JOURNAL OF THE

MISSOURI BAR

VOLUME 76
NUMBER 2

MARCH-APRIL
2020

THE VERDICT ON THE BUSINESS JUDGMENT RULE

PG. 64

THE NCAA AND ATHLETE PAY

PG.68

MoBar.org

THE VERDICT ON THE BUSINESS JUDGMENT RULE

Gerard V. Mantese and Philip G. Louis Jr[1]

The business judgment rule has been part of English and American common law on corporations for more than 250 years.[2] In theory, the business judgment rule protects management from liability for honest mistakes in judgment, as long as they act with due care and loyalty.[3] In reality, the rule is not so simple.

This article explores the origins of the business judgment rule in the 18th and 19th centuries, then its development thereafter. Finally, we examine Missouri's recent application of the rule.[4]

The Rule, Fiduciary Duties, and Context

Right or wrong, courts have applied (or at least referred to) the business judgment rule along with each of the director fiduciary duties of due care, good faith, and loyalty. Simply stated, the rule can provide protection of a fiduciary accused of breaching his or her duties where that fiduciary has properly investigated a transaction or decision, yet makes an honest mistake in judgment which harms the company or its shareholders. However, if a director makes a decision that is personally beneficial to the detriment of the corporation (the duty of loyalty), arguably the rule is irrelevant.[5] Despite this, courts continue to involve the duty of loyalty and the business judgment rule in their analyses.

The conduct of corporate management of closely held companies is often analyzed more stringently than the conduct of fiduciaries of public entities, where shareholders can more easily escape oppressive treatment[6] by selling their shares on the stock market.[7]

Delaware led the charge in developing the business judgment rule in the 20th century. Indeed, many of the cases discussed herein are from Delaware and involve public companies. Since then, most states have developed their own bodies of case law relating to the rule.

The Origins of the Rule

In 1742, an English court first suggested that directors should not be liable for good faith decisions made on behalf of the company, even if those decisions have undesirable outcomes.[8] In *Charitable Corp. v. Sutton*,[9] the lord chancellor of England wrote that directors "may be guilty of acts of commission or omission, of mal-feasance or non-feasance" but where "acts are executed within their authority… though attended with bad consequences, it will be very difficult to determine that these are breaches of trust." The court reasoned that it would be unfair "after bad consequences have arisen from such executions of their power, to say that they foresaw at the time what must necessarily happen; and therefore were guilty of a breach of trust."[10] However, the *Sutton* court declared that directors must act with "fidelity and reasonable diligence."[11]

The concepts promulgated in *Sutton* are found in an 1829 Louisiana Supreme Court decision. In *Percy v. Millaudon*,[12] a bank's shareholders sued the directors for misconduct. The court stated that directors should not be liable for mistakes and judgment "if the error was one into which a prudent man might have fallen."[13] *Percy* is considered the first American case to apply the rule of judicial deference for director errors in judgment.[14]

In *Scott v. Depeyster*,[15] shareholders sued the corporation's president and directors for the fraud of the corporation's secretary. The New York chancery court noted that directors are not required "to have attained infallibility."[16] Directors "must answer for ordinary neglect," which is "the omission of that care which every man of common prudence takes of his own concerns."[17] The *Scott* court examined the facts and ultimately concluded that the defendants reasonably relied on the secretary's representations and were not liable for misconduct.[18] Thus, the duty of due care was satisfied.

In 1847, the Alabama Supreme Court applied a similar standard in *Godbold v. Branch Bank*.[19] There, a bank's shareholders sued a director for the board's illegal conduct. The court determined that the illegal act was done in good faith and "in the exercise of the power vested in [the director]" and declined to impose liability. Directors must have "a competent knowledge" of their duties.[20] No person would become a director if this required "perfect knowledge."[21]

The Rule in the 20th Century and Beyond

In 1927, the Delaware Supreme Court decided *Bodell v. Gen. Gas & Elect. Co*.[22] The *Bodell* court stated that, absent evidence that the directors did not act in the company's best interests, courts should not be permitted to review "an honest mistake of business judgment."[23] Moreover, director decisions should not be interfered with absent fraud, "such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders."[24]

