Legal Research Development
An International Refereed e-Journal
(Peer Reviewed, Refereed & Open Access, Indexed, Journal of Law)
Web: www.lrdjournal.com; Email: journal1257@gmail.com
ISSN: 2456-3870
Vol. 4, Issue-III
March 2020
Impact Factor : 4.702 (SJIF)
e-ISJN: A4372-3116

Business Judgment Rule: Defense for the Directors in Cases of Alleged Breach of Duties

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Abstract

In this article researchers will explain about Business Judgment Rule and how it can be used as a defence by the directors' of the corporation. In simple language it can be said that the "Business judgment rule" is nothing but a judicially evolved doctrine derived out of case laws in the field of corporate laws. This doctrine has its origin in USA followed by U.K. The rule is in use in some form or the other in the common law countries e.g. whales, Australia, Canada, India &c. Australia has codified this rule under sec.1180(2) Corporations Act 2001, in South Africa Companies Act 71 of 200 section 76(4) provides for director's duty to work towards best interest of the business with due care, skill and diligence, in India section 166(2) of Companies Act, 2013 requires that for the benefit of different constituencies of a company a director must act bona fide to promote the object of the company. The Business Judgment Rule tries to protect the directors of the company by creating a safe harbour for those who works for the betterment and interest of the corporations in an honest manner and in good faith. The scope of the paper is restricted to mainly US decisions, which has seen the greatest development in interpreting cases, though certain important landmarks in the Indian and UK context have also been referred to. The paper is limited by secondary sources such as books, articles and reports available on the subject.

Key Words: Business Judgment Rule, Directors, Duties of director, Companies Act, Duty of care and skill, Duty of loyalty, Defences for breach of duty by director, standard of conduct, Takeover defences.

Meaning:

Business judgment rule is a misnomer as it does not have any compulsory content neither it is codified. It does not lay down any do's or don'ts for the directors of the corporations, decided in ***American Society for Testing Material v. Corrpro Companies Inc*.**[1] It calls for less interference by the courts as under this rule courts presume that the directors of who deal with the affairs of the corporation

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[1]. A, 02-7217, 2005 Wl. 1941653 (e.d. Pa Aug, 2005)

and take decisions with respect to management, takeovers, merger, acquisition etc. will do it in a bona fide manner and in the interest of the company.

Under this rule one can challenge actions of the board of directors but again due to above mentioned presumption the burden of proof lies on the Plaintiff held in ***Cinerama, Inc. v. Technicolor*** [2] to give evidences showing that the directors of the company breached any of their fiduciary duty which they owed towards the corporation like duty of care, loyalty, good faith, on an informed basis and if they fail to do so the rule protects the directors and their decisions.

Hindsight v Foresight

"The hindsight of judges is not sufficient for judging the foresight of directors."

The business judgment rule is deep-rooted in history for more than 100-year in where courts usually avoid replacing the decision of the board with judgment of court.[3] **In *Re Walt Disney Co. Derivative Litigation***.[4], court said that the spirit of this rule is that courts will not apply 20/20 hindsight to prognosticate the director's decision except in atypical cases where transaction cannot seems to be so erroneous on its face that directors approval fails the test of business judgment rule, because as held in *Dodge v. Ford Motor Co*. - "nothing is as easy as to be wise after the event."[5] The simple question to be asked is whether judges can perform directors' function efficiently? Can they take future business decisions without knowing the exact outcome? For deciding whether the path taken was reasonable or not after the happening of an even is not a difficult task but to foresee the outcome prior to that is.[6] For directors who fulfills the conditions of the rule are not liable to the stockholders for decision that turns out to be bad even if that decision turn out to be bad in hindsight.[7] Reason being that simple negligence alone is not sufficient for holding an officer or director personally liable to the corporation.

In the words of **Franklin Gevurtz**:[8]

'In black letter, the 'business judgment' rule sustains corporate transactions and immunizes management from liability where the transaction is within the powers of the corporation (intra-vires) and the authority of management, and involves the exercise of due care and compliance with applicable fiduciary duties.'

