The business judgment rule has been part of English and American common law for more than 200 years.¹ In theory, the business judgment rule protects corporate directors (and sometimes officers) from liability for honest mistakes in judgment as long as they act with due care and loyalty.² In reality, the rule is not so simple.

This article explores the business judgment rule’s eighteenth-century origins and analyzes subsequent caselaw to see how the rule has developed. Finally, it examines Michigan’s application of the rule.

The rule, fiduciary duties, and context

The business judgment rule implicates director fiduciary duties of due care, good faith, and loyalty. The rule affords a fiduciary some protection when, for example, the fiduciary participated in a properly investigated decision or transaction that, because of an honest mistake in business judgment, does not attain the desired result. If, however, a director acts in bad faith or makes a decision that personally benefits himself or herself, the rule is inapplicable.

The context of the challenged decision is important. The conduct of directors and controlling shareholders of closely held companies is often analyzed more stringently than the conduct of fiduciaries of public entities, where shareholders can more easily escape oppressive conduct³ by selling their shares on the stock market.⁴

The applicability of the business judgment rule is often an issue of fact precluding summary disposition.⁵ Where a plaintiff has pled factual allegations of a breach of fiduciary duty or shareholder oppression, the defendants’ conduct “cannot be excused on the face of the complaint as a simple matter of business judgment,”⁶ and therefore, summary disposition at the pleading stage will be inappropriate.
At a Glance

In general, the business judgment rule protects corporate directors from liability for honest mistakes in judgment.

Directors must act in good faith and on an informed basis, and must be disinterested in the transaction to rely on the business judgment rule.

In Michigan, directors and officers may not rely on the business judgment rule to protect themselves when their conduct amounts to shareholder oppression or a breach of fiduciary duties.

In Scott v Depeyster, shareholders sued the corporation’s president and directors for the secretary’s fraud. The New York Chancery Court noted that directors are not required “to have attained infallibility.” Directors “must answer for ordinary neglect,” which is “the omission of that care which every man of common prudence takes of his own concerns.” The Scott court examined the facts and ultimately concluded that the defendants reasonably relied on the secretary’s representations and were not liable for misconduct.

In 1847, the Alabama Supreme Court applied a similar standard in Godbold v Branch Bank. A bank’s shareholders sued a director for the board’s illegal conduct. The Court determined that the illegal act was done in good faith and “in the exercise of the power vested in [the director],” and declined to impose liability. Directors must have “a competent knowledge” of their duties. No person would become a director if this required “perfect knowledge.”

The Rhode Island Supreme Court declared in the 1850 case Hodges v New England Screw that directors “ought to be liable” if their conduct is the result of “want of proper care.” In Hunt v Cary, a New York court stated that directors are “bound not only to exercise proper care and diligence, but ordinary skill and judgment.”

In 1927, the Delaware Supreme Court decided Bodell v Gen Gas & Electric Corp. The Bodell Court stated that, absent evidence that the directors did not act in the company’s best interests, courts should not be permitted to review “an honest mistake of business judgment.” Moreover, director decisions should not be interfered with absent fraud “such as improper motive or personal gain or arbitrary action or conscious disregard of the interests of the corporation and the rights of its stockholders.”

The rule in the twentieth century

In 1940, a New York trial court eloquently articulated the business judgment rule. In Litwin v Allen, the court’s analysis incorporated both the duties of care and loyalty. 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.” Directors owe undivided loyalty and “an allegiance that is influenced in action by no consideration other than the welfare of the corporation.” Moreover, “any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising. He may not profit at the expense of his corporation...he may not for a personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment.” 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.” Directors will be liable for negligence, not “errors of judgment or for mistakes while acting with reasonable skill and prudence.”

Zapata Corp v Maldonado involved the special circumstances of a board of directors appointing a committee to investigate the merits of a derivative claim. There, the committee concluded that the suit was meritless, and the board moved to dismiss. The Delaware Supreme Court declined to apply the business judgment rule to preclude review of the board decision to seek dismissal, and adopted a two-prong test. First, the Court examined the committee’s independence and good faith, which “the corporation should have the burden of proving...” Second, even if the committee were independent, the Court still applied its own scrutiny to determine whether the board’s decision to adopt the committee’s recommendation was justified.