Early business judgment rule cases seem to have focused on the duty of care. And, in large part, it seems most cases in this regard continue to involve the duty of care. An early[25] duty of loyalty case where the business judgment rule was referenced was *Guth v. Loft, Inc.*,[26] issued in 1939 by the Delaware Supreme Court. Loft, Inc. manufactured and sold food products, including soft drink syrups. Its president, Guth, terminated Loft's contract with Coca-Cola, acquired Pepsi-Cola Company for himself, and used Loft's resources to operate Pepsi. The court noted that officers and directors are prohibited from using their position to further their personal interests and are bound to "the most scrupulous observance" of their duties.[27] After examining the facts, the court concluded that Guth acquired Pepsi to replace Coca-Cola products in Loft stores. Guth "created a conflict between self-interest and duty."[28] Ultimately, the opportunity to acquire Pepsi belonged to Loft, Inc. and not Guth.[29]

In a New York opinion, *Litwin v. Allen*,[30] the court's analysis involved a discussion of both the duties of care and loyalty and many references to the exercise of business judgment by a board of directors. The court stated that directors are "required to conduct the business of the corporation with the same degree of fidelity and care as an ordinarily prudent man would exercise in the management of his own affairs of like magnitude and importance."[31] Also, the court emphasized that directors owe undivided loyalty and "an allegiance that is influenced in action by no consideration other than the welfare of the corporation."[32] Moreover, "any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising. He may not profit at the expense of his corporation… he may not for personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment."[33] The duty of care requires directors to "act honestly and in good faith, but that is not enough. [Directors] must also exercise some degree of skill and prudence and diligence." Directors will be liable for negligence, not "errors of judgment or for mistakes while acting with reasonable skill and prudence."[34]

As perhaps some clarification as to the relevance of the business judgment rule to the duty of loyalty, two of the most cited Delaware cases are *Weinberger v. UOP, Inc.*[35] and *Aronson v. Lewis*.[36] These cases hold that if a director stands to gain from the transaction, the business judgment rule is inapplicable and the director must prove the "entire fairness" of the transaction. Entire fairness has two components: fair dealing and fair price.[37] "The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."[38]

In furtherance of this thought, a director is interested (duty of loyalty), and not protected by the business judgment rule, if he or she appears on both sides of the transaction or expects to derive a personal financial benefit from a transaction "in the sense of self-dealing."[39] Examples of interested decisions include instances in which directors: (1) usurp a corporate opportunity;[40] (2) increase their own compensation while refusing to declare dividends;[41] and (3) implement programs that provide themselves, but not other shareholders, with liquidity.[42]

With regard to the duty of care and the business judgment rule, in 1985 the Delaware Supreme Court decided *Smith v. Van Gorkom*, an oft-cited business judgment rule case.[43] In *Smith*, the shareholders of a public corporation brought a derivative claim against the directors over a merger. The court noted that the business judgment rule presumes that directors acted on an informed basis, in good faith, and with the honest belief that the action was in the company's best interests.[44] To overcome the presumption that a decision is informed, the **plaintiff** must show that it was uninformed.[45] Directors are informed when they apprise themselves of all material information reasonably available before making a decision.[46] The *Smith* board was "grossly negligent" when it approved a merger proposal based solely on a 20-minute presentation.[47] The board members were held jointly and severally liable for $23 million.[48]

The Rule in Missouri

Duty of Care

In *Virgil Kirchoff Revocable Trust Dated 06/19/2009 v. Moto, Inc.*, a duty of care case, the court described the business judgment rule in Missouri as follows:

> The business judgment rule protects the directors and officers of a corporation from liability for *intra vires* decisions within their authority and made in good faith, uninfluenced by any consideration other than an honest belief that the action promotes the corporation's best interest. The rule vests the directors and shareholders with wide latitude in making judgments that affect the running of the corporation. The rule precludes courts from interfering with the decisions of corporate officers and directors absent a showing of fraud, illegal conduct, an *ultra vires* act, or an irrational business judgment.[49]

The court in *Virgil Kirchoff Revocable Trust* concluded that the business judgment rule protected the method of valuation used by the board of directors in setting the value of shares.

