DIRECTORS' ERROR OF JUDGMENT VERSUS BUSINESS JUDGMENT RULE: WHAT ARE THE RULES OF THE GAME?

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ABSTRACT

The theoretical objective of the business judgment rule and its practical implications underscore the delicate balance that needs to be maintained between the authority of directors to make corporate decisions and the need to hold directors accountable for such decisions. A choice of the appropriate balance appears to be elusive in contemporary concepts and application of the rule. Amidst the divergent judicial opinions and legal commentaries, this article distils the issues from the original formulation and application of the rule as currently contained in the concepts of the rule as a substantive standard of liability and as a standard of judicial review. This article makes recommendations that offer guidance for the formulation of standard rules to determine how directors' error of judgment can be addressed under the business judgment rule.

Keywords: Business judgment rule, directors' error of judgment, fiduciary duties, directors' accountability, standard of liability, standard of judicial review

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1. Introduction

For over two centuries the business judgment rule has performed a relatively straightforward task in the corporate governance system, namely, protecting company directors from liability for honest mistakes and error of judgment[2]. But Bazelon has argued that the business judgment rule which began as a minor exception, is now so dominant a winning argument that the only fun left is trying to prove that it does not cover absolutely all forms of corporate misconduct[3]. From the early cases[4], the legal implication of the business judgment rule is that the court would excuse directors of a company from liability for the consequences of a mistaken act that is against the interest of the company.

As opined in *Hodges v New England Screw Co*[5], one of the early cases on business judgment rule, ‘‘a Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake’’. It was also held in a similar case that an ‘‘honest mistake of business judgment on the part of directors is not reviewable by courts’’[6]. The reason for this case law is that the business judgment rule is a presumption in law that the directors of a company act in good faith and in the interest of the company when acting on behalf of the company.

In the case of *Aronson v Lewis*[7] Justice Moore defined the business judgment rule as ‘‘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 was taken in the best interests of the company’’. Consequently, company directors enjoy a presumption of sound business judgment, and absent exceptional circumstances the court will not substitute its own notions of what is or is not sound business judgment.

However, the implication of Bazelon’s argument is that in judicial application, the business judgment rule has become more of a general sword of corporate malfeasance instead of a special directorial shield against shareholders’ attack of directors for error of judgment in making corporate decisions. The theoretical objective of the business judgment rule and its practical effect underscore the delicate

[2] Smith, D. Gordon, (2015). The Modern Business Judgment Rule: Research Handbook on Mergers and Acquisitions, BYU Law Research Paper Series No. 15-09, Available at SSRN: https://ssrn.com/abstract=2620536
[3] David Bazelon, (1967). Clients Against Lawyers, Harper’s Magazine, 104, p. 112 quoted in Lyman P.Q. Johnson, (2005). Corporate Officers and The Business Judgment Rule. Business Lawyer, Vol.60, p. 439
[4] See Hodges v New England Screw Co (1853), 3 R.I. 9, 18; Dodge v. Ford Motor Company (1919) 204 Mich. 459; Krasnick v Pac. E. Corp. (1935), 180 A. 604, 607; Aronson v. Lewis (1984), 473 A.2d 805
[5] (1853), 3 R.I. 9, 18
[6] Krasnick v Pac. E. Corp. (1935), 180 A. 604, 607
[7] (1984), 473 A.2d 805

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balance that needs to be struck between the authority of directors to make decision on behalf of the company and the need to hold the directors accountable for such decisions.

For instance, the fiduciary duty of care requires that directors exercise reasonable care in making corporate decisions, but the business judgment rule requires that courts respect directors' decisions and should not second-guess such decisions. The argument of Bainbridge is that ''corporate decision-making efficiency can be ensured only by preventing the board's decision-making authority from being trumped by courts under the guise of judicial review''[8].

Authority and accountability are therefore in constant tension because seeking to hold directors accountable for their decisions necessarily reduces the efficiency of corporate decision making. Conversely, deference to directors' authority necessarily entails a risk of opportunism and even plain carelessness[9]. A choice of the appropriate balance between directorial authority and accountability would implicate two contemporary concepts of how the business judgment rule may be better understood and applied.

First, in its original formulation under common law the business judgment rule may be understood and applied as a standard of liability by which courts review the decisions of company directors[10]. In that context it functions as the standard against which a consequential decision of directors is examined for the purpose of deciding whether to attach liability to such directors or not. Second, a proposition by Bainbridge is that the business judgment rule is ''better understood as a doctrine of abstention pursuant to which courts in fact refrain from reviewing board decisions unless exacting preconditions for review are satisfied''.

A pertinent question that emerges from both concepts is whether the same conditions would need to exist if the court is to apply the business judgment rule as a standard of liability for directors' decision emanating from error of judgment, and where the court is to refrain from reviewing such decision. In the alternative, would the same ''preconditions'' for judicial review be also applicable in the context of the business judgment rule as a standard of liability.

