The business judgement rule – approach and application

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Abstract

The business judgment rule represents a central doctrine of corporate governance, due to its major implications on corporate directors' liability and to its influence on the relationship between shareholders and the board of directors. The interpretation of the Rule as a behavioral standard or as an „abstention doctrine" can determinatively influence the liability proceedings against directors who acted in consideration of their fiduciary duties. This paper aims at analyzing the national legal provisions of the Business Judgement Rule and the compatibility of the legal provisions with the established interpretations of the Rule that can be found in the foreign literature. Absent a case law that clarifies de approaches of the Business Judgement Rule by the national courts, the research analyzes the traditional Common Law approaches of the Rule and the obstacles which hinder a faithful transfer of the Rule in Romania. The objective of these identifications is to draw de lege ferenda proposals for an efficient application of the legal provisions in the future. Considering that this Rule is the natural consequence of trust and of the powers granted to corporate directors, the conclusions of the research suggest solutions for the stabilization of the continuous tension of the supreme values of the corporate world: authority and liability.

Keywords: *Business Judgement Rule, directors' liability, fiduciary duties, duty of care, Abstention Doctrine.*

JEL Classification: K20, K22, K41

1. Introduction

In the Common Law doctrine and jurisprudence, the directors of a company owe what the Delaware Supreme Court[2] has called "*the triad of fiduciary duties*": duty of care (due diligence and prudence), good faith and duty of loyalty. These are almost uniformly recognized by the doctrine and jurisprudence as the standard of fiduciary duties, which are identified and analyzed by shareholders and

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[2] Delaware Courts are internationally recognized as the most prominent forum for resolving disputes covering domestic issues of corporations carrying much of global business. The efficiency of these courts, the predictability of rulings, the reliability of professionals on the pronounced rulings and the continuous exposure to litigation and commercial law issues it is unique in the world. *Delaware Court of Chancery* is an equity court and a standard of fairness and professionalism, determining a huge wave of *forum shopping*.

by courts when assessing the corporate directors' conduct.[3] Although the Business Judgment Rule comes into play with respect to all these three obligations[4], it is closely associated with the duty of care. In essence, the duty of care requires directors to act with the same degree of care that an ordinary careful and prudent person would have in similar circumstances. By invoking the phrase "*reasonable care (attention)*", the duty of care would be violated every time a director acted recklessly.

The Business Judgment Rule is the central doctrine of Business Law, which penetrates and affect the roles of managers, board members and of shareholders with significant power of control. The doctrines referring to this rule is among the most heterogeneous institutions, theoretical assertions and the justification to regulate this Rule are not uniform, nor in Common Law or in continental European systems and this gap has important theoretical and practical implications.

In the American and British case law, two approaches of the Business Judgement Rule are dominant. The first version appertains to the Rule as a standard of liability by which the courts take an objective examination of the merits of board decisions. The second interpretation regards this rule as an Abstention Doctrine[5], pursuant to which courts simply refuse to analyze board decisions in certain individual cases. The distinctions between the two applications of the Rule has major consequences. By the second interpretation, for example, it is very likely that the shareholders' claims against the board of directors will lead to the conclusion of court settlements[6], affecting decisively the ruling of the courts and the effects on the parties trying to resolve the dispute.

In line with the evolving case law in the early 2000s, the Business Judgment Rule was regarded as a standard of analysis based on the corporate

[3] One of the first express mentions of this *triad of fiduciary duties* in the manner it is viewed by the majority doctrine and jurisprudence nowadays is reflected in the justifications of the Case *Aronson vs. Lewis*, 473 A.2d 805, 812 (Delaware, 1984).

[4] The clear separation of this triad was rather tumultuous, a reference Case is *Walt Disney Co. Derivative Litig.* (Disney IV), 907 A.2d 693, 754 (Del. Ch. 2005).The dispute focused on Disney's board of directors failure to complain with the fiduciary duties in connection with determining the terms of employment of the CEO and with his compensation clause at the time of repealing his mandate absent any fault. The court concluded that the protection of the manager disappears only when his gross negligence is proved (unintelligent business decisions or that lack counseling, lack of the minimum steps toward information), bad faith, or if the decision cannot be attributed to any commercially rational purpose. In these cases, the manager is the one who will need to actively act by reversing the burden of proof and showing that he made a fair and equitable decision in for the company and for the shareholders.

[5] „*Abstention doctrine*” is the older interpretation of the Rule, which is becoming increasingly popular in American corporate case law. This concept was initiated and developed by Professor Stephen B. Bainbridge, University of California School of Law, one of the most prominent voices of corporate governance and fiduciary obligations.

[6] According to art. 439 of the Civil Procedure Code, these transactions can also be concluded in the Romanian courts.

governance theory and on the principle of "*shareholders' primacy*"[7]. At the opposite pole, the *"director's primacy"*[8] is a model which highlights the corporate law tension between authority and liability. Courts cannot retain directors' liability without defeating the effective exercise of their powers. Therefore, the ideal of the second interpretation of the rule is represented by the reluctance of the courts to review business decisions in the absence of manifest conflicts of interest.

Further, we intend to demonstrate that the interpretation of the Business Judgement Rule as an "Abstention Doctrine" would lead to its maximum benefits and to obtaining the most effective Court rulings.

