New Jersey Law Journal

VOL. CLXX – NO. 11 – INDEX 953 DECEMBER 16, 2002 ESTABLISHED 1878

IN PRACTICE

SECURITIES LITIGATION

By HAROLD G. LEVISON, R. EDWIN SELOVER, WILLIAM E. FRESE AND MICHAEL R. GRIFFINGER

Court Endorses the Business-Judgment Rule

Boards of directors can expect the judiciary to respect their good-faith business decisions

In *In re PSE&G Shareholder Litigation*, 173 N.J. 258, (2002), ruling on several "questions of first impression regarding the law of business organizations in New Jersey," the Supreme Court addressed at length the relationship between the business-judgment rule and derivative actions or, as the Court put it, the "interplay between … [the] protection [accorded] to corporate decision-makers to be free of unwarranted judicial intrusion … [and] a shareholder's ability to redress perceived wrongs against the corporation … when the … managers refuse to act."

In a strong endorsement of the business-judgment rule, *PSE&G* unanimously affirmed the dismissal of three shareholder derivative actions filed against the board of directors and several officers of Public Service Enterprise Group Incorporated, the holding company of Public Service Electric & Gas Company, New Jersey's largest utility. Each of the actions had alleged general, long-term, reckless mismanagement of PSE&G's nuclear power plants by the board and PSE&G's top officers. Each of the actions was dismissed based on the determination made by the board of directors — in the exercise of its business judgment — that the litigation should be terminated as not being in the best interests of PSE&G.

Shareholder derivative actions are actions brought against parties who have wronged the corporation and are brought where the corporation has failed to commence the action on its own behalf. Because, by their nature, shareholder derivative actions "infringe on director autonomy," and may have a "negative effect on corporate governance," in New Jersey and throughout the United States, a "demand rule" exists that requires shareholders, as a condition precedent to commencing a derivative action, either to (a) demand that the directors institute that litigation on behalf of the corporation, or (b) demonstrate the futility of making any such demand.

The demand rule, which has existed in the United States since the Supreme Court's decision *Hawes v. Oakland*, 104 U.S. 450 (1881), implements a judicial recognition of the "basic principle of corporate governance that the decisions of a corporation — including the decision to initiate litigation — should be made by the board of directors or the majority of shareholders." *Kamen v. Kemper Financial*, 500 U.S. 90 (1991), quoting *Daily Income Fund, Inc. v. Fox,* 464 U.S. 523 (1984).

The *PSE&G* litigation included both types of derivative actions: one action in which a demand on the board to institute litigation had been made but was rejected; and two actions in which futility of demand had been alleged.

Recognizing that it must protect a "shareholder's ability to redress perceived wrongs against the corporation," the Court in *PSE&G* first rejected the notion that it should eliminate the shareholder's option of demonstrating futility of demand, that is, that it should institute a universal demand rule. The Court reiterated a stockholder's right to claim, under New Jersey Court Rule 4:32-5, the futility of any demand on the board

Levison, a member of Kasowitz, Benson, Torres & Friedman of New York, was counsel to the board of directors in the PSE&G action. He argued the case in the Chancery Division, the Appellate Division and the Supreme Court on behalf of the board of directors. Selover is general counsel of Public Service Enterprise Group, Incorporated and Public Service Electric & Gas Company. Frese, general litigation counsel of Public Service Electric & Gas Company, served as co-counsel for PSE&G in the litigation. Griffinger, a member of Gibbons, Del Deo, Dolan, Griffinger & Vecchione of Newark, argued the case in the Chancery Division, the Appellate Division and the Supreme Court on behalf of the defendant officers.

to initiate litigation, and adopted the test set forth by the Delaware Supreme Court in *Aronson v. Lewis*, 473 A.2d 805 (1984), for pleading demand futility.

The *Aronson* court held that a plaintiff shareholder claiming demand futility must allege particularized facts creating a reasonable doubt that (1) the directors are disinterested and independent, or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.

The *PSE&G* Court cited with approval the Chancery Division's decision in *In re Prudential Ins. Co. Litig.*, 282 N.J. Super. 256 (Ch. Div. 1995), in which the court addressed the standard for establishing demand futility and defined "interestedness" as "divided loyalties," (when the director has received a "personal financial gain"), and "independence," as when the director's decision is based on the "corporate merits," and not on "extraneous" considerations.

Distinguishing the general mismanagement/duty of care case before it from cases involving fraud, self-dealing or other similar "bad acts," and in an effort to avoid "weaken[ing] the management power of directors," the Court emphasized, however, in adopting the *Aronson*/*Prudential* standard for alleging demand futility, that its standard of director disinterestedness and independence did not require "complete impartiality in the everyday sense of the word," but rather was a more tolerant "legal standard."

