The Business Judgment Rule

By Gerard V. Mantese and Emily S. Fields

The business judgment rule has been part of English and American common law for more than 200 years.[1] In theory, the business judgment rule protects corporate directors (and sometimes officers) from liability for honest mistakes in judgment as long as they act with due care and loyalty.[2] In reality, the rule is not so simple.

This article explores the business judgment rule's eighteenth-century origins and analyzes subsequent caselaw to see how the rule has developed. Finally, it examines Michigan's application of the rule.

The rule, fiduciary duties, and context

The business judgment rule implicates director fiduciary duties of due care, good faith, and loyalty. The rule affords a fiduciary some protection when, for example, the fiduciary participated in a properly investigated decision or transaction that, because of an honest mistake in business judgment, does not attain the desired result. If, however, a director acts in bad faith or makes a decision that personally benefits himself or herself, the rule is inapplicable.

The context of the challenged decision is important. The conduct of directors and controlling shareholders of *closely held* companies is often analyzed more stringently than the conduct of fiduciaries of public entities, where shareholders can more easily escape oppressive conduct[3] by selling their shares on the stock market.[4]

The applicability of the business judgment rule is often an issue of fact precluding summary disposition.[5] Where a plaintiff has pled factual allegations of a breach of fiduciary duty or shareholder oppression, the defendants' conduct "cannot be excused on the face of the complaint as a simple matter of business judgment,"[6] and therefore, summary disposition at the pleading stage will be inappropriate.

At a Glance

In general, the business judgment rule protects corporate directors from liability for honest mistakes in judgment.

Directors must act in good faith and on an informed basis, and must be disinterested in the transaction to rely on the business judgment rule.

In Michigan, directors and officers may not rely on the business judgment rule to protect themselves when their conduct amounts to shareholder oppression or a breach of fiduciary duties.

Delaware greatly contributed to the development of the business judgment rule in the twentieth century. Indeed, many of the cases discussed here are from Delaware and involve public companies. Since then, most states have developed their own bodies of caselaw 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.[7] In *Charitable Corp v Sutton*, 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."[8] 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."[9] The *Sutton* court declared that directors must act with "fidelity and reasonable diligence."[10]

The concepts promulgated in *Sutton* probably first came to American common law in an 1829 Louisiana Supreme Court decision. In *Percy v Millaudon*, a bank's shareholders sued the directors for misconduct.[11] 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."[12] *Percy* is considered the first American case to apply the rule of judicial deference for director errors in judgment.[13]

In *Scott v Depeyster*, shareholders sued the corporation's president and directors for the secretary's fraud.[14] The New York Chancery Court noted that directors are not required "to have attained infallibility."[15] Directors "must answer for ordinary neglect," which is "the omission of that care which every man of common prudence takes of his own concerns."[16] 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.[17]

In 1847, the Alabama Supreme Court applied a similar standard in *Godbold v Branch Bank*.[18] 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.[19] No person would become a director if this required "perfect knowledge."[20]

The Rhode Island Supreme Court declared in the 1850 case *Hodges v New England Screw* that directors "ought to be liable" if their conduct is the result of "want of proper care."[21] In *Hun v Cary*, a New York court stated that directors are "bound not only to exercise proper care and diligence, but ordinary skill and judgment."[22]

The rule in the twentieth century

In 1927, the Delaware Supreme Court decided *Bodell v Gen Gas & Electric Corp*.[23] 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."[24] 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."[25]

Early business judgment rule cases focused on the duty of care. The seminal (and perhaps first) duty of loyalty case, *Guth v Loft Inc*, was issued in 1939 by the Delaware Supreme Court.[26] 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 and not Guth.

In 1940, a New York trial court eloquently articulated the business judgment rule. In *Litwin v Allen*,[29] the court's analysis incorporated both the duties of care and loyalty. Directors are "required to conduct the business of a 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."[30] Directors owe undivided loyalty and "an allegiance that is influenced in action by no consideration other than the welfare of the corporation."[31] 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 a personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment."[32] 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."[33]

Zapata Corp v Maldonado involved the special circumstances of a board of directors appointing a committee to investigate the merits of a derivative claim.[34] There, the committee concluded that the suit was meritless, and the board moved to dismiss. The Delaware Supreme Court declined to apply the business judgment rule to preclude review of the board decision to seek dismissal, and adopted a two-prong test. First, the Court examined the committee's independence and good faith, which "the corporation should have the burden of proving..."[35] Second, even if the committee were independent, the Court still applied its own scrutiny to determine whether the board's decision to adopt the committee's recommendation was justified.[36]