2. The role of the business judgement rule

The Role of the Business Judgement Rule is essentially the avoidance of legal liability of the corporate management by creating a presumption that directors or managers act knowingly, in an informed manner, in good faith and in the honest belief that the actions they undertake are in the best interests of the company. Therefore, even clear errors of judgment will not lead to personal liability proceeding of a director.[9]

The Business Judgment Rule permeates all aspects of corporate law, from the analysis of possible negligent business decisions, to self-dealing operations or transactions or even the adoption of long-term business policies.

The liability of management bodies turns out as a much deeper problem than a simple transposition or adaptation of contractual or tort liability regulations in company law. This is not only because of the standardization of private law in the Romanian Civil Code, by repealing the Commercial Code, but this particular liability type is far more sensitive than classical civil liability. Under the common private law, civil liability generally depends on the fulfilling of the conditions laid down by French law and taken up by the former Romanian Civil Code, namely the existence of an injury, of an illegal act, of a causal link between the first two, but

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[7] The „*shareholders' primacy*" model is typically met in Common Law countries, the aim being to maximize shareholders' value, their profits and the stock exchange. This model is characterized by verification and control of management bodies and of the board of directors by shareholders. The „*shareholders' primacy*" model is a hybrid concept, which views the board of directors as a last resort decision-making body, but whose decisions are evaluated in terms of value maximization as a principle of corporate government.

[8] S. M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, Northwestern University Law Review 547, 2003, S.M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, Stanford Law Review 791, 2002, p. 55

[9] The Case *Aronson vs. Lewis, supra 1.* The doctrine and jurisprudence sought the answer on whether the Business Judgment Rule is a procedural presumption, a substantial limitation of liability or both. See Samuel Arsht, *The Business judgement Rule Revisited*, 8 Hofstra Law Review, 1979, which underlines the fact that completely different interpretations of the applications of the Rule are governed by disparate legal principles. This idea is reinforced by R. Franklin Balloti și James J. Hanks, *Rejudging the Business Judgement Rule*, 48 Business Law Review, 1993, who states that the Business Judgment Rule is not a "*presumption of proof in the literal sense of this word*."

especially of the guilt or fault of the person who caused the injury, either under the form of intention, recklessness or the negligence he acted with[10].

The first and most important feature of directors' liability is the lack of a mandatory proof of guilt or fault identified in the director's behavior, as it is in civil law. Although at the beginnings, directors' liability could only be retained if they committed "*administration mistakes*", namely by determining the undeniable existence of fault, beginning with the early twentieth century, with the evolution of the concept of *trust*, the issue of director' correctness began to rise, as well as his right to prove that he is worth the trust he was granted.

By its nature, the Business Judgment Rule is designed to achieve a compromise between the two competing values, a compromise to be determined on a case-by-case basis, evaluating the exercise of powers and liability. The first element, "authority" refers to the need to preserve the discretionary nature of the director's decisional powers, while the second element indicates the importance of being able to call to account the director for the business decisions taken on behalf of the company he represents, and the need to prevent and to correct improper conduct of decision makers. Although separation of ownership and control raises significant concerns regarding liability, neither of the two competing values can survive as an independent institution in modern corporate law[11].

The interpretation of the Business Judgment Rule is reflected in this paper as an application of the directors' primacy theory and not of the shareholders governing rules. The "*directors' primacy*" model is designed to answer two questions of global business law. The first question that arises is: which interest should prevail when the supreme deciding body of a company is in the situation of a tie in game between directors and shareholders? [12] The second key question is: which company body should ideally be vested with the supreme decisional power?[13]

[10] LPop, I.F. Popa, S.I. Vidu, *Tratat elementar de drept civil. Obligațiile conform Noului Cod Civil*, Universul juridic, 2012 p. 412 ff.

[11] According to researchers of the International Monetary Fund, the exercise of powers and the institution of liability cannot independently define corporate governance and the organization of a company's business, as each of these protected institutions tends to reach a distinct value, both being essential for the survival of any company. Michael P. Dooley identified in „*Two models of Corporate Governance*", The Business Lawyer, Vol. 47, Virginia, 1992, p. 461- 463, the importance of establishing corporate governance rules regarding the decision making process.

[12] The Common Law doctrine shows an opinion shared by a number of authors, according to which the Business Judgement Rule and corporate law in general should not have the ultimate goal of maximizing shareholders' wealth, but the final effect should be to authorize directors to make trade-offs between the interests of the shareholders and other stakeholders. In this context, it is worth mentioning the concept of "*Corporate Social Responsibility*" (CSR), a concept of corporate conscience, of civic spirit citizenship and of responsible business management.

[13] The third model, the "*stakeholder model*" can be found in most European countries except for the Nordic countries and the UK. The objective of this model is "*defending the overall interest of the parties involved, in one way or another, within the life of the company (employees, business partners, shareholders, managers, etc.*)." See Niculae Feleagã, *Proba europeană a guvernanței întreprinderii românești*, Revista de Economie Teoretică și Aplicată, New Series, Year XIII, No. 2 (497), 2006. The convergence of government models and systems tends to achieve the most

The *Directors' Primacy* theory is supported by the argument that a centralized decision-making process is an essential attribute of effective corporate governance. From a practical point of view, vesting decision-making powers to the board of directors raises serious concerns regarding liability, and this theory identifies the impending tension between authority and accountability as a core matter of corporate law. We consider that this dilemma can be solved by fair and accurate application of the Business Judgment Rule, namely that courts refrain from examining business decisions, if the precise premises for a substantive analysis are not met[14].

