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A Business or a Trust?: Janssen v. Best & Flanagan and Judicial Review of For-profit and Nonprofit Board of Director Decisions

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NOTE: A BUSINESS OR A TRUST?: *JANSSEN v. BEST & FLANAGAN* AND JUDICIAL REVIEW OF FOR-PROFIT AND NONPROFIT BOARD OF DIRECTOR DECISIONS

Mark Fellows[†]

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On the heels of news media accounts of corporate wrongdoing, the issue of corporate accountability periodically rises in prominence. One method by which shareholders attempt to hold corporations accountable for alleged wrongdoing is the derivative lawsuit. Because of judicial reluctance to interfere with the processes of an independent board of directors, plaintiffs must overcome the business judgment rule presumption in favor of the corporation in order to prevail. The business judgment rule, along with the board’s ability to appoint an independent “special litigation committee” to determine whether the corporation should join the lawsuit or have it dismissed, significantly reduce the plaintiffs’ chances of success in derivative lawsuits.

The recent Minnesota Supreme Court decision in Janssen v. Best &

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Flanagan¹ does not reach the important issue of which version of the business judgment rule Minnesota courts will apply in derivative lawsuits against for-profit and nonprofit corporations. However, the court's reasoning in resolving the case suggests that the strict, procedural version of the business judgment rule will be retained the next time the court reaches the issue.² This note reviews the court's reasoning and argues that both the theoretical justifications behind the business judgment rule and sound economic policy dictate that Minnesota's strict application of the business judgment rule is the correct approach in the for-profit context. In the nonprofit context, this note argues, the business judgment rule justifications do not apply as directly and traditional nonprofits should be subject to more exacting judicial review.

I. INTRODUCTION: PROTECTING BUSINESS JUDGMENT

What do the Ford Motor Company, the Chicago Cubs, Disney and Martha Stewart have in common? Each participated in litigation where the court wrestled with the question of how much deference to grant to board of director decisions.³ Defendants often raise the business judgment rule in cases disputing the major corporate controversies reflected in newspaper headlines such as "hostile" takeovers, excessive executive compensation, and insider trading.⁴ But the rule can also protect corporate boards against more routine claims such as lack of due care in corporate decision-making.⁵ The business judgment rule is simply a presumption made by the reviewing court that the board's decision was

1. 662 N.W.2d 876 (Minn. 2003).

2. For a contrary view see Eric J. Moutz, *Janssen v. Best & Flanagan: At Long Last, the Beginning of the End for the Auerbach Approach in Minnesota?*, 30 WM. MITCHELL L. REV. 489 (2003) (arguing less deferential judicial review is desirable in general and that *Janssen* provides hints that the Minnesota Supreme Court is leaning toward less-deferential review).

3. See *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961 (Del. Ch. 2003) (failure to monitor CEO's alleged insider trading); *Brehm v. Eisner*, 746 A.2d 244 (Del. Super. Ct. 2000) (executive compensation at Disney); *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968) (refusal to erect lights at home field of Chicago Cubs); *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919) (amount of declared dividends).

4. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (corporate takeover); *Brehm*, 746 A.2d 244 (executive compensation); *Beam*, 833 A.2d 961 (insider trading).

5. Compare *Brehm*, 746 A.2d at 267 (dismissing duty of care claims) with *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del. 1985) (finding board grossly negligent).

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informed and made in good faith.⁶

Without question, the business judgment rule is an important component of corporate law.⁷ For more than a century and a half, the business judgment rule has been the primary means by which courts have reviewed ordinary board decisions.⁸ Application of the rule, however, is uncertain and full of “nuance and complexity.”⁹ The root of this uncertainty is in the delicate balance the rule attempts to maintain between board independence and authority on one hand and legitimate shareholder claims on the other.¹⁰

Recently, in *Janssen v. Best & Flanagan*,¹¹ the Minnesota Supreme Court addressed the issue of how the business judgment rule applies to the board of directors of a nonprofit organization. The court decided that the business judgment rule does protect nonprofit board decisions, but did not reach the issue of which particular version of the business judgment rule applies to nonprofits in order to decide the case.¹² This note uses *Janssen* as

6. See *infra* Part II.A.-C.

7. See Michael J. Kennedy, *The Business Judgment Syllogism—Premises Governing Board Activity*, in *TECH. & EMERGING GROWTH M&As 2002* at 285, 327 (PLI Corp. L. & Practice Course, Handbook Series No. 1316, 2002), available at WL 1316 PLI/Corp 285 (stating that there are “perhaps thousands” of cases that “peel the onion of the business judgment rule’s parameters”).

8. 1 DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 7 (5th ed. 1998).

9. See Kennedy, *supra* note 7, at 287. See also Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270 (1967) (calling the business judgment rule “one of the least understood concepts in the entire corporate field”).

10. See *In re PSE & G Shareholder Litigation*, 801 A.2d 295, 306 (N.J. 2002).

To resolve this dispute, we are required to analyze the interplay between two established, but sometimes competing, corporate doctrines. The first doctrine accords protection to corporate decision-makers to be free of unwarranted judicial intrusion when making business judgments on behalf of the corporation. The second tenet recognizes a shareholder’s ability to redress perceived wrongs against the corporation by filing a derivative lawsuit when the entity’s managers refuse to act.

Id. See also Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 563-574 (2003) (contrasting the “shareholder primacy” and “director primacy” models of corporate governance); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 820-22 (2001) (presenting a social-cognitive analysis of board members’ balancing of independence and accountability).

11. 662 N.W.2d 876 (Minn. 2003).

12. See *id.* at 888 n.5 (“We do not adopt a particular version of the business judgment rule for use with Minnesota nonprofit organizations today . . . [because

an opportunity to explore the underlying justifications of the business judgment rule and to recommend a framework for applying the rule in future Minnesota cases.

First, this note develops the history of the shareholder derivative lawsuit and special litigation committee.¹³ In addition, the historical roots of the business judgment rule and the important modern formulations of the rule are described.¹⁴ Next, the note discusses and critiques the traditional policy justifications for the rule.¹⁵ Finally, the facts of the case and the court's analysis are described¹⁶ and a new framework for applying the business judgment rule to nonprofits is presented and discussed in light of *Janssen*.¹⁷ *Janssen* hints that the deferential, one-step version of the business judgment rule still applies to Minnesota for-profit corporations.¹⁸ Strong economic justifications support this position.¹⁹ Finally, this note recommends that this deferential version of the rule should extend only to nonprofit entities displaying salient features in common with for-profit corporations.²⁰

II. HISTORICAL DEVELOPMENT

A. *The Shareholder Derivative Lawsuit*

A derivative lawsuit is a vehicle through which a third party (often a shareholder) may bring a claim on behalf of a corporation or other entity.²¹ The defendant in a shareholder derivative lawsuit is often a present or former director, officer or controlling shareholder of the corporation, but may instead be a third party

the] investigation failed the most minimal version of a business judgment rule. . . .”).

13. See *infra* Parts II.A.-B.

14. See *infra* Part II.C.

15. See *infra* Part II.D.

16. See *infra* Part III.

17. See *infra* Part IV.

18. See *infra* Part IV.A.

19. See *id.*

20. See *infra* Part IV.B.

21. See BLACK'S LAW DICTIONARY 455 (7th ed. 1999) (defining derivative action as a “suit by a beneficiary of a fiduciary to enforce a right belonging to the fiduciary”). See also FED. R. CIV. P. 23.1 (“[A] derivative action brought by one or more shareholders or members to enforce a right of a corporation or . . . association, the corporation or association having failed to enforce a right which may properly be asserted by it . . .”).

