The Business Judgment Rule

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This paper is a rumination on an issue which has intrigued me for almost two decades. I hope this effort will be a continuation of my developing thinking in this area as well as a stimulus to further thought, analysis and research for me and, perhaps, others, as well.

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The nondistribution constraint and dedication to a specific mission define the charitable enterprise. However, fidelity to these animating forces and, hence the ultimate success of charity rests in the hands of its governors -- typically a self-selected, self-perpetuating board of directors. And, although an effective board may not insure success for the organization whose steward it is, a board with a capacity for hard work, attention to detail, integrity and the like will contribute to a positive outcome. Conversely, an inattentive, careless board or one, collectively, lacking in honest, principled conduct will be seen as fueling serious organizational problems, if not an organization's demise.

There are, of course, many and complex forces which bear on the capacity and effectiveness of nonprofit boards to fulfill their critical governance responsibilities. But, certainly, one important determinant is the legal standard governing director conduct -- namely, those that articulate the duties of loyalty and care.

Today, of course, there is a general consensus on the content of that duty -- care -- which prescribes <u>how</u> directors

govern. The standards set out in the typical formulation, however, are widely thought to be subject to the "business judgment rule", a rule developed in the application of court challenges to the conduct of directors of business corporations. Set forth below is one typical articulation of the business judgment rule and its workings:

> "The rule provides that judgments by boards about 'business' matters are presumptively correct and that businesses function best when those decisions remain inviolable except in cases of egregious misconduct.... It is intended to afford directors total protection from liability for business judgments so long as the judgment is plausibly rational, involves no conflicting interest, and the director has acted in a manner that he believes reasonably is informed. The rule is designed to protect honest, informed business judgments in order to allow risk-taking, innovation, and other creative entrepreneurial activities that are at the heart of corporate business enterprise. If a court determines that the business judgment rule applies, it will not undertake an assessment of the more complex and exacting duty of care standard....
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> So long as its basic requirements are met, the business judgment rule essentially insulates a board's decision-making process from judicial scrutiny. Neither the business judgment rule nor the duty of care endorse specific outcomes because few complex business decisions are verifiably correct or not correct. They protect a process rather than any specific results. The rationale for doing so in the business context rests on theories about the nature, and optimum functioning, of our fundamental economic arrangements, including their essentially private character." Daniel L. Kurtz, Board Liability 49 (1988).

What remains largely unanswered is whether or not the business judgment rule or a nonprofit cognate should apply to the

directors of charities and, if so, what are the justifications for its application. Neither the Revised Model Nonprofit Corporation Act[1] or the Guidebook for Directors of Nonprofit Corporations[2] speak with confidence about the rule's application to nonprofit directors nor does either offer much of a rationale for doing so. The same is true for most extant case law. For example, while New York courts from time to time seem to flirt with the rule, they recognize that a definitive application or construction of the rule is missing from the judicial canon. S.H. and Helen R. Scheuer Family Foundation v. 61 Associates, 179 A.D.2d 65 (N.Y. 1992). And, even in the handful of instances in which the rule has been applied by courts, the reasoning and results often seem opaque.

The purpose here then is to analyze carefully the varied justifications proffered by courts in support of the rule to determine their fitness for transposition to the nonprofit context. The business judgment rule effects two ends: it not only limits exposure of directors to potential liability but it also truncates any judicial inquiry itself. The very process of judicial inquiry is viewed as inimical to the optimum functioning of a corporate board when acting, presumably, in the interests of the corporation it serves. What the business judgment rule must presuppose is that the goal(s) of the business corporation will be less adequately fulfilled if judicial inquiry into corporate

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[1] § 8.30 commentary at 216.

[2] Ch. II at 27 (George W. Overton ed. 1993).

decision-making occurs more than rarely. Thus, in part, the rule's rationale rests on the nature and goals of the business corporation.

According to the American Law Institute's Principles of Corporate Governance: Analysis and Recommendations a business corporation has as its invariant and exclusive objective "the conduct of business activities with a view to enhancing corporate profit and shareholder gain." § 2.01 at 69 (Proposed Final Draft 1992). The policy that inheres in the business judgment rule is thought "to stimulate risktaking, innovation and other creative entrepreneurial activities.... Shareholders... accept the risk that an informed business decision... may not be vindicated by subsequent success.... The... protection afforded business judgments is also based on a desire to limit litigation and judicial intrusiveness with respect to private-sector business decisionmaking." Id. at 176.

These views rest on unarticulated assumptions about behavior which may or may not be plausible or convincing in the business context, much less that of nonprofit organizations.

Nonprofits, of course, have no single objective but a multitude of objectives. They are mission-driven and although subject to the famous non-distribution constraint, that does not define the nonprofit objective -- it only says what they are not (or may not do). Indeed, perhaps, the discussion almost could end here. It may be that directors of nonprofits will act in ways similar to their business counterparts but, certainly, the

distinct objectives cannot persuade us that this is the case -- it only would be coincidental.

