Business Lawyer* 31-33; and Lee 2003 103 *Columbia Law Review* 939.

2 2 Purpose of the rule

The rule has numerous basic purposes, which include: the encouragement of risk-taking; to persuade competent persons to undertake the office of the director; the prevention of judicial second-guessing; avoiding shareholder management in the corporation; and permitting effective market mechanisms to manage director behaviour.¹⁹ Each of these will be discussed briefly.

2 2 1 Risk-taking

The primary argument in favour of the rule is the need to encourage risk-taking activities by the directors.²⁰ It is feared that without the rule directors may become exceptionally cautious when carrying out their functions as bad decision-making could expose them to personal liability.²¹ The rule thus grants the directors certain discretion and allows the company to determine its appetite for risk. If the shareholders are not comfortable with the risks taken by the directors they can easily sell their shares and invest in a company, with which they feel more comfortable. Without the rule the court would be indirectly determining the risk level of various companies.²²

2 2 2 Persuasion of competent persons to undertake the office of director

In the market place there is a need to encourage competent persons to serve as directors.²³ Depending on the company concerned it may happen that a director will earn a relatively low wage. If this were the situation very few qualified directors would be willing to accept appointment as a director.²⁴ The rule affords directors in such a position, especially non-profit directors, a form of protection from personal liability.

2 2 3 Judicial second-guessing

Judges have legal qualifications and experience in the field of legal practice. They are ill-equipped to second-guess business decisions as economics and business practice is not the judge's area of expertise.²⁵ It is also argued that the judiciary will have the benefit of hindsight and this may lead to

¹⁹ Lee 2003 103 *Columbia Law Review* 945-960.

²⁰ Veasey "Seeking a Safe Harbor from Judicial Scrutiny of Directors' Business Decisions – An Analytical Framework for Litigation Strategy and Counselling Directors" 1982 37 *The Business Lawyer* 1266.

²¹ Kirk "The *Trans Union* Case: Is it Business Judgment Rule as Usual?" 1986 24 *American Business Law Journal* 475.

²² *Joy v North* 692 F.2d 880 (2nd Cir. 1982) 21. For a comprehensive discussion of the *Joy* case see Klein and Ramseyer *Cases and Materials on Business Associations – Agency, Partnerships and Corporations* (1991) 247-253.

²³ Block, Barton and Radin "The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers" 1987 42 *The Business Lawyer* 995.

²⁴ Hansen "The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule, A Commentary" 1986 41 *The Business Lawyer* 1239.

²⁵ Baarda "Co-op directors held to high standards" 2002 *Rural Cooperatives* 17.

unwarranted scrutiny of the decision that was taken by the directors concerned.²⁶ It was stated in *Brehm v Eisner*²⁷ that if the judges failed to respect the decisions of the directors that were made in good faith it would have the effect that the courts would become super-directors.

2 2 4 *Avoiding shareholder management of the company*

The business judgment rule allows directors, rather than shareholders, to manage the company's affairs.²⁸ It is contended that if it were not for the rule, shareholders would litigate more frequently in order to have an effect on the decisions taken by the directors.²⁹ With the rule in place shareholders will take caution, especially in light of the costs of a suit, before implementing claims against the directors.³⁰

2 2 5 *Market mechanisms*

Implementing the ordinary negligence standard, by not utilising the business judgment rule, is not necessary due to certain market mechanisms that control the conduct of directors.³¹ The corporate environment is competitive. Directors must ensure that the company is soundly managed in order to remain in the market. On a personal level directors must act with caution in light of the fact that if they do not they may be removed from their position.³² Furthermore, directors are, depending on the circumstances, given stock in the company as part of their compensation package, which to a certain extent will cause the directors to act with care.³³

It is clear from the aforementioned that the business judgment rule is entrenched in American law and serves several purposes. The rule primarily protects directors from incurring liability in instances where the directors have acted in good faith.