In fact, the Court also quoted with approval the observation in *Prudential*, that directors are not disqualified or improperly "interested" in a matter simply because "he or she may have approved the challenged transaction or because a shareholder alleges that the director would be reluctant to sue a fellow corporate decision-maker."

The Court in *PSE&G* also demonstrated its resolve to prevent abusive derivative litigation by holding that, even where the trial court found that there were particularized allegations in the complaint creating a reasonable doubt of director disinterestedness or independence, an unsuccessful pleadings motion to dismiss a complaint alleging demand futility does not preclude a board from thereafter moving to terminate the litigation on the basis of a more complete factual record submitted, as in *PSE&G*, on a motion for summary judgment.

Thus, the directors in *PSE&G* had previously filed an unsuccessful motion to dismiss, claiming the plaintiffs had insufficiently pled demand futility. The plaintiffs had argued that once the trial court had determined that futility of demand had been properly alleged, the board no longer had the power to terminate the litigation.

The *PSE&G* decision rejected the plaintiffs' argument, holding that, even where the plaintiff had adequately pled futility of demand, the board could thereafter obtain summary judgment dismissing the litigation.

The Court then issued its central holding: irrespective of whether the shareholder derivative action is a so-called "demand-made" action, or a so-called "demand-futile" action, a modified business-judgment rule will constitute the "single standard of [judicial] review" of management's response in all shareholder derivative actions.

The modified business-judgment rule requires the board of directors, as a condition of dismissal, to carry the burden of demonstrating that: it was independent and disinterested; the decision was made after an investigation conducted with due care; the decision to end the litigation was made in good faith; and the decision to terminate the derivative litigation was reasonable.

Thus, to protect the rights of the shareholders, and to ensure that the directors' decision was consistent with their fiduciary obligations to the corporation, the Court reversed the normal presumption of validity provided by the business-judgment rule and required that the board carry the burden of showing that its decision was within the rule, rather than requiring the shareholder plaintiffs to show the inapplicability of the doctrine.

The Court also balanced the shareholder's right to conduct discovery against the board's freedom from "unwarranted judicial intrusion" by declaring that the shareholder has a right to discovery, in opposing a dispositive motion based on the modified business-judgment rule, "limited to the narrow issue of what steps the directors took to inform themselves of the shareholder demand and the reasonableness of its decision." (quoting the trial court decision, 315 N.J. Super. 323).

It is critical to note that the decision of the trial court, affirmed by the Appellate Division and the Supreme Court, limited discovery to that period of time "from the time the demand was made." Thus, the scope of permissible discovery on the board in a duty of care case in connection with a motion based on the modified business-judgment rule is extremely narrow.

The trial court permitted the plaintiffs, in the demand-futile cases, discovery identical to that permitted in the demand-made action, including discovery into the interestedness of the director defendants. The issue of whether the discovery permitted the demand-futile plaintiffs should be limited to that period of time after the filing of the demand-futile complaints was never addressed because joint discovery with the demand-made case was conducted and because the demand in that case pre-dated the demand-futile complaints.

The limited discovery permitted shareholders also helps to clarify the final component of the "modified business-judgment rule" articulated by the Court, that is, that "the board's decision was reasonable." In fact, anticipating that plaintiff shareholders will argue that this final element of the test announced in *PSE&G* requires an examination of the merits of the shareholder's complaint, it is important to understand why no such review has been authorized by the Court.

Preliminarily, as the Court observed, the business-judgment rule prohibits "unwarranted judicial intrusion" or "second-guessing" by the court except in cases of "fraud, self-dealing or unconscionable conduct." Nothing in the Court's opinion remotely suggests any intention to retreat from that fundamental concept of corporate law.

Second, the Court specifically endorsed the trial court's holding that the standard of judicial review "would not permit the court to substitute its own business judgment for that of manage-

ment" — contrary to the law in Delaware, *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981).

Third, in explaining that element of the standard addressed to the board's good faith and due care in investigating the shareholders' allegations, the Court "echo[ed] the trial court's observation that 'the court's inquiry is not into the substantive decision of the board, but rather is into the procedures employed by the board in making its determination,'" an observation that becomes virtually meaningless if in respect of the "reasonableness" element of the standard, an intrusive merits review is required.

Finally, and most important, no such merits review of the plaintiffs' allegations of wrongdoing was authorized in *PSE&G*, despite vigorous arguments by the plaintiffs that such a review was precisely what was necessary to determine whether the board's decision to terminate the litigation was reasonable. 315 N.J. Super. at 337.

