

Authors

Michael Renetzky
Partner
312-443-1823
mrenetzky@lockelord.com

Nguyet T. Chau
Associate
512-305-4767
nchau@lockelord.com

Peiyi Peggy Wen
Associate (Bar Admission Pending)
312-443-0306
pwen@lockelord.com

www.lockelord.com

This *Client Alert* is provided solely for educational and informational purposes. It is not intended to constitute legal advice or to create an attorney-client relationship. Readers should obtain legal advice specific to their enterprise and circumstances in connection with each of the topics addressed.

If you would like to be removed from our mailing list, please contact us at either unsubscribe@lockelord.com or Locke Lord Bissell & Liddell LLP, 111 South Wacker Drive, Chicago, Illinois 60606, Attention: Marketing. If we are not so advised, you will continue to receive *Client Alerts*.

Attorney Advertising

© 2008 Locke Lord Bissell & Liddell LLP

The Business Judgment Rule and Mutual Insurance Companies—*Hill v. State Farm Mutual Automobile Insurance Company*

Introduction

On September 19, 2008, the second district of the California Court of Appeal affirmed an order dismissing a nationwide class action by 50 million State Farm Mutual Automobile Insurance Company (“State Farm”) policyholders (“Plaintiffs”) alleging that State Farm breached its duty to pay billions of dollars in dividends from 1983 to 1998 and thus created an excessive surplus. By applying Illinois law, the court concluded that the business judgment rule applied as a matter of law to protect decisions made by directors of a mutual insurance company. This ruling rejected Plaintiffs’ assertions that they had a *right* to receive dividends and, instead, held that State Farm’s duty was only to *consider* whether dividends should be declared. The court found that no exceptions to the business judgment rule applied in this case and also recognized that the directors were entitled to rely on reports, representations, statements, and opinions prepared by officers, employees, and experts to inform themselves on the company’s business.

The Business Judgment Rule

The business judgment rule protects directors’ decisions from liability as long as the directors acted on an informed basis, in good faith, and with the honest belief that the action taken was in the best interest of the company. The business judgment rule is process oriented and it represents a deep respect by courts for all good faith board decisions. The rule creates a presumption that directors acted appropriately in making business decisions in the absence of fraud, dishonesty, illegality, or conflict of interest. Therefore, even when directors have made honest errors and mistakes of judgment, the presumption will act to shield directors from liability. In other words, a court will not interfere with directors’ busi-

ness judgment unless an exception to the business judgment rule applies, such as the directors acted fraudulently, illegally, without becoming sufficiently informed to make an independent business decision or under oppression. The party challenging the directors’ decision has the initial burden to prove facts of those exceptions in order to rebut the presumption of the business judgment rule. If the presumption is not successfully rebutted, a court will seldom substitute its judgment for that of the directors. On the other hand, if the party challenging the board’s decision is successful, the presumption of the business judgment rule will be unavailable.

Hill v. State Farm Mutual Automobile Ins. Co.

Plaintiffs brought suit in 1998 alleging that they had a right to dividends under their insurance policies and State Farm’s bylaws, and that the State Farm Board of Directors (the “Board”) breached its duty by failing to declare dividends and thus created a surplus in excess of what State Farm reasonably needed to meet its present and future insurance obligations. As relief, Plaintiffs requested damages, attorney fees, and an injunction barring State Farm from pursuing the practices that had reduced the dividends payments.

State Farm moved for summary judgment based on the business judgment rule, asserting that the Board had made its financial decisions on an informed basis, in good faith, and with the honest belief that it was acting in the company’s best interests. Plaintiffs countered that the business judgment rule was not applicable because: (1) the Board did not adequately consider whether to declare dividends, but merely rubber-stamped management’s recommendations; (2) the Board was not sufficiently informed about dividends; (3) the Board’s dividend practices were fraudu-

lent or dishonest; and (4) the Board's dividend decisions were totally without merit.

The trial court granted State Farm's summary judgment, concluding that the business judgment rule applied as a matter of law. The Court of Appeal affirmed the trial court's decision and concluded that Plaintiffs did not have a *right* to any amount of dividends, but that State Farm had a duty to *consider* from time to time *whether* dividends *should* be declared. The court further concluded that the business judgment rule applied since State Farm's directors adequately considered whether to declare dividends.

