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Cover Page Footnote

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Articles

SECTION 727 AND THE BUSINESS JUDGMENT RULE: A COMPARATIVE ANALYSIS OF COMPANY DIRECTORS' DUTIES AND LIABILITIES IN ENGLISH AND UNITED STATES LAW

MOHAMMED R. PASBAN,* CLARE CAMPBELL,** AND JOHN BIRDS***

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I. INTRODUCTION

Over the past ten years, there have been many changes in the area of company directors' duties and liabilities in both English and United States law. While some of the developments in English law may have been unwelcome, many of the changes in United States corporate law could be regarded as giving directors more generous protection than had ever before been provided. Under English law, a director is tightly surrounded by a variety of civil and criminal liabilities. While liabilities, such as wrongful trading, have given the courts wide power to impose liability on directors, section 6 of the Company Directors Disqualification Act 1986 has supplemented the harshness of wrongful trading by removing delinquent directors

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from the corporate scene. Directors have received some protection against these new statutory liabilities with the 1989 amendment of section 310 of the Companies Act 1985. This now permits companies to provide their directors with insurance protection, something strictly prohibited until 1989. In addition, section 727 of the companies Act 1985 offers wide discretion to the courts, empowering them to relieve a director from personal liability when particular circumstances and requirements are met. Section 727, permitting the exercise of judicial discretion, is the principal protection for directors under English company law.

On the other hand, corporate law in the United States led by law of the principal state of incorporation, Delaware, has had different developments. However, these developments have gone in a very different direction than those in England. They are thought to be a result of the expectations and attitude of United States law toward corporate directors, reflected in both the commentators' and the legislative response to *Smith v. Van Gorkom*.[1] In that case, the Delaware Supreme Court held the defendant directors liable for failing to make an informed business decision; they were, thus, not entitled to the protection of the business judgment rule. As soon as the Delaware Supreme Court delivered its judgment in the *Van Gorkom* case, a storm of criticism and opposition arose throughout the country.[2] The decision contributed to the devastating insurance crisis which was already underway. While the *Van Gorkom* decision was supposed to be "a perilous time for corporate directors,"[3] or the explosion of a bomb[4] which "shocked the corporate world,"[5] it turned into a historic opportunity for corporate directors who, through their lobbies, successfully pressed the legislature to introduce the most

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

2. *See, e.g.*, Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1438 (1985) (arguing that the *Van Gorkom* court erred in holding that the actions of the defendant directors were not protected by the business judgment rule); Leo Herzel & Leo Katz, Smith v. Van Gorkom: *The Business of Judging Business Judgment*, 41 BUS. LAW. 1187, 1188 (1986) (arguing that the court's decision in *Van Gorkom* was misguided and that the defendant directors' actions were "entirely proper"); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 7 (1985) (criticizing the *Van Gorkom* court's decision and commenting that it will "generate much litigation, and thus will exacerbate the deeper crisis engulfing our legal system as a whole"); *see also* Laurie Baum, *The Job Nobody Wants*, BUS. WK., Sept. 8 1986, at 56 (criticizing the *Van Gorkom* court's decision); William B. Glaberson & William J. Powell, Jr., *A Landmark Ruling That Puts Board Members in Peril*, BUS. WK., Mar. 18, 1985, at 56, 57 (same); David Hilder, *Liability Insurance Is Difficult to Find Now*, WALL ST. J., July 10 1985, at 1 (same).

3. Glaberson & Powell, *supra* note 2, at 57.

4. *See* Manning, *supra* note 2, at 1.

5. Stephen A. Radin, *The Director's Duty of Care Three Years After* Smith v. Van Gorkom, 39 HASTINGS L.J. 707, 707 (1988).

protective provision in the history of American corporate law. This opportunity was the amendment of section 102(b)(7) of the Delaware General Corporation Law in June of 1986, which has eliminated directors' liability for gross negligence.[6] This path has been followed by most other jurisdictions in the United States.[7]

In this article, we examine section 727 of the Companies Act 1985 and this section's importance to the development of corporate law. More particularly, we explore its relationship to wrongful trading under section 214 and misfeasance under section 212 of the Insolvency Act 1986. Secondly, we review the business judgment rule under United States law, the rule's impact on judicial inquiry into the corporate decision-making process, the rule's functions and requirements, and its offensive use in the shape of "special litigation committees." Finally, in a brief conclusion, the two legal instruments are compared.

II. RELIEF UNDER SECTION 727

A. *Historical Background*

Section 727 reads:

> If in any proceedings for negligence, default, breach of duty or breach of trust against an officer of a company . . . it appears to the court hearing the case that the officer . . . is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances of the case (including those connected with his appointment) he ought fairly to be excused for the

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6. Section 102(b)(7) of the Delaware General Corporation Law provides:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [the section dealing with conflict of interest]; or (iv) for any transaction from which the director derived an improper personal benefit.

DEL. CODE ANN. tit. 8, § 102(b)(7) (1996).

7. *See, e.g.*, ALASKA STAT. § 10.06.210 (1996); ARIZ. REV. STAT. ANN. § 10-054 (1996); CAL. CORP. CODE § 204 (West 1996); GA. CODE ANN. § 14-2-202 (Michie 1996); HAW. REV. STAT. ANN. § 415-48.5 (1990); KY. REV. STAT. ANN. § 271A.271 (Baldwin 1995); MD. CORPS. & ASS'NS CODE ANN. ch. 546 § 2-405.2 (1996); MASS. GEN. LAWS ANN. ch. 156B § 13 (Law. Co-op. 1996); MINN. STAT. § 300.64 (1996); N.H. REV. STAT. § 293-A:54 (1996); N.J. STAT. ANN. § 14A: 2-7 (West 1996); N.Y. BUS. CORP. LAW § 402 (McKinney 1996); N.C. GEN. STAT. § 55A-2-02(b)(4) (1996); ORE. REV. STAT. § 60.047 (Butterworth 1996); 42 PA. CONS. STAT. ANN. § 8364 (1996); R.I. GEN. LAWS § 7-1.1-48 (1996); TENN. CODE ANN. § 48-12-102 (1995); TEX. REV. CIV. STAT. ANN. § 1302-7.06 (West 1995); WYO. STAT. § 17-16-834 (1995).