3 THE BUSINESS JUDGMENT RULE IN AMERICA

The aim of this section is to investigate the American law and to identify the characteristics of the rule. It is a daunting task to give an exact definition of the business judgment rule as the content of the rule is controversial³⁴ and

²⁶ Lee 2003 103 *Columbia Law Review* 953.

²⁷ 746 A.2d 244 (Del. Supr. 2000) 266.

²⁸ Lee 2003 103 *Columbia Law Review* 955.

²⁹ *Ibid.*

³⁰ *Ibid.*

³¹ Lee 2003 103 *Columbia Law Review* 956-957.

³² Lee 2003 103 *Columbia Law Review* 957.

³³ For a general discussion on the purpose of the business judgment rule see Block, Radin and Rosenzweig "The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade" 1990 45 *The Business Lawyer* 490; and Lee 2003 103 *Columbia Law Review* 945-960.

³⁴ The Institute of Directors in Southern Africa "King Report on Corporate Governance for South Africa" 2002 March 70.

has different meanings.³⁵ Succinctly, the rule entails that courts should not hold a director liable for a decision that produces poor results in the circumstances in which the director made the decision in good faith, with care and on an informed basis, which the director believed was in the best interest of the company.³⁶

3 1 Application of the business judgment rule

The application of the rule is defensive. In order for the rule to find application the courts will consider the business decision, due care, good faith and whether the directors believed that the decision would be in the best interest of the company.³⁷

3 1 1 Business decision

The court must determine the kind of conduct under judicial review.³⁸ For a director to benefit from the rule a decision must have been made.³⁹ It must be noted, for the purposes of the rule, that a conscious decision not to act is equivalent to a decision to act.⁴⁰ This entails that if a director deliberately made a decision not to take certain action, a business decision for the purpose of the rule would be present.⁴¹ The rule does not find application in a non-decision making context.⁴² Directors are expected to make decisions and these decisions will involve risk evaluation, assumption or avoidance. The directors must, in the course of making decisions, carry out their duties of loyalty and care. A distinction can be drawn between a routine business decision and an extraordinary decision.⁴³ In the case of a routine decision, such as a declaration of dividends, the application of the business judgment rule is straightforward.⁴⁴ However, if the decision is extraordinary in nature, such as the sale of a large asset,⁴⁵ the decision requires closer examination by the courts.⁴⁶

³⁵ Gevurtz 279; and Perkins "The ALI Corporate Governance Project in Midstream" 1986 41 *The Business Lawyer* 1203. For a general discussion of the different meanings of the business judgment rule see Gevurtz 279-288.

³⁶ See par 1 above.

³⁷ See the impact the decision of *Zapata Corp. v Maldonado* 430 A.2d 779 (Del. Supr. 1981) had in respect of the development of the American law in relation to derivative lawsuits. For a comprehensive discussion of the *Zapata* case see Block and Prussin 1981 37 *The Business Lawyer* 27-75; Gevurtz 415-419; Hamilton *Cases and Materials on Corporations Including Partnerships and Limited Liability Companies* 7ed (2001) 807-816; and Klein and Ramseyer 210-219.

³⁸ Veasey 1982 37 *The Business Lawyer* 1250.

³⁹ Block and Prussin 1981 37 *The Business Lawyer* 33.

⁴⁰ Perkins 1986 41 *The Business Lawyer* 1210.

⁴¹ Eisenberg "Whether the Business Judgment Rule Should be Codified" 1995 40 <http://www.clrc.ca.gov/bkstudies.html> (27 August 2004).

⁴² Hansen 1986 41 *The Business Lawyer* 1247.

⁴³ Veasey 1982 37 *The Business Lawyer* 1250.

⁴⁴ Veasey 1982 37 *The Business Lawyer* 1253.

⁴⁵ See *Gimbel v Signal Companies Inc* 316 A.2d 599 (Del. Ch. 1974) for an illustration of the sale of a large asset.

⁴⁶ Veasey 1982 37 *The Business Lawyer* 1250-1251 and 1253-1254.

