

ARTICLES

The Business Judgment Rule: A Shield and Sword

Key tips to know about the business judgment rule when litigating shareholder derivative actions.

By Iván Resendiz Gutierrez – July 22, 2019

Shareholders often try to use derivative suits to hold others responsible for their financial losses. The targets of these actions are usually corporate directors who stand in a fiduciary relationship of trust and confidence with the corporation. The shareholders will claim that they are suing derivatively on behalf of the corporation to vindicate corporate rights.

As fiduciaries, corporate directors owe the corporation fiduciary duties of diligence and fidelity in performing their corporate duties. The three primary fiduciary duties of directors are due care, loyalty, and good faith. *Rodriguez v. Loudeye Corp.*, 189 P.3d 168, 172 (Wash. Ct. App. 2008) (citing *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998)).

The duty of care requires a director to act with “the degree of care an ordinarily prudent person would exercise in a like position under similar circumstances.” *WSB Invs., LLC v. Pronghorn Dev. Co., LLC*, 344 P.3d 548, 560 (Or. Ct. App. 2015) (quoting William Meade Fletcher, *3A Fletcher Cyclopedia of the Law of Private Corporations* § 1032, 20 (rev. 2002)). When a plaintiff alleges bad faith as pertaining to the duty of care, “[t]he burden * * * is to show irrationality; a plaintiff must demonstrate that no reasonable business person could possibly authorize the action in good faith. Put positively, the decision must go so far beyond the bounds of reasonable business judgment that its only explanation is bad faith.” *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3d Cir. 2005) (discussing then prevailing Delaware law) (citation omitted).

The duty of loyalty requires “that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director . . . and not shared by the stockholders generally.” *Rodriguez*, 189 P.3d at 174 (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994)). Some jurisdictions, including Delaware, have classified the duty of good faith as a subset of the duty of loyalty. *See, e.g., Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (stating that “good faith ‘is a subsidiary element[,]’ i.e., a condition, ‘of the fundamental duty of loyalty.’” (citation omitted)).

A Primer on Shareholder Derivative Suits

To provide some context for the discussion about the business judgment rule, it is worth covering the basics of a shareholder derivative action.

A shareholder derivative action is not a cause of action itself. A derivative suit is also different from a class action brought by a corporation’s shareholders. While both are representative actions, the claims asserted in a derivative suit are those of the corporation. In a class action,

however, the claims asserted are individual claims of injury suffered by the shareholders themselves.

A shareholder derivative action is a creature of equity that serves as a vehicle to enforce a corporate right and allow shareholders to prosecute claims, like breach of fiduciary duty, on behalf of the corporation. The derivative claims belong to the corporation itself, rather than to the shareholder plaintiffs. That means that “the rights to be vindicated are those of the corporation, not those of plaintiffs suing derivatively on the corporation’s behalf.” *Fisher v. Flue-Cured Tobacco Coop. Stabilization Corp.*, 794 S.E.2d 699, 706 (N.C. 2016). “[A]ny damages flow back to the corporation, not to the individual shareholders bringing the [derivative] action.” *Id.* (internal quotation marks and citations omitted). As explained by the Delaware Supreme Court,

“The stockholder does not bring such a suit because *his* rights have been *directly* violated, or because the cause of action is *his*, or because *he* is entitled to the relief sought; he is permitted to sue in this manner *simply in order to set in motion the judicial machinery of the court*. . . . In fact, the plaintiff has no such direct interest; the defendant corporation alone has a direct interest; the plaintiff is permitted, notwithstanding his want of interest, to maintain the action *solely to prevent an otherwise complete failure of justice*.”

Schoon v. Smith, 953 A.2d 196, 202 (Del. 2008) (quoting 4 John Norton Pomeroy, *Pomeroy’s Equity Jurisprudence* § 1095, at 278 (5th ed. 1941)) (emphasis in original).

Shareholder derivative actions are not cheap. Indeed, “[t]he corporate cost of conducting such complex litigation is frequently formidable.” *Alford v. Shaw*, 349 S.E.2d 41, 49 (N.C. 1986) (collecting cases), *on reh’g*, 358 S.E.2d 323 (N.C. 1987). For that reason, “the decision whether and to what extent to prosecute is generally predicated on considerations which are ultimately calculated to protect and advance the economic best interest of the corporation, a responsibility which belongs to the management of the corporation.” *Id.*

Before bringing the action, the shareholder plaintiff must demand that the corporation bring the action itself. If the corporation refuses to do so, the plaintiff shareholder then may have a basis to proceed with its derivative action. Otherwise, the plaintiff’s complaint must show why such a pre-litigation demand should be excused under the so-called futility exception. *In re Cray Inc.*, 431 F. Supp. 2d 1114, 1120–21 (W.D. Wash. 2006). “Courts must look to the complaint and determine whether or not the particularized factual allegations of a derivative stockholder complaint create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.” *Id.* (internal quotation marks and citation omitted).