> negligence, default, breach of duty or breach of trust, that court may relieve him, either wholly or partly, from his liability on such terms as it thinks fit.[8]

The relief[9] under section 727 of the Companies Act 1985, unlike other protection available to a director under English law, namely insurance and indemnification, is nearly a century-old. Until the amendment of section 310 in 1989, such a relief was the only effective protection for directors. The model for section 727 was first introduced in section 3 of the Judicial Trustees Act 1896.[10] Under this act, if it appeared to the court that a trustee who had acted honestly or reasonably was liable for any breach of trust and ought fairly to have been excused for that breach, the court may have relieved him "wholly or partly from personal liability for the same."[11] The equivalent section was extended to company law by section 279 of the Companies Act 1908 and applied not only to "any proceeding against a director, or person occupying the position of director, of a company" but also, and most significantly, to cover liability for negligence.[12]

A major change came with the Companies Act 1929, section 372.[13] The scope of this section was widened to include "default, breach of duty, or breach of trust."[14] Further, section 448 of the Companies Act 1948,[15] which, with minor modifications, was replaced by section 727, introduced more changes to the law in this regard. The words "a person to whom this section applies" were replaced with the phrase "an officer of a company or a person employed by a company as auditor."[16] This change was made to grant relief to all auditors, irrespective of whether they serve as officers.

B. *Scope of Relief Under Section 727*

Section 727 relieves a director from liability for negligence, breach of duty, or breach of trust.[17] To grant such a relief, a court must find that a director: (i) acted honestly; (ii) acted reasonably;

8. Companies Act, 1985, § 727(1) (Eng.).

9. In Part II of this article, the term "relief" refers to the relief available under section 727 of the Companies Act 1985 or its predecessors.

10. Judicial Trustees Act, 1896, 59 & 60 Vict. ch. 35, § 3 (Eng.).

11. *Id.* § 3(1).

12. Companies (Consolidation) Act, 1908, 8 Edw. 7, ch. 69, § 279 (Eng.).

13. Companies Act, 1929, 19 & 20 Geo. 5, ch. 23, § 372 (Eng.).

14. *Id.* § 372(1).

15. Companies Act, 1948, 11 & 12 Geo. 6, ch. 38, § 448 (Eng.).

16. *Id.* § 448(1).

17. *See* Companies Act, 1985, § 727(1) (Eng.).

and (iii) ought fairly to be excused with regard to all circumstances of the case.[18] If these three circumstances are met, a court will usually relieve a director from liability. It should be noted, however, that this relief is discretionary and, theoretically, may be denied even where all the requirements are present.

The relief under section 727 covers a wide range of matters. However, we will concentrate upon its effect on directors' duties where a company has gone into liquidation and where the matter raised in the process is wrongful trading under section 214 of the Insolvency Act 1986 or misfeasance under section 212.

1. The Application of the Relief to a Wrongful Trading Case: Section 214

Section 214 of the Insolvency Act, 1986, provides:

> (1) [I]f in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.
>
> (2) This subsection applies in relation to a person if—
>
> > (a) the company has gone into insolvent liquidation; (b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and (c) that person was a director of the company at that time . . . .

Although section 727 in its strict sense may be confined to the traditional duties imposed on company directors, there has been a tendency to apply the relief to wrongful trading cases. Such an application has been justified by giving an unrestricted and wide interpretation to the notion of wrongful trading in order to categorize this notion within the concept of breach of duty under section 727. However, it is difficult to find any implication in the Insolvency Act 1986 from which one can claim that the legislature intended to extend section 727 relief to directors against whom wrongful trading proceedings have been initiated. When considering the extent of liability under section 214, Parliament refused to accept the proposal made by the Government Committee, chaired by Sir Kenneth Cork

18. *See id.*

(the Cork Committee),[19] that relief in exactly the same terms as those used in section 727 be made available.

The first case to consider the relationship between the provisions of section 214 and the relief under section 727 was *In re Produce Marketing Consortium, Ltd.*[20] The issue arose at an interlocutory stage. Therein, Justice Knox did not agree with the directors' submission that they had conducted the business honestly and reasonably and that they were, therefore, were entitled to relief from liability.[21] His Lordship accepted the argument of counsel for the liquidator that the wording of the two sections revealed the legislature's intention that these sections were not to be used in conjunction.[22] In his view, section 214 required that the director's conduct be assessed both by an objective and a subjective standard,[23] while under section 727 that conduct was to be viewed subjectively.[24] In the court's finding, it was difficult to determine how Parliament could have intended "both section 214 and section 727 of the several Acts to be operated by the same judge and at the same time."[25] The learned judge, therefore, concluded that section 727 was inoperative in the context of section 214 proceedings.[26]

In *In re DKG Contractors, Ltd.*,[27] a subsequent section 214 case, the High Court of Justice took a different view. Queen's Counselor John Weeks, Q.C., sitting as a Chancery judge, denied section 727 relief to the respondents.[28] The learned judge did so not because this section could not be applied in conjunction with section 214 of the Insolvency Act 1986 but because the respondents did not act reasonably One of the reasons for this finding was the fact that DKG

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19. *See* Insolvency Law & Practice: Report of the Review Committee, Cmnd. 8558, ¶ 1806(3)(b) (1982).

20. [1989] 1 W.L.R. 745 (Ch.).

21. *See id.* at 750-51.

