MEMORANDUM

July 12, 1984

TO: Daniel Goelzer
John Huber
Paul Gonson
Jake Stillman
Elisse Walter
Roz Cohen
Elliot Pinta

FROM: Eric Summergrad

RE: Business Judgment Rule/Norlin Corp. v. Rooney, Pace Inc. (2d Cir.)

Introduction

In its recent decision in Norlin Corp. v. Rooney, Pace, Inc., No. 84-7360 (June 27, 1984), a copy of which is attached, the Second Circuit held that where directors of a corporation are shown to have acted, in defending against a tender offer, out of a motive to maintain control, the usual presumption, under the business judgment rule, that the directors' actions were proper, will not apply. Instead the burden of proof will be placed on the directors to prove that their defensive actions were "fair and reasonable to the corporation." (Slip op. at 4810-11)

This decision is significant for three reasons: First, although the Second Circuit has previously said, in Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1980), and Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690 (2d Cir. 1980), that the burden of proof would be shifted where self-interest by the directors was shown, it did so in cases where it in fact found no such self-interest. In Norlin, in contrast, the court demonstrated that it is willing to shift the burden of proof. Indeed, it not only found that the directors had acted out of self-interest, it then found that they failed to meet their burden of proving their defensive actions to be fair and reasonable to the company.

Second, the court clearly split with the Third and Seventh Circuits, which have both held that a mere showing of some self-interest by the directors will not shift the burden of proof, and that the burden remains on the plaintiffs to show that self-interest was the sole or primary motive for the board's actions.

Third, and perhaps most significantly, the court placed limitations on what a self-interested board can show in demonstrating that its defensive actions were "fair and reasonable." The court appears to have held that a self-interested board cannot justify a defensive maneuver by claiming that

it was necessary to defeat a harmful tender offer. The board must establish the "independent legitimacy" of the actions, apparently meaning that they would be legitimate even in the absence of a tender offer. Most other courts have, in contrast, recognized that even a self-interested board can justify its defensive tactics by demonstrating that the tender offer posed a threat to the corporation.

Background

In Norlin the directors of Norlin, facing a threatened tender offer by Piezo Electric Products, Inc. ("Piezo"), created an employee stock option plan ("ESOP") and issued a large amount of common stock to the plan. The ESOP's trustees were board members and the directors had voting control of the stock.

Piezo successfully moved to enjoin Norlin from voting the ESOP stock on the theory that the directors had created the ESOP, and issued the stock, solely to maintain themselves in control, and thereby breached their fiduciary duty to the corporation and its shareholders.

In affirming the preliminary injunction, the Second Circuit held that Piezo had established a prima facie case that maintenance of control was at least a reason for the creation and funding of the ESOP. The court noted that the ESOP had been created just after the threatened tender offer surfaced, 1/ that stock was issued to it the very day it was created, that the directors had retained voting control over the shares, and that they had provided no rationale, other than their opposition to the tender offer, for establishing the plan. The court concluded:

> Where, as here, directors amass voting control of close to a majority of a corporation's shares by complex, convoluted and deliberate maneuvers, it strains credulity to suggest that the retention of control over corporate affairs played no part in their plans.

(Slip op. at 4812 (footnote omitted)).

Having found that self-interest played a part in the decision, the court shifted the burden of proof on Norlin's directors to show that their actions were "fair and reasonable to the corporation." (Id. at 4811). Specifically, the court said that the burden was on "the board to show that the plan was in fact created to benefit the employees, and not simply to further the aim of managerial entrenchment." (Id. at 4814) The court found, however, that no such legitimate purpose had been shown, and "that the ESOP was created solely as a tool of management self-perpetuation." (Id. (footnote omitted)).

1/ Norlin initially sought to have the tender offer enjoined. The ESOP was created five days after that attempt failed. (Slip op. at 4789-99).

Discussion

The standards applied by the Second Circuit in Norlin were initially enunciated by the court in its decision in Treadway Cos. v. Care Corp. In that case, the court said that if it was shown that the board had acted in opposing a tender offer out of a self-interested motive to retain control, the burden would shift to the board to show its actions were "fair and reasonable to the corporation." The court explained that the actions would have to be shown to have been "entered into for a proper corporate purpose, and not merely for the directors' selfish purpose." 638 F.2d at 382. 2/ Following this test, the Norlin court found the creation of the ESOP to have been entered into for no legitimate purpose, but rather solely to perpetuate management.

The Second Circuit's treatment of defensive responses to tender offers differs markedly from the approach taken by the Third Circuit in Johnson v. Trueblood 3/ and the Seventh Circuit in Panter v. Marshall Field & Co. 4/ Indeed, the Norlin court recognized this split by citing the dissenting opinions in those cases in support of its own approach. (Slip op. at 4811).