The Governing Law on a Mutual Insurance Company's Internal Affairs is the Law of the State of Domicile

The court first addressed the issue of which state's substantive law should apply before turning to the business judgment rule issue. This conflict of laws issue was the subject of an earlier Court of Appeal decision, *State Farm Mutual Automobile Insurance Company v. Superior Court*, 114 Cal. App. 4th 434 (Ct. App. 2003). That court concluded that substantive Illinois law applied, including the Illinois business judgment rule, because State Farm is an Illinois domiciled company. The court based its decision on the internal affairs doctrine which recognizes that a corporation's internal affairs, i.e., matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders (in this case, policyholders), should be governed by the state of incorporation (in this case, domicile). The court held that since corporate decisions about dividends involved the internal affairs of a company, the Illinois business judgment rule should govern as the law of the state of incorporation.

Policyholders' Right to Dividends is Contractual

On appeal, Plaintiffs contended that they are entitled to receive dividends under their insurance policies and State Farm's bylaws and newsletters. The court first noted that the rights and interests of the policyholders in the assets of a mutual insurance company are contractual and are measured by the terms of the documents that comprise their contracts. The court then found that the language of the policies, bylaws, and newsletters expressly gives the Board discretion to determine whether to declare dividends, and those documents cannot be construed to confer a right on Plaintiffs to any amount of dividends at any particular time or from any specific source. However, the court also held that State Farm's Board had a duty to decide whether to declare dividends in a manner that met its fiduciary duty of care, i.e., the Board's obligation to act on an informed basis after due consideration of the relevant materials and appropriate deliberation.

Reasons Why the Business Judgment Rule Applied to Protect the Board from Liabilities

Plaintiffs alleged several exceptions to the business judgment rule applied to the facts of the case. The Court of Appeal considered those allegations and ultimately determined that the business judgment rule applied. The court concluded:

1. The Board Made Independent Deliberations Adequately Based on Other Persons' Input

On the one hand, the court recognized Plaintiffs correctly pointed out that the business judgment rule does not protect the Board if it makes no decision, and "a board must do more than pas-

sively rubber-stamp the decisions of the active managers." On the other hand, the court noted that the Board does not have to discuss every aspect of the company's business, that minutes of the Board's meetings need not provide a verbatim transcript and that the Board was not required to discuss a possible dividend every year. Furthermore, the Board may under normal circumstances rely on officers, employees, and other experts for information and recommendations "without the need for independent verification or further inquiry," and it may also delegate responsibility of evaluating various matters to officers and employees. The court then concluded that the State Farm Board adequately considered whether to declare dividends based on the financial reports and additional input received from others, and the Board engaged in its own deliberations.

2. The Board Made Informed Decisions

The court recognized that the business judgment rule does not apply if the directors do not become sufficiently informed to make an independent business decision. However, the court pointed out that the Board does not have to be informed of every fact; rather, the Board needs to consider only material facts that are reasonably available to it. The extent of information required is that which the directors "reasonably believe to be appropriate under the circumstances," and directors may be "informed by the general views or specialized experience of colleagues." The court then found that the State Farm Board was sufficiently informed through numerous financial reports, actuarial data, and discussions among officers and directors, and it acted independently without succumbing to the influences of other persons. The court stated

that “[i]n light of the foregoing evidence, we conclude that, as a matter of law, the Board was sufficiently informed to make independent decisions about dividends and the surplus. The directors relied on what they reasonably believed to be adequate information, and the Board’s decisions were anything but faithless acts.”

“In light of the foregoing evidence, we conclude that, as a matter of law, the Board was sufficiently informed to make independent decisions about dividends and the surplus. The directors relied on what they reasonably believed to be adequate information, and the Board’s decisions were anything but faithless acts.”

an Exception to the Business Judgment Rule in Absence of Fraud or Dishonesty

Plaintiffs alleged that the Board’s decisions not to declare dividends were without merit. However, the court rejected this as an exception to the business judgment rule. The court noted that the business judgment rule focuses on the *process* of making the decision, not the quality of the decision

in favor of State Farm. The court emphasized that “[t]he fact that a corporation has earned profits out of which directors might lawfully declare a dividend ... is insufficient alone to justify judicial intervention compelling a declaration and payment.”