Two of the most cited Delaware cases on the duty of loyalty are Weinberger v UOP, Inc and Aronson v Lewis. These cases hold that if a director stands to gain from the transaction, the business judgment rule is inapplicable and the directors must prove the “entire fairness” of the transaction. Entire fairness has two components: fair dealing and fair price. “The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.”

A director is interested and not protected by the business judgment rule if he or she appears on both sides of the transaction or expects to derive a personal financial benefit from a transaction “in the sense of self-dealing.” Examples of interested decisions include instances in which directors usurp a corporate opportunity; increase their own compensation while refusing to declare dividends; and implement programs that provide themselves, but not other shareholders, with liquidity.

In 1985, the Delaware Supreme Court decided Smith v Van Gorkom. In Smith, the shareholders of a public corporation brought a derivative claim against the directors over a merger. The Court noted that the business judgment rule presumes that directors acted on an informed basis, in good faith, and with the honest belief that the action was in the company’s best interests. To overcome the presumption that a decision is informed, the plaintiff must show that it was uninformed. Directors are informed when they apprise themselves of all material information reasonably available before making a decision. The Smith board was “grossly negligent” when it approved a merger proposal based solely on a 20-minute presentation. The board members were held jointly and severally liable for $23 million.

The rule in Michigan

In Michigan, under MCL 450.1541a, which the Michigan Court of Appeals has held is the standard applicable in derivative action claims, directors and officers must act in good faith, with the care of an ordinarily prudent person, and in the company’s best interests. Directors and officers may rely on competent information from directors, officers, or employees of the corporation, outside experts, or a board committee.

Directors, officers, and those in control of closely held corporations must adhere to a heightened standard of “fiduciary
responsibility, a standard more akin to partnership law."55 This higher standard of responsibility is reflected in the shareholder oppression statute, MCL 450.1489, which prohibits those in control of closely held corporations from acting in an “illegal, fraudulent, or willfully unfair and oppressive” manner.

In Dodge v Ford Motor Co, several Ford shareholders sued the directors to compel dividends.56 The Court began its analysis by noting that application of the business judgment rule is fact- or context-based. Upon a review of Ford’s finances and past practices, the Court determined that the refusal to issue dividends was arbitrary and not within the directors’ discretion. The directors were ordered to issue a dividend of approximately $19 million.

The Michigan Supreme Court decided Wagner Electric Corp v Hydraulic Brake Co in 1934.57 In Wagner, the Court declared that directors must act for the company’s best interests and “are prohibited by law from acting in any antagonistic position whether for their own personal benefit or for the benefit of other competitive corporations.”58 As long as the directors act accordingly, “matters of business judgment and discretion are not subject to judicial review.”59

In 1955, Reed v Burton acknowledged that courts will not interfere with corporate decisions absent “a clear showing of actual or impending wrong.”60 However, courts will intervene when those in control willfully abuse their powers, act in bad faith, neglect their duties, act contrary to the corporation’s purposes, or commit a breach of trust or fraud.61

The Michigan Court of Appeals declined to apply the business judgment rule in its 1977 decision in Miller v Magline.62 In Miller, the shareholders sued the directors to compel dividends. At the outset of its analysis, the Court noted that a breach of a fiduciary duty justified judicial intervention and suggested that corporate doctrines such as the business judgment rule may be applied differently in cases involving close corporations.63 The Court affirmed the trial court’s determination that a non-dividend policy defeated a major purpose of a profit corporation (distributing profits to owners) and that defendants’ argument that a dividend would endanger the company was “untenable” in light of the large bonuses they issued themselves.64 The Court of Appeals found that the business judgment rule was inapplicable because the directors were interested in the decisions at issue. The Court ordered the defendants to issue dividends.

In 1983, the Michigan Supreme Court acknowledged in Matter of Estate v Butterfield that absent bad faith or fraud, it could not substitute its judgment for that of the directors.65 However, courts may intervene when the refusal to declare dividends amounts to a breach of fiduciary duty.66

In Madugula v Taub, a shareholder sued the company’s president after the president terminated the shareholder’s employment and compensation in breach of the shareholder agreement.67 Significantly, the defendant, who stood to gain from the conduct, did not rely on the business judgment rule.