[8] Stephen M. Bainbridge, (2004). The Business Judgment Rule as Abstention Doctrine, 57 Vanderbilt Law Review 83

[9] ibid

[10] See William T. Allen et al., (2002). 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, 96 NW. U. L. REV. 449; Melvin Aron Eisenberg, (1993). The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 Fordham Law Review 437, 444-45

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This article seeks to proffer answers to these questions by examining the current legal position on the application of the business judgment rule. Amidst the divergent judicial opinions and legal commentaries, the objective of this article is to distil the standard rules for determining how the business judgment rule should be applied where directors made decisions as a result of error of judgment – where directors' management decision results in harm or loss to the company.

2. Business Judgment Rule in its Original Application

From its common law origin, the business judgment rule is meant to protect directors of company from liability for error of judgment made in their management decisions. Because directors stand in a fiduciary relationship with their company the law allows them a degree of misjudgement when their decisions turn out negative for the company. However, for business judgment rule to apply directors must act in good faith and must not be personally interested in the transaction that is called to question. Directors may be precluded from taking advantage of the rule if their conduct amounts to an egregious breach of their fiduciary duties.

In this original meaning and application, the business judgment rule has evolved as part of English and American common law for more than 200 years[11]. For instance, it is noted that business judgment rule was first suggested in about the first half of the eighteenth century by an English court which held that directors should not be liable for decisions made in good faith on behalf of the company even if such decisions have unintended negative consequences[12]. In the earliest relevant case of *Charitable Corp v Sutton*[13], the Lord Chancellor of England opined that directors ''may be guilty of acts of commission or omission, of mal-feasance or non-feasance'' but where ''acts are executed within their authority though attended with bad consequences, it will be very difficult to determine that these are breaches of trust''[14].

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[11] For clarification, this article is based on the United States of America's jurisprudence on business judgment rule. By far, the US is the most developed common law jurisdiction in terms of the business judgment rule. In particular, the State of Delaware is generally known to be the headquarters of corporate law in the US with more than 47% of the fortune 500 companies having their registered offices in the State. Delaware sets the pace and pushes the frontiers of corporate law in the US. In the case of Kamen v Kemper Financial Services Inc (1991), 908 F.2d 1338, 1343 the US Supreme Court, per Justice Marshall, referred to the Delaware Supreme Court as the ''Mother Court of corporate law''. Accordingly, the case law examined in this article is mainly from the State of Delaware appellate and Supreme courts.

[12] M.M. McMurray, (1987). An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule, 40 Vand L Rev 605, 605. Available at: https://scholarship.law.vanderbilt.edu/vlr/vol40/iss3/4

[13] (1742) 2 Atk 400, 26 Eng Rep 642

[14] Despite these earliest English cases, the United Kingdom does not have the business judgment rule the way it is developed in the US. The UK Law Commission even noted that the US-style business judgment rule was not necessary to be included in the Companies Act 2006 because of the firmly established presumption of directors' good faith and

The Lord Chancellor noted that it would be unfair ''after bad consequences have arisen from such executions of their power, to say that they foresaw at the time what must necessarily happen; and therefore, were guilty of a breach of trust, provided that the directors acted with ''fidelity and reasonable diligence''. According to Mantese and Fields[15], the concepts promulgated in *Charitable Corp v Sutton* may have first come to American common law in the 1829 Louisiana Supreme Court decision in the case of *Percy v Millaudon*[16]. In that case, a bank's shareholders had sued the directors for misconduct. The court opined that directors should not be liable for mistakes and error of judgment ''if the error was one into which a prudent man might have fallen''.

From the subsequent cases that adopted and expanded this legal opinion, *Percy v Millaudon* is therefore considered as the first American case to apply the rule of judicial deference for directors' errors of judgment. For example, in *Godbold v Branch Bank*[17], it was held that directors are not responsible for even ''absurd and ridiculous'' errors of judgment if they are made honestly and ''within the scope of the directors' powers''. The Court noted that the illegal act in issue was committed by the director in good faith and in the exercise of directorial power hence the court declined to impose liability.

According to the court in *Godbold v Branch Bank*, while directors need to have a competent knowledge in order to be able to discharge their duties, nobody would become a director if ''perfect knowledge'' is the requisite qualification. This point was reiterated in *Scott v Depeyster*[18] where the court opined that directors are not required ''to have attained infallibility''. In summary, the crux of the early case law on business judgment rule is that directors do not incur liability when they exercise reasonable business judgments that later prove to be wrong, or against the interest of their company. The emergent case law also contained the exceptional circumstances in which the rule would not apply.