3 1 2 *Due care*

With reference to the due care requirement, the court's basic inquiry will be to ascertain whether the directors considered all the relevant information prior to making the decision.⁴⁷ The inquiry will explore the process that the directors employed that led them to arrive at the decision.⁴⁸ The court may consider what methodology the directors utilized,⁴⁹ whether the directors read the crucial information and whether the directors relied upon corporate books, reports and expert opinion.⁵⁰

A notable case that relates to the due care requirement is that of *Smith v Van Gorkom*.⁵¹ Van Gorkom was the Chairman and Chief Executive Officer of Trans Union Corporation.⁵² In August 1980 Van Gorkom met with senior management of Trans Union, at which the sale of the company was discussed.⁵³ By September 1980 Van Gorkom had found a buyer, Pritzker, who was willing to pay \$55 per share.⁵⁴ This particular offer was disclosed to senior management. The reaction to the offer was negative and it was contended by the Chief Financial Officer of Trans Union that the price was too low.⁵⁵ Despite the pessimistic attitude of management Van Gorkom proceeded to present the offer to the board of directors.⁵⁶ The members of the board had extensive knowledge concerning the characteristics of the company and were familiar with the company's current financial standing.⁵⁷ Van Gorkom's presentation to the board, concerning the sale, lasted a mere twenty minutes and the board was not afforded the opportunity to study the merger agreement.⁵⁸ Van Gorkom furthermore failed to disclose the methodology that was utilized in order to arrive at a sale price of \$55 per share.⁵⁹ Based upon this meeting, which lasted two hours, the board approved the merger agreement.⁶⁰ The agreement was subsequently executed without Van Gorkom or any other director having read the merger agreement.⁶¹

The court held, under these circumstances, that the board did not come to an informed business judgment by approving of the sale at a price of \$55 per share.⁶² It was found that the directors were grossly negligent in approving

⁴⁷ *Thomas v Kempner* 398 A.2d 320 (Del. Ch. 1979).

⁴⁸ Veasey 1982 37 *The Business Lawyer* 1252.

⁴⁹ *Kaplan v Goldsamt* 380 A.2d 556 (Del. Ch. 1977).

⁵⁰ Veasey 1982 37 *The Business Lawyer* 1252.

⁵¹ 488 A.2d 858 (Del. 1985) as cited in Hamilton 767.

⁵² Hamilton 768.

⁵³ *Ibid.*

⁵⁴ Hamilton 770.

⁵⁵ Hamilton 771.

⁵⁶ *Ibid.*

⁵⁷ Hamilton 772.

⁵⁸ *Ibid.*

⁵⁹ *Ibid.*

⁶⁰ Hamilton 773.

⁶¹ *Ibid.*

⁶² Hamilton 775.

the sale of the company upon two hours' consideration⁶³ and that the directors could not have become properly informed of the merger by a mere presentation by Van Gorkom.⁶⁴ Therefore the business judgment rule could not be utilized to protect the directors from liability.

The decision in *Van Gorkom* has been met with harsh criticism.⁶⁵ This is due to the contention that liability based upon the breach of the duty of care, particularly the failure of directors to become adequately informed, will lead directors to become exceptionally cautious in decision-making and that this may consequently render such directors ineffective.⁶⁶

3 1 3 *Good faith and the best interest of the company*

The content of subjective good faith comprises honesty and integrity.⁶⁷ Good faith presupposes the existence of a rational business purpose.⁶⁸ A director who acts foolishly may not be acting in good faith.⁶⁹ Therefore a director who acts without rational business purpose, even though he exercises due care, may not be acting in good faith.⁷⁰

It is required that the director must be disinterested in the transaction. This entails that the director must not be a party to the transaction and must not expect to derive a benefit from it.⁷¹ In addition, the conduct of the director may not have been of a shocking nature.⁷² The court will enquire whether the director acted as a person of sound ordinary business judgment. Thus the enquiry is subjective, taking into account an objective element.⁷³ The director must be independent and have the ability to freely exercise his or her judgment. This could also entail that the director must not be unduly influenced or dominated by another.⁷⁴

With regards to the best interest of the company, a decision that is made with due care and good faith will fall within the ambit of the rule if the directors believed the decision to be in the interest of the company. This requirement is analogous to the good faith test.⁷⁵

⁶³ Hamilton 777.

