

The Business Judgment Rule

Partial Armor for Directors and Officers

by Michael L. Rich

A shareholder sues the board of directors derivatively on behalf of the corporation. The corporation or directors seeks legal representation to defend them from individual liability. The practitioner instantly thinks of the business judgment rule, the go-to defense in shareholder derivative litigation and various other director and officer liability lawsuits. It's common knowledge that the rule provides some degree of protection against many such actions. But when can this rule be invoked to shield from second-guessing or liability? How much armor does it really afford? There are some important questions the practitioner needs to consider regarding which party bears the burden of proof and how deferential the applicable law will be to his or her clients. This article addresses several of these important questions, and is intended as a basic primer on the business judgment rule as applied in New Jersey. It also discusses some nuanced differences between the law in New Jersey and its sister states, as well as some recent decisions.

The Director's Duty

Although shareholders own the corporation, it is the directors who are charged with the management of its business and affairs.¹ In actuality, the directors' role may be described more aptly as ensuring the corporation is effectively managed by its officers. In most closely held corporations, however, the directors, officers and shareholders are often the same individuals.

Directors owe to the corporation the duty of care, the duty of loyalty, the duty of disclosure, and the duty of good faith.² A director can violate these duties by commission—such as violating a law or acting intentionally to serve a purpose other than the good of the corporation—or by omission—such as failing to act when an affirmative duty to act exists.³ Notably, even when directors hold the majority ownership and control

the board, they generally cannot act in their own self-interests, but rather must act for the good of the corporation and all of its shareholders.⁴

The ABCs of the Business Judgment Rule

The business judgment rule “is embedded in American corporate law.”⁵ Yet, it is not a ‘rule’ in any ordinary sense of the word. It does not, itself, prescribe specific conduct for corporate directors and officers. Rather, the rule generally “protects a board of directors from being questioned or second-guessed on conduct of corporate affairs except in instances of fraud, self-dealing, or unconscionable conduct.”⁶ One of its purposes is to “promote and protect the full and free exercise of the power of management given to the directors.”⁷ The rule also serves to encourage qualified business people to serve as directors and to take entrepreneurial risks inherent in running a business. Generally, the business judgment rule reflects the courts’ reluctance to interfere with business decisions absent a showing of bad faith.⁸

The business judgment rule, however, is not absolute. Rather, it is a “‘rebuttable presumption’ that places an initial burden on the person who challenges a corporate decision to demonstrate the decision-maker’s ‘self-dealing or other disabling factor.’”⁹ If a challenger sustains that initial burden, the burden of proof shifts to the defendant directors or officers to show that their actions were, in fact, fair to the corporation.¹⁰ Breach of any of the requisite duties—due care, loyalty, and good faith—eliminates the presumption the business judgment rule affords and permits the act of the board to be challenged under the entire fairness standard.¹¹

Directors owe a fiduciary duty to the corporation and, by extension, its shareholders.¹² The breach of that duty imposes personal liability on the director and enables individual shareholders to initiate a derivative claim on behalf of the corporation. The business judgment rule does not protect directors

who abuse their discretion or fail to inform themselves of all material information readily available prior to making a business decision. Simply put, there is no safe-haven protection under New Jersey law for so-called dummy, figurehead or accommodation directors.¹³

While New Jersey courts have not directly held that officers are entitled to the same protection as directors, they have implied as much.¹⁴ The New Jersey statute defining a director's standard duty of care states, "Directors and members of any committee designated by the board shall discharge their duties in good faith..."¹⁵ Most states, as well as commentators such as the American Law Institute and the American Bar Association, have ruled or presumed that the protection afforded to directors extends to officers.¹⁶

Shifting the Burden:

The Modified Business Judgment Rule

Derivative suits can be a potent tool to redress the conduct of unfaithful directors or officers. By its very nature, however, the derivative action impinges on the managerial freedom of directors. At worst, if abused by opportunistic shareholders, derivative suits can impede the best interests of the corporation; hence, the need to balance these competing interests. The New Jersey Supreme Court strived to do that by adopting a "modified business judgment rule" in cases involving a board's decision to reject a shareholder's demand for litigation or where the requirement for pre-suit demand is excused (*i.e.*, demand-made and demand-excused cases).¹⁷ This modified approach places the initial burden on directors to demonstrate their actions were disinterested and independent, made in good faith, and reasonable. All three elements must be satisfied.¹⁸ Moreover, shareholders in these circumstances are permitted a limited degree of discovery prior to a court's ruling on

whether a corporation properly determined to reject or terminate the derivative litigation.¹⁹