The exceptions are evident in courts' opinions which originally conceptualized the business judgment rule. In *Percy v Millaudon*, the court noted that directors are liable only for business mistakes ''of

deep tradition of non-interference with business decisions in the UK legal history. See the Law Commission, (2001). Thirty-sixth Annual Report: HC 642. Available at: https://assets.publishing.service.gov.uk/media/5a7cd62fe5274a34d8d333ce/0642.pdf

[15] Gerard V. Mantese and Emily S. Fields, (2020). The Business Judgment Rule. Michigan Bar Journal. Available at: https://manteselaw.com/wp-content/uploads/2021/03/The-Busienss-Judgment-Rule-Mantese-and-Fields.pdf

[16] (1829) 8 Mart (n s) 68

[17] (1847) 11 Ala 191

[18] (1832) 1 Edw Ch 513; 6 NY Ch Ann 229

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so gross a kind that a man of common sense, and ordinary attention, would not have committed them''. The court also noted in *Hodges v New England Screw & Co*[19] that directors ''ought to be liable'' if their conduct is the result of ''want of proper care''. From these and subsequent cases, it appears that the business judgment rule would not apply if directors were in breach of their fiduciary duty to exercise due care, skill, and competence ordinarily expected in directorial decision-making for company.

For instance, in the case of *Hun v Cary*[20], the court held that directors are ''bound not only to exercise proper care and diligence, but ordinary skill and judgment'', and if damage is caused by their want of judgment, they cannot excuse themselves by alleging their gross ignorance. The court stated further that errors of judgment are not excused by ''gross ignorance'' and that directors must ''exercise proper care and diligence''. The court had pointed out in the earlier case of *Goldbold v Branch Bank*[21] that ''bank directors are not responsible for errors of judgment unless the error be of the grossest kind''.

In other cases, the court indicated that when directors exercise business judgment, courts will not interfere unless their judgment is ''a wilful abuse of their discretion, or the result of bad faith, or of a wilful neglect or breach of a known duty'', and that ''in the absence of fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors''[22]. From the case law, the original legal position on business judgment rule is that directors enjoy a presumption of sound business judgment, provided their decisions can be attributed to any rational business purpose that is in the interest of the company.

If the decision of directors turns out to be wrong but evidently connected to a reasonable business purpose of the company then such wrongful decision would not be considered as a product of fraud, bad faith, gross overreaching, wilful abuse of discretion, want of proper care and diligence, or any other breach of a fiduciary duty. In the early cases the courts were less concerned about analytical scrutiny of the elements of the fiduciary duties for the purpose of determining whether a breach had occurred to prevent the application of the business judgment rule.

The twentieth century era when the courts began to critically weigh the rule against directors' fiduciary duties, particularly the duty of loyalty, due care, and good faith, marked a significant

[19] (1853), 3 R.I. 9, 18
[20] (1880) 82 N.Y. 65, 74
[21] (1847) 11 Ala. 191, 200-01
[22] In Panter v Marshall Field & Co (1980) 486 F. Supp. 1168, 1194

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development in business judgment rule jurisprudence. Since then, business judgment rule has been subject of different judicial and academic analyses in terms of purpose, justification, and basis of application where breach of a fiduciary duty is alleged or implicated.

3. Development in Business Judgment Rule

Considering the development in case law in the last century, application of business judgment rule is no longer ‘‘a relatively straightforward task’’ but follows critical analysis of the rule in the context of the relevant fiduciary duty that pertains to directors’ conduct. In that context, the business judgment rule is applied both as an evidentiary presumption and as a substantive standard of liability. For instance, as a substantive standard of liability any want of good faith, due care, loyalty, and material conflict of interest on the part of directors will rebut the business judgment rule and require the directors to establish that the challenged decision or transaction was fairly in the interest of the company.

As an evidentiary presumption, if a shareholder who alleges a wrongful directorial decision that hurts the interest of the company is not able to rebut the presumption that the directors acted in good faith in the interest of the company, the business judgment rule would apply to protect the directors and uphold the decision. According to the court in the case of *Citron v Fairchild Camera & Instrument Corp*[23], if a shareholder plaintiff ‘‘fails to meet her burden of establishing facts rebutting the presumption, the business judgment rule, as a substantive rule of law, will attach to protect the directors and the decisions they make’’.

The courts determine whether the rule should apply after weighing the presumption against the implications of the alleged breach of fiduciary duty. The case of *Guth v Loft Inc*[24] decided about the first quarter of the twentieth century exemplified how the application of the business judgment began to be dependent upon the analysis of the implicated fiduciary duty. In the case, a controlling director had manipulated events for the purpose of taking up an opportunity that the company was interested in and could itself have exploited to its profit and more returns on investments for shareholders.

Chief Justice Layton noted in the case that the fiduciary rule demands of directors the most scrupulous observance of their duty, not only affirmatively to protect the interest of the company but also to refrain from doing anything that would work injury to the company, or to deprive it of profit or

[23] (1989) 569 A.2d 53, 64
[24] (1939) 23 Del Ch 255

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advantage which their directorial skill and ability might properly bring to the company. The Chief Justice further opined that where directors embrace the opportunity that is meant for the company, their self-interest will be brought into conflict with that of the company hence, the business judgment rule will not permit them to seize such opportunity for themselves.