22. *See id.* at 751.

23. This hybrid standard is laid down in section 214(4) as follows:

> For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both—
>
> (a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that director has.

Insolvency Act, 1986, § 214(4) (Eng.).

24. *See In re Produce Marketing Consortium, Ltd.*, [1989] 1 W.L.R. at 745.

25. *Id.* at 751.

26. *See id.* at 751-52.

27. [1990] BCC 903, 912 (Ch.).

28. *See id.*

Contractors, Ltd., did not meet its obligations to outside creditors.[29] Had the defendant directors acted reasonably, the court would have most likely exercised its discretion and relieved the directors from liability.

The objective of section 214 is to protect the interests of insolvent corporate creditors. Yet, the view that the two sections work in conjunction may frustrate this objective. Nonetheless, one can counter-argue that introduction of law against wrongful trading took place long after the enactment of section 727, so that Parliament could not have intended to provide relief against a future statutory liability. Therefore, the relief is applicable only in the case of directors' liability under the Companies Act 1985, but not under the Insolvency Act 1986.

On the other hand, it may be argued that although section 214 "does not impose a duty in a literal sense,"[30] the main element of wrongful trading liability is a breach of a negative rather than a positive duty. The corollary of this element is that to avoid liability, the directors must cease trading once they know or ought to know that the company is in financial trouble or insolvent. There may even be a duty to take some appropriate actions, such as calling an extraordinary meeting of the company shareholders, or enlisting the assistance of an insolvency practitioner.

2. The Applicability of Section 727 to Other Cases

The general applicability of section 727 has been examined in several cases.[31] As already indicated, to relieve a defendant under the section, three requirements must be satisfied. If one of these requirements is not present, the court will turn down an application for the relief under section 727. In *Guinness v. Saunders*,[32] for example, the Court of Appeal rejected the defendant director's plea for relief because with regard to the circumstances of the case, where the defendant wrongfully received £5.2 million from the company, the court found it impossible to exercise its discretion under the section to relieve the respondent from liability.[33]

Likewise, in *Dorchester Finance Co. v. Stebbing*,[34] two directors of Dorchester Finance Co. were charged with negligence and reckless

29. *See id.* at 913.

30. *In re Produce Marketing Consortium, Ltd.*, [1989] 1 W.L.R. at 751.

31. *See, e.g.*, Customs and Excise Comm'rs v. Hedon Alpha, Ltd., [1981] 2 W.L.R. 791 (C.A.); *see also In re* Claridge's Patent Asphalte Co., [1921] 1 Ch. 543, 545.

32. [1988] 1 W.L.R. 863 (C.A.), *aff'd on other grounds*, [1990] 3 W.L.R. 324.

33. *Id.* at 871.

34. [1989] BCLC 498 (Ch.).

participation in the misapplication of the company's assets.[35] The High Court rejected the defendants' claim for relief under section 727 because, in the court's view, the defendants did not act reasonably and ought not fairly to be excused.[36]

In *In re Kirbys Coaches, Ltd.*,[37] where directors were sued for negligence, Justice Hoffmann, accepting that the defendants bore the burden of showing that they ought to be relieved under the section, held that they were not bound to plead the section in their defense.[38] In this case, the defendants refused to give particulars required by the liquidator and ordered by the registrar; however, they argued they had acted honestly and reasonably and, therefore, ought to have been excused from liability.[39] The High Court, allowing the appeal and discharging the registrar's order, held that the defendants did not have to take a positive case, but in the absence of evidence to the contrary, it was for them to show that they had acted honestly and reasonably and ought fairly to have been excused.[40]

The case of *In re Welfab Engineers, Ltd.*,[41] involved an application of the relief under section 727 in relation to negligent conduct. Here, the company had been trading at a loss, and it was evident to its directors that in order to carry on its business, the company had to sell its freehold property, which was its principal asset. The directors received several offers and chose to accept a £110,000 offer, although there was a higher price offer of £125,000.[42] However, the offer they were proposing to accept involved the transfer of the company's work force, including the directors, to the purchasing company.[43] In examining a charge of breach of duty against the directors, the judge stated his view on the matter in favor of the applicability of the relief to negligence as follows:

> I . . . consider that the respondents were not in breach of duty and that the summons must be dismissed. If I were wrong in this, I would consider that the respondents had acted honestly and reasonably and ought fairly to be excused from liability under section 727 of the Companies Act 1985.[44]

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35. *Id.*
36. *See id.* at 506.
37. [1991] BCC 130 (Ch.).
38. *Id.* at 131.
39. *See id.*
40. *See id.*
41. [1990] BCLC 883 (Ch.).
42. *See id.*
43. *See id.*
44. *Id.*

The court concluded that the defendant directors had acted honestly and reasonably and, even if they had breached their duty, they ought to have been excused.[45]

In *In re D'Jan of London, Ltd. v. D'Jan*,[46] Lord Hoffmann exercised his discretionary power to limit the respondent's liability. However, applying the test of reasonableness required by section 727, the learned judge made some comments which opened new horizons on the matter. His Lordship's view on how one could have acted reasonably and at the same time negligently challenges the test recognized in section 727. He opined:

> [It] may be odd that a person found to have been guilty of negligence, which involves failing to take reasonable care, can ever satisfy the court that he acted reasonably. Nevertheless the section clearly contemplates that he may do so and it follows that conduct may be reasonable for the purposes of section 727 despite amounting to lack of reasonable care at common law.[47]