In *In re PSE & G Shareholder Litigation*, the board of directors rejected the shareholders' demand to sue on behalf of the corporation after malfunctions and safety problems at the corporation's power plants led to shutdowns and regulatory fines.²⁰ The Supreme Court affirmed the lower court's grant of summary judgment to the defendants, finding the board hired an independent law firm to conduct an extensive investigation, based the decision on the company's best interests, and acted reasonably in choosing not to pursue litigation.²¹

Where the shareholder has not made a demand to the board, he or she has the burden of proving a demand would have been futile.²² In a demand-excused case, the plaintiff must establish a reasonable doubt regarding the directors' independence and exercise of valid business judgment.²³ This two-part test, known as the *Aronson* test, was formulated by the Delaware Supreme Court and has been adopted by New Jersey courts.²⁴ The New Jersey derivative action statute was revised in 2013, strengthening the demand requirement by requiring demand be made to allow the corporation to act in one of the ways specified, except only where "irreparable injury to the corporation would result."²⁵

The business judgment rule is often invoked in minority shareholder oppression actions. Generally, a claim of majority oppression or freeze-out in a closely held corporation will similarly shift the burden to defendants "to show the intrinsic fairness of the transaction in question upon the showing of self-dealing or 'other disabling factor.'"²⁶

Differences from Sister States: New York and Delaware

Across the country, courts generally apply the traditional business judgment

rule or one of a number of variations in evaluating the level of judicial scrutiny to be applied to a board's response to shareholder derivative litigation. New York adheres to a more traditional or deferential standard than Delaware or New Jersey. The decision in *Auerbach v. Bennett* exemplifies New York's more deferential approach.²⁷ There, the state's highest court considered whether to apply the business judgment rule when evaluating the decision of a special committee that elected not to proceed with a derivative action. The court determined its inquiry should be limited to an examination of the committee's independence and the sufficiency of its procedures.²⁸ It also determined that "[w]hile 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."²⁹

New Jersey eschewed New York's deferential approach in adopting its modified business judgment rule approach in *PSE & G Shareholder Litigation*.³⁰ Thus, New Jersey aligned itself more closely, although not identically, with Delaware law. In Delaware, absent an abuse of discretion, a board's business judgment generally will be respected by the courts.³¹ Certain common principles govern the application and operation of the rule. First, its protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment.³² Second, to invoke the rule's protection, directors have a duty to inform themselves, prior to making a decision, of all material information reasonably available to them, and must act with requisite care in the discharge of their duties.³³ Where demand on directors is made or excused, the board may appoint a committee of independent, disinterested directors to determine whether the

derivative action should be pursued or dismissed.³⁴ Delaware courts apply a two-tier test in these circumstances, which first requires the corporation to show the committee's independence and reasonable investigation, and then permits the court to apply its own independent business judgment.³⁵

In cases where directors are on both sides of a transaction—posing a conflict of interest—Delaware applies an “entire fairness” standard.³⁶ The burden shifts to the defending director to prove the transaction was fair and reasonable.³⁷ However, the presumption of validity may be reinstated if the decision was approved by disinterested directors or by shareholders after full disclosure of the conflict of interest.³⁸

New Jersey has adopted a similar standard.³⁹ In *Casey v. Brown*, a shareholder derivative action was initiated against a corporation's board of directors who also happened to be majority shareholders. The court held that when a “shareholder claim of unfairness involves a corporate transaction in which the directors stand to realize a personal benefit by continuing as shareholders after paying the minority an unfairly low price [for their shares],” the fiduciary relationship imposes upon directors the burden of proving the transaction was not unfair.⁴⁰

New York allows a non-shareholder director to sue another director derivatively on behalf of the corporation. Neither Delaware nor New Jersey permits this.⁴¹