3. Competing apprehensions of the business judgement rule – the standard liability models *vs.* the abstention doctrine

The first intendment, which regards this rule as a standard, as a model to be applied in all cases of directors' liability proceedings was advocated by Professor Melvin Eisenberg[15]. According to this theory, the duty of care would be the ideal behavioral model that corporate managers should adopt and the Business Judgment Rule represents the examination standard of the actual conduct[16] According to this interpretation, the main function of the Business Judgment Rule is to create a less demanding control standard than the ideal standard of conduct created by the definition of due diligence and prudence[17]. Thus, certain courts and authors consider that the Business Judgement Rule protects directors as long as they act in good faith, while some authors deem that the only role of the Rule is to "raise the bar" from simple negligence to gross negligence, indifference or thoughtlessness[18].

The alternative is the Abstention Doctrine. According to this view, the presumption of good faith does not create a standard of liability, but it rather

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efficient political, economic and social model. The possibility of such a phenomena leads to the idea of aligning all EU Member States to the American type of shareholders governance. However, the main obstacle in this endeavor is represented in our view by cultural differences especially in terms of the structure of the society.

14 Stephen M. Bainbridge, *The Business Judgement Rule as Abstention Doctrine*, University of California Los Angeles School of Law, Law and Economics Research Paper no. 03-18, 2003.

15 Melvin Aron Eisenberg, *The divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62, Fordham Law Review, 1993, p. 444-445.

16 Melvin Aron Eisenberg, *Corporations and other business organizations; Cases and materials*, 8th edition, 2000, p. 544-549.

17 William T. Allen, *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem*, 96 NW U. Law Review, 449 (2002)

18 This doctrine is based on the provisions of the Model Business Corporation Act, a set of standard rules drafted by the Corporate Affairs Commission of the National Bar Association of the United States. The model is followed by 24 US states and determines in art. 8.30-8.32 the fact that a director can be held liable in cases where he acted in bad faith, when he reasonably did not believe that his intervention was in the best interest of the company, if he was not properly and reasonably informed, if he didn't act independently, if he was involved in self-dealing cases of if he failed to vigorously maintain a business overview for a period of time.

establishes a negative presumption[19] of the judicial review of due diligence and prudence. According to the latter theory, courts will refrain from analyzing the merits and the substance of directors' conduct, excepting the situations when the claimant can rebut the good faith presumption instituted by the Business Judgment Rule.

3.1 The Business Judgement Rule as a standard assessment of liability

The dominant interpretation in the literature is treating the Business Judgement Rule as an essential liability standard assessment of liability. Some authors only relate subjectively to good faith[20], while others view the Rule as a condition of the rational judgment[21] or as a test to identify gross negligence. The common base of most doctrinal opinions is that the Business Judgment Rule determines an objective, but limited examination of the quality of business decisions taken by the board or by a director.

The best known and most edifying example[22] to illustrate this approach is *Cede & Co. vs. Technicolor Inc*[23]. In this very controversial case at the time the court was seized in 1982, the board of directors of Technicolor approved a merger of the company with a subsidiary of MacAndrews and Forbes Group Inc. Following the completion of this transaction, Technicolor shareholders received an amount of 23 USD/share. The claimant Cinerama, which held 4.4% of Technicolor shares opposed the merger and brought the case before the courts in Delaware. Part of the her request was acknowledging the violation of due diligence and prudence

[19] The interpretation of the Business Judgement Rule as a negative presumption can be often found in Doctrine, a broad description d offered by Prof. Lyman Johnson in *The Modest Business Judgement Rule*, 55 Business Law Review, 2000, p. 625, namely „ *Under a proper understanding of the Business Judgment Rule as a policy of non-review, the substantive force of the Rule always applies in a duty of care case, immunizing the quality of the business decision from judicial review whether or not care was exercised*."

[20] În the Case *Omicare Inc. Vs. NCS Healthcare Inc*, 818 A.2d 914, 927 (Delaware, 2003), the court noted that "*the Business Judgment Rule, as the standard of judicial examination is a recognition of the Common Law statutory authority to manage a company, authority vested in the board of directors*".

[21] Wayne O. Hanewicz, "*When silece is Golden. Why the business judgement rule should apply to no-shops in stock-for-stock Merger Agreements*", Iowa Journal for Corporation Law, 2003, p.205, asserting that "*the standard of conduct for directors is to act reasonably. But the Business Judgment Rule's standard of review is much more limited and diverges sharply from this standard of conduct*."

[22] We mention that this example is edificatory for the first historical interpretation of the Rule, but it doesn't represent the standard for Common Law jurisprudence. However, among others, Prof. David A Skeel observes in the paper *„The Unanimity Norm in Delaware Corporate Law"*, Virginia Law Review no. 127, 1997, that Delaware case law regarding the application of the Business Judgement Rule traversed cyclical trends between the two embodiments presented herein, the same scheme interchanged at different intervals, depending on political, social, economic and tax law factors. The same mechanism was observed by Prof. Bainbridge in his referential Corporate Law text book, *Corporation Law and Economics*, Foundation Press, 2003, pp. 249-251.

[23] *Cede & Co vs. Technicolor Inc*, 13, Delaware, 1987, A 2d 1182

by the board of directors of Technicolor at the time of approving the merger, basing her claims on a similar case, *Smith vs. Van Gorkom*[24]. In the appeal, the Superior Court focused on the decision-making procedure that the board followed in reaching the conclusion to approve the merger. The court also identified some qualitative deficiencies of the decision-making procedure, which taken together lead to the conclusion of the breach of the duty of care. First, the directors have failed to conduct a market research for alternatives before approving the merger. In addition, after questioning the parties, the court concluded that before the council meeting at which the merger was voted, most managers were poorly informed about the terms and effects of the merger and they did not have sufficient information about the counterparty.

