

Application of the Business Judgment Rule to Corporate Officers

by Gianfranco A. Pietrafesa

The business judgment rule is one of long standing in the corporate law of many states, including New Jersey.¹ The basic premise of the business judgment rule is that management of the business and affairs of a corporation generally resides with the board of directors,² and consequently, informed business decisions of the directors will not be second-guessed by a court when the directors in good faith have made what turns out to be the wrong decision, resulting in adverse consequences to the corporation or its shareholders.

The focus of this article is whether the business judgment rule also protects the decisions, judgments and acts of non-director officers, meaning corporate officers who do not also serve as directors. The article will first set forth the business judgment rule as stated by the New Jersey courts. It will review any New Jersey case law addressing the application of the rule to corporate officers. It will then summarize the positions taken on the issue by prominent corporate law commentators, both within and outside of New Jersey. Finally, it will predict how a court in New Jersey would decide the issue.

The Business Judgment Rule

The business judgment rule was recently examined in *In re PSE&G Shareholder Litigation*,³ where the New Jersey Supreme Court summarized it as follows:

The business judgment rule 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.

...New Jersey courts have long accepted that a decision made by a board of directors pertaining to the manner in which corporate affairs are to be conducted should not be tampered with by the judiciary so long as the decision is one within the power delegated to the directors and there is no

showing of bad faith.

The business judgment rule "is a rebuttable presumption." It places an initial burden on the person who challenges a corporate decision to demonstrate the decision-maker's "self-dealing or other disabling factor." If a challenger sustains that initial burden, then the "presumption of the rule is rebutted, and the burden of proof shifts to the defendant or defendants to show that the transaction was, in fact, fair to the corporation."⁴

Under the business judgment rule, the court will not interfere with the directors' decision. For example, the trial court in the *PSE&G* case noted: "It is also settled that a board's decision...will not be overturned unless it is wrongful. 'A board's [decision] is only wrongful if it is not a valid exercise of its business judgment.'"⁵

In addition, the business judgment rule protects directors from liability for honest mistakes: "Under the rule, when business judgments are made in good faith based on reasonable business knowledge, the decision makers are immune from liability from actions brought by others who may have an interest in the business entity."⁶

The purpose behind the business judgment rule was well summarized by the trial court in the *PSE&G* case, as follows:

The rationale behind the business judgment rule is to encourage qualified men and women to serve as directors and to motivate them to be willing to take entrepreneurial risks. The duties of directors consist principally of establishing corporate policy, weighing major business decisions and overseeing management. The decisions directors are asked to make may not be susceptible to right or wrong analysis at the time they are made. With hindsight, decisions may prove to have been wrong, but that does not necessarily mean a director's decision was wrong when made. Directors act for the owners of the corporation; they make the decisions that the owners would

otherwise have to make. Unless they engage in conduct in which no reasonable owner would be likely to engage, the directors should not expect to be monetarily liable. No owner is likely to intentionally inflict harm on his business—an irrational act.⁷

While the business judgment rule is unquestionably applicable to directors, whether it applies to corporate officers is much less clear. There is no New Jersey case law directly addressing the issue, and precious little case law elsewhere. Three New Jersey cases, however, do refer to corporate officers within the same breath as the business judgment rule.

New Jersey Cases

In *Johnson v. Johnson*,⁸ the court noted that “Under [the business judgment rule], the court examines the director’s or officer’s good faith, and whether he made an informed decision based on a rational belief that the corporation would be benefited.” However, the court did not further discuss the rule.

Several years later, in *Maul v. Kirkman*,⁹ the court noted that “bad judgment, without bad faith, does not ordinarily make officers individually liable.” There, minority shareholders filed suit against the president (who was also a director and the majority shareholder), directors and the corporation. The focus of the court’s decision, however, was on the action of the directors in paying taxes instead of dividends to depress the value of the corporation’s shares, and not on the action of the officer (*i.e.*, the president), although the president clearly influenced the directors.

More recently, in the *PSE&G* case, shareholders brought suit against directors and officers. The Supreme Court’s decision only addressed the business judgment rule in the context of the board of directors’ action in rejecting a

shareholders’ request to file a lawsuit against management.¹⁰ The application of the business judgment rule to officers was not addressed by the Court.

Incidentally, Delaware, a haven for corporations because of its favorable corporate laws and courts, also has not addressed the issue: “Although there is no Delaware case directly on point, it has been suggested in *dicta* that decisions of executive officers may be protected by the business judgment rule.”¹¹

New Jersey Commentators

New Jersey corporate law commentators do not distinguish between the application of the rule to officers and directors. They group officers and directors together. Yet, it would appear that they would support the application of the business judgment rule to corporate officers.

New Jersey attorney Laurence Reich writes that: “A director (*or officer*) is protected by the business judgment rule when he has exercised his authority in good faith and made decisions based on a rational belief that the corporation would benefit therefrom.”¹² By including “officer” in parenthesis, Reich presumably recognizes that the case law in New Jersey (*Johnson* and *Maul*) makes reference to officers when discussing the business judgment rule (or, he believes that the rule should apply to officers).