Two of the most cited Delaware cases on the duty of loyalty are *Weinberger v UOP, Inc*[37] and *Aronson v Lewis*.[38] These cases hold that if a director stands to gain from the transaction, the business judgment rule is inapplicable and the directors must prove the "entire fairness" of the transaction. Entire fairness has two components: fair dealing and fair price.[39] "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."[40]

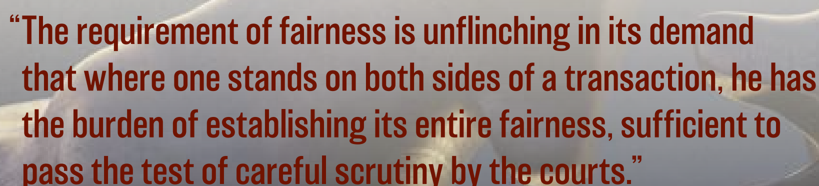
A director is interested and not protected by the business judgment rule if he or she appears on both sides of the transaction or expects to derive a personal financial benefit from a transaction "in the sense of self-dealing."[41] Examples of interested decisions include instances in which directors usurp a corporate opportunity;[42] increase their own compensation while refusing to declare dividends;[43] and implement programs that provide themselves, but not other shareholders, with liquidity.[44]

In 1985, the Delaware Supreme Court decided *Smith v Van Gorkom*.[45] 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.[46] To overcome the presumption that a decision is informed, the plaintiff must show that it was uninformed.[47] Directors are informed when they apprise themselves of all material information reasonably available before making a decision.[48] The *Smith* board was "grossly negligent" when it approved a merger proposal based solely on a 20-minute presentation.[49] The board members were held jointly and severally liable for $23 million.[50]

The rule in Michigan

In Michigan,[51] under MCL 450.1541a, which the Michigan Court of Appeals has held is the standard applicable in derivative action claims,[52] directors and officers must act in good faith, with the care of an ordinarily prudent person, and in the company's best interests.[53] Directors and officers may rely on competent information from directors, officers, or employees of the corporation, outside experts, or a board committee.[54]

Directors, officers, and those in control of closely held corporations must adhere to a heightened standard of "fiduciary



"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."

responsibility, a standard more akin to partnership law."[55] This higher standard of responsibility is reflected in the shareholder oppression statute, MCL 450.1489, which prohibits those in control of closely held corporations from acting in an "illegal, fraudulent, or willfully unfair and oppressive" manner.

In *Dodge v Ford Motor Co*, several Ford shareholders sued the directors to compel dividends.[56] The Court began its analysis by noting that application of the business judgment rule is fact- or context-based. Upon a review of Ford's finances and past practices, the Court determined that the refusal to issue dividends was arbitrary and not within the directors' discretion. The directors were ordered to issue a dividend of approximately $19 million.

The Michigan Supreme Court decided *Wagner Electric Corp v Hydraulic Brake Co* in 1934.[57] In *Wagner*, the Court declared that directors must act for the company's best interests and "are prohibited by law from acting in any antagonistic position whether for their own personal benefit or for the benefit of other competitive corporations."[58] As long as the directors act accordingly, "matters of business judgment and discretion are not subject to judicial review."[59]

In 1955, *Reed v Burton* acknowledged that courts will not interfere with corporate decisions absent "a clear showing of actual or impending wrong."[60] However, courts will interfere when those in control willfully abuse their powers, act in bad faith, neglect their duties, act contrary to the corporation's purposes, or commit a breach of trust or fraud.[61]

The Michigan Court of Appeals declined to apply the business judgment rule in its 1977 decision in *Miller v Magline*.[62] In *Miller*, the shareholders sued the directors to compel dividends. At the outset of its analysis, the Court noted that a breach of a fiduciary duty justified judicial intervention and suggested that corporate doctrines such as the business judgment rule may be applied *differently* in cases involving close corporations.[63] The Court affirmed the trial court's determination that a non-dividend policy defeated a major purpose of a profit corporation (distributing profits to owners) and that defendants' argument that a dividend would endanger the company was "untenable" in light of the large bonuses they issued themselves.[64] The Court of Appeals found that the business judgment rule was inapplicable because the directors were interested in the decisions at issue. The Court ordered the defendants to issue dividends.