The *Van Gorkom* case established the requirement which was later called "professional diligence" or diligence of the decision making process[25], as being a prerequisite for invoking the Business Judgment Rule. In other words, directors who fail to act in an informed manner and after proper deliberation, will not be entitled to rely in their defense on the effects of the Business Judgment Rule. Thus, even if the value of the shares was set at a lower price than the amount actually received by the selling shareholders, the court found that managers have not considered all material data they could reasonably have at their disposal before the approval and the signature of the merger agreement.

The innovative character of this decision is not only given by the complexity of reasoning, but also by the fact that it represents a transition between the two interpretations of the Business Judgement Rule. Delaware District Court began by ruling that „ *business and affairs of a corporation are managed by or under the direction of its board of directors. In exercising these powers, directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders. The business judgment rule is an extension of these basic principles.*" Moreover, the court underlines the fact that the claimant, who doubts a decision of the board of directors has from the beginning of the litigation the „*the burden [...] to rebut the rule's presumption, [...i.e. to show] evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty – good faith, loyalty or due care. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule intervenes attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments. If the rule is rebutted, the burden shifts to the*

24 *Smith vs. Van Gorkom*, 488, A.2d 858 Delaware 1985. Even though it is less controversial than the ruling pronounced in *Cede & Co. vs. Technicolor Inc*, this case is among the first ones where the court defines the application of the Business Judgement Rule as a behavioral standard for directors, therefore it is often being invoked in case law, along with *Cede.*

25 The „*due diligence*" concept of *Common Law* is translated in the Romanian literature as "duty of care and prudence". Given the fact that the similarities and overlaps of fiduciary duties with the duties of an agent under Romanian law are not the purpose of the paper at hands, we will use the term "professional diligence".

defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the entire fairness of the transaction"[26].

We consider that by applying this first interpretation of the Business Judgment Rule, its purpose can be easily diverted. The essence of the Rule is to protect managers whose decisions are challenged, and the trend of the application of the rule after 2000 was precisely the prevention of situations where a court raises the question: did the board of directors breach the duty of care?

3.2 The Case Shlensky vs. Wrigley: „The Abstention Doctrine"

A baseline case which enshrines the second interpretation of the Business Judgement Rule is *Shlensky vs. Wrigley*[27]. The claimant Shlensky brought before the court Philip Wrigley's famous refusal to install night lights on the baseball Wrigley Field in Chicago. At the time, Wrigley was the majority shareholder and chairman of the board of directors of the Chicago National League Ball Club Inc., a Delaware company which owned the *Chicago Cubs* and which operated the game sports ground. Shlensky was a minority shareholder and claimed that between 1961 and 1965, the team has recorded more losses due to reduced number of matches played on local Chicago athletic field. The complainant claimed that the repeated losses were caused by Wrigley's refusal to install lights on the Wrigley Field and to organize games in the evenings. He also argued that the director was not motivated by maximization of shareholders' wealth, but by his personal views and senses, namely he considered baseball a being a day sport and that nocturnal matches would have a negative impact on the residential neighborhood where the playing field was located.

The approach of the defendant director in this case was one of the first attempts to avoid entering the substance of the dispute, claiming the absence of subject of the act of apprehension and, by invoking a determined approach of the abstention concept in the interpretation of the Rule. The arguments raised by the defendant were included in the motivation and reasoning of the judgment, that "*courts will not interfere unless the [directors'] powers have been illegally or unconscientiously executed; or unless it be made to appear that the acts were fraudulent or collusive, and destructive of the rights of the stockholders. Mere errors of judgment are not sufficien*t". In examining the arguments of the defendant, the court displayed and defined certain "fundamental rules" by developing arguments drawn from previous cases.

First, courts will not try to control the company's business tactics and methods, although it believes that a wiser policy could have been adopted, which

[26] The Common Law doctrine and case law uses the term „*entire fairness*", as one of the evaluation methods of the diligence exercised by corporate directors. The five fairness tests will only be applied in cases where the claimant achieved the *prima facie* proof that the directors violated the fiduciary duties or trespassed the limits of their competence. The five Rules are the *Enhanced Business Judgement Rule, Revlon*, the *Entire fairness test, Blasius* and Schnell.

[27] Case *Shlens*ky vs. Wrigley, 95 Ill. App. 2d 173, 237 N.E.2d 776 (App. Ct. 1968)

would have resulted in more prosperous business if the directors would have resorted to other methods. Second, the court noted the disparity of views on directors' business decisions and provided a representative and realistic description of equity rulings that should be applied in similar circumstances: "*The behavior of the courts in such cases should reflect their function, which is to resolve internal political issues and business administration. Administrators are appointed to answer those questions and their judgment should be accepted as decisive, if it proves to be tainted by fraudulent interests*"[28].

Finally, we keep the court's observation in mind, which we fully meet for all the cases where fraud and conflict of interest are excluded *ab initio*: "*In a purely business corporation [...] the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act within the law, and the court is without authority to substitute its judgment for that of the directors*"[29].

We consider that almost every issue which concerns the analysis of the a corporate director's conduct may be limited to the identification of the existence of circumstances that indicate fraud, illegality or conflict of interests, therefore courts should be reluctant to examine the business decisions of honest directors. This approach meets the legal and social needs of contemporary corporate law[30] and it comports with the increased decision-making freedom that should be enjoyed by the managers of a successful business[31].