The implication of this position seems to be that while reasonableness for the purposes of negligence liability is primarily objective, it is at least partly subjective in the context of an application for relief under section 727. Unless section 727 were held not to apply to cases where directors are sued for negligence (which is hardly feasible, given that the section expressly refers to negligence), there seems to be no other possible interpretation. This view clearly supports the argument that section 727 can be applicable to wrongful trading situations, although in practice it might be difficult to successfully establish a case for relief. Finally, the particular facts of the case were, in the judge's opinion, decisive. The respondent, the former controlling director, was holder of ninety-nine percent of the issued shares. The court stressed that although the company had its own separate identity, it appeared to be reasonable that the respondent personally took risks in relation to his own property, with regard to the extent of his shareholding whereas his actions would have been unreasonable in relation to someone else's property or shareholding. It seems, therefore, that if the respondent had not been the sole effective shareholder, the relief would not have been available to him. One might respectfully question whether or not this view took sufficient account of the fact that the shareholders' interests are replaced by those of the company's creditors,

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45. *See id.; see also In re* J. Franklin & Son, Ltd., [1937] 4 All E.R. 43, 46 (Ch.).
46. [1993] BCC 646.
47. *Id.* at 654.

employees, and the society as a whole when a company is financially troubled.

In light of the above decisions, it could be said that there seems to be an increasing reluctance on the part of the courts to easily grant relief in misfeasance proceedings, even under section 727.[48]

Most of the relevant cases arose out of misfeasance proceedings issued under what has now become section 212 of the Insolvency Act 1986, but there are a number of other cases where the matter originated otherwise. For example, in *In re Allsop*,[49] where the charge was breach of trust, the respondents applied for relief under section 3 of the Judicial Trustee Act 1896. In that case, Justice Cozens-Hardy, refused to apply a restricted meaning to the relief and stated: "I can see no ground for narrowing or limiting the application of the wide words of the section. 'Any breach of trust' are emphatic words. The statute was obviously designed to protect honest trustees, and it ought not to be construed in a narrow sense."[50]

Lord Hamilton found the section to be "comprehensive and unrestricted"[51] and agreed with the above view. Further, supporting Justice Cozens-Hardy's position, Lord Swinfen stated:

> The language of s. 3 is wide, and a narrow construction ought not to be placed on it. It was intended to give power to the Court to relieve an honest trustee in proper cases. The words "is or may be liable" appear to point doubtful questions of construction. In my opinion the case of a trustee committing a breach of trust by paying the wrong person in consequence of acting upon an erroneous construction is within the section, and the Court has jurisdiction to relieve against the personal liability.[52]

In *In re Claridge's Patent Asphalte Co.*,[53] the liquidator of the Claridge Company in compulsory liquidation sued the directors for misfeasance and acting *ultra vires*.[54] The liquidator claimed that the investment by the directors of £6334 in taking up 4,334 shares and 2,000 debentures in the Clarmac Company was *ultra vires* and, there-

48. There is no doubt that a defendant director charged with fraudulent trading can never enjoy the relief, since fraudulent trading conduct is based on such elements as dishonesty and knowing misconduct which fairly ought not be excused. Moreover, public policy is a main consideration which strictly prohibits relieving a delinquent director from personal liability for a fraudulent conduct.

49. [1914] 1 Ch. 1.

50. *Id.* at 11.

51. *Id.* at 14.

52. *Id.* at 21.

53. [1921] 1 Ch. 543.

54. *Id.* at 545.

fore, invalid.[55] In addition to this, the liquidator sought to establish that this act was a misfeasance or misappropriation of the company's funds.[56] Both counsel for the defendant directors and Justice Astbury acknowledged that the respondents' conduct was *ultra vires.*[57] However, the learned judge considered the fact that although the respondents had no power to carry out the scheme, they were advised that they could do so with full approval of the company's shareholders.[58] His Lordship concluded:

> In my opinion s. 279 clearly applies to a case of ultra vires. All applications of a company's money ultra vires the company are in fact breaches of trust on the part of the directors. The language of s. 279 is perfectly wide and general, and I see no reason for limiting the wide generality of that section to breaches of trust where no question of ultra vires comes in.[59]

In *In re Duomatic, Ltd.,*[60] an action was brought by the company's liquidator alleging that the defendant director had wrongfully received remuneration.[61] The court refused to exercise its discretion under section 448 of the Companies Act 1948 not because the matter was outside the section's scope but, rather, because the respondent, in the court's view, did not act reasonably.[62] Thus Justice Buckley opined that the director had not been acting "in the way in which a man of affairs dealing with his own affairs with reasonable care and circumspection could reasonably be expected to act in such a case."[63]

C. Extent of the Court's Discretion

Finally, it is necessary to look in some detail at the extent of the court's discretion to accept or reject an application on the part of defendant director for relief. First, there are clear indications in section 727 that the power of the court is discretionary but not mandatory. Thus section 488 contains the phrase, "[i]f . . . it appears to the court," not "if it is proven" or "if it is shown," thereby underscoring the discretionary nature of the relief. Second, the three requirements provided for invoking the relief, namely that the respondent "has acted honestly, reasonably, and that having regard to all the

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55. *See id.*
56. *See id.*
57. *See id.* at 548.
58. *See id.* at 547, 549.
59. *Id.* at 548.
60. [1969] 1 All E.R. 161 (Ch. 1968).
61. *Id.*
62. *See id.* at 162.
63. *Id.* at 171.

circumstances of the case . . . he ought fairly to be excused," grant a wide and flexible discretion for the court hearing the case.[64] As *Gore-Browne* points out, while the first two requirements can be proven, the third one, which is left to the courts' discretion, is not easy to prove.[65] The case of *DKG Contractors, Ltd.*, already examined, is a good example, where the court dismissed the respondents' application for a relief not because the relief was inoperative in a wrongful trading case but mainly because, in the court's view, they had not acted reasonably.[66] Thus in another case with similar facts, a different judge might have found the respondents' conduct reasonable and granted the relief.[67]

The last requirement, "having regard to all the circumstances . . . of the case," is clearly very open-ended. It appears to permit the judges to examine all or any of the aspects of the company's business and the directors' conduct in weighing the evidence for and against granting the relief.