In 1983, the Michigan Supreme Court acknowledged in *Matter of Estate v Butterfield* that absent bad faith or fraud, it could not substitute its judgment for that of the directors.[65] However, courts may intervene when the refusal to declare dividends amounts to a breach of fiduciary duty.[66]

In *Madugula v Taub*, a shareholder sued the company's president after the president terminated the shareholder's employment and compensation in breach of the shareholder agreement.[67] Significantly, the defendant, who stood to gain from the conduct, did not rely on the business judgment rule. The Michigan Supreme Court remanded the case to determine whether the plaintiff established oppression. The trial court found oppression without considering the rule.[68]

In 2019, the Michigan Court of Appeals analyzed how the business judgment rule applies to shareholder oppression claims. In *Franks v Franks*,[69] the Court acknowledged that the rule remained the same as the rule set forth in *Burton* and *Butterfield*.[70] The oppression statute, MCL 450.1489, identifies as oppression, acts "that are inherently wrongful and would warrant court intervention. Accordingly, a shareholder necessarily overcomes the business judgment rule by presenting evidence to establish the elements of a claim under the shareholder-oppression statute."[71] The *Franks* plaintiffs "presented evidence that defendants' decisions were not taken for legitimate business reasons" but were taken to harm the shareholders.[72] Thus, when a plaintiff establishes a claim of shareholder oppression, the plaintiff overcomes the business judgment rule.

Conclusion

The business judgment rule gives directors protections from honest mistakes if they act with due care and loyalty. It is inapplicable if directors commit oppression or breach their fiduciary duties, e.g., if the directors stand to gain a personal benefit. 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 on the facts of a particular transaction. ■

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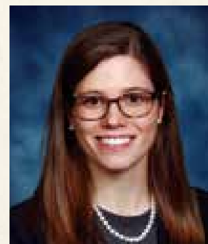