Under Johnson and Panter the burden remains on the plaintiff to demonstrate not simply some degree of self-interest by the directors, but rather that self-interest was the primary of sole motivation for the board's actions. The plaintiff under Johnson and Panter must show a lack of any legitimate corporate reason for the directors' actions, while under Norlin the burden is shifted, once some self-interest is shown, to the directors to demonstrate a legitimate corporate reason. 5/

2/ The Treadway court indicated that the board would not have to prove that the terms of their transactions were intrinsically fair to the corporation and its shareholders, so long as the transactions were undertaken for a legitimate purpose. Id. at 382 n.47. The Norlin court likewise said it would not require proof that the company received a fair price for the shares transfered to the ESOP, although the absence of a fair price might be evidenc of lack of a legitimate corporate purpose. (Slip op. at 4815)

3/ 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981).

4/ 646 F.2d 271 (7th Cir. 1981), cert. denied, 454 U.S. 1092 (1982).

5/ The Panter and Johnson courts were construing Delaware law, while Norlin was applying New York law. There is, however, no New York case law directly on point, and the Norlin court looked to the law of a variety of states, including Delaware. (Slip op. at 4811). The Norlin court, in fact, cited the dissenters in Johnson and Panter, who argued (probably correctly) that Delaware law requires shifting the burden of proof in these circumstances. (See id.) Thus, the split among the circuits is not due to application of different state laws, but represents a fundamental disagreement over the law.

While Norlin applies the burden of proof announced by the Second Circuit in Treadway, it appears to make it more difficult to meet that burden of proof by limiting the range of legitimate corporate interests which may be asserted as justification for a defensive maneuver.

In Norlin the company claimed that the creation of the ESOP served a legitimate corporate interest in defeating a tender offer that the board deemed harmful to the corporation. The court held, however, that regardless of how justified this concern was, it did not constitute a legitimate reason for creation of the ESOP:

> even if Norlin's fears were legitimate, that would only help to justify the board's determination that an anticipated takeover attempt should be opposed as not in the corporation's best interest. It has no relevance to our evaluation whether the actions taken by the board in response to that decision were fair and reasonable.

(Slip op. at 4815-16).

The court's out of hand rejection of this explanation is difficult to understand. The court did not explain why the board should not be able to use harmful effects of the tender offer to prove that the ESOP "was in fact created to benefit the employees, and not simply to further the aim of managerial entrenchment." It could readily be argued that nothing would be of greater benefit to the employees than defeating a tender offer that threatens the ongoing viability of the company.

The court in fact recognized that defeat of a harmful tender offer ordinarily would be a legitimate reason for creating an ESOP. It cited, without disapproving, a case in which a South Carolina district court approved creation of an ESOP for purposes of defeating a harmful tender offer. 6/ It sought to distinguish the case, however, by noting that that case involved a disinterested board. (Slip op. at 4817 n.13)

The court held that a self-interested board, in contrast, cannot use defeat of what it views as a harmful tender offer as a reason for its defensive manuevers. Rather, the board must "establish the independent legitimacy of the actions taken * * * to counter a perceived threat." (Slip op. at 4816) Apparently, this means that the board must show that the action is one that would have been justified even if no tender offer existed.

6/ The Second Circuit itself recognized in Treadway that defeat of a harmful tender offer is a legitimate corporate objective. It held that once the directors in that case "determined that a Care takeover would be detrimental to Treadway, it was similarly reasonable that the directors should move to oppose it" by issuing stock to a friendly merger partner. 638 F.2d at 381.

If this is what the court intended to say, it goes much further than other decisions, which have recognized the right of even a self-interested board to take actions solely for the purpose of defeating what it views as a harmful tender offer. Those cases suggest, of course, that the burden will be placed on a self-interested board to show that its fears of harm are valid. But the Norlin court said that even a legitimate fear of harm would not justify the board's action.

While the court attempted to limit itself to actions by self-interested boards, this limitation may in practice prove largely meaningless. Virtually any action taken by a board to defeat a tender offer can be construed as motivated by self-interest, since the defeat of a tender offer almost always implies retention of control by management. 7/ Thus, it will be a rare case where a board which acts solely for the purpose of defeating a tender offer cannot be deemed to have acted out of self-interest. 8/

In short, the Norlin decision follows Second Circuit precedent by shifting the burden of proof to the directors where they are shown to have defended against a tender offer out of self-interest. And it applies the burden of proof imposed by those cases, requiring the directors to show that their actions were "fair and reasonable to the corporation." By apparently not allowing, however, a self-interested board to take into account the harmful effects of the tender offer in proving their actions "fair and reasonable," the court has effectively increased the burden on the directors and has thereby limited the range of options available to a board confronting a tender offer.

Attachment

7/ This is demonstrated by Norlin itself. The sole evidence of self-interest was that the board quickly set up an ESOP in the wake of a threatened tender offer, retained voting control over the ESOP stock, and presented, as their sole rationale, their desire to defeat the tender offer. These facts could, of course, be construed to evince a desire to defeat a harmful tender offer as easily as the court construed them as evidence of self-interest.

8/ The court refused, furthermore, to distinguish between actions taken by independent directors and those taken by inside directors. (Slip op. at 4815 n.12) Thus, a board could not assure its disinterested status by delegating its defensive decisions to a committee of independent directors.