It is necessary to remark that we do not understand the Abstention Doctrine as an automatic validation by courts of any decision made by corporate directors. Analyzing the reasoning of the above mentioned cases, it follows unequivocally that the Business Judgment Rule does not prevent judicial examination of directors' conduct in cases where there is evidence of fraud or self-dealing. In addition, before invoking the Rule in any given situation, certain fundamental conditions will be checked in advance.

We consider that directors of a company have the right to invoke the Business Judgment Rule only in situations when they adopted the business decision

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28 The Court reiterated part of the reasoning of the Case *Davis vs. Louisville Gas&Electric Co*, 142 A 654, Delaware, 1928

29 The Court reiterated part of the reasoning of the Case *Toebelman vs. Missouri-Kansas Pipe Line Co*, 41 F. Supp, 334, 339, Del. 1941

30 The beginnings of this interpretation date from 1888, when New York Supreme Court explained in *Leslie vs. Lorillard*, 18 N.E, NY 1888, the fact that "*courts will not interfere unless the [directors'] powers have been illegally or unconscientiously executed; or unless it be made to appear that the acts were fraudulent or collusive, and destructive of the rights of the stockholders. Mere errors of judgment are not sufficient*."

31 Although it used an acerb expression, Michigan State Supreme Court clearly described the central idea of the doctrine in the famous Case *Dodge vs. Ford Motor Co.*, namely that "*judges are not business experts". Dodge vs. Ford Motor Co*, 170 N.W, 668, 684, Michigan 1919. This Case remains important for case law and for the history of Ford Company, that is mentioned even in the novel "Wheels", by Arthur Hailey, 1971.

consciously and in an informed way[32].The rule does not preclude judicial review of the board of directors' failure to exercise appropriate supervision of the management of the company and precisely because of this, good faith and independence or lack of personal interest are often identified as prerequisites that precede the application of the Business Judgement Rule.

We note that the Business Judgment Rule does not protect irrational business decisions. Instead, the Abstention Doctrine is confined to the principle that, if indispensable prerequisites are met, judicial examination of the substance or content of business decisions is no longer applicable, because it no longer has a "cover area". However, the real possibility of being able to assign the business decision to a commercially rational purpose must not be confused with the need of concrete proving by directors of the existence of this commercial reasoning[33].

4. The practical importance of the doctrine

After analyzing the reasoning of the previous cases, we observe a light trivialization of the Rule, if we establish as its primary function the allocation of the burden of proof. Therefore, the sole purpose of the Business Judgement Rule will be investing the claimant with the responsibility to create a *prima facie* case, namely the very same obligation incumbent upon a claimant in an ordinary civil litigation. If the applicant fails to meet this procedural obligation, the court will reject the claim without entering into the research of the case substance. According to this understanding, the Business Judgement Rule is nothing more than a reiteration of the fundamental principles of civil procedure, both in Common Law and in the legal systems of French origin, according to which the burden of proof to establish a *prima facie* dispute belongs to the claimant[34].

In addition to this, as previously detailed, involving courts into elements of substance and content of trade decisions is beyond the examination of the decision-making process and limits the scope and purpose of the Rule. The center of gravity of the significance analysis of the Business Judgement Rule should be limited to the interpretation of due diligence and prudence in terms of the adequacy of the

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[32] Although this condition has been implicit since the early 20th century, it was formulated expressly and unequivocally in a judicial reasons only 1984, in the Case *Aronson vs. Lewis*, 473, A 2d, 805, Delaware 1984, "*where directors have either abdicated their functions, or absent a conscious decision, failed to ac*t".

[33] Michael P. Dooley, observes in his paper „*Two models of Corporate Governance*", The Business Lawyer, Vol. 47, Virginia, 1992, pp. 478-479, the fact that "*the term 'rational' is to be equated with conceivable or imaginable and means only that the court will not even look at the board's judgment if there is any possibility that it was actuated by a legitimate business reason. It clearly does not mean, and cannot legitimately be cited for the proposition, that individual directors must have, and be prepared to put forth, proof of rational reasons for their decisions*."

[34] The term used in Common Law for a judgment entered by a court for one party and against another party summarily, i.e., without a full trial is „*Summary judgement*". Such a judgment may be issued on the merits of an entire case, or on discrete issues in that case. Under Romanian law, the burden of proof lies primarily with the complainant, according to art. 249 of the Civil Procedure Code.

decision making process. The essential purpose is exceeded in cases when courts verify whether the same decision would have been made by a reasonable person in a similar hypothetical situation.

Management and decision-making powers vested in the directors and the discretionary nature of decisions which they are entitled to adopt is limited by law, both explicitly and implicitly[35]. We believe that the current corporate governance system is mainly characterized by *directors' primacy*, a model that we understand differently from the American doctrine, due to its application in the context of the mandate (agency) governed by the Civil Code[36]. Consequently, we consider that as the legislation stands, a company's director cannot be considered as having ingenerated powers[37], given, first, the reference norms of the Romanian Companies Act, and secondly, due to the nature of the obligations of the agent provided the Civil Code[38].

It is obvious that no company of modern world could survive unless its directors are granted with a wide decisional freedom. On the other hand, holding that power, allows directors to deviate from the obtaining the profit for the company to their own use. Thus, we consider that the best corporate theory is the one that creates a balance between the quality of discretionary actions, by ensuring the exercise of these authorities in a responsible way.