[2], 663 A.2d at 1162 (Del. 1995).
[3] 170 N.W. 668 (Mich. 1919).
[4] 731 A.2d 342, 262 (Del. Ch. 1998)
[5] Baruch Fischhoff; Hindsight v Foresight: The Effect of Outcome Knowledge on business decisions
[6] Reid hastie & W.Kip Viscusi: What juries can't do well: The Jury's performance as a risk manager;1998, Arizona.L.Rev.
[7] Louisiana World Exposition v Federal Insurance Co, 864 F2d 1147, 1151 (5th Cir 1989)
[8] Dennis J. Block, Nancy E. Barton, and Stephen A. Radin, The business judgment rule: Fiduciary duties of corporate directors (5th ed. 1998) Aspen Law & Business, Gaithesburg, Maryland (20878).

FIDUCIARY DUTIES:

In *City equitable Fire Insurance Co.* as per Romer J.[9]- Fiduciary duties means duty to act as trustees, but to expound directors as trustees does not hold to be strictly perfect nor unfailingly helpful today in the present scenario calling directors' as the trustees of the company or its property would be a misnomer instead they can be said to be the agents of the company. By referring them as an agent they stand in fiduciary relationship to the company. The duties of care and good faith which this relationship puts are virtually similar to those imposed on trustees, and to this extent the explanation "trustee" still holds well. Therefore directors acting as trustees are required to carry out the affairs with a view to promote common interest of the stakeholders and not their own interest. By virtue of acquiring office they undertake to give their judgment in the best interest of the company, unfettered by any inimical interest of their own.'

In ***Permanent Building Society (in liq) v. Wheeler*** [10] decided that fiduciary powers and duties of director may be exercised only for the purpose for which they were conferred and not for any other subordinate or improper purpose. It must be shown that the major purpose was improper or subordinate to their duties as directors of the company. The Court shall determine whether but for any the dishonest, corrupt or subordinate purpose the directors would have indulged in the act impugned.

Lastly, we can see from catena cases that if put in application, the business judgment rule forbids a judicial review of a board's decision, regardless of the accuracy or the brilliance of a decision. The rule of presumption notably not only does it safeguard risk involving decisions, but as courts and professors radiantly tell us it also guards against imprudent, horrendous, and egregious decisions,[11]whereas tort law would never allow the fool person defence.

DUTY OF CARE AND SKILL

The directors of the corporation are having fiduciary duties towards the corporation namely duty of care, duty of loyalty and duty to carry out their work lawfully. Of which duty of care concerns us the most with respect to business judgment rule. Putting it simply we can say that directors while managing the functions of the corporation are required to act as a prudent man will do in ordinary circumstances and the same to be in the best interest of the company.

Actions of the directors are guarded by business judgment rule and presumption is that any decision taken by them would not go against the interest of the corporation unless such decisions are a

[9] Re [1925] Ch. 407 at 426
[10] (1994) 14 ACSR 109 at 137
[11] In re Caremark Int'l Inc. Derivative Litigation., 698 A.2d 959, 967 (Del. Ch. 1996).

complete sham or waste. Under this rule decisions which are so one sided that a prudent man would not consider the same say for example agreeing for low bid during takeovers, paying more for acquiring assets, going wrong while deciding for mergers etc. He is under a moral duty to act carefully because his actions might result in injury to others thus it involves substantial risk. Say for example a doctor owes a duty of care towards his patient while operating him.

The duties imposed on the directors can be identified in following ways

- Duty to conduct business of the corporation and monitor the same in an informed manner.
- Duty to enquire into the information received by having regular follow ups.
- Duty to apply pr3udent decision making methodology.

Under duty of care directors will not be responsible for any bad judgment but they would be questioned if they fail to apply reasonable decision where required. The definition of care as given in the case of ***Graham v. Allis-Chalmers Manufacturing Co***. is followed as a guiding rule for standard of care; care was defined as "gross negligence"[12]. Two questions were discussed in this case firstly what amount of care is to be applied by the director as required by law and secondly in case of supervision of employees what degree of care is required by them. Answering the first question court decided in ***Graham v. Allis-Chalmers Manufacturing Co.***[13]that: "amount of care which ordinarily careful and prudent men would use in similar circumstances" they are not required to act as an expertise in that field would do[14]. One thing to be pointed here is that duty of care may not be the same in all circumstances and degree of care may vary depending upon the case and situation. In another leading case of ***Case v. New York Central Railroad Co.***, the court lowered the standard of duty of care based on the fact that a majority-minority relation had appeared.[15] Whereas in the case of ***Treadway Companies Inc. v. Care Corporation***[16], the majority acknowledged the lack of correspondence in case law and held that directors' proper and good faith conduct insulate them from liability.