It is in this respect that it has been argued that the business judgment rule reflects ‘‘an underlying distrust of the strict fiduciary duty to maximize shareholder returns’’[25]. And that the business judgment rule precludes liability where directors fail to maximize shareholder wealth[26]. In *Litwin v Allen*[27], after a critical analysis of the fiduciary duties of due care and loyalty for the purpose of determining whether the business judgment rule was applicable, the court held that directors are ‘‘required to conduct the business of a corporation with the same degree of fidelity and care as an ordinarily prudent man would exercise in the management of his own affairs of like magnitude and importance’’.

The court in *Litwin v Allen* summed up the dynamic interdependence relationship between directors' fiduciary duties and the business judgment rule. The court noted that the duty of care requires directors to ‘‘act honestly and in good faith, but that is not enough. Directors must also exercise some degree of skill and prudence and diligence’’. Adding that; ‘‘Directors will be liable for negligence, not errors of judgment or for mistakes while acting with reasonable skill and prudence’’. Thus, development in the case law on business judgment rule in the twentieth century has made the application of the rule to proceed from the prism of directors' fiduciary duties.

This development has made business judgment rule to be uncertain in application and indeterminate in objective because the rule no longer commands its original presumptive form when it applied in all cases of director's corporate decisions until rebutted under the doctrine of waste. The doctrine of waste is a theoretical exception to the business judgment rule because it holds that some directorial decisions may be so egregious that liability may follow even in the absence of proof of conflict of interest or improper motivation[28]. As held in *Grogan v O'Neil*[29], it is where the ‘‘plaintiff must show

[25] Kent Greenfield & John E. Nilsson, (1997). Gradgrind's Education: Using Dickens and Aristotle to Understand (and Replace?) the Business Judgment Rule, 63 Brook Law Review, 799, 831
[26] D. Gordon Smith, (1998). The Shareholder Primacy Norm, 23 Journal of Corporate Law, 277, 286-87
[27] (1940) 25 NYS2d 667
[28] See the opinion of Chancellor Allen in the case of Gagliardi v. TriFoods Int'l, Inc. (1996) 683 A.2d 1049, 1052
[29] (2003) 292 F. Supp. 2d 1282; See also Glazer v Zapata Corp. (1993) 658 A.2d 176, 183 where the court defined ‘‘waste’’ as ‘‘an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration’’; and in re Lear Corporation Shareholder Litigation (2008) 967 A.2d 640, 657 as ‘‘a rigorous test designed to smoke out shady, bad faith deals’’.

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that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests''.

Though, courts may still frame the business judgment rule as a presumption that the directors acted in good faith and in the honest belief that they were acting for the best interests of the company, rebutting the presumption now tends to require the absence of a scintilla of breach of any of the fiduciary duties. It requires a judicial determination whether directors made or refrained from making a business decision consciously and in the exercise of their directorial powers. This approach inevitably beams a searchlight on which fiduciary duty was engaged and how the directors discharged such duty.

Two possible forms of applying the business judgment rule underscore two key questions whether the rule should be determine by[30]: an inquiry into the subjective motivation of directors, in which case the shareholder plaintiff shows that the directors failed to act in good faith and with an honest belief that their decisions were in the best interests of the company; or an inquiry into procedure, the plaintiff showing that the directors failed to fully inform themselves before making the decisions. Thus, in contemporary times different concepts of the business judgment rule has emerged.

4. Contemporary Concepts of Business Judgment Rule

Under the original formulation and application of the business judgment rule, directors are presumed to act with loyalty, due care, and in good faith as such the courts refuse to second-guess the merits of their management decisions, even if the company or its shareholders are harmed by those decisions[31]. From the development in the case law, the legal purpose of the business judgment rule is to protect directors from error of judgment or honest mistakes if they act with loyalty, due care, and in good faith.

However, this purpose of the rule is defeated if directors are judicially determined to have breached their fiduciary duties after a critical analysis of the duties in relation to the decisions they made. A central point that emerges from the development is that the business judgment rule has no place where directors have either abdicated their functions, or absent a conscious decision, failed to act. In such a

[30] Smith, D. Gordon, (2015). The Modern Business Judgment Rule: Research Handbook on Mergers and Acquisitions, op.cit

[31] Ibid

case, the courts would not bother to determine the directors' action or decision in relation to whether the business judgment rule applies.

This is in line with the holding in *Aronson v Lewis*[32] that where the claim is by reason of inexcusable unawareness or inattention the directors failed to take corrective or preventive action toward matters about which something should have been done to prevent harm to the company or its shareholders, the business judgment rule provides no defence. However, if the rule does provide a defence in that the directors acted and decided, the courts then critically inquire into the procedure adopted for arriving at such decision.

The epochal case of *Smith v Van Gorkom*[33] offers foundational support for the contemporary concepts of business judgment rule because in the case the directors made a management decision and the court had to inquire into the process leading to the decision. The case arose from a shareholder's claim that the decision of the directors of the company to approve a merger was in breach of the directors' duty of care. The directors had approved the merger of the company after a two-hour meeting in which they relied only on oral reports by the company's CEO and CFO to establish the company's value.