⁶⁴ *Ibid*; Monks and Minow *Corporate Governance* 2ed (2001) 197-198.

⁶⁵ Hamilton 780-781. See in general Herzel and Katz "Smith v Van Gorkom: The Business of Judging Business Judgment" 1986 41 *The Business Lawyer* 1187-1193; and Manning "Reflections and Practical Tips on Life in the Boardroom After Van Gorkom" 1985 41 *The Business Lawyer* 1-14.

⁶⁶ Kirk 1986 24 *American Business Law Journal* 475.

⁶⁷ Veasey 1982 37 *The Business Lawyer* 1251.

⁶⁸ *Ibid*.

⁶⁹ *Ibid*.

⁷⁰ *Ibid*.

⁷¹ Hansen 1986 41 *The Business Lawyer* 1248.

⁷² Hansen 1986 41 *The Business Lawyer* 1249; the term "egregious" was used to describe the conduct as quoted from the case of *Aronson v Lewis* 473 A.2d 805 (Del. 1984). For a comprehensive discussion of the *Aronson* case see Hamilton 816-829.

⁷³ Hansen 1986 41 *The Business Lawyer* 1249.

⁷⁴ *Ibid*.

⁷⁵ Veasey 1982 37 *The Business Lawyer* 1252.

3 2 Consequences of the rule

When the rule is utilized it essentially has two effects. Firstly, it precludes the court from examining the merits of the director's decision once it is evident that the director acted in good faith and, secondly, the rule creates a presumption in favour of the director of due care and good faith.⁷⁶

3 2 1 Examination of the merits

If the business judgment rule finds application to a particular set of circumstances, the court may not consider whether the directors deliberated the alternatives available to them, as this is exactly what the rule precludes.⁷⁷

However, this principle will not completely prevent the courts from examining the merits of the director's decision.⁷⁸ The merits can be considered by the court in order to determine whether the directors could have reasonably believed that their decision was in the best interest of the company.⁷⁹ By doing this the court will be investigating whether the directors abused their discretion.⁸⁰

This principle may be illustrated by considering *Gimbel v Signal Companies Inc*⁸¹ In this case the court was asked to examine the directors' decision to sell a subsidiary of the company for an effective sale price exceeding \$480-million.⁸² The plaintiff alleged, on the basis of an expert opinion, that the true fair market value of the subsidiary was in fact \$761-million and that the decision was made with haste.⁸³ After taking into account the decision-making process the court concluded that the ultimate question in this instance was not the method that was followed but rather the value of the company.⁸⁴ The court subsequently granted the plaintiff's application for a preliminary injunction barring the sale.⁸⁵

The case of *Gimbel v Signal Companies Inc*⁸⁶ illustrates that although in a business judgment case the court will generally limit its inquiry to motivational and procedural issues, the court may, if there is evidence that the decision was seriously wrong, consider this fact as evidence of a lack of

⁷⁶ Block and Prussin 1981 37 *The Business Lawyer* 33.

⁷⁷ Block and Prussin 1981 37 *The Business Lawyer* 37. See in general Lipton "Takeover Bids in the Target's Boardroom; An Update After One Year" 1981 36 *The Business Lawyer* 1017-1028.

⁷⁸ Block and Prussin 1981 37 *The Business Lawyer* 37.

⁷⁹ *Ibid.*

⁸⁰ *Ibid.*

⁸¹ 316 A.2d 599 (Del. Ch. 1974).

⁸² *Gimbel v Signal Companies Inc supra* 601.