In *Davis v. Lakewood Property Owners Association, Inc.*, a due care case where the issue was the effect of the board exceeding its authority, the court stated, "[t]he term 'ultra vires' has a broad application and includes not only acts prohibited by the charter, but acts which are in excess of powers granted and not prohibited."[50] In *Davis*, the board of directors was charged with determining the annual assessment on lots in a real estate development. The declaration, which governed the board, provided a formula to be used to calculate the assessment. The bylaws, which the board subsequently adopted, provided a different formula. Where the bylaws and the declaration were in conflict, the declaration controlled. The board of directors used the formula provided for in the bylaws to calculate the annual assessment. The court found that the board's calculation based on the formula in the bylaws was unauthorized and concluded that the calculations were ultra vires. Thus, the board's conduct was not protected by the business judgment rule.

Oppression

Another recent Missouri case, *S.M.S. v. J.B.S.*, holds that the business judgment rule cannot shield an oppression claim.[51] In the case, the court stated that a husband could not use the business judgment rule as a shield to insulate himself from his wife's claim to portions of the retained earnings of closely held companies, in which the husband had substantial control, during the pendency of their dissolution of marriage proceedings. In *S.M.S.,* the court held that the husband was not disinterested in making decisions to hold back and not distribute retained earnings of companies during the pendency of the dissolution proceedings since he had a financial and pecuniary interest in a transaction.. The court stated: "The business judgment rule only protects a director or officer in making decisions in which he is, *inter alia,* 'disinterested.'" Further, "[t]he business judgment rule protects the directors and officers of a corporation from liability for *intra vires* decisions [in which they are, among other things,] uninfluenced by any consideration other than an honest belief that the action promotes the corporation's best interest."[52]

It is important to remember that the business judgment rule does not apply where oppressive conduct is claimed.[53] This is because, in the context of shareholder oppression within closely held companies, the reasoning behind the business judgment rule is generally not relevant.

The intimate nature of relationships among participants in a closely held enterprise means that when there is a falling out among participants, it will often come down to a fight between the in group and the out group – and the group with the power will have a conflict when they are engaging in transactions that benefit themselves and harm the out group. That would disable reliance on the business judgment rule.

The indiscriminate application of the business judgment rule in such settings in some early writings sometimes reflected a court's unwillingness to recognize the conflict often inherent, but not addressed, in an oppression context in a closely held business and the difficulty of reconciling a majority right to make ownership decisions with the fiduciaries' duties when exercising control. Sometimes courts revert to a too easy invocation of the business judgment rule without discussing differences in a close corporation setting. In contrast, modern cases recognize that the business judgment rule does not insulate freezing out another participant and that there is no business judgment to apply when the board did not exercise good faith judgment.[54]

Duty of Loyalty

Despite the question as to whether the business judgment rule has any application to a claimed breach of the duty of loyalty, courts may continue to insert the business judgment rule in breach of loyalty cases. In this regard, however, it is important to keep in mind the protection that § 351.327, RSMo affords directors and officers in a self-interest situation. That statute absolves a director or officer who might otherwise be held to have breached his or her duty of loyalty. Simply stated, absolution is warranted where there is adequate disclosure and either disinterested directors or the shareholders approve the transaction, or the transaction is proven to be fair to the corporation.

Procedural Matters

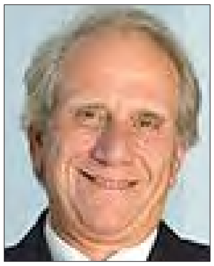
Even where the parties do not dispute the basic facts, the business judgment rule often requires "the trial court to make credibility determinations and to choose among competing inferences."[55] Indeed, courts in Missouri have expressly declined to apply the business judgment rule when considering a motion to dismiss.[56] *Robinson v. Lagenbach* offers guidance on the procedural issues surrounding the business judgment defense.[57] In *Robinson*, the court held that the resolution of the plaintiff's challenges concerning shareholder oppression, breach of the defendants' fiduciary duty as directors and controlling shareholders, and application of the business judgment rule, however, require making credibility determinations and choosing among competing inferences.[58] Therefore, the case was reversed and remanded for trial on these issues.