More Recent Developments

Where shareholders have already approved a board's action, courts are hesitant to intervene. For example, the New Jersey Supreme Court considered a stockholder suit alleging that a stock option incentive plan granting directors restricted stock awards was improper.⁴² The Court affirmed judgment in favor of the defendant bank and its directors,

holding that the proxy statements and disclosures made to the stockholders sufficiently placed them on notice before they approved the plan. The Court further found that while rewarding the corporation's directors did not align with the plan's purpose to attract new talent and retain existing personnel, other purposes of the plan, such as providing proprietary incentives to contribute to the corporation's success and rewarding outstanding performance, were satisfied by the stock option grants. Because the plaintiff failed to demonstrate the incentive plan involved an “exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade,” the claim for corporate waste also failed.⁴³

The decision to sacrifice some savings in order to retain flexibility of compensation decisions and to attract better talent is a classic exercise of business judgment. In a recent case, the Delaware Supreme Court rejected a shareholder's derivative complaint for corporate waste that challenged the board's decision to pay certain executive bonuses without adopting a plan that could make those bonuses tax deductible.⁴⁴ During the litigation, the company adopted the tax-deductible plan under 26 U.S.C. § 162(m), and most of the plaintiff's claims were dismissed as moot. The plaintiff then filed for recovery of attorney's fees under the corporate benefit doctrine but failed because she did not allege that any of the bonuses would have been tax deductible under such a plan. The Court held that although the board made an arguably poor business judgment in its initial bonus compensation plan, the directors were protected by the business judgment rule.⁴⁵

Recent decisions have reaffirmed that the business judgment rule will not shield directors from allegations of fraud or self-dealing. For instance, in

Jurista v. Amerinox Processing, Inc.,⁴⁶ suit was instituted against the sole shareholders, officers, and directors of Jermax, the debtor company in bankruptcy, and also a related company, Amerinox. The defendants allegedly siphoned funds from Jermax to Amerinox, leading to Jermax's Chapter 11 bankruptcy. In refusing to dismiss the plaintiff's claims for breach of fiduciary duty, the court stated, “Defendants are alleged to have acted in bad faith in furtherance of a fraudulent scheme and for their own self-interest... In such instances, the business judgment rule ceases to protect the conduct of corporate officers.”⁴⁷

Conclusion

The business judgment rule can afford significant protective armor to directors and officers. It does not, however, shield directors or officers from instances of fraud, self-dealing, or other unconscionable conduct. When director and officer liability claims arise, it is important to understand which party will bear the burden of proof and how expansive the defense is under the applicable law. If the derivative suit involves the board's decision to reject a shareholder's demand for litigation or pre-suit demand is excused, the directors will bear the burden of proving they were disinterested and independent. If the shareholder has not made a demand to the board, the shareholder has the burden to disprove the applicability of the business judgment rule. If a minority shareholder claiming oppression shows self-dealing or other disabling factors, or if there is a conflict of interest, the burden shifts to the board of directors. As compared to New Jersey and Delaware, New York's business judgment rule is more deferential to the board of directors. A Delaware court, on the other hand, may apply its own independent business judgment in certain instances. And, so, the business judg-

ment rule's application and operation often depend on which state law applies and the circumstances presented. 5