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against whom the corporation has a possible claim.²² A derivative action is different than a direct shareholder or class-action lawsuit in that the corporation, and not the shareholder/plaintiff, is the real party in interest²³ in the action.²⁴

The origin of the modern derivative action is traced to eighteenth century British courts taking equity jurisdiction to enforce the fiduciary²⁵ duties of directors of joint stock and charitable corporations.²⁶ American courts recognized the concept of corporate directors as fiduciaries through an analogy to trusts. Early cases allowed shareholder recovery from corporations for misused funds.²⁷ Later cases with third-party actors as defendants required courts to introduce the concept of derivative actions in order to avoid the possibility of dual recovery (by both the corporation and the shareholder) for a single injury.²⁸

While most shareholder derivative actions are dismissed or settled before they go to trial,²⁹ the risk of an adverse outcome to the corporation is real in both the duty of care³⁰ and duty of

22. DEBORAH DEMOTT, *SHAREHOLDER DERIVATIVE ACTIONS: LAW AND PRACTICE* § 1:01 (2002).

23. CHARLES ALAN WRIGHT, *LAW OF FEDERAL COURTS* § 70 (5th ed. 1994) (defining real party in interest as the party possessing the substantive right to be enforced and not necessarily the party who will ultimately benefit from recovery).

24. DEMOTT, *supra* note 22, § 101, at 1-2. Procedurally, this means that the corporation is an indispensable party and the shareholder bringing the action is a nominal plaintiff responsible for joining the corporation in the action. *Ross v. Bernard*, 396 U.S. 531, 538 (1970). *See also Koster v. Am. Lumbermens Mut. Cas. Co.*, 330 U.S. 518, 522-23 (1947) (examining the jurisdictional implications of properly aligning the adverse parties in a derivative action).

25. BLACK'S LAW DICTIONARY, *supra* note 21, at 640 (defining a fiduciary as "one who must exercise a high standard of care in managing another's money or property"; listing specifically the fiduciary duties of "good faith, trust, confidence and candor").

26. *See generally* Bert Prunty, *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. REV. 980, 981-82 (1957) (tracing the impulse behind the derivative action from early efforts by kings and chancellors to protect group members against their delegates to its modern American form).

27. *See, e.g., Robinson v. Smith*, 3 Paige Ch. 222, 226 (N.Y. Ch. 1832) ("if the corporation was still under the control of those who must be made the defendants in the suit, the stockholders . . . would be permitted to file a bill in their own names"); *Taylor v. Miami Exp. Co.*, 5 Ohio 162, 167 (1831) ("if this corporation and directors were trustees and agents of the stockholders, can they not call them to account for the funds placed under their care[?]").

28. *See also* Prunty, *supra* note 26, at 991-92 (discussing these decisions and the logical leap taken by courts in allowing shareholders to assert corporate rights).

29. DEMOTT, *supra* note 22, § 1:01, at 3.

30. In most jurisdictions the current standard of care expected of corporate

loyalty³¹ contexts. From the corporation's perspective, the adverse outcome is forced participation in a lawsuit. If the plaintiff/shareholder brings the suit strictly for nuisance value or in hopes that a settlement will be less expensive for the corporation than the risk of the lawsuit moving forward, it is termed a "strike suit."³² The law developed the special litigation committee and the business judgment rule to provide corporations with efficient means to terminate lawsuits running counter to their legitimate interests.³³

B. *The Special Litigation Committee*

Starting in the 1970s it became common practice for boards of directors to establish a special litigation committee of independent directors and to delegate to the committee the decision whether to join a derivative lawsuit.³⁴ It is important that the committee be granted actual and meaningful authority to decide the matter and not merely be empowered to recommend a course of action to the board for ultimate approval.³⁵ Special litigation committees are

directors is such care and diligence that an ordinarily careful and prudent person could reasonably be expected to exercise on behalf of the corporation under similar circumstances. See 1 JAMES D. COX & THOMAS LEE HAZEN, COX & HAZEN ON CORPORATIONS § 10:03 (2d ed. 2003). In practice this standard of care is decreased in the shareholder derivative context because the business judgment rule requirements must also be met.

31. The duty of loyalty encompasses officer or director self-dealing, conflict-of-interest transactions, the personal usurping of corporate opportunity and other situations where officers or directors act to protect their personal self-interest and neglect to serve the interests of the corporation and its stockholders. 1 COX & HAZEN, *supra* note 30, § 10.11, at 517.

32. See Dennis J. Block, et al., *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 BUS. LAW. 469, 473 (1990) (defining "strike suits" as actions brought to "induce settlements beneficial to the named plaintiff or his counsel" and not to remedy wrongs done to the corporation) (footnote omitted).

33. See *infra* Part II.B-C. For a treatment of special litigation committees as alternative dispute resolution devices, see Daniel S. Kleinberger & Imanta Bergmanis, *Direct vs. Derivative, or "What's a Lawsuit Between Friends in an Incorporated Partnership?"* 22 WM. MITCHELL L. REV. 1203, 1235 (1996).

34. 2 COX & HAZEN, *supra* note 30, § 15.08, at 939. See, e.g., *Gall v. Exxon Corp.* 418 F. Supp. 508, 517 (S.D.N.Y. 1976) ("Indeed, in carrying out its investigation and in reaching its conclusions, the Special Committee exercised the full powers of the Board."); *Lasker v. Burks*, 404 F. Supp. 1172, 1180 (S.D.N.Y. 1975) ("If the minority directors were truly disinterested and independent the court will not substitute its judgment for that of the Board."), *rev'd*, 567 F.2d 1208 (2d Cir. 1978), *rev'd and remanded*, 441 U.S. 471 (1979).

35. See Lawrence J. Fox, *The Special Litigation Committee Investigation: No*

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seen as an efficient method of judging the corporate interest in a derivative lawsuit when the court may see the decision of the full board as colored by self-interest.³⁶ However, the degree to which such committees are able to exercise truly independent judgment over actions of their board colleagues has been repeatedly questioned.³⁷ Nearly all jurisdictions protect independent special litigation committee decisions under some formulation of the business judgment rule.³⁸

C. *The Business Judgment Rule*

The business judgment rule is a deferential standard of judicial review of corporate director conduct that presumes directors act in good faith, on an informed basis, and “in the honest belief that their actions are in the corporation’s best interests.”³⁹ This presumption protects director conduct that can be attributed to any rational business purpose.⁴⁰ Justice Brandeis succinctly

Undertaking for the Faint of Heart, in INTERNAL CORPORATE INVESTIGATIONS 299, 302-03 (Brad D. Brian & Barry F. McNeil eds., 2d ed. 2003).

36. 2 COX & HAZEN, *supra* note 30, § 15.08, at 940.

37. This tendency not to deliver negative outcomes onto one’s board of director colleagues has been termed “‘there but for the grace of God go I’ empathy.” *Zapata Corp. v. Maldonado*, 430 A.2d 779, 787 (Del. 1981). The tendency has also been referred to as “structural bias.” *See, e.g., Miller v. Register & Tribune Syndicate, Inc.* 336 N.W.2d 709, 716 (Iowa 1983) (“The central theme of these concerns has been focused on the ‘structural bias’ approach, which suggests that it is unrealistic to assume that the members of independent committees are free from personal, financial or moral influences which flow from the directors who appoint them.”).

38. Iowa is the most notable exception. Iowa does not provide deferential review of special litigation committee decisions. Instead, the corporation is required to apply for a court-appointed panel, thereby avoiding “structural bias,” in order to be protected under the business judgment rule. *See* Matthew G. Dore, *The Duties and Liabilities of an Iowa Corporate Director*, 50 *DRAKE L. REV.* 207, 240 (2002).

39. BLACK’S LAW DICTIONARY, *supra* note 21, at 192. The business judgment rule began to appear in court decisions in essentially its modern form in the mid nineteenth century in the United States. *See, e.g., In re Spering*, 71 Pa. 11, 24 (1872) (“they are not liable for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope of the powers and discretion confided to the managing body”). *See generally* HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW, 1836-1937*, 59-63 (1991) (tracing the historical development of shareholder derivative suits and the business judgment rule).