The difficulty of reaching this balance is determined by the antithesis between the concepts of "authority" and "responsibility" or liability. According to Nobel laureate in Economics, Kenneth Arrow, this dilemma can be succinctly defined in the statement "*the power to hold accountable is ultimately the power to decide*"[39].

The efforts to hold managers accountable necessarily involves the transmission of a part of the decision authority to shareholders or judges. Following the granting of this authority, most business decisions are adopted in modern societies by the board of directors that acts under the powers delegated to

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35 Even though we cannot embosom the original or primary character of corporate directors' functions, the argument of the legal limit of this discretionary position is a valid one. In the publication *The Economic Structure of Corporate Law*, Frank H. Easterbook, D.R. Fischel, 1991, p. 90-93, the authors explain the manner in which fiduciary duties should be understood, as elements which fill the lacks and gaps that determine the inherently incomplete contract between the corporation and shareholders.

36 Regarding the obligations and the liability of directors, art. 72 of Law no. 31/1990, the Companies Act, republished, expressly makes a reference to common law rules regarding the mandate (agency). In the concept of the Civil Code, the contractual nature of this contract prevails and the new legal formula aims at creating a legal horizontal relationship with a strong *intuituu personae* character.

37 One of the limits of the discretionary nature of directors' decision, resulting from the original character of their position is the obligation to maximize shareholders' wealth. This duty is not only specific to Common Law, it can also be found in French law systems. Thus arises the tension between *authority and liability.*

38 Art. 72 of Law no. 31/1990, the Companies Act, republished, provides that "*the duties and the liability of directors are regulated by the provision referring to the mandate (agency) and by the special norms of this Law*".

39 Kenneth J. Arrow, *The limits of Organization*, Norton, New York, 1974, p. 78.

them[40]. Modern boards of directors tend to be more independent than in the past, and in case of major disagreements, under common law, boards of directors have the legal prerogative and the power to appoint and dismiss persons in management positions[41].

Although the authority is critical to organizational effectiveness, it must be exercised responsibly. Authority without the risk to bear responsibility may lead to unnecessary errors and may be exercised opportunistically. The central decision-making body may divert organizational resources to pursue their own benefits instead of pursuing the wealth of the organization and of its components. In the current corporate law system, the potential of corporate opportunism is increased due to the separation between ownership and control, and is not limited to intentional cases of self-dealing, but it can be extended to other ways of shirking from fulfilling the responsibilities, like negligence, carelessness, incapacity or even honest and common errors.

What is the role of this barrier to holding managers accountable, a barrier created by the Business Judgment Rule? If liability for damages encourages managers to be cautious, a court examination of business decision would equally encourage managers to be careful and thorough in pursuing their work. The reason why decisions taken by directors should not be verified unless they regard self-dealing is that the law grants a distinct value to the authority of the boards of directors, a value that would be eroded if the directors' decisions would be regularly analyzed by courts. The source of this value can be found precisely in Arrow's observation, who argues that the power to hold accountable is ultimately the power to decide. Arrow explains that these mechanisms of holding directors accountable should be able to correct errors, but not to such an extent as to destroy the genuine values of authority. ”*Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem*”[42].

Consequently, we consider that the liability of the board of directors cannot occur without a transfer of part of the decision-making authority to shareholders or to courts. To preserve the value and the importance of the authority given to the board, this liability will be held exceptionally and business decisions may be reviewed only in situations when the performance is degraded and sufficiently removed from the original expectations of the shareholders.

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[40] Examples of these types of delegations can be found in Law no. 31/1990 (Romanian Companies Act), for example in art. 114 ("*The exercise of the powers referred to in Art. 113 b), c) and f) can be delegated to the board of directors or to the directorate, through the articles of association or by decision of the Extraordinary General Meeting of Shareholders*") and art. 142 para. 1 (the "*Board of Directors is responsible for carrying out all the necessary and appropriate acts to achieve the objects of the company, except those reserved by law for the General Meeting of Shareholders*").

[41] Art. 142 par. 2 c of the Law no. 31/1990, the Companies Act, modified and actualized.

[42] See Arrow, n.s. 56

As a final remark to emphasize the importance of Business Judgment Rule, we mention the protection it ensures for the directors and for the members of governing bodies for two reasons. First, they are protected against the inherent risk of retrospective examination of their business decisions and secondly, it reduces the risk of lack of innovation and of foolish commercial activity.

The discrepancy between the interests of shareholders and those of directors deepens when directors are exposed to additional risks of legal liability, in addition to economic loss in the event of failure resulting from a bad business decision. Business decisions are rarely described as black or white situations. These situations involve prudent and conscientious judgments of the particular case and placing the same case in the context of plausible alternatives[43]. Moreover, given the unsteady character of business, even prudently and cautiously taken options can end disastrously[44].

At this moment, the well-known flaw of *retrospect review* or *hindsight bias* arises[45]. Governing bodies tend to devote an aberrant high probability of the actual manifestation of an event, just because it finally happened indeed[46]. If a judge or a jury knows that a complainant was prejudiced, he or they will tend to favor liability for negligence, even if according to an *ex ante* vision, the probability of this event to take place was very low, and to take precautions against this injury wouldn't have been efficient in terms of costs[47].

Therefore, the risk of this *ex post* review is very high, because shareholders as plaintiffs and judges invested to adjudicate cases often do not distinguish between competent management and negligence, because negative results are often regarded *ex post*[48]. In this regard, they assess them as being predictable and thus, possible to be prevented *ex ante*[49]. The circumstances of a business decisions are not easily reconstructed into a courtroom years later, since the business activity imperatives require rapid decisions based on incomplete evidence and information.