The other expression in section 727 which contains an absolute discretion for the courts is "that court may relieve him."[68] This language indicates that even when the three above requirements are satisfied, the court has no obligation to relieve the respondent from liability. Had the legislature intended to provide for otherwise, it would have used the obligatory word of "shall" or "will" instead of "may." It is quite understandable that section 727 should have been drafted in such wide terms. Otherwise, any hint of providing an obligatory exercise of power for the courts in this respect would put the judges in a difficult situation, where they would not think fit to grant the relief to a delinquent director. What is quite clear, though, is that a great deal will depend on the attitude of the trial judge towards the exercise of the discretion vested to him. If a case is brought before a judge who applies a wide and general interpretation of the concepts, the respondent will likely be given the relief,[69] whereas if a case is proceeded by a judge who interprets legal expressions in a strict way, an application for the relief may likely be rejected.[70]

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64. *See In re* J. Franklin & Son, Ltd., [1937] 4 All E.R. 43, 46 (Ch.).

65. GORE-BROWNE ON COMPANIES ¶ 21-05 (44th ed. 1986).

66. *In re DKG Contractors, Ltd.*, [1990] BCC 903.

67. *See id.*

68. Companies Act, 1985, § 727(1) (Eng.).

69. *See, e. g., In re* Claridge's Patent Asphalte Co., [1921] 1 Ch. 543, 549 (per Astbury, J.); *see also In re* Allsop, [1914] 1 Ch. 1, 2 (per Hamilton, L.J., Eady, L.J.).

70. *See, e.g.,* Customs & Excise Comm'rs v. Hedon Alpha, Ltd., [1981] 2 W.L.R. 791 (per Ackner, J.) (strictly interpreting the meaning of the relief which is applicable to "default").

In conclusion, the relief under section 727 has been an effective tool of protecting corporate directors. However, the courts have perhaps failed to resolve some of the problems and ambiguities inherent in this section. The section is in need of amendment, in particular to clarify or to expand its ambit with regard to wrongful trading cases.

III. THE BUSINESS JUDGMENT RULE IN THE UNITED STATES

The business judgment rule is a result of judicial recognition that decisions made by directors in good faith and in the exercise of business judgment should not be reviewed by the courts. As stated by a New York court, "the directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions."[71] Some American commentators have suggested that the business judgment rule grew from English common law principles,[72] particularly the case of *Charitable Corp. v. Sutton*[73] over 250 years ago. However, a better view is that the rule can be identified in its present form from 1828,[74] during the period of dominance of the well-known economic and political theory of *laissez-faire*.[75]

A. *Definition and Presumption of the Rule*

The business judgment rule is well-recognized as a specific application of the directors' duty of care in a situation where, after a reasonable investigation, the directors take an action that they honestly and reasonably believe to be in the corporation's best interests, but, as a result of a miscalculation, this turns out to have been in error. The rule has been analyzed in a number of important decisions[76] and explained by the Supreme Court of Delaware in *Warshaw v. Calhoun*[77] as follows:

> In the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts. The burden of

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71. Kmin v. American Express Co., 383 N.Y.S.2d 807, 810-11 (1943).

72. *See, e.g.*, DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF DIRECTORS 1 (3d ed. 1989); Dennis J. Block & H. Adam Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva* Zapata, 37 BUS. LAW. 27, 31 (1981).

73. 2 Atk. 400, 404 (1742), 26 Eng. Rep. 642 (Ch. 1742).

74. *See* Percy v. Millaudon, 8 Mart. 68, 77-78 (La. 1829).

75. *See* J. Gordon Arbuckle, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 GEO. WASH. L. REV. 562, 565 (1967).

76. *See, e.g.*, United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917).

77. 221 A.2d 487 (Del. 1966).

> showing the existence of bad faith or abuse of discretion rests upon the plaintiff who charges that the corporate action was taken to benefit the majority at the expense of the minority. The acts of directors are presumptively acts taken in good faith and inspired for the best interests of the corporation, and a minority stockholder who challenges their *bona fides* of purpose has the burden of proof.[78]

The business judgment rule is an evidentiary presumption that directors, in their decision-making, have satisfied the requirements necessary to benefit from the protection of the rule. The presumption is based on the rationale that directors who are responsible for managing the corporation have the best access to the necessary information. Because the directors are required to act in the best interests of the corporation and its shareholders and because they are vested with a broad discretion in their decision-making, they are the ones who can make the most appropriate decision.[79] Commentators have referred to the rule as "a safe harbor,"[80] or as a statement of the circumstances (informed basis, good faith, honest belief) under which a court will not substitute its judgment for that of directors, either to hold them liable or to invalidate a transaction they have approved.[81]

In *Robinson v. Pittsburgh Oil Refining Corp.*,[82] the Court of Chancery of Delaware described the rule as follows: "The directors of the defendant corporation are clothed with that presumption which the law accords to them of being actuated in their conduct by a bona fide regard for the interests of the corporation whose affairs the stockholders have committed to their charge."[83]

Similarly, in the leading case of *Aronson v. Lewis*,[84] the rule was described as "an acknowledgment of the managerial prerogatives of Delaware directors" under section 141(a) of the Delaware General Corporation Law.[85] In this case, the Supreme Court of Delaware said:

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78. *Id.* at 492-93 (citations omitted).

79. *See* Scott V. Simpson, *The Emerging Rule of the Special Committee—Ensuring Business Judgment Rule Protection in the Context of Management Leveraged Buyouts and Other Corporate Transactions Involving Conflicts of Interest*, 43 BUS. LAW. 665, 671 (1988).

80. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(d) (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

81. *See* R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1339 (1993).

82. 126 A. 46 (Del. Ch. 1924).

83. *Id.* at 48.

84. 473 A.2d 805 (Del. 1984).