40. *See, e.g., Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (“A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of

formulated the business judgment rule as follows:

Courts seldom interfere to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment; and, as a rule, only after application to the stockholders, unless it appears that there was no opportunity for such application, that such application would be futile (as where the wrongdoers control the corporation), or that the delay involved would defeat recovery.⁴¹

To be successful, a plaintiff must plead and prove sufficient facts to overcome this presumption.⁴² Where the business judgment rule presumption is overcome by the plaintiff, the directors bear the burden of proving the fairness of the conduct being challenged.⁴³ In practice, the difference between deferential review in light of the presumption in favor of directors and more rigorous review requiring that directors prove fairness often determines the outcome of derivative litigation.⁴⁴

The business judgment rule places emphasis on the board's decision-making process rather than on the substance of the decision.⁴⁵ The fact that a majority of independent and disinterested directors has approved of board action nearly always means that a court will apply the deferential business judgment standard of review if the action is later attacked for a breach of the duty of care.⁴⁶

Deferential business judgment review is a broadly accepted

what is or is not sound business judgment.”).

41. *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263-64 (1917) (footnote omitted).

42. 1 DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 18 (5th ed. 1998).

43. *Id.* at 18-19.

44. *Id.* at 19.

45. *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 49 (Del. 1997) (“It applies when that decision is questioned and the analysis is primarily a process inquiry. Courts give deference to directors’ decisions reached by a proper process, and do not apply an objective reasonableness test in such a case to examine the wisdom of the decision itself.”) (footnotes omitted).

46. *Grobow v. Perot*, 539 A.2d 180, 191 (Del. 1988), *overruled on different grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). “We view a board of directors with a majority of outside directors, such as this Board, as being in the nature of overseers of management.” *Id.*

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common law concept⁴⁷ accepted as a presumption in the influential⁴⁸ state of Delaware⁴⁹ and at least twenty-five other jurisdictions⁵⁰ including Minnesota,⁵¹ Iowa,⁵² and Wisconsin.⁵³ Two distinct business judgment rule philosophies have emerged that come to different conclusions about the scope of judicial review under the rule and the conditions under which a corporate board can terminate a shareholder derivative lawsuit.⁵⁴

1. *New York's One-Step Approach*

New York's approach, exemplified in *Auerbach v. Bennett*, is the most deferential in that it trusts decisions by disinterested directors

47. See MODEL BUS. CORP. ACT § 8.31, Note on Directors' Liability (2000) ("this standard of judicial review for director conduct—deeply rooted in the case law—presumes that, absent self-dealing or other breach of the duty of loyalty, directors' decision-making satisfies the applicable legal requirements").

48. Delaware precedent in corporate law matters is very influential in forming what some commentators call the "corporate judiciary" and is heavily cited in other jurisdictions. DAVID SCIULI, CORPORATE POWER IN CIVIL SOCIETY 15 (2001). New York, New Jersey, and California are other influential jurisdictions in this regard. *Id.*

49. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) *overruled on other grounds* by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) ("It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) ("Under Delaware law, the business judgment rule is the offspring of the fundamental principle . . . that the business and affairs of a Delaware corporation are managed by or under its board of directors.") (citing DEL. CODE ANN. tit. 8, § 141(a)).

50. See BLOCK ET AL., *supra* note 8, at 22-24 (listing jurisdictions that accept the business judgment rule presumption and providing citations to cases).

51. *Gelco Corp. v. Coniston Partners*, 652 F. Supp. 829, 845 (D. Minn. 1986) ("Under Minnesota law, there is a strong presumption protecting a director's business decision."), *aff'd in part and vacated in part on other grounds*, 811 F.2d 414 (8th Cir. 1987); *Westgor v. Grimm*, 318 N.W.2d 56, 58 (Minn. 1982) (stating that "we have traditionally been reluctant to interfere with the inner workings of a corporation").

52. *Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc.*, 430 N.W.2d 447, 453 (Iowa 1988) (holding that "in duty of care challenges the burden of proof is on plaintiffs because of the business judgment rule which affords directors the presumption that their decisions are informed, made in good faith, and honestly believed by them to be in the best interests of the company").

53. *R.D. Smith & Co. v. Preway Inc.*, 644 F. Supp. 868, 877 (W.D. Wis. 1986) ("If plaintiffs are able to prove their allegations that the board's consideration of alternatives was merely perfunctory, this would mean that defendants did not meet their duty of good faith and reasonable investigation.")

54. See 2 BLOCK ET AL., *supra* note 8, at 1689-1702 (providing a comprehensive review of business judgment rule litigation including numerous citations).

whether to pursue derivative claims as long as the decision is preceded by a good-faith investigation.⁵⁵ The court explains that judges are especially qualified to review the investigative procedures undertaken by a board or committee.⁵⁶ However, the substantive decision to terminate the lawsuit “involving as it did the weighing and balancing of legal, ethical, commercial, promotional, public relations, fiscal and other factors familiar to the resolution of many if not most corporate problems” is beyond the scope of judicial review.⁵⁷

The appropriate scope of review of board investigatory procedures under the *Auerbach* standard can be gleaned from the decision.⁵⁸ The court notes that the board committee “promptly engaged eminent special counsel to guide its deliberations and to advise it” and “reviewed the prior work of the audit committee, testing its completeness, accuracy and thoroughness by interviewing representatives” of the outside auditors.⁵⁹ The committee also reviewed “transcripts of the testimony of 10 corporate officers and employees before the Securities and Exchange Commission” and reviewed documents collected during an earlier investigation conducted by a law firm.⁶⁰ Finally, “[i]ndividual interviews were conducted with the directors found to have participated in any way” in the questioned activities and “[q]uestionnaires were sent to and answered by each of the corporation’s nonmanagement directors.”⁶¹ While stating that the court’s determination of which investigative methods are appropriate and sufficient “must always turn on the nature and characteristics of the particular subject being investigated,” the court found nothing in the record to “raise a triable issue of fact as to the good-faith pursuit of its examination by that committee.”⁶²

55. 393 N.E.2d 994, 1002 (N.Y. 1979) (“While the court may properly inquire as to the adequacy and appropriateness of the committee’s investigative procedures and methodologies, it may not under the guise of consideration of such factors trespass in the domain of business judgment.”).

56. *Id.* (“[C]ourts are well equipped by long and continuing experience and practice In fact they are better qualified in this regard than are corporate directors in general.”).

57. *Id.* at 1002 (“Inquiry into such matters would go to the very core of the business judgment made by the committee.”).

58. *See id.* at 1003.

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

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The *Auerbach* standard of judicial review of board decisions is a one-step process in that the investigative procedures, but not the substance of the decision, are analyzed by the court.⁶³ Under this philosophy, to delve into the substance of corporate decisions “would be to emasculate the business judgment doctrine as applied to the actions and determinations of the special litigation committee.”⁶⁴

2. Delaware’s Two-Step Approach

Delaware’s philosophy on judicial review, laid out in *Zapata Corp. v. Maldonado*, is less deferential in that it gives the court discretion to exercise its own “independent business judgment” whether to dismiss the case.⁶⁵ Step one under *Zapata* requires the court to “inquire into the independence and good faith of the committee and the bases supporting its conclusions.”⁶⁶ Instead of receiving the traditional business-judgment presumption in its favor, the board has the burden of establishing the independence, good faith, and reasonableness of the committee’s determination.⁶⁷ If the corporation meets this burden, the court has a choice to either 1) dismiss the action⁶⁸ or 2) move into step two of the test.⁶⁹

In step two, the court “should determine, applying its own independent business judgment, whether the motion should be granted.”⁷⁰ This step considers the balance between “legitimate corporate claims as expressed in a derivative stockholder suit” and

63. Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 23 (1993) (stating if a litigation committee is disinterested and follows appropriate procedures, *Auerbach* prevents a court from examining the merits of the board’s decision).