Summary: A Mutual Company Board’s Fiduciary Duty and Protection of the Business Judgment Rule

In essence, this ruling restated the well-established business judgment rule under Illinois case law and confirmed that it applies in the same manner to mutual insurance companies as to general corporations. The business judgment rule applies only when a board makes its own decision and it protects the Board from liability only when such decision was made in the absence of fraud, dishonesty, oppression, or illegality. Even when a board fulfills its fiduciary duty of loyalty and makes a decision it believes to be in the best interest of the corporation,

the board must still act in a manner that meets its fiduciary duty of care. Fulfilling its duty of care means that the board must act to assure themselves that:

“The court noted that the business judgment rule focuses on the *process* of making the decision, not the quality of the decision itself.”

- *The board is sufficiently informed to make an independent business decision.* The board must timely and adequately inform itself of all critical information that is reasonably available to it. In informing itself of material information, the Board is entitled to rely on information, opinions, and reports provided by any board member, management, employees, and other experts.

3. The Board Acted Without Fraud or Dishonesty

Plaintiffs also contended that the Board engaged in fraudulent and dishonest behavior in two respects: (1) the Board failed to disclose the company’s dividend practices in the insurance policy or the bylaws; and (2) the Board disclosed misleading information regarding the company’s financial condition in annual reports. The court rejected the first contention by concluding that insurance companies are not required to explain their dividend practices where the insurance policy or bylaws expressly vests broad discretion over dividends in the Board. The court found the second contention was flawed because the information disclosed in the annual reports was taken from audit reports prepared by independent accountants, complied with statutory accounting principles and was literally true. In reaching these conclusions, the court found no evidence that the Board acted with ill motives.

4. Plaintiffs’ Contention that the Board’s Decisions were Without Merit Is Not

an Exception to the Business Judgment Rule in Absence of Fraud or Dishonesty

Plaintiffs alleged that the Board’s decisions not to declare dividends were without merit. However, the court rejected this as an exception to the business judgment rule. The court noted that the business judgment rule focuses on the *process* of making the decision, not the quality of the decision itself; in other words, the business judgment rule must first be found inapplicable under an exception such as fraud, oppression, or illegality, before the merits of the Board’s decision can be examined. Thus, whether the decision reached is *right* or turns out to be the best course for the company is relatively unimportant when evaluating whether the business judgment rule applies to shield the Board from liability. The court concluded that Plaintiffs did not show that the Board’s decision-making process was tainted by fraud, oppression, illegality, or a similar flaw, and therefore, no exception existed to bar the application of the business judgment rule.

Conclusion

The Court of Appeal concluded that Plaintiffs failed to show facts supporting exceptions to the business judgment rule. Accordingly, the Court of Appeal affirmed the trial court’s deci-

Offices

Atlanta

Austin

Boston

Chicago

Dallas

Houston

London

Los Angeles

New Orleans

New York

Sacramento

Washington DC

The Business Judgment Rule and Mutual Insurance Companies—*Hill v. State Farm Mutual Automobile Insurance Company* (cont'd.)

- *The board devotes sufficient time and effort to consider such information, and deliberates the decision independently rather than simply rubber-stamps management's decision.* The board should actively question and analyze information and advice received from management, experts, and other persons. The board should also carefully document its decision-making process, such as keeping detailed minutes of its meetings. However, the minutes do not need to provide a verbatim transcript of the meetings; they only have to be made faithfully and accurately to reflect what has taken place.

About the Authors

Michael Renetzky's practice focuses on investment management, securities and corporate law. Mr. Renetzky devotes a substantial portion of his time to counseling boards of directors on corporate governance and fiduciary duty matters, including in the mergers and acquisitions contexts. Additionally, he has considerable experience counseling clients on securities law compliance, debt and equity financing matters, investment adviser, investment company and broker-dealer regulation.

Mr. Renetzky is a member of the firm's Board of Directors and the head of the firm's Investment Adviser and Fund Management practice.

Nguyet Chau is an associate at LLB&L. She works on matters in the general corporate, mergers and acquisitions, investment management, securities, intellectual property and insurance practice areas.

Peggy Wen is a first-year associate at LLB&L where she awaits bar admission for Illinois. She works on matters in the insurance and securities practice areas.