⁸³ *Gimbel v Signal Companies Inc supra* 604 and 616.

⁸⁴ *Gimbel v Signal Companies Inc supra* 615.

⁸⁵ *Gimbel v Signal Companies Inc supra* 618.

⁸⁶ *Supra.*

due care and good faith.⁸⁷ Ultimately, the more important the decision is to the company,⁸⁸ the more likely the court will be to take the merits into consideration.

3.2.2 *Presumption of due care and good faith*

The good faith requirement will be met if it transpires that the directors honestly sought to benefit the company.⁸⁹ In order to establish bad faith on the part of the directors the plaintiff must bring forth objective facts that reveal the presence of ulterior motive.⁹⁰ Factors that would indicate the existence of ulterior motive would include insider trading,⁹¹ competing with the company,⁹² usurpation of corporate opportunity,⁹³ purchase or sale of corporate control, or conflict of interest.⁹⁴ If any one of these facts is established the business judgment rule will not apply and the burden shifts to the director to establish the “intrinsic fairness” of the transaction to the company.⁹⁵

It should be noted though, that a motive for personal gain will not necessarily render the rule inapplicable if a *bona fide* corporate purpose also exists.⁹⁶ This principle can be illustrated by the decision in *Treadway Companies, Inc v Care Corp.*⁹⁷ In this case it was held that the business judgment rule did find application where the board authorized the sale of stock and merger with a “white knight” in order to defeat a hostile tender from another company. The board realised that the majority of the directors would lose their positions due to the merger. This fact coupled with evidence that the board carefully considered the merits of the merger led to the court concluding that the directors did not act out of self-interest.⁹⁸

Case law illustrates that the burden of proving the director’s interest or bad faith, in order to render the business judgment rule inapplicable, rests on the plaintiff and that self-interest will not be presumed.⁹⁹

⁸⁷ Block and Prussin 1981 37 *The Business Lawyer* 38.

⁸⁸ *Ibid.*

⁸⁹ Block and Prussin 1981 37 *The Business Lawyer* 34.

⁹⁰ *Ibid.*

⁹¹ *Diamond v Oreamuno* 24 N.Y.2d 494 (1969).

⁹² *Duane Jones Co. v Burke* 306 N.Y. 172 (1954).

⁹³ *Burg v Horn* 380 F.2d 897 (2nd Cir. 1967).

⁹⁴ Block and Prussin 1981 37 *The Business Lawyer* 34.

⁹⁵ *Ibid.* For a general discussion of the “intrinsic fairness standard” see Gilson and Kraakman “Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?” 1989 44 *The Business Lawyer* 247-273.

⁹⁶ Block and Prussin 1981 37 *The Business Lawyer* 34.

⁹⁷ 638 F.2d 357 (2nd Cir. 1980).

⁹⁸ Block and Prussin 1981 37 *The Business Lawyer* 36.

⁹⁹ *Crouse-Hinds v Internorth, Inc* 634 F.2d 690 (2nd Cir 1980); *Johnson v Trueblood* 629 F.2d 287 (3rd Cir. 1980); and *Treadway Companies, Inc v Care Corp supra*. For a general discussion see Block and Prussin 1981 37 *The Business Lawyer* 33-38.

3 3 Illustration of the rule – *Schlensky v Wrigley*¹⁰⁰

An interesting illustration of the rule is to be found in the case of *Schlensky v Wrigley*.¹⁰¹ In this case the plaintiff was a minority shareholder of the defendant company, Chicago National League Ball Club (Inc).¹⁰² The company owned the baseball franchise for the Chicago Cubs together with Wrigley Field, the venue for the Cubs' games.¹⁰³ The defendant, Philip K Wrigley, who was president of the company, owned 80 per cent of the stock.¹⁰⁴