64. *Auerbach*, 393 N.E.2d at 1002.

65. 430 A.2d 779, 789 (Del. 1981).

66. *Id.* at 788.

67. *Id.* (stating that “the moving party should be prepared to meet the normal burden under [Delaware Chancery Court] Rule 56 that there is no genuine issue as to any material fact and that the moving party is entitled to dismiss as a matter of law”).

68. *Id.* at 789 (“If the Court determines either that the committee is not independent or has not shown reasonable bases for its conclusions, or, if the Court is not satisfied for other reasons relating to the process, including but not limited to the good faith of the committee, the Court shall deny the corporation’s motion.”).

69. *Id.* (“If, however, the Court is satisfied . . . that the committee was independent and showed reasonable bases for good faith findings and recommendations, the Court may proceed, in its discretion, to the next step.”).

70. *Id.*

the best interest of the corporation as expressed by the independent committee.⁷¹ At this stage, the court should consider instances where the corporate actions meet the criteria of step one but the “result does not appear to satisfy its spirit.”⁷² The court may also weigh “matters of law and public policy in addition to the corporation’s best interests.”⁷³ Step two reflects the *Zapata* court’s concern with respecting the power of a board to run the business of a corporation while at the same time allowing meritorious shareholder lawsuits to go forward.⁷⁴

It is important to note that Delaware only applies the *Zapata* approach to judicial review in cases where shareholder demand⁷⁵ is excused due to futility or wrongful refusal.⁷⁶ Where demand is rightly refused due to the sufficient independence of the board, Delaware provides corporate boards the full protection of the business judgment rule.⁷⁷ In practice, applying the second *Zapata* step may amount to overruling a board decision that seems “egregious” or “irrational” even though board independence and good faith satisfy step one.⁷⁸

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.* at 788 (“We thus steer a middle course between those cases which yield to the independent business judgment of a board committee and this case as determined below which would yield to unbridled plaintiff stockholder control.”).

75. In order to have standing to initiate derivative litigation, a shareholder must first demand in writing that the board of directors commence the lawsuit in question. BLOCK ET AL., *supra* note 8, at 1407 (defining “shareholder demand” and noting that its purpose is to limit derivative litigation to situations where the corporation unjustly failed to act for itself).

76. Demand futility is essentially a determination that the board of directors is insufficiently disinterested and independent to be trusted to make a decision in the best interests of the corporation. *See, e.g.,* McKee v. Rogers, 156 A. 191, 193 (Del. Ch. 1931) (stating that “the officers are under an influence that sterilizes discretion and could not be proper persons to conduct the litigation”). *See also* DEL. R. CH. CT. 23.1 (“The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.”) (emphasis added).

77. *Zapata*, 430 A.2d at 784 (stating that “[c]onsistent with the purpose of requiring a demand, a board decision to cause a derivative suit to be dismissed as detrimental to the company, after demand has been made and refused, will be respected unless it was wrongful”).

78. BLOCK ET AL., *supra* note 8, at 1720 (citing Carlton Invs. v. TLC Beatrice Int’l Holdings, Inc., No. CIV.A.13950, 1997 WL 305829, at *2 (Del. Ch. May 30, 1997)).

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3. *Minnesota's Historical Approach*

Minnesota courts historically have used the *Auerbach* one-step approach to review board of director decisions.⁷⁹ Until 1989, one-step review for independence and good faith in the special litigation committee context was mandated by statute.⁸⁰ In 1989, the statute was repealed and its replacement did not address the degree of deference to be afforded to special litigation committee decisions.⁸¹ Subsequent court of appeals decisions refused to apply a more stringent standard of review despite the statutory changes.⁸² One-step review for independence and good faith remained the standard in Minnesota notwithstanding some plaintiff arguments that the standard should be strengthened in the direction of the *Zapata* two-step approach that allows the court to review the reasonableness of the decision.⁸³

D. *Justifications of the Rule*

The ultimate purpose that is served by the business judgment rule is striking a balance between the authority of the board of directors and its accountability to other stakeholders.⁸⁴ The context of the derivative action sharpens the focus on this balance: it is the corporate entity and not the nominal plaintiff that has suffered the alleged wrong.⁸⁵ Therefore, it follows that it should be within the province of an independent board of directors to decide whether or not to seek redress in the courts. Unlike in a direct

79. See, e.g., *Black v. NuAire, Inc.*, 426 N.W.2d 203, 210-11 (Minn. Ct. App. 1988).

80. See MINN. STAT. § 302A.243 (1988) (“The good faith determinations of the committee are binding upon the corporation and its directors, officers, and shareholders.”), *repealed by* 1989 Minn. Laws ch. 172, § 11.

81. See MINN. STAT. § 302A.241 subd. 1 (2003).

82. See, e.g., *Skoglund v. Brady*, 541 N.W.2d 17, 21 (Minn. Ct. App. 1995) (stating that the repealing of section 302A.243 “was not intended to convey any legislative intent with regard to the substance of the repealed section”). *But see* *Moutz*, *supra* note 2, at 497 (arguing that legislative intent associated with the repeal of section 302A.243 “[a]t the very least” requires courts to “substantively consider alternatives to *Auerbach*”).

83. See *Drilling v. Berman*, 589 N.W.2d 503, 507-09 (Minn. Ct. App. 1999) (rejecting plaintiff arguments that rely on decisions from jurisdictions applying more stringent standards of review), *see also* *Moutz*, *supra* note 2, at 511 (advocating that Minnesota adopt the *Zapata* approach).

84. See STEPHAN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 208 (2002) (noting the “tension between authority and accountability” inherent in questioning board of director decisions and actions).

85. See *BLOCK ET AL.*, *supra* note 8, at 1380.

lawsuit, corporate stakeholders have the option to “vote with their feet” and dissociate themselves from the situation.⁸⁶

Within the essential tension between authority and accountability, several specific theoretical justifications for the business judgment rule emerge.

1. *Encouraging Directors to Serve*

Courts have repeatedly recognized that even informed, well-intentioned directors can make decisions that, with the benefit of hindsight, later appear misguided.⁸⁷ If each incident of human fallibility in board decisionmaking that results in a negative outcome were to lead to personal liability for the individual board members, it is easy to see that competent individuals might be discouraged from accepting board positions.⁸⁸ This is especially true given the massive scale of operation of many modern corporations; director actions later judged grossly negligent with the benefit of hindsight could lead to massive joint and several liability for the entire loss.⁸⁹

86. Shareholders in closely held corporations are not an exception although they would seem to be without the necessary liquidity to be able to “vote with their feet.” However, they are protected by Minnesota closely held corporation law under a completely different and much less deferential standard. *See* Kleinberger & Bergmanis, *supra* note 33, at 1238 (“Minnesota’s leading close corporation cases have featured egregious conduct and overwhelming evidence, and the decisions exhibit none of the deference to management that characterizes business judgment cases.”). Employee-owned stock may be under alienation restrictions that prevent exiting in the face of corporate wrongdoing. *See* Moutz, *supra* note 2, at 508-09. However, employee stock ownership does not carry with it the assumption of diversification that is one of the important foundations of the business judgment rule. *See infra* Part II.D.2.

87. *See* BLOCK ET AL., *supra* note 8, at 12 (citing numerous cases that mention this justification for the business judgment rule).