Duty of Loyalty:

Amongst fiduciary duties of the directors next comes duty of loyalty it demands director to be fully loyal to the corporation in all times. It also requires them to avoid decisions having possible conflicting interest, by doing this they stop them from indulging in any self-dealing or taking advantage of position to have personal gain. In the case of ***NorlinCorp. v. Rooney Pace Inc.***[17]**,** it was held that the

[12] As opposed to simply negligence, gross negligence is considered a voluntary disregard of the need to use reasonable care.
[13] 78, 188 A.2d 125 (Del.Supr. 1963) at 130.
[14] Walter, p 654 note 31.
[15] Walter p. 657
[16] 638 F.2d 357 at 382
[17] 744 F.2d 255, 255 (2nd Cir. 1984). at 255, 264.

main underlying purpose of the duty of loyalty is to prevent the directors to act in their own interest; to prohibit self-dealing that inheres in the fiduciary relationship. With duty of loyalty come many other responsibilities upon the director. They are required to keep any information received in their official capacity as confidential and therefore obligated not to disclose the same. Under business judgment rule a mere claim that the director is self-interested without any further evidence does not nullify the business judgment rule presumption.[18] The Delaware Supreme Court stated in the case of Cede that a careful director shall exercise his or her duty of loyalty in order to protect the interest of the corporation, as well as, refrain from causing injury to the corporation through depriving it from its profit, advantage or enable it to make reasonable and lawful exercise of its powers.[19]

The Duty of Care and the Business Judgment Rule: Anallysis

"The Duty of Care and the Business Judgment Rule are Bound Together in an Enigma."[20]

The director's duty of care is frequently kept parallel with duty of care in tort law.[21]At the point when company law expresses that an executive should go about as a "normally cautious and judicious" individual as held in ***Graham v. Allis-Chalmers Mfg. Co***.[22], and breach of 'duty of care' is characterized as "gross negligence."[23] Under a right account of the tort homology, the duty of care and the business judgment rule are not anti-poles of a mystery, but rather are corresponding standards overseeing obligation and its addendum.

Two principles play major role here. First under the tort precept of industry traditions, the extent of a director's duty of care mirrors the inferred 'standard of care' that would be embraced by business members. A tort based suggestion is reliable with the predominant offer-acceptance hypothesis of corporate law, and it demonstrates that the carelessness standard would not make a difference to the substance of business choices. Second, theories of immaculate lucrative misfortune give the establishment standards to decide and suggest that duty of care on part of directors' does not envelop carelessly delivered business misfortune.

The classic case of ***Smith v Van Gorkom***[24] court holding the director's liable decided that the most apt criteria of review was "gross negligence" and for the first time stated that there was breach of duty of care with reference to the business judgment rule thus Delaware Supreme Court held that board's met this standard. Many years later Delaware Apex court again ruled that directors are liable for

[18] Cede at 634.
[19] Cede at 361
[20] William T. Allen et al; 'commentaries and cases on the law of business organization' 256 (2d ed. 2007)
[21] Marcel Kahan & Edward B. Rock; When the Government is the Controlling shareholder, 89 TEX. L. REV. 1293, 1327 (2011)
[22] 188 A.2d 125, 130 (Del. 1963).
[23] 488 A.2d 858, 873 (Del. 1985).
[24] 488 A.2d 858, 873 (Del. 1985).

breach of duty of care on their part in ***Cede & co. v. Technicolor's, Inc.***[25] case was almost similar to that of ***Van Gorkam (supra).*** In chancery court, Chancellor William Allen, pronounced "grave doubts" that the directors' fulfilled the *Gorkam (supra)* standard.[26]

In both the above mentioned cases the BJR did not safeguard the board because of the finding of breach of duty on their part. In Delaware, the duty of care is restricted by substantive-procedural tussle which was expressed in ***Brehem v. Eisner***[27]:

'As for the plaintiffs' contention that the board flunk to exercise "substantive due care," we should note that such a notion is alien to the business judgment rule. Courts do not assess, contemplate or quantify directors' actions. We do not even determine if they are fair-minded in this context. Due care in reference to the decision making is that process is adopted with due care only.'