The court held that the business judgment rule did not avail the directors of protection because their decision suffered procedural errors and irregularities. According to the court, the directors ''failed to inform themselves of all material information reasonably available'', and that directors who fail to act in an ''informed and deliberate manner'' may not assert the business judgment rule as a defence to a claim of breach of fiduciary duty of care.

The directors were held disentitled to the defence offered by the business judgment rule not for *what* they decided but for *how* they decided it[34]. The court overlooked the substantive decision and instead focused exclusively on the procedural steps. Since *Smith v Van Gorkom* and till contemporary times the two dominant concepts of the business judgment rule, as may be gleaned from case law and legal commentaries, are whether the rule is understood and applied as a substantive standard of liability or as a standard of judicial review.

[32] (1984) 473 A.2d 805, 813
[33] (1985) 488 A.2d 858
[34] Lynn A. Stout, (2001). In Praise of Procedure: An Economic and Behavioral Defense of Smith V. Van Gorkom and the Business Judgment Rule. Available at SSRN: https://ssrn.com/abstract=290938 or http://dx.doi.org/10.2139/ssrn.290938

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4.1 The Concept of Business Judgment Rule as Substantive Standard of Liability

Bainbridge notes that the modern trend is to treat the business judgment rule as a substantive standard of liability[35]. The focal point is on directors' triad fiduciary duties of care, loyalty, and good faith and whether from the deposed facts the directors' conduct fell short of standard for the business judgment rule to apply and prevent liability, or to not apply and permits liability[36]. In determining whether directors have fulfilled their fiduciary duties of care from the facts of a particular case, the business judgment rule from this perspective permits the court to consider the quality of the directors' decision *vis-à-vis* their duty of care.

Therefore, the business judgment rule provides a judicial lens for determining if directorial conduct and the quality of the emergent decision incur or prevent directorial liability. If the court is satisfied that in reaching the decision in question the directors had acted with the interest of the company at the centre of their decision-making, the court would refrain from further inquiry based on the business judgment rule. Thus, the court would defer to the decision of directors where their conduct reflects due care for the interest of the company, and no basis would be found for disturbing the decision or attaching liability.

As noted by Justice Horsey in *Litwin v Allen*[37], ''for the rule of judicial deference to be invoked, directors of a board must be found to have met not only their duty of loyalty but also their duty of care''. Directorial conduct in relation to fiduciary duties therefore constitutes the standard for determining directorial liability. In particular, the duty of care – ''that amount of care which ordinarily careful and prudent men would use in similar circumstances''[38] – including the duty of good faith, plays a significant role in the concept of the business judgment as a standard of liability.

In one of the foundational cases that support this concept of business judgment rule[39], it was held that if in the course of management directors arrive at a decision for which there is a reasonable basis, and they act with due care and in good faith, as the result of their independent judgment, and uninfluenced by any consideration other than what they honestly believe to be in the best interests of the company, it is not the function of the court to say that it would have acted differently and to charge the directors for any loss or expenditures incurred.

[35] Stephen M. Bainbridge, (2004). The Business Judgment Rule as Abstention Doctrine, op.ct

[36] As the court held in the case of *Emerald Partners v Berlin* (1999) 726 A.2d 1215, 1221; ''a breach of any one of the board of directors' triad of fiduciary duties, loyalty, good faith, or due care, sufficiently rebuts the business judgment rule and permits a challenge to the board's action under the entire fairness standard''.

[37] (1940) 25 N.Y.S.2d 667

[38] Graham v Allis-Chalmers Mfg. Co. (1963) 188 A.2d 125, 130

[39] Casey v Woodruff (1944) 49 N.Y.S.2d 625, 642-43

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The case of *Shlensky v Wrigley*[40] exemplifies the concept of the business judgment rule as a substantive standard of liability because it contains standard-defining statements such as that ‘‘the courts will not step in and interfere with honest business judgment of the directors unless there is a showing of fraud, illegality or conflict of interest’’[41] – fiduciary duties which coincide with the triad duties of care, loyalty, and good faith. In the case, a minority shareholder claimed that the decision of the controlling directors to not install lights at a games’ stadium was made in breach of the duties because the decision was responsible for the low attendance of fans hence losses for the company.

The court held that since there was no obvious breach of the alleged duties the decision of the directors ‘‘was a correct one’’. The court opined that it was ‘‘beyond our jurisdiction and ability’’ to disturb the decision or find the directors liable because ‘‘the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision’’.

As may be gleaned from the cases[42], an understanding of the business judgment rule as a standard of liability is founded in the original meaning and application of the rule, where there is a presumption that directors act with due care, in good faith and in the interest of the company. This is consequentially different from an understanding and application of the rule as a standard of judicial review.