88. A powerful example of this concern is reflected in the 1986 revision of title 8, section 102(b)(7) of the Delaware Code to allow corporate bylaws to exempt directors from liability for duty-of-care violations under certain circumstances. *See* Diane L. Saltoun, Note, *Fortifying the Directorial Stronghold: Delaware Limits Director Liability*, 29 B.C. L. REV. 481, 481-82 (1988). *See also* Smith v. Van Gorkum, 488 A.2d 858, 884 (Del. 1985) (holding that directors were personally liable for gross negligence for approving a merger without reasonable investigation).

89. *See* William T. Allen et al., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkum and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 457 (2002) (arguing risk/reward ratio for directors discourages board service and risk-taking).

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2. *Protecting Risk-Taking*

Shareholders (or at least economically rational shareholders) depend upon corporate growth and do not want directors to behave in a risk-averse manner.⁹⁰ Accordingly, courts appreciate that risk-taking and innovation are important elements of economic growth.⁹¹ Without the threat of personal liability, directors are free to honestly and rationally assess the risk involved with any given opportunity and react accordingly.⁹² The fact that investors are able to diversify their portfolio of investments and the associated risks is additional justification for protecting director risk-taking in individual corporations.⁹³

3. *Courts Are Ill-Equipped*

Courts reviewing board of director decisions often justify their deference by stating that they are ill-equipped to second-guess an informed board of directors.⁹⁴ Judges often argue that they lack special expertise and specific history with the corporation in question or that they are missing an intangible “sense” for the business and the particular marketplace.⁹⁵ The business judgment rule, from this perspective, protects board decisions because of the special expertise of the directors and the relative lack of expertise

90. See *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996) (noting that shareholders should prefer investments that maximize the “risk adjusted rate of return”).

91. See, e.g., *Resolution Trust Corp. v. Blasdel*, 930 F. Supp. 417, 423 (D. Ariz. 1994) (“[O]ur country’s corporate system depends to a degree on the willingness of corporations to take risk.”).

92. *Gagliardi*, 683 A.2d at 1052 (stating that, given the scale of corporate activities, even a small probability of liability has a significant chilling effect on director risk taking). See also *Allen*, *supra* note 89, at 456-57 (arguing the massive scale of potential liability inhibits risk-taking among directors).

93. See *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959, 968 n.16 (Del. Ch. 1996) (“The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk.”); see also Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law and Organization: The Case of the Business Judgment Rule*, 77 CHI.-KENT L. REV. 179, 205 (2001) (arguing the business judgment rule appropriately lessens board concern with minimizing diversifiable risk).

94. See, e.g., *In re Caremark*, 698 A.2d at 967 (review “would expose directors to substantive second guessing by ill-equipped judges or juries”); *Auerbach v. Bennett*, 47 N.Y.2d 619, 630 (“the business judgment doctrine . . . is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments”).

95. See Douglas M. Branson, *The Rule that Isn’t a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 637 (2002).

of judges.⁹⁶

However, the premise that courts should grant deferential review based upon a lack of specific expertise has been criticized on the grounds that courts are willing to more strictly review decisions in other complex domains, such as medical malpractice.⁹⁷ Other commentators argue that courts are ill-equipped based not upon a lack of expertise, but rather because of the dangers of hindsight bias and the lack of objective standards against which to evaluate business decisions.⁹⁸

III. THE *JANSSEN* DECISION

A. *Facts*

The board of directors of the Minneapolis Police Relief Association⁹⁹ (MPRA) in 1996 and 1997 lost approximately \$15 million in an investment in a company known as Technimar.¹⁰⁰ George Janssen and other members of MPRA (hereinafter Janssen) brought a derivative lawsuit on behalf of MPRA against the law firm of Best & Flanagan, which advised the MPRA board of directors.¹⁰¹ Among other claims, the lawsuit alleged that the Best & Flanagan attorneys who served as general counsel to MPRA were negligent in failing to conduct a “due diligence” inquiry into the Technimar investment.¹⁰²

As a response to the lawsuit, the MPRA board issued a resolution appointing attorney Robert Murnane as “special

96. See *Paramount Communications Inc. v. Time Inc.*, 1989 WL 79880, at *29 (Del.Ch. July 14, 1989) (stating the designation of authority to the board to make business and financial decisions is one of the “important benefits of the business judgment rule”).

97. See Jeffrey O’Connell & Andrew S. Boutros, *Treating Medical Malpractice Claims Under a Variant of the Business Judgment Rule*, 77 NOTRE DAME L. REV. 373, 426 (2002) (“Much of the reasoning that supports the existence of the business judgment rule likewise applies to health care and other enterprises.”).

98. See William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1296 (2001) (hindsight bias); Charles W. Murdock, *Corporate Governance—The Role of Special Litigation Committees*, 68 WASH. L. REV. 79, 91 (1993) (“no available objective standard”).

99. MPRA is a Minnesota nonprofit corporation governed by a board of nine directors that administers a pension plan for Minneapolis police officers hired before June 15, 1980. See MINN. STAT. § 423B.01-.04 (2002).

100. *Janssen v. Best & Flanagan*, 662 N.W.2d 876, 879 (Minn. 2003).

101. *Id.*

102. *Id.* at 879-80.

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counsel” to investigate Janssen’s claims.¹⁰³ The resolution instructed Murnane to conduct an independent review of the derivative lawsuit and determine on behalf of the board of directors whether MPRA should join the lawsuit against Best & Flanagan.¹⁰⁴ In particular, the resolution instructed Murnane “not to reinvestigate, verify or otherwise attempt to prove or disprove the factual findings, determinations, events or circumstances” described in two previous investigative reports and a set of discovery materials from a related lawsuit.¹⁰⁵ Murnane was not limited by the conclusions of the previous reports, but was specifically instructed to “accept as correct” their factual findings.¹⁰⁶

Over the next few months Murnane reviewed “thousands of pages of reports, documents and deposition transcripts” while investigating the prospects of a malpractice lawsuit against Best & Flanagan.¹⁰⁷ Murnane did not, however, conduct any of his own investigation nor speak to the Janssen claimants and attorneys.¹⁰⁸ The report Murnane submitted to the MPRA board of directors on September 26, 2000, concluded that “the totality of the materials reviewed does not support a finding that Best & Flanagan committed legal malpractice in its handling of the MPRA affairs” and that “to spend money in the pursuit of a legal malpractice claim against Best & Flanagan would not be prudent use of the

103. *Id.* at 880. While the board resolution labeled Murnane’s role as that of “special counsel,” their ultimate intention was that he provide an independent business judgment in the role of the board’s independent special litigation committee. *See infra* Part III.B.2.A. The distinction between serving as “special counsel” and as a special litigation committee is potentially significant because a role as board counsel implies a possible past and/or future role in advising the board and a particular fiduciary relationship with the directors themselves that could color the independence of the counsel or committee’s conclusions. *See* James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1084-85 (2003) (“earlier, and particularly on-going, representation of the corporation raises questions regarding independence and, hence, possible biasing of the information and advice counsel may provide the committee”). The advice provided by legal counsel may also be considered more limited in scope than that provided by a special litigation committee responsible for providing a “business judgment.” *See Janssen*, 662 N.W.2d at 888 (“instead MPRA hired Murnane to serve as its special counsel and he acted more like a legal advisor than a neutral decision maker”).

104. *Janssen*, 662 N.W.2d at 880.

105. *Id.* Two different law firms, Jones, Day, Reavis & Pogue (Jones Day) and Dorsey & Whitney, LLP (Dorsey Whitney), already had conducted investigations surrounding some of the issues and provided the written reports. *Id.* at 879.

106. *Id.* at 880.