A new concept of business judgment was articulated in ***Arson v. Lewis*** [28] which says that rule is nothing but a presumption that while making business decisions the board acted on an informed basis, bonafide in honest belief that the decision so taken was in the best interest of the company.[29]

Kamin v. American Express Co.[30] is a notable instance of business judgment rule at work. In this case American bank bought stake in an investment bank, but later its value declined and board decided to divest the same. Board had two options either to sell the stake or to distribute it by way of special in-kind dividends to the shareholders. By going with the first option they would have incurred $25 million loss on turnover which would result in tax saving of approximately $8 million. And distribution of dividends would have saved loss but would have forfeited tax advantage. The board after evaluation and going through both the options made a wrong decision and issued special dividends. Board believed that a reduction in income would lower the share price. The directors wanted to take $8million cash on the table or no cash at all.

Prima facie the decision taken was wrong was clear still court dismissed plaintiff's appeal by applying doctrine of business judgment rule. As board was reasonably informed and went through proper process with due care and skill. Held that: board's mistake "presents no basis for the superimposition of judicial judgment, so long as it appears that the directors have been acting in good faith."[31]

Therefore business judgment rule can be substantiated on several policy grounds. **First reasoning** in favor of business judgment rule is that courts are unskilled for reviewing business

[25] 634 A.2d 345 (Del. 1993).
[26] 17 Del.J. Corp. L. 551, 560 (1992),
[27] 746 A.2d 244 (Del. 2000).
[28] 473 A.2d 805 (Del. 1984).
[29] Id. at 812.
[30] 383 N.Y.S.2d 807 (1976)
[31] Kamin, 383 N.Y.S.2d at 812

decisions. Judges and experts have suggested that complication of business is not within the intellectual reach of courts. By saying that it is beyond competence of judges doesn't mean that decision so taken by the board is correct. In ***Dodge v. Ford Motor Co.***[32] court held that "the judges are not business experts." In ***Auerbach v. Bennett***[33], court said that: 'courts are essentially ill equipped with business matters and therefore rarely called to judge what should be a reasonable business judgments.' Thus courts practically are not well equipped to handle efficiently complex business decision making.[34] Also judges' lack required competence to evaluate multiplex corporate decisions[35] because they lack special knowledge with respect to working of corporations. Still many decisions have been reviewed judicially in the past. And they interfere only when plaintiff's able to rebut the presumption of business judgment rule.

Second reasoning in favour of business judgment rule relates to 'standard of conduct' versus 'standard of review' digress in corporate law. Standard of conduct on part of directors require duty of care which is an objective norm facilitating directors' direction on how to manage the business and take business related decisions effectively. While standard of review is the legal rule with respect to business judgment rule which provides legal standard to courts to assess legal responsibility of directors'. In other areas of law for example law of tort, review by courts and standard of conduct both relates to one standard that is for the purpose of judicial review. Whereas in corporate law the above mentioned standards are said to digress because of "institutional nature of corporation"[36] directors usually try foreseeing the tentative outcome of their decision. They proceed on incomplete data and information and on the basis of required rationality. Keeping the standard of review by the courts and standard of care required by the directors' at par would result in great bias. For the judges deciding on matters which already took place given what is the outcome foresee ability is not needed because all the information relating to such decision are available which makes their task easy. Thus dichotomy of these two standards shows that directors' duty is a fiduciary one and not legal duty which is backed by force of law. And therefore minimizes courts role and tries to explain academically the concept of divergence between role of directors' and that of courts in corporate law.

[32] 170 N.W. 668, 684 (Mich. 1919)
[33] 393 N.E.2d 994, 1000 (N.Y. 1979)
[34] 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, 490 (1990)
[35] RobertJ. Haft, Business Decisions by the New Board: Behavioral Science and Corporate Law, 80 MICH. L. REv.1,15 (1981)
[36] Melvin Aron Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 fordham law. rev. 437 (1993);

Defenses for Breach of Duties:

There are mainly three kinds of defences that a director can utilize in case of an alleged breach of duty. They are stated below:

- The business judgment rule
- Reliance on others
- Use of a delegated power

Of all the three we are concerned here with the business judgment rule. In case of an alleged breach of duty by a director the doctrine of business judgment rule can be taken as defense by the directors but given that it is an un-codified law its effectiveness continues to be skeptic and a matter of debate. No director can take the defense of Business Judgment Rule completely to avoid liability for breach of duty of due care and skill. The scope of this rule is very narrow as it is applicable on 'business judgments' only.

