Legal Backgrounder

Washington Legal Foundation

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2009 Massachusetts Ave., NW
Washington, D.C. 20036
202.588.0302

Vol. 17 No. 23 June 7, 2002

CRIMINALIZING BUSINESS JUDGMENT COULD STAGNATE U.S. ECONOMY

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Not surprisingly, the collapse of Enron has resulted in an avalanche of reform proposals from all corners of Washington. Under the guise of restoring confidence in corporate America, Congress has at least forty new proposals pending before it, regulators have proposed dozens of rule changes, and even the White House has offered its own "Ten Point Plan" of proposed reforms.

No less keen observer of corporate governance than Federal Reserve Chairman Alan Greenspan has already strongly cautioned lawmakers against responding to the wave of recent corporate and accounting scandals by increasing regulation, arguing that market forces are already enforcing higher ethical standards. Remarks by Chairman Alan Greenspan at the Stern School of Business, New York University, New York, NY, Mar. 26, 2002. Mr. Greenspan rejected the notion that greater regulation is a cure for the hypothesized causes of Enron's troubles. Indeed, the current barrage of one-size-fits-all reforms, if enacted, could cause irreparable damage to the entire U.S. economy. In an attempt to offer potential solutions to perceived problems, lawmakers and regulators must be mindful of preserving the competitive position of our nation and its businesses. *See* Robert Novak, *Enron Hysteria Fuels Credit Crisis*, CHICAGO SUN-TIMES, Feb. 28, 2002, at 29.

Perhaps the most potentially harmful of the new proposals is the plan to hold corporate officers and directors strictly liable for the accuracy and quality of disclosures in their companies' financial statements. Under this plan, senior management of companies that issue false or misleading financial information could be forced automatically to forfeit their salaries and bonuses. Though it appears in a variety of guises, the most-publicized of these solutions can be found in the President's Ten Point Plan. If adopted, the Plan would impose a strict liability standard for the accuracy of financial statements on those individuals who had no actual role in their preparation, and who previously enjoyed a presumptive right to rely on the competence and honesty of those within the corporation whose role it is to compile financial information as well as the outside auditors who actually prepared them. *In re George W. Phillips*, 1994 SEC LEXIS

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2657, *10 (Aug. 6, 1994) (holding that a CEO is allowed to rely on the representations of those who report to him, as well as outside auditors, and is allowed to assume that they are carrying out their professional duties honestly).

The President's proposal, as well as the variations that have been suggested on the Hill and within the SEC, effectively sound the death knell for the Business Judgment Rule. The authors believe that this poses a threat to the continued growth of the U.S. industrial base. Creating a legal standard of liability that penalizes good faith business judgments where failure ensues eliminates a core protection and incentive for entrepreneurial action. Adopting a strict liability standard will trigger resignations by management and directors across the country as well as send a message to those brave enough to remain at the helms of public companies that their corporate strategy better be risk averse or they may be exposed to virtually limitless personal liability. This could effectively freeze industrial growth in the U.S. indefinitely.

The Business Judgment Rule. For over 150 years, the Business Judgment Rule ("BJR") has been the primary means by which courts have reviewed decisions of corporate officers and directors concerning ordinary day-to-day business matters.[1] It is premised on the notion that when a board of directors and senior management has acted with reasonable care and in good faith, its decisions will be regarded as "business judgments," and the directors and management will not be personally liable for damages even if a decision proves to be detrimental to the corporation. This holds true even if, in hindsight, these decisions proved to be unwise or inexpedient.[2]

The BJR is a judicially-developed concept that the business decisions of corporate management should not be second-guessed by courts.[3] It stands for the premise that if a decision can be attributed to any rational business purpose, courts will neither interfere with such decision nor will they impose liability on management, even if it turns out that the decision is controversial, unpopular, or even wrong.[4] In 1919 the presumptions of the BJR protected the directors of the Ford Motor Company from liability when their decision to reinvest corporate profits in an unproven automobile manufacturing industry was challenged. *See Dodge v. Ford Motor Company*, 170 N.W. 668 (Mich. 1919). Likewise, in 1968 it protected the directors of the Chicago Cubs baseball team when they refused to install lights and schedule night games at Wrigley Field. *See Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968).