The plaintiff contended that since the introduction of night baseball in 1935, nineteen of the twenty league teams had scheduled night games in order to encourage attendance, thereby increasing revenue.¹⁰⁵ In the years 1961-1965 the Cubs sustained operating losses especially when playing home games,¹⁰⁶ it being apparent that when the Cubs played away games the gate revenues were substantially higher in comparison to the revenues at home games.¹⁰⁷ The plaintiff attributed the operating loss of the Cubs to poor game attendance as Wrigley Field did not have field lights and therefore none of the Cub's games could be played at night.¹⁰⁸

The directors decided not to install lights at Wrigley Field as they felt that this would have a negative impact upon the surrounding neighbourhood.¹⁰⁹ The minority shareholders were not satisfied with this decision and therefore brought a derivative action against the directors for negligence and mismanagement, claiming damages and seeking an order to compel the defendants to install lights at Wrigley Field.¹¹⁰

It was held that the directors' decision not to install lights was protected by the business judgment rule.¹¹¹ Sullivan J stated that the consideration of neighbourly relations by the directors was founded and that the long term interest of the company in its property value at Wrigley Field may well demand efforts to prevent the neighbourhood from deteriorating.¹¹² The judge contended that this does not mean that the decision was in fact correct, as that reasoning was beyond the jurisdiction of the court. It was concluded that in the absence of fraud, illegality or conflict of interest the court will not interfere with the directors' decision.¹¹³

¹⁰⁰ 237 NE 2d 776 (1968 App Ct of Ill) as cited in Hamilton 754.

¹⁰¹ Hamilton 754.

¹⁰² *Ibid.*

¹⁰³ *Ibid.*

¹⁰⁴ *Ibid.*

¹⁰⁵ *Ibid.*

¹⁰⁶ Hamilton 755.

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*

¹⁰⁹ *Ibid.*

¹¹⁰ Hamilton 754.

¹¹¹ Hamilton 756-757.

¹¹² Hamilton 757.

¹¹³ Hamilton 757; see also Klein and Ramseyer 237-243.

3 4 Codification of the business judgment rule

There were two notable attempts in America to codify the business judgment rule.¹¹⁴ The first was by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association (ABA).¹¹⁵ The ABA undertook to revise section 35 of the Model Business Corporation Act¹¹⁶ in order for the Act to accurately reflect the rule as enunciated by the courts. This attempt was, however, unsuccessful as the committee could not reach consensus in respect of a formulation of the rule and concluded that it could not complete this tremendous task within the limited time it was afforded.¹¹⁷ Thus, the ABA decided to leave the rule uncodified as the committee contended that the rule was a doctrine that could be interpreted and applied on a case-by-case basis.¹¹⁸ Gevurtz contends that the difficulty surrounding the attempt to define the rule stems from an incorrect premise.¹¹⁹ This premise is the belief that there is a single rule, when in fact there is no single rule as the business judgment rule has a number of different meanings.¹²⁰

The second attempt at codification was tackled by the American Law Institute (ALI).¹²¹ The ALI sought, in section 4.01, to prescribe the exact elements of the rule and the circumstances in which the rule would find application.¹²² This attempt at codification has, however, been subject to severe criticism. The ALI's Corporate Governance Project does not adequately recognize the diversity of the American corporate structure,¹²³ nor does section 4.01 accurately reflect the law that has been applied by the courts in the past.¹²⁴ It is contended that the ALI draft has failed to mend the problematic issues pertaining to the classical formulation of the rule and that, in terms of the draft, directors could be exposed to a wider range of liability.¹²⁵ Legal scholars argue that it would be unwise to implement section 4.01 of the draft into legislation as it is contended that the rule is well founded within the common law and can be developed on a case-by-case basis.¹²⁶ Section 4.01 furthermore fails to distinguish between a director's duty of care in a decision-making and non-decision making context¹²⁷ and it is clear that such a distinction is necessary due to the fact that the business

¹¹⁴ Botha and Jooste "A Critique of the Recommendations in the King Report Regarding a Director's Duty of Care and Skill" 1997 114 *SALJ* 65 75.