4.2 The Concept of Business Judgment Rule as a Standard of Judicial Review

In this concept, the business judgment rule is not an analysis of fiduciary duties, or a standard used to determine whether a breach of the duties has occurred in order to displace the rule and fix directors with liability. Rather, it is a standard of judicial evaluation of the procedure adopted by directors in arriving at their decisions. As the court noted in the case of *Omnicare Inc v NCS Healthcare Inc*[43],

[40] (1968) 237 N.E.2d 776
[41] See William L. Cary and Melvin Aron Eisenberg, (1995). Corporations: Cases And Materials 603 (7th ed.), p. 61, noting that it may be mere subjective good faith, it may be a requirement of rationality, or it may be gross negligence but the key point, however, is that the business judgment rule, so conceived, entails ‘‘some objective review of the quality of the board’s decision, however limited’’.
[42] For the line of cases, see Aronson v Lewis (1984), 473 A.2d 805; Howard Smith Ltd v Ampol Petroleum Ltd (1974) AC 821, 832; Harlowe’s Nominees Pty Ltd v Woodside (Lakes Entrance) Oil Co NL (1968) 121 CLR 483, 493; Graham v Allis-Chalmers Mfg. Co. (1963) 188 A.2d 125, 130; Krasnick v Pac. E. Corp. (1935), 180 A. 604, 607; Hodges v New England Screw Co (1853), 3 R.I. 9, 18; Dodge v. Ford Motor Company (1919) 204 Mich. 459
[43] (2003) 818 A.2d 914, 927

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the business judgment rule, ''as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors''.

Thus, while directors are presumed to act with authority and in accordance with their fiduciary duties, the court would review *how* directors have exercised their authority and discharged their duties in the particular decision that is called to question. In this concept, the presumption of good faith under the business judgment rule does not state a standard of liability because the court refrains from reviewing the substantive merits of directors' decisions but only their procedural conduct in cases where breach of good faith is alleged.

The business judgment rule is therefore understood and applied as a procedural guide for determining whether in making a business decision directors acted on an informed basis, in good faith and in the honest belief that the decision taken was in the best interest of the company. A notable and classic case for this concept of business judgment rule is *Cede & Co v Technicolor Inc*[44], which was based on the precedent of *Smith v Van Gorkom* because a shareholder had alleged that directors violated their duty of care when they approved a merger of the company.

Instructively, it was determined that the fair value of the company at the time of the merger was $21.60 per share, while the shareholders had been offered $23 under the merger agreement. Nevertheless, the court found gross negligence on the part of the directors after identifying ''five process failures, collectively amounting to a breach of the duty of care''. For example, the court found that the directors had failed to make a prudent search for better alternatives, that most of the directors had little information about the merger and its terms before the meeting at which they approved it, and that the board was not adequately informed before approving the merger.

Consequently, the court concluded that the directors ''failed to inform themselves fully concerning all material information reasonably available prior to approving the merger agreement''. In holding the directors liable, the court held that the plaintiff shareholder ''clearly met its burden of proof for the purpose of rebutting the rule's presumption''. This is because under this concept of the business judgment rule the burden falls on the plaintiff to ''rebut the presumption by introducing evidence either of director self-interest, if not self-dealing, or that the directors either lacked good faith or failed to exercise due care''[45].

[44] (1993) 634 A.2d 345
[45] Citron v Fairchild Camera & Instrument Corp (1989) 569 A.2d 53, 64

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The crux of the business judgment rule in this context is not a presumption that directors have acted well or not, but rather an inclination not to question the substance of directors' decisions where there is no proof that they have acted against the interest of the company. This is evident from the *Technicolor Inc* case where the shareholders were offered a share price that was higher than the company's share value at the material time. Judicial review of directors' conduct in cases of breach of fiduciary duties only acknowledges ''a requirement of what might be called procedural or process due care as a prerequisite for invoking the business judgment rule''[46].

In the subsequent case of *Brehm v Eisner*[47] the court rejected the notion of ''substantive due care''[48] and noted that; ''Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is process due care only''. The court stated further that the examination of the duty of care should focus on process only, such as whether directors reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

In sum, the concept of the business judgment rule as a standard of judicial review implies that the court will only review the procedural conduct of directors for the purpose of disallowing the rule if a plaintiff shareholder alleges a breach of fiduciary duties. If the plaintiff cannot show that the directors breached one of the duties, the court will almost always refrain from reviewing the substantive merits of the directors' decision. According to Smith, the ''court will not ask whether the board made the correct decision or the best decision. The case is effectively over''[49]

5. Toward Standard Rules for Applying Business Judgment Rule

It is arguable whether the conceptual bifurcation of the business judgment rule along the lines of standard of liability and standard of judicial review enhances the clarity of purpose and application of the rule. Both concepts of the business judgment rule derive from the development in the case law since the last two decades of the twentieth century and till contemporary times. As a substantive standard of liability, the business judgment rule essentially assumes its original common law formulation and application.