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Directors have several ways to stop a shareholder derivative suit in its early stages. As mentioned, directors could quash the action based on the shareholder plaintiff’s failure to meet

the pre-litigation demand requirement or failure to show futility. As explained by the U.S. District Court for the Western District of Washington,

In order to proceed with a derivative suit after a board rejects a shareholder's demand, the shareholder must allege facts with particularity creating a reasonable doubt that the board's decision was entitled to the protection of the business judgment rule. A board's refusal of a shareholder litigation demand merits presumptive protection by the business judgment rule unless a plaintiff alleges particular facts that support the inference that the board's investigation was unreasonable or that its decision making process was not undertaken in good faith. Thus, when a board refuses a demand, courts will examine the good faith and reasonableness of its investigation. Vitally, the court's inquiry is not into the substantive decision of the board, but rather is into the procedures employed by the board in making its determination.

Barovic v. Ballmer, 72 F. Supp. 3d 1210, 1214–15 (W.D. Wash. 2014).

If the pre-litigation demand is not an issue or is unsuccessfully challenged, then the directors can use the corporation's articles of incorporation as a second line of defense. A corporation's articles of incorporation may shield directors from liability for money damages based on breaches of the duty of care. *Grassmueck v. Barnett*, 281 F. Supp. 2d 1227, 1232 (W.D. Wash. 2003) ("In Washington and Delaware, directors are protected against general claims for breach of the duty of care when pursuant to state law a corporation adopts a director protection provision into its articles of incorporation.").

In addition to those contractual limitations, directors may rely on a powerful common-law rule commonly referred to as the "business judgment rule." This rule "protects directors from spurious claims against their exercise of discretion in an effort to 'promote the full and free exercise of the managerial power granted to Delaware directors.'" *In re ALH Holdings LLC*, 675 F. Supp. 2d 462, 477 (D. Del. 2009) (quoting *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985)). The rule "is a corollary that flows from the authority and responsibility inherent in the director's role. Pursuant to this maxim, a court will not disturb the business decisions of loyal and informed directors 'if they can be attributed to any rational business purpose.'" *Id.* (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)); *see also Crandon Capital Partners v. Shelk*, 181 P.3d 773, 782 (Or. Ct. App. 2008) ("A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose.") (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985)). The rule "is based on the premise that those to whom the management of a business organization has been entrusted, and not the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization's affairs or expedient for the attainment of its purposes." *FDIC ex rel. Cty. Bank v. Hawker*, No. CV F 12-0127 LJO DLB, 2012 WL 2068773, at *7 (E.D. Cal. June 7, 2012) (quoting *Berg & Berg Enters., LLC v. Boyle*, 100 Cal. Rptr. 3d 875 (Cal. Ct. App. 2009)).

Basically, “the business judgment rule acts as a rule of evidence which creates a presumption that ‘in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.’” *Id.* (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)); *see also Bernards v. Summit Real Estate Mgmt., Inc.*, 213 P.3d 1, 5 (Or. Ct. App. 2009) (explaining the business judgment rule “generally operates to bar judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes”); *Kloha v. Duda*, 246 F. Supp. 2d 1237, 1249–50 (M.D. Fla. 2003) (“directors will not be called to account for their actions, no matter how poor their business judgment, absent some showing of abuse of discretion, fraud, bad faith, or illegality”); *Devlin v. Moore*, 130 P. 35, 45 (Or. Ct. App. 1913) (holding that officers are “not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors”).

Under the business judgment rule, “corporate management is immunized from liability in a corporate transaction where (1) the decision to undertake the transaction is within the power of the corporation and the authority of management, and (2) there is a reasonable basis to indicate that the transaction was made in good faith.” *Nelson v. Pryor*, No. 49640-2-II, 2018 WL 1611624, at *9 (Wash. Ct. App. Apr. 3, 2018) (quoting *Scott v. Trans-Sys., Inc.*, 64 P.3d 1 (Wash. 2003)). In other words, while this rule immunizes directors who breach their duty of care, it does not immunize directors who breach their duties of loyalty or good faith and fair dealing.

Although the business judgment rule is a common-law rule, many states have chosen to codify it in their respective statutes. *FDIC ex rel. Cty. Bank v. Hawker*, No. CV F 12-0127 LJO DLB, 2012 WL 2068773, at *7 (E.D. Cal. June 7, 2012). For example, in Oregon, the business judgment rule is codified in section 60.357(1) of the Oregon Revised Statutes, which is a part of the Oregon Business Corporation Act. That provision requires directors to discharge their duties “in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the director reasonably believes to be in the best interests of the corporation.” Or. Rev. Stat. § 60.357(1). The statute further provides:

- (2) In discharging the duties of a director, a director is entitled to rely on information, opinions, reports or statements including financial statements and other financial data, if prepared or presented by:
- (a) One or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
 - (b) Legal counsel, public accountants or other persons as to matters the director reasonably believes are within the person’s professional or expert competence; or
 - (c) A committee of the board of directors of which the director is not a member if the director reasonably believes the committee merits confidence.