85. DEL. CODE ANN. tit. 8, § 141(a) (1996).

> It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts.[86]

Therefore, where compliance with the business judgment rule is at issue, the plaintiff must plead facts to overcome the presumption; failure to do so will end the proceedings.[87]

B. *Requirements*

Defendant directors who wish to enjoy the protection of the business judgment rule are expected to satisfy certain important requirements.[88] First, directors must inform themselves of all material information available to them before making any business decision,[89] and they must act with requisite care in the discharge of their duties.[90] Second, a defendant director seeking business judgment rule protection must act in genuine good faith.[91] If a director "stands on both sides" of a transaction, the court will place the burden on the director to demonstrate that such action was intrinsically fair to the corporation.[92] A director who has acted with a view to guaranteeing his control over the corporation cannot expect protection unless he can justify the acts as primarily in the corporate

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86. *Aronson*, 473 A.2d at 812 (citations omitted); *see also* Cole v. National Cash Credit Ass'n, 156 A.183, 188 (Del. Ch. 1931) (stating that there is a presumption that the judgment of the governing body of a corporation is formed in good faith and inspired by a bona fide purpose); Davis v. Louisville Gas & Electric Co., 142 A. 654, 659 (Del. Ch. 1928) (stating it is not the courts' function to resolve questions of policy and business management for corporations).

87. *See* Marshal L. Small, *Conflict of Interests and the ALI Corporate Governance Project*, 48 BUS. LAW. 1377 (1993).

88. *See* Lewis v. S. L. & E., Inc., 629 F.2d 764, 769 (2d Cir. 1980); *see also* United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917); Treadway Co. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980); *Aronson*, 473 A.2d at 812.

89. *See* Thomas v. Kempner, 398 A.2d 320, 323-24 (Del. Ch. 1979); *see also* Stoner v. Walsh, 772 F. Supp. 790, 801 (1991).

90. *See, e.g.*, PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 80, § 4.01(c)(2); *see also* Smith v. Van Gorkom, 488 A.2d 858, 873-74 (1985); Gimbel v. Signal Co., 316 A.2d 599, 615 (Del. Ch. 1974) (stating that the business judgment rule will not apply when "directors acted so far without information that they can be said to have passed an unintelligent and unadvised judgment").

91. The good faith required is a subjective test, namely acting in the honest belief that the decision concerned was in the best interests of the corporation. *See* L. A. Partners, L.P. v. Allegis Corp., No. 9033 (Del. Ch. Oct. 22, 1987); *see also* Guth v. Loft, 5 A.2d 503, 510 (Del. 1939).

92. *See, e.g.*, Fliegler v. Lawrence, 361 A.2d 218, 221 (Del. 1976). The *Fliegler* court did not relieve directors of the burden of proof simply because the decision received ratification. *See id.* Only one third of disinterested shareholders voted, which showed neither approval nor disapproval of the action. *See id.*

interest.[93] However, in *Johnson v. Trueblood,*[94] where the directors were charged with authorizing the sale of corporate stock with the intention of preserving their control over the corporation, the business judgment rule applied because, in the court's view, the rule was applicable unless the "sole or primary motivation" for the challenged decision was to retain the control.[95]

The third requirement for application of the business judgment rule is that the directors be independent.[96] Several courts[97] and some legal scholars[98] have equated independence with disinterestedness.[99] This view is justified because there is a direct connection between independence and disinterestedness since a director cannot be interested and at the same time independent. The reverse is also true. Where the director stands to benefit directly or indirectly from a decision, his independence is tainted by doing so.[100] In order for the plaintiff to prove a director's lack of independence, the plaintiff has to demonstrate the existence of financial gain or entrenchment of the director's position, or any other specific advantage, such as preserving the director's seat on the board of directors.[101]

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93. *See, e.g.,* Bennett v. Propp, 187 A.2d 405, 408 (Del. 1962); Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975).

94. 629 F.2d 287 (3d Cir. 1980).

95. *See id.* at 293. The court agreed with the instruction given to the jury that "so long as other rational business reasons support a director's decision, the mere fact that a business decision involves a retention of control does not constitute a showing of bad faith to rebut the business judgment rule." *Id.* at 292.

96. *See* Scattered Corp. v. Chicago Stock Exchange, Inc., 1996 WL 417507, at *3 (Del. Ch. July 12, 1996) (stating that traditional business judgment rule standards include "the board's disinterest and independence"); *see also* Benerofe v. Cha, 1996 WL 535405, at *5 (Del. Ch. Sep. 12, 1996) (requiring the board of directors to be independent and disinterested). A director is independent if he or she is "capable of making decisions for the corporation based on the merits of the subject matter rather than on 'extraneous considerations or influences.'" *Id.* at *7 (quoting Aronson v. Lewis, 473 A.2d 805, 816 (Del. Ch. 1924)).

97. *See, e.g.,* Abramowitz v. Posner, 513 F. Supp. 120, 126 (S.D.N.Y. 1981) ("[T]he business judgment rule is sufficiently broad to permit disinterested, independent directors to terminate a derivative suit. . . .").

98. *See* BLOCK ET AL., *supra* note 72, at 14; *see also* Thomas C. Wagner, Note, *The Business Judgment Rule Imposes Procedural Requirements on Corporate Directors:* Smith v. Van Gorkom, 14 FLA. ST. U. L. REV. 109, 111 (1986).

99. "[D]irectors must 'possess a disinterested independence and . . . not stand in a dual relation which prevents an unprejudicial exercise of judgment.'" BLOCK ET AL., *supra* note 72, at 14 (quoting Auerbach v. Bennett, 393 N.E. 2d 994, 1001 (N.Y. 1979)).

100. When a director has a substantial personal interest in a corporate transaction, the business judgment rule will not apply unless the director demonstrates "that the transaction is intrinsically fair to the corporation." Wagner, *supra* note 98, at 110.