107. *Id.*

108. *Id.*

MPRA funds.”¹⁰⁹ The MPRA board then brought a motion to dismiss the Janssen lawsuit on the theory that the court should defer to the business judgment of Murnane who served as the board’s special litigation committee.¹¹⁰

The district court accepted Murnane as a special litigation committee and applied the business judgment rule to his report.¹¹¹ The court tested Murnane’s investigation for independence and good faith and concluded that the investigation failed even this limited standard of review.¹¹² The court found Murnane’s investigation lacked independence because “he was told by the board of directors what to believe.”¹¹³ The court did not find good faith because Murnane did not seek or receive input from the plaintiffs.¹¹⁴ In addition, the district court noted that it could not determine whether Murnane offered legal advice or a business judgment decision to the MPRA board.¹¹⁵

Instead of denying MPRA’s motion to dismiss the lawsuit, the district court postponed decision on the motion to allow MPRA to modify the delegation of authority to its special litigation committee.¹¹⁶ The court stated that it would not grant business judgment deference to the committee’s decision “until adequate evidence of independence and good faith is submitted by the MPRA, and until it is clear that Murnane has rendered a business judgment.”¹¹⁷

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.* The district court appears to apply a strict version of the business judgment rule (following the *Auerbach* one-step approach) by only examining the investigative procedures undertaken by the special litigation committee. *See id.* (“[the district court] examined only whether the committee conducted its investigation with independence and good faith”).

113. *Id.* The district court concluded that the investigation lacked independence because the board gave Murnane “only limited access to information.” *Janssen v. Best & Flanagan*, 645 N.W.2d 495, 497 (Minn. Ct. App. 2002) [hereinafter “*Janssen Appeal*”].

114. *Janssen*, 662 N.W.2d at 880. (“the [district] court was left to assume that such input was not sought because the board’s instructions limited the scope of the investigation”).

115. *Id.* Operating as a “special counsel” offering legal advice does not meet the standard of neutrality and independence required of a special litigation committee of the board. *See id.* at 888.

116. *Id.* at 880-81. The court postponed a decision on the motion to allow Murnane a second chance to investigate and not merely as a time extension to supplement the record. *See id.* at 889 n.6.

117. *Id.* at 881.

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As a result, the MPRA board issued a second resolution in December of 2000 declaring that Murnane was to function as a special litigation committee, that no limits be imposed on his investigation, and asking that Murnane exercise his business judgment about whether it was in the best interest of MPRA to join in the derivative lawsuit.¹¹⁸ Murnane undertook a second investigation during which he met with some of the plaintiffs and the involved attorneys at Best & Flanagan.¹¹⁹ Murnane's second report concluded that it would be a "poor business judgment" for MPRA to join in the lawsuit against Best & Flanagan.¹²⁰ MPRA then renewed its motion to dismiss the derivative lawsuit.¹²¹ The district court concluded that the special litigation committee's second investigation was conducted independently and in good faith.¹²² The court deferred to Murnane's business judgment according to the business judgment rule and granted MPRA's motion to dismiss the lawsuit against Best & Flanagan.¹²³

The court of appeals reversed the district court and held that the Minnesota Nonprofit Corporations Act¹²⁴ does not authorize nonprofit organizations to create and empower special litigation committees.¹²⁵ The court of appeals also stated that, even assuming MPRA could legally form a special litigation committee, Murnane's initial report failed the independence and good faith requirements and the court would not have deferred to the committee's findings even after the second investigation and report.¹²⁶ The stated deficiencies were that 1) the scope of Murnane's investigation was limited by the MPRA board, 2) Murnane failed to interview the plaintiffs, and 3) Murnane's conclusions amounted to legal advice rather than business judgment.¹²⁷

118. The second resolution grants Murnane "complete independence" and states that he "may undertake whatever good faith investigation he chooses." *Id.*

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

124. MINN. STAT. § 317A.241 subd. 1 (2002). See also discussion *infra* note 142.

125. *Janssen Appeal*, 645 N.W.2d at 498 ("authorizing the use of special litigation committees by for-profit corporations and omitting any reference to them for nonprofit corporations is a clear statement of legislative intent to treat the business entities differently in this aspect of management").

126. See *id.* at 500 (concluding that the two Murnane investigations considered together failed the independence and good faith requirements).

127. *Id.* at 499-500 (listing the three district court findings on which the court of appeals based its conclusion).

B. *The Supreme Court's Analysis*

The Minnesota Supreme Court affirmed the court of appeals decision¹²⁸ that Murnane's investigation did not meet the business judgment threshold.¹²⁹ The supreme court decided the case in three steps. The first step was determining whether the deferential business judgment standard of review should be applied to board of director decisions in a nonprofit corporation.¹³⁰ The second was deciding whether the Minnesota Nonprofit Corporations Act¹³¹ prohibits a board of directors from establishing a special litigation committee with authority to make decisions about derivative litigation.¹³² The third decision was whether Murnane, serving as MPRA's special litigation committee, displayed sufficient independence and good faith to warrant the deferential standard of review of the business judgment rule.¹³³

1. *Nonprofits and the Business Judgment Rule*

The court began by noting the balance that must be maintained between the important goals of allowing a corporation to control its own destiny and holding directors accountable by allowing derivative lawsuits.¹³⁴ The two traditional justifications for the business judgment standard are: 1) shielding directors' reasonable risks is economically desirable to allow businesses to attract risk-averse managers and adapt to changing markets and trends,¹³⁵ and 2) courts are generally ill-equipped to judge the merits of business decisions.¹³⁶

All parties in the case presumed that the business judgment rule would apply, and the court found no authority denying a nonprofit corporation business judgment protection.¹³⁷ The court

128. *Janssen Appeal*, 645 N.W.2d at 500.

129. *Janssen*, 662 N.W.2d at 890.

130. *See infra* Part III.B.1.

131. MINN. STAT. ch. 317A (2002).

132. *See* authorities cited *infra* note 142.

133. *See infra* Part III.B.2.

134. *Janssen*, 662 N.W.2d at 881-82 (citing *In re PSE & G S'holder Litig.*, 801 A.2d 295, 306 (N.J. 2002)).

135. *See supra* Part II.D.2.

136. *See supra* Part II.D.3.

137. *Janssen*, 662 N.W.2d at 883 (citing *Fairhope Single Tax Corp. v. Rezner*, 527 So. 2d 1232, 1236 (Ala. 1987); *Chun v. Bd. of Trs. of the Employees' Ret. Sys.*, 952 P.2d 1215, 1226-27 (Haw. 1998); *Mahan v. Avera St. Luke's*, 621 N.W.2d 150, 154 (S.D. 2001); *Rywalt v. Writer Corp.*, 526 P.2d 316, 317 (Colo. Ct. App. 1974);

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argued that, like for-profit corporations, nonprofits are autonomous agents deserving to “control their own destiny.”¹³⁸ Additionally, directors of nonprofits “may take fewer risks than would be optimal” if they had too much concern for liability for well-intentioned decisions,¹³⁹ and that courts are no better equipped to second-guess nonprofit board decisions than for-profit board decisions.¹⁴⁰ Finally, the court reasoned that judges should no more insert themselves between disputing factions of nonprofits than between dissatisfied shareholders and boards of for-profit corporations.¹⁴¹ Concluding that the two business judgment rule justifications presented earlier apply in the nonprofit context as well, the court held that nonprofit boards are also protected by the rule.¹⁴²

2. *Applying the Business Judgment Standard*

The court separately addressed the first board resolution and investigation and the second resolution and investigation allowed by the district court.¹⁴³

a. *First Investigation*

The court set out the “minimum” standard that must be met in

Scheuer Family Found. Inc. v. 61 Assoc., 582 N.Y.S.2d 662, 663 (N.Y. App. Div. 1992); *Soloman v. Edgewater Yacht Club. Inc.*, 519 N.E.2d 429, 431 (Ohio Mun. 1987); *Dockside Ass’n, Inc. v. Detyens*, 352 S.E.2d 714, 716 (S.C. Ct. App. 1987); *Burke v. Tenn. Walking Horse Breeders’ & Exhibitors’ Ass’n*, No. 01A01-9611-CH-0511, 1997 WL 277999 at *9, (Tenn. Ct. App. 1997); *John v. John*, 450 N.W.2d 795, 801-02 (Wis. Ct. App. 1989)).