¹¹⁵ Manning "The Business Judgment Rule and the Director's Duty of Attention: Time for Reality" 1984 39 *The Business Lawyer* 1495.

¹¹⁶ Gevurtz 279.

¹¹⁷ Gevurtz 279; and Manning 1984 39 *The Business Lawyer* 1495.

¹¹⁸ Botha and Jooste 1997 114 *SALJ* 75; and Gevurtz 279.

¹¹⁹ Gevurtz 279.

¹²⁰ For a general discussion of the different meanings of the business judgment rule see Gevurtz 279-288.

¹²¹ Botha and Jooste 1997 114 *SALJ* 75.

¹²² Manning 1984 39 *The Business Lawyer* 1495.

¹²³ Subak 1987 42 *The Business Lawyer* 761.

¹²⁴ Hansen 1986 41 *The Business Lawyer* 1237.

¹²⁵ Manning 1984 39 *The Business Lawyer* 1496.

¹²⁶ Hinsey 1984 52 *The George Washington Law Review* 618.

¹²⁷ Hansen "The duty of care, the business judgment rule, and the American Law Institute Corporate Governance Project" 1993 48 *The Business Lawyer* 1355.

judgment rule only finds application in a decision-making context.¹²⁸ It is apparent that a strict black letter formulation of the rule is a formidable task particularly in light of the imprecise language that the courts have used in the development of the rule over the years.¹²⁹

The difficulty surrounding the rule arises the moment the courts and legal scholars venture beyond the general concept of judicial restraint and attempt to define the precise content of the rule.¹³⁰ This is particularly evident from the various descriptions and the attempted codifications of the rule. It is clear though, that the rule is practically a sensible notion, as business decisions involve taking calculated risks and it is necessary to afford a measure of protection to the decision makers in the event that the decision produces a result that is hurtful to the company.

3 5 CONCLUSION

The business judgment rule was developed by the American judiciary.¹³¹ From the above discussion it is clear that the exact content of the business judgement rule is difficult to define,¹³² The American courts attach different interpretations to the rule.¹³³ America has twice attempted, unsuccessfully, to codify the business judgement rule.¹³⁴ Further to that, no legislation has been implemented in any federal state in America that imposes the business judgment rule.¹³⁵

In part 2 of this article the South African law relating to the director's duty of care, the relevant provisions of the Companies Act, the recommendations of the King Committee¹³⁶ and the recent report concerning corporate law reform that was issued by the South African Department of Trade and Industry will be analysed.¹³⁷ The discussion will, where applicable, take into account the effectiveness of the current South African law and evaluate this in light of the characteristics of the business judgment rule.

¹²⁸ Hansen 1986 41 *The Business Lawyer* 1240; par 3 1 1 above.

¹²⁹ Hansen 1986 41 *The Business Lawyer* 1238-1239; Perkins 1986 41 *The Business Lawyer* 1203; and see also Eisenberg 1995 <http://www.clrc.ca.gov/bkstudies.html> (27 August 2004) 49 where it was recommended that it would be desirable to codify the business judgment rule in California.

¹³⁰ Gevurtz 279.

¹³¹ See par 2 1 above.

¹³² Gevurtz 279.

¹³³ Havenga "The Business Judgment Rule – Should We Follow the Australian Example?" 2000 12 *SA Merc LJ* 36.

¹³⁴ See par 3 4 above.

¹³⁵ Botha and Jooste 1997 114 *SALJ* 75-76; Havenga 2000 12 *SA Merc LJ* 33. However see Eisenberg 1995 <http://www.clrc.ca.gov/bkstudies.html> (27 August 2004) where it was recommended that it would be desirable to codify the business judgment rule in California.

¹³⁶ The Institute of Directors in Southern Africa 1994 November; The Institute of Directors in Southern Africa 2002 March.

¹³⁷ The Department of Trade and Industry in Southern Africa "South African Company Law for the 21st Century: Guidelines for Corporate Law Reform" 2004 May.