Instead, as noted above, notwithstanding the plaintiffs' allegations of wrongdoing dating back to 1983, discovery in *PSE&G* was limited to the time period after the Oct. 1995 shareholders' demand for the commencement of litigation.

Further, rather than conduct an in-depth review of the plaintiffs' allegations, the *PSE&G* Court identified the allegations and analyzed the board's expressed justifications for not proceeding with any litigation. Specifically, the Court reviewed for thoroughness the report of the board's counsel, the testimony of the directors as to why the demand for litigation was rejected, and the advice of the directors' counsel in respect of the limitation of liability provisions in the PSE&G certificate of incorporation. The Court concluded that the board's judgment in terminating the litigation "was reasonable under the totality of the circumstances."

The applicable standard of judicial review when looking at management's response to shareholder allegations of wrongdoing has also been addressed in a number of other jurisdictions. See *Auerbach v. Bennett*, 47 N.Y.2d 619 (N.Y. 1979); *Alford v. Shaw*, 358 S.E.2d 323 (N.C. 1987); *Houle v. Low*, 556 N.E.2d 51 (Mass. 1990); and *Harhen v. Brown*, 730 N.E.2d 859 (Mass. 2000), each of which involved alleged breaches of the duty of loyalty.

Standards of judicial review in shareholder derivative actions have also been addressed in the American Law Institute Principles of Corporate Governance, Sections 4.01, 7.04, 7.10, and in the American Bar Association's Model Business Corporation Act, Section 7.44.

The standards adopted by these courts range from the very deferential standard adopted in *Auerbach* — under which the court examines the independence, disinterestedness and procedures of the committee — to the two-step process of *Zapata*, in which the court first determines whether the committee was independent, acted in good faith and had a reasonable basis for its decision, and then, in its discretion, whether in the court's own business judgment, the committee's decision was in the best interest of the corporation.

In comparing the standard of judicial review established in *PSE&G* with those established in other states, it must be recognized that although the *PSE&G* standard permits only minimal judicial review, it was a duty of care case, not one involving a breach of the duty of loyalty. It is, however, important to realize that all of the directors in *PSE&G* were targets of the shareholder's demand letter and that, nevertheless, the Court did not require heightened or extensive judicial review.

Moreover, the Court in *PSE&G* did not require the establishment of a "special litigation committee" to consider the plaintiffs' allegations, even though the plaintiffs argued — relying on *Zapata* — that only a special litigation committee could determine to terminate the litigation without a trial on the merits once the motion to dismiss the futility of a demand complaint had been denied.

The Court observed only that nothing in the New Jersey Business Corporation Act would "preclude the use of a special litigation committee in this setting." A special litigation committee is a committee of a board that has the final authority to determine whether to institute litigation on behalf of the corporation or whether to terminate already-filed derivative litigation. By not requiring the board in *PSE&G* to delegate final authority over these issues to a special litigation committee, the *PSE&G* decision underscores the Court's resolve to support the business-judgment rule.

Critical to the ultimate conclusion that the board had carried its burden of satisfying the modified business-judgment rule was the investigation into the shareholders' allegations conducted by the board and its counsel. Whether the subject was the disinterestedness and independence of the board members, the good faith and due care of the board, or the reasonableness of the board's decision to terminate the litigation, the Court referred to the thoroughness of the investigation and the board's right to rely on it in finding that the board satisfied each of the factors under the modified business-judgment rule.

The *PSE&G* decision is particularly significant because of the current atmosphere of distrust of directors and other corporate officials. Thus, even though numerous courts have previously refused to disqualify directors from considering derivative litigation issues even where the directors have been named as defendants in the litigation, none has done so in the current climate of corporate accounting and disclosure scandals.

Similarly, although a number of courts have previously announced a standard of judicial review of board decisions to terminate derivative litigation more deferential than that announced in *Zapata*, none had done so within the past year.

The Supreme Court sent a clear message in *PSE&G* that in cases of alleged breaches of the duty of care — reserving for another day the issues implicated by breaches of the duty of loyalty, self-dealing, fraud or improper personal gain — boards of directors can expect the judiciary to respect their good faith business decisions, including those made about litigation on behalf of the corporation. ■

GIBBONS

GIBBONS, DEL DEO, DOLAN, GRIFFINGER & VECCHIONE

A PROFESSIONAL CORPORATION

ATTORNEYS AT LAW

Newark, New Jersey
973-596-4500
Fax: 973-596-0545

New York, New York
212-649-4700
Fax: 212-333-5980

Trenton, New Jersey
609-394-5300
Fax: 609-394-5301

e-mail: firm@gibbonslaw.com • web site: www.gibbonslaw.com