Or. Rev. Stat. § 60.357(2).

If the director performed the duties of the director’s office in compliance with section 60.357, then the “director is not liable for any action taken as a director, or any failure to take any action.” Or. Rev. Stat. § 60.357(4); *see also Colvin v. Colvin*, No. CIV.05-409-AA, 2007 WL 2248160, at *11 (D. Or. Aug. 1, 2007) (“When applicable, the business judgment rule ‘insulates directors from liability, and imposes upon the party challenging the decision the burden of rebutting the presumption.’” (quoting *Navellier v. Sletten*, 262 F.3d 923, 946 n.12 (9th Cir. 2001))).

Crucially, directors and their counsel can sometimes use the business judgment rule as a ground for a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6). *E.g.*, *FDIC v. Perry*, No. CV 11-5561-ODW MRWX, 2012 WL 589569, at *2 (C.D. Cal. Feb. 21, 2012) (“[I]f [the business judgment rule] applies to corporate officers under California law, the Complaint must include facts pleading around the defense.”). However, many jurisdictions (including Delaware) have held that the business judgment rule is not a ground for dismissal under Rule 12(b)(6). Recently, the U.S. District Court for the Northern District of Illinois explained:

“In Delaware, the business judgment rule is a presumption that directors act in good faith, on an informed basis, honestly believing that their action is in the best interests of the company.” *In re Tower Air, Inc.*, 416 F.3d 229, 238 (3rd Cir. 2005) (citing *Aronson v. Lewis*, 473 A.3d 805, 812 (Del. 1984)). “Generally speaking, [courts] will not rely on an affirmative defense such as the business judgment rule to trigger dismissal of a complaint under Rule 12(b)(6).” *Id.*; *see also Shamrock Holdings, Inc. v. Arenson*, 456 F. Supp. 2d 599, 609 (D. Del. 2006) (“The court . . . holds that defendants are not required to plead around the business judgment rule at this stage in the proceedings.”). If, however, an unanswered affirmative defense appears on the face of the complaint, the Court may dismiss the complaint. *Id.* (proceeding to evaluate a complaint under the business judgment rule on a motion to dismiss because it “declare[d] that the business judgment rule d[id] not vitiate any of [the plaintiff’s] claims”).

Overwell Harvest Ltd. v. Widerhorn, No. 17 C 6806 (N.D. Ill. Jan. 31, 2019). *See also Data Key Partners v. Permira Advisers LLC*, 849 N.W.2d 693, 720 (Wis. 2014) (noting that in *Shamrock*, “the court declared that as a general rule the court will not rely on the business judgment rule to trigger dismissal of a complaint at the motion-to-dismiss stage”).

How to Overcome the Presumption Against Director Liability

As with most things, the presumption provided by the business judgment rule that shields directors from breach of fiduciary claims is not limitless. To overcome the presumption, the plaintiff must allege facts demonstrating that the directors defrauded the corporation or were dishonest or incompetent (i.e., were disloyal or acted in bad faith). *In re Spokane Concrete Prods., Inc.*, 892 P.2d 98, 104 (Wash. 1995); *Schwarzmann v. Ass’n of Apartment Owners of Bridgehaven*, 655 P.2d 1177, 1180 (Wash. Ct. App. 1982) (“Courts are reluctant to interfere with

the internal management of corporations and generally refuse to substitute their judgment for that of the directors.”). The plaintiff “has the burden to establish facts that rebut this presumption.” *Myers v. Alstead*, No. C16-1580 RAJ, 2018 WL 3046425, at *1 (W.D. Wash. June 20, 2018) (citing *Aronson*, 473 A.2d at 812). It is a “near-Herculean task” for a challenger to meet this burden. *Stanziale v. Nachtomi*, 416 F.3d 229, 238 (3d Cir. 2005).

The Ninth Circuit put it best when it wrote the following:

It is clear that the rule does not protect a director in certain situations, such as where there is a conflict of interest, fraud, oppression, or corruption. Neither does the business judgment rule protect a director who has wholly abdicated his corporate responsibility, closing his or her eyes to corporate affairs. But the rule does protect well-meaning directors who are misinformed, misguided, and honestly mistaken. Contrary to the implications made by the [plaintiff], the Corporations Code does not impose on directors a duty of possessing specialized knowledge. Rather, directors are charged with a duty of “good faith” and conducting business “in a manner such director believes to be in the best interests of the corporation and its shareholders.”

FDIC v. Castetter, 184 F.3d 1040, 1046 (9th Cir. 1999) (citations and footnote omitted).

Conclusion

There being no sign of a decrease in shareholder derivative lawsuits for breach of fiduciary duty, corporate litigators should ensure that they know the latest developments in their jurisdiction with respect to the business judgment rule. The business judgment rule provides a key defense to corporate directors that may result in an early dismissal. For those seeking to challenge corporate officers’ actions, structuring the claim to overcome a business judgment rule defense will be a key to success.

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