101. *See* Grobow v. Perot, 539 A.2d 180, 188 (Del. 1988).

C. Functions of the Rule

The business judgment rule offers directors the wide discretion necessary to take proper actions that they honestly believe to be in the corporation's best interests and to formulate corporate policy effectively without fear of personal liability or judicial scrutiny.[102] The rule was developed in recognition that "judges are not business experts qualified to evaluate complex commercial transactions."[103] Accordingly, the rule precludes, or at least limits, the courts' interference with the decision-making policy of corporate management.[104] The business judgment rule has both a defensive and offensive function.

The defensive use traditionally has been the main purpose of the business judgment rule, which enables a director who has made a misjudgment in good faith in performance of his duties to be relieved from personal liability.[105] It has operated as a shield to protect directors from liability for their honest decisions.[106] Furthermore, it is not justifiable for the courts, which may lack the necessary business expertise, to carry out an inquiry into the minutiae of the decision-making policy of corporations. The function of the business judgment rule should be to limit the scope of judicial review as to such policy decisions. This limitation will be removed in the case of fraud[107] or acts of directors in breach of their fiduciary duty.[108] However, even in these particular cases, the inquiry cannot go further than to find out whether the director made a reasonable effort to avail himself of all necessary information for the challenged decision. Commentators argue that as long as the rule protects

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102. *See* Cramer v. General Tel. & Elec. Corp., 582 F.2d 259, 274 (3d Cir. 1978) ("Absent bad faith or some other corrupt motive, directors are normally not liable to the corporation for mistakes of judgment . . . .").

103. Wagner, *supra* note 98, at 109.

104. *See id.* at 109-10.

105. *See Cramer*, 582 F.2d at 274 (commenting that the business judgment rule "originated as a means of limiting the liability of corporate directors and officers for mistakes made while performing their duties").

106. *See* Wagner, *supra* note 98, at 109. Directors who seek protection of the business judgment rule "must inform themselves adequately of 'all material information reasonably available' . . . [and] [a]fter gathering this information, directors must act with due care as they discharge their duties and will be held accountable for acts amounting to gross negligence." Benerofe v. Cha, 1996 WL 535405, at *8 (Del. Ch. Sep. 12, 1996) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. Ch. 1924)).

107. *See* Gimbel v. Signal Companies, Inc., 316 A.2d 599, 609 (Del. Ch. 1974); *see also* Auerbach v. Bennett, 393 N.E. 2d 999, 1000 (N.Y. 1979).

108. Courts generally will not apply the protection of the business judgment rule "where the party challenging a transaction establishes a material personal interest or self-dealing by a majority of the corporation's directors . . . ." BLOCK ET AL., *supra* note 72, at 14 (citing Jedwab v. MGM Grand Hotels, Inc., 509 A.2d 584, 505 n.7 (Del. Ch. 1986)).

directors from imprudent decisions made in good faith or from the unfortunate consequences of reasonable decisions, the rule is desirable, but when application of the rule "leads to the relaxation of fiduciary conscientiousness, it must yield to the paramount societal interest in shareholder protection."[109]

The business judgment rule also has an offensive use exercised through special litigation committees.[110] These committees, which have been described as one of the most odd and complicated phenomena in corporate law, are examined in the following section.

D. *Special Litigation Committee: Offensive Use – Demand Rule*

In the United States, the minority shareholder's derivative action is a common method by which allegations of breaches of directors' duties are litigated.[111] Prior to the development of special litigation committees, the United States courts restricted the authority of boards of directors to decide whether to maintain a derivative action when a majority of the board's members were involved in the alleged wrongdoing.[112] The 1970s saw an extensive attempt by corporations, supported by the courts, to designate special committees consisting of independent and disinterested directors, to investigate the allegations made by shareholders against directors.[113] Such committees were then empowered to recommend dismissal of the case upon finding that proceeding was not in the best interests of the corporation.[114]

Corporations have a number of reasons for seeking to terminate many derivative actions as early as possible. First, the legal expenses for such actions are extremely high not only because many of these actions are complex but, more importantly, because the corporations are required to pay for several separate teams of lawyers. Second, derivative actions interrupt the corporation's business when the board of directors, particularly the top management, is engaged in such legal proceedings. Third, and perhaps the most significant,

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109. Wagner, *supra* note 98, at 126.

110. *See id.* at 111.

111. *See* Alan Higbee, Note, *The Misapplication of the Business Judgment Rule to Dismiss Shareholder Derivative Suits Against Directors*, 33 U. FLA. L. REV. 589, 598 (1981) (commenting that special litigation committees have become an "increasingly popular method of handling alleged disputes involving corporate director activities"); *see also* BLOCK ET AL., *supra* note 72, at 437-38. In a shareholder derivative suit, one or more minority shareholders bring an action on behalf of the corporation against third parties, directors, officers, employees or other corporate agents. *See id.*

112. *See* Higbee, *supra* note 111, at 598.

113. *See generally* BLOCK ET AL., *supra* note 72, at 492, 497-98.

114. *See* Wagner, *supra* note 98, at 111.

reason for the termination of a derivative action is the necessity of avoiding any procedure which may taint the corporation's reputation and its long-term viability.[115]

According to the traditional view consistent with the rationale of the business judgment rule, judicial inquiry was limited to reviewing the independence of the members of such committees, and the decision of the disinterested directors was validated. However, the modern approach exemplified in *Zapata Corp. v. Maldonado*[116] does not give as much attention to the business judgment rule and examines the real independence and disinterestedness of such a committee when the committee is subject to and may be oversympathetic to the board of directors.[117] Thus the *Zapata* case was a turning point and an end to "the clear trend in corporate law,"[118] marking a revolutionary change to the traditional judicial view that a litigation committee could terminate a derivative action.[119] The decision was later followed by other Delaware courts and federal courts.[120]

IV. COMPARISON AND CONCLUSION

At first glance, section 727 of the Companies Act 1985 appears very similar to the American business judgment rule since the main requirements for a director to be able to enjoy the protection of section 727 and the business judgment rule are acting honestly and with due care or being properly informed. However, in spite of these similarities, because of different treatment given by the two legal systems to the subject, the differences between these two legal concepts are substantial.