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[43] James J Hanks Jr, *Evaluating Recent State Legislation on Director and officer liability limitation and indemnification,* Business Law Review no. 43, 1988, p. 1207, 1232.

[44] In the reasoning of the Case *In Re Limited Inc*, 2002 WL, Delaware Ch 2002, the Court underlines the idea that "*the fact that the plaintiff identifies viable alternatives to the Board's decision here is not enough - it is precisely this kind of judicial after-the-fact evaluation that the business judgment rule seeks to prevent*".

[45] In the Case *Agranoff vs Miller,* 791 A 2d 892 Delaware Ch. 2001, Delaware Vice-Chancellor explained the fact that the possibility of the negative influence of retrospective and of cognitive distortions is very high.

[46] Christine Jolls, *A Behavioral Approach to Law and Economics*, Stanford Law Review no. 5, 1998, p. 1471, 1523.

[47] A simple analysis of the influence of retrospective evaluation of the Business Judgement Rule can be found in Hal R. Arkes and Cindy A Schipani, *Medical Malpractice vs the Business Judgement Rule. Differences in Hindsight Bias*, 73 Oregon Law Review, 1994.

[48] Chris Guthrie, *Inside the Judicial Mind,* 86, Cornell Law Review, 2001, a debate on the empirical evidence of the alteration of the decision making process due to influences of retrospective thinking.

[49] În *Joy vs. North* 692, F 2d, 880, 885, 460 US 1051, 1983, Courts admit that after-the-fact examination is an imperfect way to evaluate business decisions.

The position of the responsible for making decisions and for taking over the risks is to face these risks and to combat the factors of uncertainty. A reasoned decision on that point may seem suspicious years later, in the context of the full understanding of all circumstances[50]. If liability is determined by the negative business results, without consideration of the *ex ante* quality of the decision and of the decision making process, directors will be discouraged to bear those commercial risks[51].

5. Proposal to interpret the business judgment rule within the Romanian corporate law

Representation is undoubtedly an intrinsic element of management according to the mandate contract (agency), given the explicit regulation contained in art. 2012 Civil Code. Moreover, art. 218 Civil Code expressly provides that acts done by the management bodies within the limits of the powers they have been conferred, are documents of the legal entity itself and bind the company itself, even if those acts exceed the powers of representation conferred to managers. This regulation mainly highlights the exceptional direct liability of managers to third parties. Thus, we ascertain that the previous regulations of Decree no. 31/1954 concerning representation, taken over by the Civil Code, have been adapted to current realities and the representation powers of companies' directors were expanded considerably. According to art. 1914 Civil Code, directors have the right to sign all documents that are necessary for the fulfillment of the object of the company, "*in the absence of shareholders' opposition*", a provision that is supplemented by art. 70 of Law no. 31/1990, republished, which provides that directors are entitled to decide on "*all operations [...] apart from the restrictions referred to in the articles of association*".

Without intending to exhaust this complex issue of representation or of fiduciary duties, it is worth pointing out that, regardless of civil or commercial nature of the mandate (agency), this also covers all documents necessary for its execution, even if the concrete acts are not expressly specified in the contents of the mandate contract. The novelty of art. 2017 Civil Code to the previous regulation (art. 1537 Civil Code 1864) and the completion of this rule with the provisions of art. 802 Civil Code adapts the current civil and commercial circuit, where the director is sometimes forced to deviate from the instructions he received and when his business judgment is challenged. We estimate that this is one of the best examples of modernization regarding the rules of representation, taking into account the unforeseen complex commercial situations.

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50 See also Jeffrey J Rachlinsky, *A Positive Psychological Theory of Judging in Hindsigh*, 65 University of Chicago Law Review, 1998, arguing that in corporate law, the Business Judgement Rule protects corporate managers and board members from liability for their negligent business decisions, partly because of the inevitability of some less successful results.

51 Supra 79, *Arkes & Schipani*, suggests that *retrospectiv*e evaluation of business decisions may discourage well-qualified persons to engage as members of the board. See also Frank H. Easterbrook, Daniel R. Fischel, *The Corporate Contract*, Columbia Law Review no. 89, 1989, p. 99.

This challenge of the director's business judgment is completed by the express regulation of the Business Judgement Rule in the Companies Act no. 31/1990, introduced in 2006 and amended 2007. The Business Judgment Rule, although expressly provided for by art. 144 ind. 1 of the Company Law no. 31/1990, republished, does not enjoy sufficient recognition in the Romanian doctrine and jurisprudence. The lack of a rick doctrine of analysis of the Rule can be attributed to lack of case law, but also to the declarative legal provision of art. 144 ind. 1, which does not provide any indication of the manner the Rule should be applied by courts.

We welcome the legislature trend to achieve higher flexibility in decision-making within companies. Of the two modernizing directions of company law, namely the extension of directors' powers or of those of shareholders, the Romanian legislature clearly opted for broadening the rights of corporate executives. Inspired by the American model of corporate decision making without discouraging the inherent risk of trade and innovation of any kind, the Romanian model confirms its preference for "*risk of director error to that of judicial error*".