[46] Stephen M. Bainbridge, (2004). The Business Judgment Rule as Abstention Doctrine, op.cit
[47] (2000) 746 A.2d 244
[48] Which is the basis of the concept of the business judgment rule as a substantive standard of liability.
[49] Smith, D. Gordon, (2015). The Modern Business Judgment Rule: Research Handbook on Mergers and Acquisitions, op.cit

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But the concept of the business judgment rule as a standard of judicial review is extrapolated from the 1985 case of *Smith v Van Gorkom* which established a procedural or process due care, adopted and expanded in 1993 in the *Technicolor Inc* case, including the case of *Brehm v Eisner* in 2000. The two concepts of the business judgment rule appear to be two possible ways of contextualizing and applying the rule, and the choice of any of the two would depend on different factors such as jurisdictions, the facts of the case, the inclination of the particular court, the persuasiveness of legal counsel, amongst others.

Between the two concepts, there does not seem to be clear standard rules for determining when and where the business judgment rule would apply in cases of directors' error of judgment in decisions that breach any of the fiduciary duties. More than two decades ago, at the beginning of this century 21st century in the case of *McMullin v Beran*[50], the court opined that the business judgment rule ''operates as both a procedural guide for litigants and a substantive rule of law''. According to the court, procedurally, ''the initial burden is on the plaintiff to rebut the presumption of the business judgment rule''. And substantively, ''if the plaintiff fails to meet that evidentiary burden, the business judgment rule attaches and operates to protect directors from liability for making the decision at issue''.

The implication of the case law on the business judgment rule is that courts in common law jurisdictions may pick and choose which of the concepts of the rule to adopt and apply. It is therefore understandable that some jurisdictions have made statutory provisions for the business judgment rule. As far back as 1985, immediately after the *Smith v Van Gorkom* decision, the US State of Delaware amended its General Corporation Law to address the court's introduction of ''procedural or process due care'' concept under which it held directors liable for their management decision. A new provision introduced to the Law authorized corporations to adopt charter provisions insulating directors from liability for monetary damages for breach of the fiduciary duty of care[51].

In contrast, the US Model Business Corporation Act 2001 stipulates the standards of conduct for directors by providing that a director can be held liable to the corporation or any shareholder under requirements that amount to the business judgment rule such as good faith, disinterested business decision, and reasonably belief[52]. Directors' conduct that satisfies the requirements cannot result in liability while conduct that falls short of the requirements can only result in liability if it violates the

[50] (2000) 765 A.2d 910
[51] See section 102(b)(7) of the Delaware General Corporation Law 1985
[52] Section 8.31 of the Revised Model Business Corporation Act 2001

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standards of director liability as provided under the Act[53]. Both the Delaware Corporation Law and the Model Business Corporation Act do not expressly adopt or reflect the common law business judgment rule because their provisions mainly cover directors' fiduciary duties to corporations.

The most comprehensive and refinement of the business judgment rule in statutory form is the Australian Corporations Act 2001. Unlike under the common law, the Act expressly defines ''business judgment'' as ''any decision to take or not take action in respect of a matter relevant to the business operations of the corporation''[54]. The statutory requirements for the conduct and decisions of directors to be entitled to the business judgment rule are substantially adopted from common law precedents relating to directors' fiduciary duties of due care, good faith, proper purpose, conflict of interest, best interests of the corporation, and rational belief[55]. However, the provisions are couched as a defence to the fiduciary duty to offer ''a safe harbour for directors and officers'' of companies involve in risk-taking because ''a successful economy depends upon a certain level of corporate risk-taking''[56].

In the case of *Australian Securities and Investments Commission v Rich*[57] decided on the statutory provisions for business judgment rule, the court found in favour of the directors and upheld the directors' decision. This notable case shows that the Australian courts may be inclined to adopt the procedural due care concept of the business judgment rule with focus on how directors arrive at their decisions than the substance of the decision. For instance, the court examined how the director formed their belief about the best interests of the corporation and assessed the rationality of the belief on the basis of the information they obtained through compliance with the statutory provisions.

In holding that the directors complied with the statutory provisions to be entitled to the business judgment rule, the court noted in the *Rich* case that it is not to be assumed that the directors knew

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[53] see Gordon D. Smith, (1999). A Proposal to Eliminate Director Standards from the Model Business Corporation Act. 67 University of Cincinnati Law Review, 1201
[54] Section 181(3) of the Corporations Act 2001
[55] Section 180 generally of the Corporations Act 2001. Comparative analysis of the common law business judgment rule and the Australian Corporations Act 2001 is not intended here other than to point out the contextual differences between both legal regimes. For such comparative analysis, see Michael Legg and Dean Jordan, (2014). The Australian Business Judgment Rule after ASIC v. Rich: Balancing Director Authority and Accountability (2013). Adelaide Law Review, Vol. 34, No. 2, 2014; Andrew Lumsden, (2010). The Business Judgement Defence - Insights from ASIC v. Rich. Companies and Securities Law Journal, Vol. 28, No.3
[56] See Andrew Lumsden, (2010). The Business Judgement Defence - Insights from ASIC v. Rich. Companies and Securities Law Journal, ibid; See also the case of Australian Securities and Investments Commission v Rich [2009] NSWSC 1229 where the court noted that the business judgment rule could apply to the management decisions made by the directors and that the defence had a material impact upon their duty of care and diligence as provided under section 180 of the Corporations Act 2001.
[57] (2009) NSWSC 1229

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everything that they ought to have known, but only the things that they reasonably believed to be appropriate. From the academic analysis of the case[58], the interpretation of the Australian statutory provisions on the business judgment rule and its application in the *Rich* case indicate that it may require a considerable body of judicial analysis and precedents before clearer standard rules can emerge.