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ENDNOTES

1. McMillan, *The Business Judgment Rule as an Immunity Doctrine*, 4 Wm & Mary Bus L Rev 521, 521 (2013), available at <https://scholarship.law.wm.edu/wmblr/vol4/iss2/5/> [https://perma.cc/J2MQ-TRSF]; Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand L Rev 83, 83–84 (2004), available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=429260> [https://perma.cc/Y2DW-7BT6]; Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S Cal L Rev 287, 289 (1994), available at <https://scholarlycommons.pacific.edu/cgi/viewcontent.cgi?article=1184&context=facultyarticles> [https://perma.cc/JT96-YLKN]; and Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L Rev 93, 93 (1979), available at <https://scholarlycommons.law.hofstra.edu/hlr/vol8/iss1/6/> [https://perma.cc/NY8Q-4RHG]. All websites cited in this article were accessed November 16, 2019.
2. Sharfman, *The Importance of the Business Judgment Rule* (January 19, 2017) <https://corpgov.law.harvard.edu/2017/01/19/the-importance-of-the-business-judgment-rule/> [https://perma.cc/5UT3-BQFL] and Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 Del J Corp L 405, 411 (2013), available at <https://scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=1346&context=wlufac> [https://perma.cc/FN6C-WJDS].
3. *Miller v Magline*, 76 Mich App 284, 303; 256 NW2d 761 (1977) and *Matter of Kemp & Beatley, Inc*, 64 NY2d 63, 71; 473 NE2d 1173 (1984).
4. 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.
5. *Nunnally v Dist of Columbia*, 243 F Supp 3d 55, 69 (D DC, 2017) and *FDIC v Baldini*, 983 F Supp 2d 772, 783–784 (SD W Va, 2013).
6. *Coppola v Manning*, unpublished opinion per curiam of the Court of Appeals, issued November 17, 2015 (Docket No. 323994), n 3, and *Franks v Franks*, unpublished opinion per curiam of the Court of Appeals, issued September 24, 2019 (Docket No. 343290), at * 11 (Mr. Mantese argued for the plaintiffs in *Franks* in the Michigan Court of Appeals.). See also *In re Tower Air*, 416 F3d 229, 238 (CA 3, 2005).
7. See, e.g., Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U Penn J Bus L 675, 679 (2009), available at <https://scholarship.law.upenn.edu/jbl/vol11/iss3/4/> [https://perma.cc/8AZY-66JU]; Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 Del J Corp L 971, 975 (1994); and 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).
8. *Charitable Corp v Sutton*, 2 Atk 400, 26 Eng Rep 642 (1742).
9. *Id.* at 405.
10. *Id.* at 426.
11. *Percy v Millaudon*, 8 Mart (n s) 68 (1829).
12. *Id.* at 77–78.
13. *The Duty of Care Component* at 975 n 5.
14. *Scott v Depeyster*, 1 Edw Ch 513; 6 NY Ch Ann 229 (1832).
15. *Id.* at 534–535.
16. *Id.* at 543.
17. *Id.* at 550.
18. *Godbold v Branch Bank at Mobile*, 11 Ala 191 (1847).
19. *Id.* at 199.
20. *Id.*
21. *Hodges v New England Screw*, 1 RI 312, 346 (1850).
22. *Hun v Cary*, 82 NY 65, 73–74 (1880).
23. *Bodell v Gen Gas & Electric Corp*, 15 Del Ch 420 (1927).
24. *Id.* at 426.
25. *Id.* at 427.
26. *Guth v Loft Inc*, 23 Del Ch 255 (1939) and *Delaware Directors' Fiduciary Duties*, 11 U Penn J Bus L at 683 n 5.
27. *Guth*, 23 Del Ch at 270–271.
28. *Id.* at 281.
29. *Litwin v Allen*, 25 NYS2d 667 (1940).
30. *Id.*
31. *Id.* at 677–687.
32. *Id.*
33. *Id.*
34. *Zapata Corp v Maldonado*, 430 A2d 779 (1981).
35. *Id.* at 788. Conversely, when a committee or an advisor appointed to investigate a derivative claim is not independent, the resulting investigation should not be evidence of good-faith business judgment.
36. *Id.* at 789.
37. *Weinberger v UOP, Inc*, 457 A2d 701 (1983).
38. *Aronson v Lewis*, 473 A2d 805 (1984), overruled on other grounds by *Brehm v Eisner*, 746 A2d 244 (2000).
39. See, e.g., *Weinberger*, 457 A2d at 711.
40. *Id.* at 710.
41. *Id.* See also *Madugula* article discussion, *infra*, *Marchand II v Barnhill*, 212 A3d 805 (2019), and *Cement Masons Local 789 Pension Fund v Schleifer*, 56 Misc 3d 1204(A); 2017 NY Slip Op 50875(U) (2017).
42. *Guth*, 23 Del Ch at 270–271.
43. *Miller*, 76 Mich App at 303.
44. *Nixon v Blackwell*, 626 A2d 1366 (Del 1993).
45. *Smith v Van Gorkom*, 488 A2d 858 (1985), overruled in part by *Gantler v Stephens*, 965 A2d 695, 713 n 54 (2009).
46. *Id.* at 872.
47. *Id.*
48. *Id.*
49. *Id.* at 868.
50. *Delaware Directors' Fiduciary Duties*, 11 U Penn J Bus L at 691.
51. No published Michigan appellate court has specifically addressed whether the business judgment rule applies to managers or members of an LLC, though some courts have applied the rule in the LLC context.
52. *Estes v Idea Engineering & Fabricating*, 250 Mich App 270, 285; 649 NW2d 84 (2002).
53. MCL 450.1541a(1)(a)–(c).
54. MCL 450.1541a(2)(a)–(c).
55. *Estes*, 250 Mich App at 281.
56. *Dodge v Ford Motor Co*, 204 Mich 459; 170 NW 668 (1919).
57. *Wagner Electric Corp v Hydraulic Brake Co*, 269 Mich 560; 257 NW 884 (1934).
58. *Id.* at 567.
59. *Id.* at 568.
60. *Reed v Burton*, 344 Mich 126, 130; 73 NW2d 333 (1955).
61. *Id.* at 131.
62. *Miller v Magline*, 76 Mich App 284; 256 NW2d 761 (1977).
63. *Id.* at 303.
64. *Id.* at 307.
65. *In re Estate of Butterfield v Page*, 418 Mich 241, 255; 341 NW2d 543 (1983).
66. *Id.* at 255–256.
67. *Madugula v Taub*, 496 Mich 685; 853 NW2d 75 (2014). Mr. Mantese argued for the plaintiff in the Michigan Supreme Court.
68. *Madugula v Taub*, unpublished opinion of the Washtenaw County Circuit Court, issued May 26, 2016 (Docket No. 2008-537-CK). Mr. Mantese and Ian Williamson represented the plaintiff on remand.
69. *Franks.*
70. *Id.* at 13–14.
71. *Id.*
72. *Id.*