Takeover Defenses:

Hostile takeovers are not very common in India. Advanced takeover defenses are majorly found in United States. The doctrine of Business Judgment Rule in USA has evolved from case laws having different sates having their different laws with respect to Business Judgment Rule. Delaware corporate law being the most developed one in this field.[37]

In the case of ***Aronson v. Lewis***[38] held: the business judgment rule presumes that while making business decisions directors of a company acted on an informed basis, in honest belief and in good faith and action taken by them was in the best interest of the company.

In ***Smith v. Van Gorkom***[39] in a case of cash out merger a group action was brought by shareholders. CEO after meeting a takeover specialist decided for cash out merger after having discussion with the specialist, without doing any adequate valuation of the proposal. And called a special meeting and persuaded directors to approve the same and place it for voting before the shareholders. Question framed by the CEO at the meeting was not as to whether price decided is the highest obtainable one, but that: whether price arrived at is fair one and the same should be placed before the shareholders for accepting or rejecting it. The Board of Directors after going through a presentation and without having any documents regarding the proposal decided to put forward the same for shareholder vote.

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[37] E. Norman Veasey; commentary from the bar: the new incarnation of the business judgment rule in takeover defences. Delaware Journal of Corporate Law WINTER, 1987

[38] 473 A2d at 812

[39] 488 A2.d 858; 46 A.L.R.4th 821[1]

Held: the board of directors were grossly negligent while accepting the proposal and acted without due care and in an uninformed manner while agreeing to the merger proposal. Directors are required to go through the proposal before placing the same before the shareholders. Board cannot abdicate their duty by putting it before the shareholders.

In Van Gorkom case court observed that even if there was substantial premium in the merger proposal price merger but other sound factors were not present and in their absence for evaluation mere fact of high price alone cannot be considered as the deciding factor for accessing the fairness of the proposal. Therefore just because a company is doing well does not mean that it cannot do any better.

Conclusion:

The aim of the business judgment rule in overpowering a risk involved corporate scenario is in part summarized by several former Vice-Chancellors of the Delaware Court of Chancery who write:

'If law-trained judges are permitted to make after-the-fact judgments that business persons have made "unreasonable" or "negligent" business decisions for which they must respond in monetary damages, directors may, in the future avoid committing their companies to potentially valuable corporate opportunities that have some risk of failure. Highly qualified directors may also avoid service if they face liability risks that are disproportionate to the benefits of service.'[40]

At present the scope of this rule as judicially interpreted is that Board of directors of a corporation in managing the corporate affairs are bound to use that amount of care which, ordinarily, careful and prudent men would use in similar circumstances. A director must have such degree of skill that "may reasonably be expected from a person undertaking those duties" – as held in Norman v. Theodore Goddard.[41] Referring to the case above it was held in a subsequent case that "courts may not in future be prepared to accept minimalistic standard of competence said to be tolerated by law" and that, courts may "Impose an increasing objectivity in determining whether directors have acted reasonably".

In the end we need to ask one question whether this rule is working in real sense or not? No doubt judicial review of corporate decision is done with the help of hindsight of judges whereas directors when taking any business decisions foresee the result and evaluate the options and choose one which will yield maximum benefit to the corporation and its stakeholders. The decision might not turn

[40] W Allen, J Jacobs & L Strine, Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny As a Standard of Review Problem (2002) 96 Nw. U.L. Rev. 449
[41] (1991) BCLC 1028:

out to be favorable in all the circumstances and once failed should not be taken as ground for holding the board personally liable as it is not possible for them to foresee the exact outcome and to review their decision would be unfavorable with approval of hindsight. But again other aspect to this is how far is it fair to give such substantial protection to the board of directors while duties they owe towards company as a fiduciary is getting casual. Say for example judicial reviewing of actions which are evident business wrong or instances where director would be able to understand that decision will be detrimental for the company in such situations protection under the will turn out to be against the interest of corporation and there courts need to step in and take strict actions and should not follow the presumption rule given the change in business era it will be desirable to have some altercations in the rule if not for stakeholders as a whole then at least from the perspective of shareholders.

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