The mere fact that a corporation loses a large amount of money does not, in and of itself, suggest that the officers and directors are unqualified to exercise business judgment. The reality is that some

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[1]Although the BJR is usually defined in terms of the Board of Directors, "it is equally applicable to corporate officers exercising their authority and is also applicable in certain instances to controlling shareholders when exercising their more extraordinary management functions." *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253, 1261 n.16 (Conn. 1994). *See also Estate of Detwiler*, 728 F. Supp. 103, 148 (S.D.N.Y. 1989) ("courts apply the business judgment rule when assessing a shareholder suit challenging a business decision as a breach of the officers' and directors' duty of care.").

[2]The BJR applies no matter how "controversial, unpopular or even wrong such a decision might turn out to be." *Grobow v. Perot*, 526 A.2d 914, 928 (Del. Ch. 1987), aff'd 539 A.2d 180 (Del. 1988). *See also Potter v. Pohlad*, 560 N.W.2d 389, 393 (Minn. Ct. App. 1987) (holding that, under the BJR, directors will not be held liable for conduct that is "undoubtedly imprudent in hindsight").

[3]The BJR rests on the notion that corporate directors are "more qualified to make business decisions than are judges." *Federal Deposit Ins. Corp. v. Stahl*, 89 F.3d 1510, 1517 (11th Cir. 1996) (quoting *International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989). *See also Kumpf v. Steinhaus*, 779 F.2d 1323, 1325 (7th Cir. 1985) ("The press of market forces . . . will more effectively serve the interests of all participants than will an error-prone judicial process.").

[4]Both state courts and legislatures have broadly adopted the BJR. At least 25 state courts apply a BJR presumption, and the Model Business Corp. Act § 8.31 official cmt, recognizes the BJR as a "broad common law concept."

  ISBN 1056 3059

corporations lose large amounts of money and, in doing so, are protected by the business judgment rule except where the integrity of the decision-making process itself could be called into question. However, where the business outcome of a decision is unaffected by director self-interest or bad faith, the BJR proscribes officer and director liability.[5]

The Danger of Reduced Standards of Liability. Concerns over the standards applied to officer and director liability reached a height in the wake of *Smith v. van Gorkom*, 488 A.2d 858 (Del. 1985), wherein the court denied the protections of the BJR to a board's decision to sell the company for a substantial premium over the stock's current market price, on the grounds that the board had failed to make a reasonable effort to inform itself of the company's true value. The court lowered the standard of liability to "gross negligence." Needless to say, the reaction was swift. There was widespread concern, in the wake of *van Gorkom*, that due to this new level of exposure to liability, qualified individuals might decline to serve on corporate boards entirely. Indeed, *Business Week* carried a story entitled, "A Job Nobody Wants," with an illustration on its cover of an empty director's chair with its seat cushion full of spikes. BUS. WK, Sept. 8, 1986, at 56. Within eighteen months, Delaware had enacted a statute permitting a corporation's charter to limit the officers' and directors' monetary liability for breach of the duty of care. DEL. CODE ANN. TIT. 8 § 102(b)(7). Virtually every other state followed suit.

The fact of the matter is, the BJR is a standard of review for officer and director conduct, not a standard of conduct. Indeed, there is not, nor could there be, a commonly articulated roster of functions for officers and directors. The question of what should be expected from officers and directors and what kind of liability should follow does not have, nor could it accommodate, a one-size-fits-all answer.

There are several reasons for this. First, it is not reasonable to expect that directors and officers could personally ensure that every potential corporate problem is anticipated or that every instance of wrongdoing could be prevented. In fact, due to the complexity and scale of many modern corporations, it is generally conceded that officers and directors may, in the discharge of their duties, rely upon experts and specialists. This includes accountants, lawyers, engineers, employees, and other experts.