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115. Empirical studies show that when a shareholder derivative suit is announced, the price of the corporation's stock is driven downward. *See* Jeffrey A. Sanborn, Note, *The Rise of "Shareholder Derivative Arbitration" in Public Corporations:* In re Solomon Inc. Shareholders' Derivative Litigation, 31 WAKE FOREST L. REV. 337, 366 (1996); *see also* Thomas P. Kinney, Comment, *Stockholder Derivative Suits: Demand and Futility Where the Board Fails to Stop Wrongdoers*, 78 MARQ. L. REV. 172, 175 (1994) (commenting that corporations might suffer from damaged reputation because of a derivative suit).

116. 430 A.2d 779, 787 (Del. 1981).

117. *See* Wagner, *supra* note 98, at 111.

118. S. Andrew Bowman, Comment, *The Business Judgment Rule and the Litigation Committee: The End of a Clear Trend in Corporate Law*, 14 IND. L. REV. 617, 631 (1981).

119. *See* Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT'L L.J. 3, 34 (1996) (commenting that special litigation committees "are the standard mechanism for terminating derivative litigation in the United States").

120. *See, e.g.*, Peller v. Southern Co., 911 F.2d 1532, 1538 (11th Cir. 1990); *In re* Orange Sec. Litigation, 829 F. Supp. 1176, 1187 (N.D. Cal. 1993); Rosengarten v. Buckley, 613 F. Supp. 1493, 1496 (D. Md. 1985); Spiegel v. Buntrock, 571 A.2d 767, 770 (Del. 1990); Lewis v. Fuqua, 502 A.2d 962, 965 (Del. Ch. 1985); Merritt v. Colonial Foods, Inc., 505 A.2d 757, 764 (Del. Ch. 1985).

First, the business judgment rule is the product of judicial development emerging from the original common law.[121] In contrast, the ancestry of section 727 is purely statutory.[122] Second, the relative lack of case law on section 727 and ambiguities inherent in its application mean that there remain some uncertainties about its operation.[123] The situation regarding the business judgment rule is different. Since its inception, the rule has been constantly applied, and the courts have exercised their discretion once the main requirements of the rule, namely acting informed and in good faith, are satisfied. If a court refuses to relieve a director on the basis of the rule, where there is a possibility of relieving him, the court can expect a backlash of criticisms from academics and other commentators.[124]

Third, there has been no serious academic discussion by British commentators on the various aspects of section 727 or its potential impact on the development of the law governing company directors. This lack of discussion seems curious, given a general concern among commentators as to the harshness of some statutory liabilities, particularly disqualification and wrongful trading. It is surprising to see no serious attempts to clarify and discuss this potentially effective instrument of protection whose application could alleviate the harshness of those statutory liabilities and satisfy commentators' concerns.

In contrast, the business judgment rule has dramatically developed through a large volume of case law. Furthermore, the rule found its way into the board room when it inspired the formation of the special litigation committee. In addi-tion, numerous comments have been made on the different features of the business judgment rule, and institutions and associations, such as the American Law Institute and the American Bar Association, have contributed to the development of the rule. One commentator, in comparing United States and English law, states that in English law the "position under the most liberal indemnification statutes is not much different from that obtaining as a result of the combination of the Companies

121. *See* Corinne Ball & Robert L. Messineo, *Fiduciary Duties of Officers and Directors of the Financially Troubled Company: A Primer, in* MERGERS AND ACQUISITIONS IN THE 90S 171, 175 (PLI Corp. Law & Practice Course Handbook Series No. 971, 1996) (stating that the business judgment rule "is a common law standard of judicial review").

122. *See supra* text accompanying notes 10-16.

123. *See In re* Produce Marketing Consortium, Ltd., [1989] 1 W.L.R. 745 (Ch.); *see also In re* D'Jan of London, Ltd., v. D'Jan, [1994] 1 BCLC 561.

124. *See, e.g.,* Herzel & Katz, *supra* note 2, at 1188-89; Manning, *supra* note 2, at 6-7.

Act section 727 and the virtually unrestricted freedom of shareholders to provide indemnities after a loss has arisen."[125]

The different means of protection provided by United States law is not comparable with those offered to an English corporate director because the former is very much more protective of the corporation and management than the latter.[126] While the United States law has permitted a corporation to amend its articles to eliminate its directors' liability even for gross negligence,[127] English law has strictly prohibited any elimination of liability.[128] English law authorizes indemnification against the costs of defense mainly when the director has a successful defense whereas the extent of such protection in United States law is wider.[129]

In conclusion, it is worth pointing out that United States commentators have created much from nothing while the English are still dithering. It is still not too late. Section 727 of the Companies Act 1985 presents an ideal opportunity for English law to fill an obvious gap in the area of the protection of its company directors from harsh statutory and common law liabilities. In doing so, much could be learned from the United States experience.

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125. Colin Baxter, *Demystifying D & O Insurance*, 15 OXFORD J. LEGAL STUD. 537, 564 (1995).

126. *See* Babatunde M. Animashaun, *The Business Judgment Rule: Fiduciary Duties and Liabilities of Corporate Directors*, 16 S.U. L. REV. 345, 349 (1989).

127. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (1996).

128. *See* Companies Act, 1985, § 310(1) (Eng.).

129. *See* DEL. CODE ANN. tit. 8, § 145(a) (1996).