John McKay 2d, a New Jersey attorney, cites several cases involving claims against corporate officers and states: “The common sense evidenced by the courts in dealing with claims by corporations against officers reflects an implicit adoption of the business judgment rule to protect officers from personal liability. The term is not usually used in the cases, but the concept is nonetheless instinctively applied.”¹³

Finally, New Jersey attorney Stuart Pachman analyzes the business judgment rule in the context of directors’

actions, but he also cites an out-of-state case standing for the proposition that: “The business judgment rule recognizes that corporate directors *or officers* should rarely be held liable ‘simply for bad judgment or unsuccessful business decisions.’”¹⁴

Looking Beyond New Jersey

Both the American Law Institute (ALI) and the American Bar Association (ABA), Business Law Section, Committee on Corporate Laws have weighed in on the issue.

The ALI’s *Principles of Corporate Governance* provides that both directors and officers are protected by the business judgment rule. Section 4.01 provides in pertinent part: “A director *or officer* who makes a business decision in good faith fulfills the duty under this Section...”¹⁵

The ALI’s comments to Section 4.01 provide:

It should be noted the Subsections (a), (c) and (d) of §4.01 deal with both directors and officers. Although most precedents and statutory provisions deal solely with directors, it is relatively well settled that officers will be held to the same duty of care and business judgment standards as directors. Sound public policy points in this direction, as does the little case authority that exists, statutory precedents in at least eighteen states, and the views of most commentators.¹⁶

Likewise, Section 8.42 of the ABA’s Model Business Corporation Act, titled “Standard of Conduct for Officers,” provides in pertinent part:

An officer shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as an officer, if the duties of the office are performed in compliance with this Section....

The ABA comments to Section 8.42 note that: “the business judgment rule will normally apply to decisions within an officer’s discretionary authority.”¹⁷

National Corporate Law Commentators

Several prominent national corporate law commentators have addressed the issue. Some of these commentators have influenced the positions of the ALI and the ABA on the issue, and vice versa.

Delaware attorney A. Gilchrist Sparks III and Widener University School of Law Professor Lawrence A. Hamermesh are perhaps the first commentators who suggested that the business judgment rule should be applied to corporate officers. In a 1992 article, they noted that directors delegate managerial authority to officers, and concluded that the rationale of the business judgment rule should apply to officers discharging the discretionary authority delegated to them by the directors.¹⁸ The Sparks and Hamermesh article influenced the ABA’s inclusion of officers within the protection of the business judgment rule.¹⁹

On the other hand, 13 years later, in 2005, Washington and Lee University Law School Professor Lyman P.Q. Johnson took the position that the business judgment rule should not apply to corporate officers “in the same broad manner” that it is applied to directors.²⁰ He noted that the case law on the issue is “quite sparse,” and what little case law there is does not clearly support the application of the rule to officers.²¹ He further noted that both the ALI’s *Principles of Corporate Governance* and the ABA’s Model Business Corporation Act apply the business judgment rule to officers, but that these two authorities rely on the “sparse” case law to support their positions.²² Professor Johnson’s contention is that the policy reasons for the rule do not support its application to corporate officers.²³ (The reader interested in this topic should study Professor Johnson’s article, although he appears

to be a contrarian on the issue.)

In their article in reply to Professor Johnson, Hamermesh and Sparks note that only a few cases and commentators have addressed the issue since their 1992 article, yet they believe the policy considerations applicable to directors support the application of the business judgment rule to officers, as noted by both the ALI principles and the ABA model act.²⁴

Likewise, another commentator, UCLA School of Law Professor Stephen Bainbridge, has noted:

It is reasonably well-settled that officers owe a duty of care to the corporation. It is less well-settled that officers get the benefit of the business judgment rule. Under the ALI...,the rule applies to both directors and officers.

Judicial precedents are divided, however. At least one court claims that that former view is the majority position, rejecting an argument that “the business judgment rule applies only to the conduct of corporate directors and not to the conduct of corporate officers” on ground that it was “clearly contrary to the substantial body of corporate case law which was developed on this issue.”

Most of the theoretical justifications for the business judgment rule extend from the boardroom to corporate officers. Many corporate decision are made by officers, for example, who are likely to be even more risk averse than directors. Accordingly, insulation from liability may be necessary to encourage optimal levels of risk-taking by officers....

...In sum, the better view is that officers are eligible for the protections of the business judgment rule.²⁵

Attorneys William E. Knepper and Dan A. Bailey also have noted:

The rationale and justification for the

business judgment rule suggests that the rule should apply to both directors and officers. Commentators generally agree with this conclusion. However, relatively little judicial authority addresses the issue. Courts have generally recognized the rule either does or may extend to officers. However, at least one case has limited the rule to only directors.²⁶

Finally, *Fletcher’s Cyclopedia on the Law of Private Corporations* also has noted that “The rule can be used to protect executive officers...,though there is some authority to the contrary.”²⁷

Therefore, it appears that Professor Johnson stands alone on the issue, as all of the other prominent commentators agree that, in light of the policies behind the business judgment rule, the protection of the rule should extend to corporate officers.