Endnotes

1. Stuart Pachman, *Title 14A – Corporations*, p. 287 (2014), citing *In re PSE&G Shareholder Lit.*, 315 N.J. Super. 323, 327 (Ch. Div. 1998), *aff'd at In re PSE & G Shareholder Litigation*, 173 N.J. 258, 277 (2002).
2. N.J.S.A. 14A:6-8, -14; *Scheidt v. DRS Technologies, Inc.*, 424 N.J. Super. 188, 200 n. 9 (App. Div. 2012).
3. Pachman, *Title 14A – Corporations*, p. 302 (2014).
4. See, e.g., *Casey v. Brennan*, 344 N.J. Super. 83, 108-110 (App. Div. 2001), *aff'd* 173 N.J. 177 (2002) (ruling that directors, who also were majority shareholders, breached their fiduciary duty to treat the minority shareholders fairly by failing to disclose material information about a cash-out merger that would have resulted in substantial benefit to the majority shareholders/directors).
5. *In re PSE & G Shareholder Litig.*, 173 N.J. at 276.
6. *In re PSE & G Shareholder Litig.*, 173 N.J. at 276-77, quoting *Maul v. Kirkman*, 270 N.J. Super. 596, 614 (App. Div. 1994).
7. *Id.*
8. *Exadaktilos v. Cinnaminson Realty Co., Inc.*, 167 N.J. Super. 141, 151 (Law Div. 1979).
9. *PSE & G Shareholder Litig.*, 173 N.J. at 277, quoting *Maul*, 270 N.J. Super. at 637.
10. *Id.*
11. *Brundage v. The New Jersey Zinc Co.*, 48 N.J. 450, 475-477 (1967).
12. See, e.g., *Eliasberg v. Standard Oil Co.*, 23 N.J. Super. 431, 441 (Ch. Div. 1952).
13. Pachman, *Title 14A – Corporations*, p. 306; citing *Francis v. United Jersey Bank*, 87 N.J. 15 (1981); *Mulford v. Computer Leasing, Inc.* 334 N.J. Super. 385, 397 (Law Div. 1999).
14. *Seidman v. Clifton Sav. Bank, S.L.A.*, 205 N.J. 150, 176 (2011); *Maul*, 270 N.J. Super. at 614; *Johnson v. Johnson*, 212 N.J. Super. 368, 386 (Ch. Div. 1986).
15. N.J. Stat. § 14A:6-14 (emphasis added).
16. See, e.g., *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253, 1261 n.16 (Conn. 1994); Model Bus. Corp. Act § 8.42(c) cmt. ¶ 9 (2007); but see *Nat'l Credit Union Admin. v. Siravo*, No. 10-1597-GW, 2011 U.S. Dist. LEXIS 155785, at *5 (C.D. Cal. July 7, 2011) (holding that the applicable California statute does not provide protection for officers under the business judgment rule).
17. *In re PSE & G Shareholder Litig.*, 173 N.J. at 286.
18. *Id.*
19. *Id.* at 287.
20. *Id.* at 268.
21. *Id.* at 290-91, 294, 297.
22. N.J.R. 4:32-3; see also *Johnson v. Glassman*, 401 N.J. Super. 222 (App. Div. 2008) (finding plaintiff shareholders' claims that one family controlled the board were insufficient to demonstrate demand futility).
23. *In re PSE & G Shareholder Litig.*, 173 N.J. at 282.
24. *Matter of Prudential Ins. Co. Derivative Litig.*, 282 N.J. Super. 256, 275 (Ch. Div. 1995), following *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
25. N.J.S.A. 14A:3-6.1 to 6.9. See N.J.S.A. 14A:3-6.3 for new demand requirements, applicable if corporation's certificate of incorporation so provides.
26. *Grato v. Grato*, 272 N.J. Super. 140, 152 (App. Div. 1994), quoting *Maul*, 270 N.J. Super. at 637; see also *Schwartz v. Marien*, 335 N.E.2d 334 (N.Y. 1975).
27. *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979).
28. *Id.* at 623-624.
29. *Id.* at 634.
30. *PSE & G Shareholder Litig.*, 173 N.J. at 285-286.
31. *Aronson v. Lewis*, 473 A.2d at 812.
32. *Id.*
33. *Id.*
34. *Id.* at 813 (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981)).
35. *Zapata Corp.*, 430 A.2d at 788-89.
36. *Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993).
37. *Id.* at 1374.
38. *In re LNR Prop. Corp. S'holders Litig.*, 896 A.2d 169, 176 (Del. Ch. 2005).
39. See, e.g., *Casey v. Brown*, 344 N.J. Super. 83, (App. Div. 2001).
40. *Id.* at 108.
41. See *Schoon v. Smith*, 953 A.2d 196, 210 (Del. 2008); N.J. Stat. § 14A:3-6.1; N.J. Ct. R. 4:32-3.
42. *Seidman v. Clifton Sav. Bank, S.L.A.*, 205 N.J. at 177.
43. *Id.* at 181-182 (quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997)).
44. *Freedman v. Adams*, 58 A.3d 414, 416-417 (Del. 2013).
45. *Id.*
46. *Jurista v. Amerinox Processing, Inc.*, No. 12-3825, 2013 U.S. Dist. LEXIS 44057, at *105-06 (D. N.J. March 28, 2013).
47. *Id.* at *105-06.

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