Second, while many directors are invited to sit on boards because of their business backgrounds, many other directors are added in spite of their lack of business experience. They may be invited to sit because they hold specialized skills or sensitivities which are of relevance to some aspect of the company's operations, its community, or its customers. Both types of directors have important contributions to make.

Therefore, given the elasticity of the phrase "good faith," there is a great deal of latitude afforded the interpretation of the law's expectations of directors. Certainly, if, as the President has proposed, the standards of liability for directors were reduced, substantial fall-out would ensue, including a wave of resignations from the halls of management and board rooms. Indeed, it would be virtually impossible for an officer or director to raise every question, pursue every unpleasant rumor, or personally investigate and indemnify every aspect of the company's operations. Even the most conscientious officer or director will inevitably miss things.

The Loss of Innovation for Fear of Risk. Our corporate legal framework should encourage directors and officers to enter new markets, develop new products, innovate, and take business risks. The fact of the matter is that some board actions, although sound when undertaken, will result in losses to the

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[5]Shareholder plaintiff can rebut the BJR presumption by demonstrating that the directors breached their duty of good faith, loyalty, or due care. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1164 (Del. 1995). "If a shareholder plaintiffs fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make." *Id.* at 1162. *See also Wolf v. Rand*, 685 N.Y.S.2d 708, 711 (App. Div. 1999) ("the business judgment rule does not protect corporate officials who engage in fraud or self-dealing").

  ISBN 1056 3059

corporation, while many inventions, innovations, and discoveries, which may have seemed unique or unusual to some when proposed, ultimately turn into enormously profitable decisions.[6]

Innovation and risk-taking substantially benefit our economy and our entire industrial base. *See* Merrill Matthews, Jr., *Risk-taking is Not a Crime*, USA TODAY, Apr. 2, 2002, at A12. Certainly the medical and technological innovations of the past decade would have been less likely to have occurred if the corporate framework for liability which the President is now proposing were in place. If the senior management and directors at Microsoft were personally liable for risk of business loss, even if they acted in good faith, would we be enjoying the same innovations in software we do today? Similarly, as only hindsight is infallible, it would be more logical for officers and directors of pharmaceutical and bio-technical companies to produce buggy whips if losses due to experimentation and innovation put their remuneration and assets at risk.

The problem with the President's proposal is that it runs contrary to shareholders' economic interest in offering sufficient protection to directors from liability for decisions made in good faith, and for possible errors made by those upon whom they are allowed to rely.

Conclusion. It is possible that the most significant outcome from the current wave of corporate events will not come as a result of law or regulation, but from voluntary change. Indeed, the marketplace even now is not waiting while the government debates the issues. Corporations large and small have taken extra pains to more fully explain details of debt and other arrangements that could, under certain circumstances, require sudden cash payments. Stock price valuations as well as corporations' borrowing costs are both beginning to reflect investors' degree of confidence in the respective companies' financial statements.

The significance of these and other voluntary responses is that the current law is broad enough to address all of the corporate issues that have been raised in recent months. There already exists a plethora of laws and regulations to punish corporate wrong-doing. Indeed, the Business Judgment Rule does not insulate officers and directors whatsoever from self-dealing, fraud, illegality, or *ultra vires* conduct. The mistake, therefore, would be instituting reforms that, rather than improving corporate governance, would discourage rational officers and directors from participating in the process because they would be forced to assume great personal risk relating to *ex post facto* claims of liability due to any resulting corporate loss.

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[6]Courts recognize the need for risk-taking as a rationale for the BJR. *See Air Line Pilots Ass'n v. UAL Corp.*, 717 F. Supp. 575, 582 (N.D. Ill. 1989) (noting that the BJR "encourages directors to engage in ventures which have potential for great profit but which may entail some risk"); *Resolution Trust Corp. v. Blasdell*, 930 F.Supp. 417, 423 (D. Ariz. 1994) ("our country's corporate system depends to a degree on the willingness of corporations to take risk.").

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