Conclusion

Under proper circumstances, the business judgment rule can afford management protection from honest mistakes if they act with due care. In the context of the duty of loyalty, the rule seems inapplicable where directors stand to gain a personal benefit to the detriment of the corporation. Further, the rule does not apply with respect to shareholder oppression claims, particularly where the oppressors are the holders of a majority of voting stock and the oppression is based on the use of such voting power. Even when the rule applies, it is not a talisman that prevents scrutiny into whether directors have acted reasonably and in good faith. Whether directors have acted properly depends upon the facts of a particular transaction and typically would not be successfully asserted in a pretrial motion to dismiss.

Endnotes

Gerard V. Mantese



Philip G. Louis Jr.

1 Gerard Mantese is a partner at Mantese Honigman, P.C., with offices in Michigan, Missouri, and New York. Mantese has a national business law practice, focusing on shareholder and member disputes, fiduciary duties, contracts, and real estate matters. The State Bar of Michigan conferred the Champion of Justice award on Mr. Mantese for his work advocating for survivors of domestic assault and children with autism spectrum disorder. A similar version of this article, focusing on Michigan law, was previously published in the Michigan Bar Journal. As a partner in Armstrong Teasdale's Corporate Services practice group, Philip Louis focuses on mergers and acquisitions, antitrust, and financing matters. His past roles as a litigator, tax attorney, vice-chair of the firm's banking department, and practicing CPA in tax and auditing provide him with a wide range of experience. Louis is licensed to practice law in New York, Illinois, and Missouri.

2 *See, e.g.*, Lori McMillan, *The Business Judgment Rule as An Immunity Doctrine*, 4 Wm. & Mary Bus. L. Rev. 521, 521 (2013); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine?*, 57 Vand. L. Rev. 83, 83-84 (2004); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. Cal. L. Rev. 287, 289 (1994); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 93 (1979).

3 *See, e.g.*, Bernard S. Sharfman, *The Importance of the Business Judgment Rule*, 14 N.Y.U. J. L. & Bus. 27, 29 (2017); Lyman P. Q. Johnson, *Unsettledness in Delaware Corporate Law*, 38 Del. J. Corp. L. 405, 411 (2013).

4 This discussion is limited to the common law business judgment rule as it pertains to corporations. The applicability of the doctrine in the context of a limited liability company or partnership is not addressed other than in this footnote. No Missouri case in this regard has been uncovered. As an example, however, it appears that one New York court applied the defense in a limited liability case. *See*, *Zuckerbrod v. 355 Company, LLC*, 113 A.D.3d 675, 979 N.Y.S.2d 119 (N.Y. App. Div. 2014). In *Flippo, et. al. v. CSC Associates III, L.L.C.*, the court seems to treat a Virginia limited liability company statutory provision (Code §§ 13.1–1024.1(B)) as the business judgment rule. *See, Flippo, et. al. v. CSC Associates III, L.L.C.*, 262 Va. 48, 547 S.E.2d 216 (S. Ct. Va. 2001). As to Missouri in this regard, see § 347.088, RSMo. This statute arguably makes the rule applicable to limited liability companies by providing that an authorized person must act "with the care a corporate officer of like position would exercise under similar circumstances."

5 If a director wrongfully usurps a corporate opportunity or secretly benefits from a corporate transaction, then it is likely the director acted in bad faith and the business judgment rule should not be relevant. This concept is revisited below.

6 *See, e.g.*, *Miller v. Magline*, 76 Mich. App. 284, 303 (Mich. Ct. App. 1977); *Matter of Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 71 (N.Y. Ct. App. 1984).

7 While beyond the scope of this article, the issue of whether claims are derivative versus direct may also affect the application of the business judgment rule.

8 *See, e.g.*, Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. Penn. J. Bus. L. 675, 679 (2009); Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 Del. J. Corp. L. 971, 975 (1994); Marcia M. McMurray, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 Vand. L. Rev. 605, 605 (1987).

9 2 Atk. 400, 26 Eng. Rep. 642 (1742).

10 *Id*. at 405.

11 *Id*. at 426.

CONTINUED ON PAGE 88