138. *Janssen*, 662 N.W.2d at 883.

139. *Id.* See also *supra* Part II.D.2.

140. *Janssen*, 662 N.W.2d at 883. See also *supra* Part II.D.3.

141. *Janssen*, 662 N.W.2d at 883.

142. *Id.* The supreme court also reversed the court of appeals holding that nonprofit boards are not permitted to grant authority to special litigation committees. *Id.* at 884. The Minnesota Nonprofit Corporations Act states that committees appointed by a nonprofit board are “subject at all times to the direction and control of the board.” MINN. STAT. § 317A.241 subd. 1 (2002). This language would appear to prohibit granting the type of authority necessary to establish independence in the business judgment rule context. See *Janssen*, 662 N.W.2d at 885 (noting that a strict reading would “make true independence impossible”). In construing the statute, the court reasoned that there are “no characteristics of nonprofits that justify treating nonprofit and for-profit corporations differently in terms of their ability to delegate board authority.” *Id.* at 886.

143. See *supra* Part III.A.

order for a litigation committee decision to deserve protection under the business judgment rule.¹⁴⁴ The committee must act in good faith and with sufficient independence from the board to dispassionately review the derivative lawsuit.¹⁴⁵ Filling a “mere advisory role” is not enough: the board must delegate to the committee the full power to control the litigation.¹⁴⁶

The court noted two aspects of Murnane’s initial investigation to illustrate that he lacked sufficient independence from the board.¹⁴⁷ First, the resolution explicitly restricted the scope of his factual investigation.¹⁴⁸ Murnane was told to rely on facts developed during other law firms’ earlier investigations of related legal issues.¹⁴⁹ Second, the court concluded that Murnane saw his role as being determined by the title “special counsel” rather than as a special litigation committee tasked to provide an independent business judgment that would bind the board.¹⁵⁰ Supporting this conclusion is the fact that Murnane did not interview Janssen or his counsel.¹⁵¹ The court noted that Murnane’s conclusions sounded like legal advice rather than business judgment.¹⁵²

Two features of Murnane’s procedures pointed to a lack of good faith investigation.¹⁵³ First, he failed “a fundamental task in reaching an informed decision” by never interviewing Janssen or

144. *Janssen*, 662 N.W.2d at 888. The court does not adopt a particular version of the business judgment rule in its analysis. Instead, it applies the “good faith” and “independence” tests as elements common to all state “variations” upon the rule. *Id.*

145. *Id.*

146. *Id.* (calling delegation of power to control the litigation a “key factor in evaluating independence”).

147. *Id.* The court analyzed independence and good faith as a conjunctive test with two parts, but applied some facts about the investigation to both the independence and good faith parts of the test. *See supra* notes 109-119 and accompanying text.

148. *Janssen*, 662 N.W.2d at 888.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.* The court does not give a definitive indication of the characteristics that define “legal advice” versus an “independent business judgment.” However, it appears that business judgment must at least consider information from the perspective of other parties outside of the board and must consider a broader range of factors relevant to operating a business in making a decision. *See infra* note 157.

153. The court defines the good faith element as requiring “a good faith attempt to deduce the best interest of MPRA with respect to the litigation against Best & Flanagan.” *Janssen*, 662 N.W.2d at 889.

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his counsel.¹⁵⁴ Second, Murnane failed to consider “*all* of the germane benefits and detriments” of this litigation for MPRA.¹⁵⁵ Murnane concluded that the materials reviewed “do[] not support a finding that Best & Flanagan committed legal malpractice” and that spending money in pursuit of a malpractice claim “would not be prudent use of MPRA funds.”¹⁵⁶ The court viewed this as the “language . . . of a special counsel evaluating the likelihood of a legal victory” instead of a “much more comprehensive weighing and balancing of factors” expected in “reasoned business decisions.”¹⁵⁷ Based upon these arguments, the court held that Murnane’s initial investigation “lacked the independence and good faith necessary to merit deference from this court.”¹⁵⁸

b. Second Investigation

Although the district court deferred MPRA’s motion to dismiss and allowed its board to issue a second resolution and empower Murnane to conduct a second investigation, the supreme court refused to consider the second, “improved” investigation.¹⁵⁹ Although finding no directly relevant precedent, the court argued that procedure dictates a derivative lawsuit should proceed to trial if the board fails to meet its burden of proving independence and good faith.¹⁶⁰ The court stated that an investigation that is so restricted in scope or so shallow as to constitute a pretext raises questions of good faith and “would never be shielded” by the business judgment rule.¹⁶¹

The court found a second justification for refusing to consider the second investigation in the principles behind the business judgment rule.¹⁶² The rule attempts to strike a balance between allowing corporations to control their own destiny and permitting meritorious shareholder lawsuits to go forward.¹⁶³ The court

154. *Id.*

155. *Id.* (emphasis added).

156. *Id.* (internal quotes omitted).

157. *Id.* (listing factors appropriately considered such as how joining or quashing the lawsuit could affect: 1) MPRA’s economic health, 2) member/board relations, 3) public relations, and 4) other factors common to reasoned business decisions).

158. *Id.*

159. *Id.* at 890.

160. *Id.* at 889 (citing *Houle v. Low*, 556 N.E.2d 51, 58 (Mass. 1990)).

161. *Id.* (quoting *Auerbach v. Bennett*, 393 N.E.2d 994, 1003 (N.Y. 1979)).

162. *Id.* at 889-90.

163. *Id.* at 890 (citing *Kaplan v. Wyatt*, 484 A.2d 501, 508 (Del. Ch. 1984)).

argued that allowing boards “to continually improve their investigation to bolster their business decision” creates a situation where shareholder rights are “effectively nullified.”¹⁶⁴ The court concluded that the district court erred in deferring the motion to dismiss and permitting the board to remedy defects in their delegation of authority to Murnane.¹⁶⁵

IV. ANALYSIS

A. *For-Profit Review: Hints of Auerbach*

While declining to formally adopt any particular version of the business judgment rule, the supreme court in *Janssen* leaves some significant hints that it favors the deferential *Auerbach* one-step approach.¹⁶⁶ The first hint is in the reasoning the court uses to reject consideration of the MPRA’s second resolution and Murnane’s second investigation.¹⁶⁷ The court presents very strict procedural requirements in its “one strike and you are out” holding and equates flaws in a committee investigation with the investigation itself being merely pretextual and, therefore, unworthy of judicial deference.¹⁶⁸ The fact that the court takes such a strong procedural stand is possibly indicative of a preference for the (strictly procedural) *Auerbach* formulation of the business judgment rule.¹⁶⁹ A court leaning toward the *Zapata* formulation of the rule can afford to be less strict in reviewing the investigative procedures because optional review of the substance of the decision for reasonableness is available.¹⁷⁰ In contrast, *Auerbach*

164. *Id.* This argument applies to any requirement that is purely procedural because the procedure can be continually modified and improved while the substance of the decision remains the same. Therefore, if the court defers decision on the motion to dismiss while the board continually refines the investigative procedures until they meet court scrutiny, the plaintiff will never have a chance to bring the suit forward.

165. *Id.*

166. *See supra* Part II.C.1.

167. *See supra* Part III.B.2.b.

168. *Janssen*, 662 N.W.2d at 889 (citing *Auerbach v. Bennett*, 393 N.E.2d 994, 1003 (N.Y. 1979)).

169. In contrast, the dissent argues that the second resolution and investigation are completely appropriate by appealing to an analogy to summary judgment motions generally; denial does not become “law of the case” that precludes a renewed motion. *Id.* at 890 (Hanson, J., dissenting).

170. *See supra* Part II.C.2.