However, with the benefit of the original common law formulation and application of the business judgment rule, the development of case law, and the two prevailing concepts, including the Australian jurisprudence on the rule, there are certain clear guidelines that can be gleaned. The American Law Institute's Principles of Corporate Governance[59], based on more than two centuries of common law development of the business judgment rule, also offers some useful guidelines that can be adapted for the formulation of standard rules to determine the conduct of directors in their decision-making on behalf of companies. The following recommendations can constitute the standard rules for applying the business judgment rule[60].

5.1 Focus on process and not substance

There is need to be a clear distinction between judicial scrutiny of directors' decisions and a review of the process the directors used to arrive at the decision. For the purpose of determining the application of the business judgment rule, the focus should be on the process and not the substance of the decision. Judicial scrutiny of the substance of directors' decisions inevitably undermines the well-grounded justifications for the rule.

5.2 Decisions as product of active judgment

In order to determine whether the business judgment rule applies, directors' decisions in question need to emanate from an active and conscious exercise of judgment. Failure to make a decision for whatever reasons should not be considered in the context of the rule.

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[58] For examples, see Michael Legg and Dean Jordan, (2014). The Australian Business Judgment Rule after ASIC v. Rich: Balancing Director Authority and Accountability. Adelaide Law Review, Vol. 34, No. 2; Andrew Lumsden, (2010). The Business Judgement Defence - Insights from ASIC v. Rich. Companies and Securities Law Journal, Vol. 28, No.3; Neil Young, (2009). 'Directors Duty of Care and Diligence: A Review in Light of the Recent Decision in ASIC v MacDonald (No 11)' in R P Austin and A Y Bilski (eds), Directors in Troubled Times (Ross Parsons Centre of Commercial, Corporate and Taxation Law, 94

[59] See American Law Institute, (1994). Principles Of Corporate Governance: Analysis and Recommendations, section 4.01

[60] Some of these recommendations are also drawn from Michael Legg and Dean Jordan, (2014). The Australian Business Judgment Rule after ASIC v. Rich: Balancing Director Authority and Accountability. Adelaide Law Review, Vol. 34, No. 2,

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5.3 Presence of good faith and absence of personal interest

Rather than the ‘‘triad fiduciary duties, the good faith of directors and the absence of their personal interests should constitute the guiding light for determining the altruism of their decisions. Other fiduciary duties such as loyalty and due care ultimately leads the court into considering the substance of the decision in determining whether the business judgment rule should apply.

5.4 Informed decisions by directors

Focus on process through which directors make their decisions necessarily demands judicial scrutiny of how directors arrived at the decisions. In determining whether the business judgment rule should apply the court needs to be satisfied that directors were adequately informed of all material details and followed required stages of data collection and analysis, where necessary.

5.5 Onus of proof on plaintiff

The legal maxim, ‘‘who alleges must prove’’, needs to apply in claims that directors’ decisions are in bad faith and for personal interests. Based on the justifications for the business judgment rule[61], it is in the interests of the company, shareholders, and the society at large that the rule inures in favour of the directors. The party inviting the court to deny directors the benefit of the rule needs to show necessary proof for that purpose.

6. Conclusion

The theoretical objective of the business judgment rule and its practical implications underscore the delicate balance that needs to be maintained between the authority of directors to make decision on behalf of the company and the need to hold the directors accountable for such decisions. A choice of the appropriate balance between directors’ authority and directors’ accountability under the business judgment rule appears to be elusive in contemporary concepts and application of the rule.

[61] The justifications for the business judgment rule have long been identified to include: (1) the limited ability of judges and juries who are not business experts to evaluate complicated business decisions, (2) the need to encourage entrepreneurial risk taking by corporate directors who might otherwise avoid business risks (or even refuse to serve) if they faced potential negligence liability, (3) the availability of other mechanisms, such as employment and securities markets, to provide corporate directors with incentives to avoid mismanagement and (4) the voluntary assumption by shareholders of business risk in exchange for a potential return on their investment which is contractually unlimited. See Peter V. Letsou, (2001). Implications of Shareholder Diversification on Corporate Law and Organization: The Case of the Business Judgment Rule, 77 Chi.-Kent L. Rev. 179. Available at: https://scholarship.kentlaw.iit.edu/cklawreview/vol77/iss1/9

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Amidst the divergent judicial opinions and legal commentaries, this article distils the issues from the original formulation of the business rule as currently contained in both concepts of the rule as a substantive standard of liability and as a standard of judicial review. The recommendations proposed in this article can provide useful guidance for the formulation of standard rules to determine the conduct of directors as they make corporate decisions.

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