Conclusion

To apply the business judgment rule to corporate officers is consistent with common sense and the policy behind the rule. The officer who acts in good faith in the exercise of his or her fiduciary duty to the corporation and its shareholders should not be second-guessed by a court that has the benefit of 20-20 hindsight. As noted by the Connecticut Supreme Court:

Although the business judgment rule is usually defined in terms of the role of corporate directors, it is equally applicable to corporate officers exercising their authority...Although [defendant] was an officer, director and controlling shareholder...it was the exercise of his discretion as a corporate officer of [the corporation] that gave rise to [plaintiff’s] claim of mismanagement and to which the business judgment rule applies in this instance.²⁸

Based on the scant New Jersey case

law, the out-of-state case law, and the overwhelming commentary within and outside New Jersey, it is reasonable to conclude that a New Jersey court would extend the protection of the business judgment rule to corporate officers. ☞

Endnotes

1. Early expressions of the business judgment rule in New Jersey can be found in *Ellerman v. Chicago Junction Railways*, 49 N.J. Eq. 217, 323 (Ch. 1891) and *Elkins v. Camden Atlantic Railroad Co.*, 36 N.J. Eq. 241, 244 (Ch. 1882).
2. See N.J.S.A. 14A:6-1.
3. 173 N.J. 258 (2002).
4. *Id.* at 276-277 (citations omitted).
5. *In re PSE&G Shareholder Litigation*, 315 N.J. Super. 323, 327 (Ch. Div. 1998) (citations omitted).
6. *Green Party v. Hartz Mountain Ind.*, 164 N.J. 127, 147 (2000) (citation omitted).
7. *In re PSE&G Shareholder Litigation*, 315 N.J. Super. at 328 (citation omitted).
8. 212 N.J. Super. 368, 386 (Ch. Div. 1986) (citation omitted; emphasis added).
9. 270 N.J. Super. 596, 614 (App. Div. 1994) (emphasis added).
10. See, e.g., *PSE&G*, 173 N.J. at 286 (creating modified business judgment rule for decisions relating to demand to commence legal action on behalf of corporation).
11. R. Franklin Balotti and Jesse A. Finkelstein, 1 *The Delaware Law of Corporations and Business Organizations* 3d (Aspen 2005), §4.17, at 4-38.
12. Laurence Reich, *New Jersey Corporation Law and Practice* (Aspen Law 1998 Supp.) §6.13 at 128 (citing *Johnson v. Johnson*, discussed above).
13. John McKay 2d, *New Jersey Business Corporation and Other Business Entities* 3d §12.07[2][a], at 12-24.
14. Stuart Pachman, *Title 14A Corpora-*
15. *tions* (Gann 2007), note 17(a) to N.J.S.A. 14:6, at 288.
16. Comment “a” to §4.01. See also Reporter’s Note No. 5 to § 4.01(c).
17. See Committee on Corporate Laws, “Changes in the Model Business Corporation Act—Proposed Amendments, etc.” 59 *The Business Lawyer*, 569, 684 (ABA Feb. 2004). See also Committee on Corporate Laws, “Changes in the Model Business Corporation Act Pertaining to the Standards of Conduct for Officers, etc.,” 54 *The Business Lawyer* 1229 (ABA May 1999).
18. See A. Gilchrist Sparks, III and Lawrence A. Hamermesh, “Common Law Duties of Non-Director Corporate Officers,” 48 *The Business Lawyer* 215, 230 (ABA Nov. 1992).
19. See Committee on Corporate Laws, “Changes in the Model Business Corporation Act Pertaining to the Standards of Conduct for Officers, etc.,” 54 *The Business Lawyer* 1229 (ABA May 1999).
20. See Lyman P. Q. Johnson, “Corporate Officers and the Business Judgment Rule,” 60 *The Business Lawyer* 439, 440 (ABA Feb. 2005).
21. See *Id.* at 443.
22. See *Id.* at 441-43.
23. See *Id.* at 443 and 453-69.
24. See Lawrence A. Hamermesh and A. Gilchrist Sparks III, “Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson,” 60 *The Business Lawyer* 865 (ABA May 2005).
25. Stephen Bainbridge, *Corporation Law and Economics* (Foundation Press 2002), quoted in www.professorbainbridge.com/2006/01/discussing_disn.html (last viewed Sept. 14, 2006).
26. William E. Knepper and Dan A. Bailey, 1 *Liability of Corporate Officers and Directors* 6th (Lexis 1998), §2-3, at 52.
27. William Meade Fletcher, 3A *Fletcher Cyclopedia on the Law of Private Corporations* (Thomson West 2002), §1036, at 37-38.
28. *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253, 1261 n.16 (Conn. 1994).

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