The Michigan Supreme Court remanded the case to determine whether the plaintiff established oppression. The trial court found oppression without considering the rule.68

In 2019, the Michigan Court of Appeals analyzed how the business judgment rule applies to shareholder oppression claims. In Franks v Franks,69 the Court acknowledged that the rule remained the same as the rule set forth in Burton and Butterfield.70 The oppression statute, MCL 450.1489, identifies as oppression, acts “that are inherently wrongful and would warrant court intervention. Accordingly, a shareholder necessarily overcomes the business judgment rule by presenting evidence to establish the elements of a claim under the shareholder-oppression statute.”71 The Franks plaintiffs “presented evidence that defendants’ decisions were not taken for legitimate business reasons” but were taken to harm the shareholders.72 Thus, when a plaintiff establishes a claim of shareholder oppression, the plaintiff overcomes the business judgment rule.

Conclusion

The business judgment rule gives directors protections from honest mistakes if they act with due care and loyalty. It is inapplicable if directors commit oppression or breach their fiduciary duties, e.g., if the directors stand to gain a personal benefit. Even when the rule applies, it is not a talisman that prevents scrutiny into whether directors have acted reasonably and in good faith. Whether directors have acted properly depends on the facts of a particular transaction.
ENDNOTES


4. While beyond the scope of this article, the issue of whether claims are derivative versus direct may also affect the application of the business judgment rule.


6. Coppola v Manning, unpublished opinion per curiam of the Court of Appeals, issued November 7, 2015 (Docket No. 323924), n 3, and Franks v Franks, unpublished opinion per curiam of the Court of Appeals, issued September 24, 2019 (Docket No. 343290), at *11 (Mr. Mantese argued for the plaintiffs in Franks in the Michigan Court of Appeals.). See also In re Tower Air, 416 F3d 229, 238 (CA 3, 2005).


8. Charitable Corp v Sutton, 2 Ark 400, 26 Eng Rep 642 (1742).

9. Id. at 405.

10. Id. at 426.

11. Percy v Milladon, 8 Mart (n s) 68 (1829).

12. Id. at 77–78.

13. The Duty of Care Component at 975 n 5.

14. Scott v Depenstey, 1 Edw Ch 513, 6 NY Ch Ann 229 (1832).

15. Id. at 534–535.

16. Id. at 543.

17. Id. at 550.

18. Godbold v Branch Bank at Mobile, 11 Ala 191 (1847).

19. Id. at 199.

20. Id.


24. Id. at 426.

25. Id. at 427.


27. Guth, 23 Del Ch at 270–271.

28. Id. at 281.


30. Id.

31. Id. at 677–687.

32. Id.

33. Id.


35. Id. at 788. Conversely, when a committee or an advisor appointed to investigate a derivative claim is not independent, the resulting investigation should not be evidence of good-faith business judgment.

36. Id. at 789.


39. See, e.g., Weinberger, 457 A2d at 711.

40. Id. at 710.

41. Id. See also Madugula article discussion, infra, Marchand II v Barnhill, 212 A3d 805 (2019), and Cement Masons local 789 Pension Fund v Schleifer, 56 Misc 3d 1204A; 2017 NY Slip Op 50875(U) (2017).

42. Guth, 23 Del Ch at 270–271.

43. Miller, 76 Mich App at 303.

44. Nixon v Blackwell, 626 A2d 1366 (Del 1993).


46. Id. at 872.

47. Id.

48. Id.

49. Id. at 868.

50. Delaware Directors’ Fiduciary Duties, 11 U Penn J Bus L at 691.

51. No published Michigan appellate court has specifically addressed whether the business judgment rule applies to managers or members of an LLC, though some courts have applied the rule in the LLC context.


53. MCI 450.1541a(1)(a)–(c).

54. MCI 450.1541a(2)(a)–(c).


58. Id. at 567.

59. Id. at 568.

60. Reed v Burton, 344 Mich 126, 130, 73 NW2d 333 (1955).

61. Id. at 131.


63. Id. at 303.

64. Id. at 307.


66. Id. at 255–256.


68. Madugula v Taub, unpublished opinion of the Washtenaw County Circuit Court, issued May 26, 2016 (Docket No. 2008-537-CK). Mr. Mantese and Ian Williamson represented the plaintiff on remand.

69. Franks.

70. Id. at 13–14.

71. Id.

72. Id.