In other words, business corporation directors when managing or monitoring are presumed to act optimally when their conduct is largely unfettered legally as a consequence of the economic character of the enterprise in which they are engaged. But, there is no reason to believe that nonprofit directors -- pursuing a multitude of non-economic objectives -- will be similarly motivated.

While certain of the proffered rationales for the business judgment rule might support a nonprofit version, it is obvious that many -- perhaps, most -- do not. The ALI study suggests that "in large measure directors and officers carry out their functions because of motives unrelated to their legal obligations." Id. at 177. The motives identified include "a personal sense of responsibility, economic and career incentives, pride, professionalism, peer pressure and the discipline instilled by competitive markets and tender offers." Similarly, Professor Daniel R. Fischel, a leading exponent of the law and economics school at University of Chicago's Law School, noted that "[i]mplicit in the rule is the recognition that liability rules... play a relatively minor role in aligning the interests of managers with those of shareholders." Fischel, The Business Judgment Rule and the Trans Union Case, 40 Bus. Law. 1437, 1439 (1985). Such economic and career incentives would have scant application in the nonprofit context because nonprofit directors

can have no economic stake in the organization (the famous non-distribution constraint, again) and virtually all are volunteers. Indeed, nonprofits typically disfavor "inside" directors who just might have such incentives (which in turn might put too much pressure on the integrity of the non-distribution constraint). The discipline of the markets also would seem, at most, tangential (except, of course, for such problematic areas as health care which, perhaps, are more akin to businesses in any case). Similarly, pride, professionalism and peer pressures all seem to point to a competitive economic and career environment peculiar to the culture of the business corporation and the composition of its boards, with cadres of inside directors and increasing numbers of "professional" directors, as well as corporate managers serving on boards not their own.

The typical nonprofit board is distinct from the business board in so many attributes -- size, committee service, compensation, frequency of meetings, attendance, etc. -- that directors' behavior on nonprofits often is strikingly different and cannot be presumed to be similarly actuated. Indeed, this often appears to be distressingly true when corporate director types occupy board positions in nonprofits.

Professor Fischel subjects the business judgment rule to an elegant economic analysis, claiming the lack of a coherent theory of the rule. However, at the very outset of his discussion, it becomes clear why the rule cannot be mechanically transposed to a nonbusiness context. As already noted, Fischel

assumes that managers' performance is optimal when their interests are aligned with those of shareholders. In nonprofits, of course, that is impossible. Nonprofits have no owners -- indeed, a test of an organization's legitimacy is the indeterminacy of its beneficiaries (perhaps, the closest to shareholders we have) and managers, thanks to the non-distribution constraint, cannot have economic incentives in bottom-line corporate performance (by and large). As Fischel notes, some managers typically have a large portion of their wealth invested in the firms they serve and their compensation is often performance-based (verboten generally for nonprofits).

Discouraging shareholder suits[3] -- a goal of the business judgment rule -- is a legitimate objective. Shareholder suits are an exception to the principle that investors are worse off by allowing those with tiny stakes to determine corporate policy. That should be the privilege of those (presumably, shareholders) with the largest economic stake (one share, one vote). For nonprofits, however, no one has an obvious economic stake. You can't even conduct the discussion on such terms. And, attorneys general's superior ability to police nonprofits seems just a convenient but not very convincing convention. Nor, do nonprofit directors, unlike their forprofit counterparts, seem to have as clear an "expertise" advantage by

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[3] Shareholders, of course, are far superior risk-bearers than beneficiaries. They simply can disinvest. Beneficiaries can't always do that, except at real cost (Adelphi students, for example, or runaways dependent on Covenant House's outreach program).

virtue of their access to superior information, particularly given the purely volunteer nature of their service in most cases.

There are, of course, other justifications for the rule, some of which may apply to nonprofits. The issue remains, however, whether or not there are powerful enough reason(s) for extending its application. One of the traditional justifications in favor of the rule is based on the fact that lawsuits typically follow bad outcomes. The latter, however, may be a consequence of bad luck, improvidence or due care. Distinguishing what are the complex causes of such events in a courtroom, long after the fact, may be a futile exercise. Put simply, that hindsight is unerring in its acute vision says little of what a corporate manager faced at the time the decision(s) were made (or not). This is probably the most persuasive reason for some limitation on the exposure to judicial second-guessing.

Another reason frequently encountered is the rule's role in preventing courts from becoming enmeshed in complex corporate decision-making, a task some feel courts are ill-equipped to handle and directors uniquely qualified to assume. Dennis J. Block, et al., The Business Judgment Rule 4th ed. 1993 & Supp. 1995). While the rule has some superficial attraction, even a staunch defender like Professor Fischel notes that such reasons do not explain why some judges who "presumably are able to resolve other commercial disputes are unable to decide whether a business decision was made negligently." 40 Bus. Law. at 1439.