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review provides no such “back up plan.”¹⁷¹

The second hint that the court is oriented toward deferential, one-step review is contained in the language the court uses in refusing to adopt a particular standard of review for nonprofit board decisions.¹⁷² The court states that it “need not reach the question of whether a more exacting standard of judicial review may be appropriate for nonprofit corporations than in the case of for-profit corporations.”¹⁷³ There are certainly other ways that this proposition could be phrased that would not so strongly imply that for-profit boards are currently entitled to deferential review. The consistent use of one-step review in court of appeals decisions serves as the context for this statement by the supreme court.¹⁷⁴

Given the emphasis that the court places on board autonomy,¹⁷⁵ deferential review is the appropriate standard for Minnesota for-profit corporations. While a hot-button corporate issue or particularly compelling facts may tempt a court to reach beyond one-step business judgment review and address the substance of the board’s decision, it is important to remember the statutory command that “[t]he business and affairs of a corporation shall be managed by or under the direction of a board.”¹⁷⁶ Similar corporate constituency statutes exist in most states and, when respected, represent the legal foundation for the tremendous economic growth that has occurred in the United States.¹⁷⁷ Deferential, one-step review properly respects this statutory concession of authority to the board. It also promotes appropriate risk-taking by individual board members and healthy group processes by the board acting in concert.¹⁷⁸

171. See *supra* Part II.C.1. Other commentators have criticized the *Janssen* “one-strike” approach as inconsistent with the business judgment rule underlying purpose of preserving board autonomy. See Moutz, *supra* note 2, at 506 (“courts should have the discretion to permit additional investigations . . . provided that the committee proceeded independently and in good faith”).

172. See *Janssen*, 662 N.W.2d at 888 n.5.

173. *Id.* The implication is that *less* exacting review is appropriate in the case of for-profit corporations.

174. See *supra* Part II.C.3.

175. *Janssen*, 662 N.W.2d at 881-82.

176. MINN. STAT. § 302A.201 subd. 1 (2002).

177. See Eric W. Orts, *The Complexity and Legitimacy of Corporate Law*, 50 WASH. & LEE L. REV. 1565, 1595-96 (1993) (discussing generally the relationship between corporate legal structures and long-term economic growth in the United States).

178. See discussion *supra* Part II.D.1-2 (discussing risk taking by individual board members); see also Stephan M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1, 50 (2002).

The *Janssen* decision hints that Minnesota still applies one-step review to for-profit board decisions. For the sound economic reasons listed above, the court should confirm those hints by applying deferential business judgment review when provided the opportunity in the future.

B. Nonprofit Review: A Business or a Trust?

In deciding to apply the business judgment rule to Minnesota nonprofits, the court invokes the rule justifications that 1) risk-taking should be encouraged and 2) courts are ill-equipped to review board decisions.¹⁷⁹ The court also notes that organizations are autonomous agents that should be allowed to control their own destiny.¹⁸⁰ It appears that the court is arguing that nonprofit and for-profit entities are so similar with respect to characteristics that are relevant to applying the business judgment rule that the rule should apply to both.¹⁸¹ The problem with this argument is the fact that nonprofit entities are extremely diverse: some nonprofits operate very much like for-profits and some are quite different.¹⁸²

In turn, risk-averse directors take excessive precautions and avoid risky decisions. If the risk of shareholder litigation causes some members of the team to exercise more care than is optimal, the team must now monitor not only the quality of the decision-making inputs coming from each member, but also the risk that any given member is unusually risk averse and thus especially subject to having his or her inputs into the team processes skewed by the fear of liability.

Id.

179. See *Janssen*, 662 N.W.2d at 883.

180. *Id.* (citing *Auerbach v. Bennett*, 393 N.E.2d 994, 1000-01 (N.Y. 1979)).

181. These characteristics of nonprofits and for-profits are the ones that relate to the traditional justifications for the business judgment rule: encouraging board members to serve, protecting risk-taking, and realizing that courts are ill-equipped to substitute their judgment for the board's judgment. A fair number of jurisdictions have established a blanket rule that the corporate duty-of-care standard applies to nonprofits. See Daniel L. Kurtz, *BOARD LIABILITY: A GUIDE FOR NONPROFIT DIRECTORS* 23 (1988).

182. See Denise Ping Lee, *The Business Judgment Rule: Should It Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925, 928 (2003) (arguing for less deferential judicial review for nonprofit boards).

The world of nonprofits has changed significantly over time; some have continued to operate as small, neighborhood charitable organizations, while others have transformed themselves into large, quasi-business operations, similar to their behemoth corporate counterparts. As with any group of this size, nonprofit activities vary widely, with organizations ranging from traditional charities, such as neighborhood soup kitchens and the Red Cross, to hospitals run in a manner similar to for-profit hospitals, to even the National Football

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An approach that is more appropriate in light of the varied nature of nonprofit corporations is to examine the characteristics of the organization and determine whether it operates more like a for-profit entity or more like a traditional nonprofit. If the organization is clearly a traditional nonprofit, more exacting review such as an ordinary negligence standard may be appropriate.¹⁸³ In this way, a nonprofit where the director's role is more similar to a trustee than to a for-profit director would be subject to the more exacting standard of judicial review of a trustee.¹⁸⁴

The nonprofit's characteristics that would be relevant to this determination are the characteristics that relate to the traditional justifications for the business judgment rule. For example: whether the directors are expected to be risk-averse, whether the shareholder/members are able to diversify their risks by removing funds or controlling investment decisions, and whether the shareholder/members have other remedies available such as leaving the organization without significant penalty or voting out directors. As a practical matter, establishing these characteristics could be a pleading requirement that burdens the plaintiff.

Applying this approach to *Janssen* would require a remand to district court to establish relevant facts about MPRA. The most important considerations are likely to be Janssen's reasonable expectations about the type of risk-taking that the board was authorized to undertake and whether Janssen was able to diversify his retirement funds outside of MPRA or remove them entirely. It is likely that MPRA was expected to undertake sufficient risk regarding its pension fund investments so as to provide reasonable capital growth to its retirees.¹⁸⁵ If this fact alone is true it becomes a strong argument for deferential review of MPRA board decisions in order to not inhibit appropriate investment management risk-taking.

League.

Id.

183. *See id.* at 927.

184. *See* RESTATEMENT (SECOND) OF TRUSTS § 174 (1959). "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."

Id.

185. Information about the MPRA's investment strategies or goals or the mission of the pension fund is not found in the organizations bylaws. *See* MINNEAPOLIS POLICE RELIEF ASSOCIATION, FIRST RESTATED BY-LAWS OF THE MINNEAPOLIS POLICE RELIEF ASSOCIATION, available at <http://www.mpra.net/bylaws.htm> (last visited Apr. 26, 2004).

V. CONCLUSION

Deficiencies in the MPRA special litigation committee investigation of the merits of the derivative lawsuit against Best & Flanagan allowed the supreme court to decide *Janssen* without reaching the issue of which version of the business judgment rule applies to Minnesota nonprofit corporations. In reasoning the decision, the court strongly hinted that deferential, one-step review applies to Minnesota for-profit corporations. This presumed stance is appropriate given the importance of board autonomy and board authority in taking reasonable corporate risks for long-term growth.

The court holds that the business judgment rule also applies to Minnesota nonprofits. This decision is problematic because of the great variety of forms nonprofit corporations take. A more appropriate approach analyzes the relevant characteristics of the particular nonprofit to establish whether it is more like a trust or a business. Nonprofits displaying trust characteristics should be afforded less deferential, ordinary negligence review for board decisions. The *Janssen* fact-finding upon remand should focus on reasonable expectations of board risk-taking and the ability of members to diversify their investment risk. If the MPRA is expected to take sufficient risks to achieve long-term capital growth, their board is most likely entitled to deferential business judgment rule review.