Yet another rationale often advanced is the rule's salutary role in reinforcing the statutory scheme where decision making stays with the Board without excessive interference from shareholders. Resolution Trust Corp v. Hovnianian, Civ. No. 94-450(HLS), 1994 U.S. Dist. LEXIS 19359 (D.N.J. Oct. 11, 1994). Allowing frequent judicial review of business judgments at the instigation of shareholders would result in "[a] transfer [of] ultimate decision-making authority from the board to any shareholder who is willing to sign a complaint." Block et al., at 10. By limiting judicial review, the rule preserves the statutory scheme of centralized decision-making for shareholders and protects them.

Here, again, of course, this rationale doesn't "have legs". The presumed superiority of board-centered decision-making in businesses is predicated on the concrete, arguably objective reasons why business boards may act in a particular way. There, of course, also are no shareholders in nonprofits to bring suits which would lead to the rule's invocation. Suits, for example, by an attorney general in which the rule could not be applied would do little to shift the locus of decision-making from the Board to members, if any, or beneficiaries.

Some maintain that exposing directors to liability for well-reasoned decisions that cause a corporation to incur losses (i.e., a mistaken business decision) will be counterproductive[4];

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[4] Indeed, a proliferation of lawsuits leading to liability in the nonprofit world itself seems quite remote. Few of the incentives are present in such litigation, either for the lawyers

individuals will be reluctant to serve on boards and/or directors' fees and the costs of D&O insurance will escalate. Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), rev'd on other grounds, 481 U.S. 69 (1987). While some of these concerns may be implicated in the dynamics of nonprofit decision-making, others seem entirely absent. Directors almost never receive fees; D&O costs are largely determined, as we learned once again in the 1980s, not so much by the prevalence of claims, but by the cyclical nature of insurance industry revenues and investment results; and, the difficulty in finding willing and able directors is sheer speculation which, moreover, assumes that the universe of current directors is an approach to the ideal. This, of course, is not to say that there are not good reasons for limiting judicial review of decision-making by nonprofit directors. But, what I believe this does suggest, is that a persuasive case has not been made for doing so.

To see how this might be done, it is instructive to review the case of Levandusky v. One Fifth Ave. Apt. Corp., 75 N.Y.2d 530 (1990).

In Levandusky the New York Court of Appeals, for the first time, determined the standard to be applied in judicial review of a challenge to a decision by the board of directors of a residential cooperative corporation. The Court noted, by way of introduction to its analysis, the "salient characteristics" of

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or litigants.

governing board-homeowner relationships: the resemblance of the association to a government with the lease reflecting the consent of owners to be governed by the board; board responsibility for running day-to-day affairs with broad powers; and, the consequent restrictions such authority may impose on owners' rights. Finally, the court notes the purely voluntary cession of the governed in exchange for the stability offered by board control. The standard of review chosen -- necessary to check considerable power -- should reflect these characteristics. The Levandusky court concluded that "a standard of review... analogous to the business judgment rule" (emphasis supplied) should apply. Id. at 537.

The Court stressed the analogy and noted that fiduciary principles identified in existing case law would be adapted over time to directors of nonprofit housing cooperatives. In reaffirming New York's leading business judgment rule decision -- Auerbach v. Bennett -- which observed that courts are the wrong forum for business decisions -- the Levandusky court stated that "even if decisions of a cooperative board do not generally involve expertise beyond the usual ken of the judiciary, at least the board members will possess experience of the peculiar needs of their building and its residents not shared by the Court." Id. at 539. A more generous standard of review would threaten the stability of common living arrangements and the effectiveness of the board's management authority regarding highly charged emotional and competing views over living space.

What the Court of Appeals has done in Levandusky -- scrutinizing the character of board service, the relationship with the corporation, the differing interests implicated, the nature of the corporation itself -- lucidly illustrates what must be done (and remains undone) to make a comparably persuasive case for applying a business judgment rule analogue to nonprofits. Unlike a cooperative corporation, charities generally have no members whose consent can be presumed or obtained. That is true a fortiori for beneficiaries, except by the most implausible fiction. Charity directors also lack the common interest with beneficiaries that cooperative directors and shareholders almost invariably have. In effect, charities, unlike cooperatives are explicitly not "a quasi-government - a little democratic sub-society of necessity." Id. at 536. Beneficiaries, unlike, shareholders, are not necessarily free "not to purchase" and cannot be viewed fairly as ceding privileges of ownership to fellow owners in exchange for effective stable management.

This, of course, if not to say that a similarly persuasive rationale may not be developed to justify the application of a business judgment rule variant to nonprofits. But, it is my contention that much needs to be done before that case is made convincingly.[5] Many of the most persuasive reasons

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for the development of the business judgment rule are manifestly inapplicable, as I have suggested. While there are some justifications in common -- a sense of responsibility on the part of directors or the ostensible difficulties in recruiting directors -- these alone don't seem nearly sufficient when much of the other support adumbrated here is absent.

The next task facing those who advocate for the existence of a protective shield for nonprofit directors is to develop the predicates, as the ALI study does, as some of the more thoughtful cases do, as the Levandusky court did, for a nonprofit extension.

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issues, not merely private interests.