In comparison to Common Law jurisdictions, Romania tries to achieve a fair balance between the rights of creditors and the fulfilling of the business purpose, by granting directors with increased confidence. In the same manner, the German law confers directors a wide range of decisions and they are expected to behave as the representative of a *rational player* and to act as such. The great confidence conferred to directors must be reconciled with the duty of loyalty, directors may not be incompatible[52], they cannot render competitive activities without the consent of shareholders, nor on their own or for other legal entities, and their appointment entails the absence of any doubt concerning a possible conflict of interest[53]. The same reasoning binds the duty of care, the director is presumed by the formulation of the law that he acts reasonably, fairly and prudently in the interest of the company[54]. The burden of proof falls on the ones who invoke the opposite.

The widening trust conferred to directors can be observed with almost every modification of corporate law. It is though obvious that under the current procedural rules, no Romanian court will apply the Abstention Doctrine. In the absence of a legal framework allowing for the application of the doctrine in a particular case, it will not be able to be effective when it is invoked. This raises the questions regarding the reasoning provided by Romanian courts when it decides not to hold accountable a corporate director as a result of the application of the Business Judgement Rule, according to its first interpretation, as a standard.

The partial answer is given by the *Decision no. 2827 of 27 September 2011 pronounced in an appeal by the Commercial Division of the Supreme Court.* We

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[52] Art. 17 Government Ordinance no. 82/2007 for the modification of art. 138 ind. 2 Companies Act no. 31/1990, republished.

[53] Art 197 par. 2 and 3 of the Companies Act no. 31/1990, republished.

[54] Art. 144 ind. 1 of the Companies Act no. 31/1990, republished, modified by Government Ordinance no 82/2007.

appreciate the Court's reasoning as being in full compliance with the spirit and purpose of the regulation of this rule, as well as with the international trends of the rule's application. The Supreme Court ruled that the duty of care of a director, enshrined in the provisions of art. 144 ind. 1 of the Companies Act is not violated if, while making a business decision, the manager is reasonably entitled to consider that he acts in the interest of the company and based on adequate information. The Supreme Court ruled that the law only provides protection against negligence and fraud, and not against inherent business risks, when a decision made in good faith turns into a failure. In this regard, the Supreme Court also stated that as long as "*the director's discernment is not affected by a personal stake, he is properly informed about the nature of the business and he is convinced that the decisions taken are in the interests of the company, then the directors is relieved of any liability*". This motivation is circumscribed to the application of the Rule according to its interpretation as a standard, but we consider that the grounds of judgment of this case does not contain all the essential elements for not holding a director accountable for his acts. Although the rationally commercial purpose and the exhaustive information from the point of view of the decision-making body are determined, we consider that verifying the compliance with the triad of fiduciary duties by the same director is necessary, namely to verify the elements of all three fiduciary duties, and not least, the compliance with the procedures for the decision making procedures by the board, if necessary.

According to art. 144 ind. 1 Companies Act, it follows that the court should examine several conditions for the application of the Business Judgement Rule[55]. First, the existence of a business decision will be identified, the business judgment of the director, namely the rationales considered by managers in the context of decision making and their proper information prior to making decisions.

The reluctance of applying the Business Judgment Rule as a liability standard or as abstention of the courts to research content of business decisions is not only caused by the lack of an adequate civil procedure frame, but is also determined by cultural differences between legal systems. Although Romanian commercial law tends to augmenting confidence in the decisional abilities of directors, the society, the legal environment and especially investors, need time to adapt to the new implications of the judiciary. The court is not called upon to decide on the usefulness or appropriateness of an act of management, but only on the compliance with the interests of social business while adopting a certain decision[56].

We consider that the legislature has already expressed a clear willingness to regulate directors' liability for the easiest form of fault, namely negligence or recklessness. Thus, we consider that the *de lege ferenda*, for the proper and uniform application of the Business Judgment Rule, the Companies Act would suggest the preference for one application manner of the rule, in order to remove

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[55] Radu N. Catană, *Dreptul Societăților Comerciale, Probleme actuale priind societățile pe acțiuni. Democrația acționarială*, Sfera, Cluj-Napoca, 2007, pp. 192-193

[56] *Idem*, p. 183

any doubt about the role of the judge and to grant predictability on the degree to which a business decision can influence the fate of a company and the mandate of the directors.

Such regulation would not only contribute to the predictability of the application of art. 144 ind. 1 of the Companies Act, but by the above arguments, it would also encourage the taking of rational commercial risks. Moreover, an additional explanatory regulation would enhance the confidence of the persons who own the company to the persons who control it, which is another level of efficiency of current commercial law.

However, we stress that excessive technical regulation of the application methods of the Business Judgment Rule distort its essence. Romanian Corporate law is firstly marked by legislative imports from other Member States of the European Union and by light influences of American corporate law, but it is often inspired by market realities and by the commercial jurisprudence. We appreciate that the lack of creativity of Romanian enactment is not a shortcoming or an obstacle to development, but an option of the legislator not to "shock" the market and to maintain the entrenched encodings in the commercial behavior on the domestic market, supplemented with some "legislative transplants"[57]. By this approach, Romania joins the European chart, therefore the simple, but comprehensive regulation of the Business Judgment Rule is not to be regarded with skepticism.

We appreciate that the regulation of the Rule does not represent an obstacle in the way of its implementation. The creation of a clear and uniform legal framework for the application of the Rule by courts by creating clear guidelines for understanding of an institution transposed from a completely different system of law, will support the transformation of the director's role to a function with a categorical decision-making role, with the ability to adopt independent decisions and implement them.

6. Conclusion

A comprehensive explanation of corporate law implies the need to develop sets of rules and standards that allow companies to adopt effective decision making systems and procedures. We consider that the efficiency of decision-making in a company can only be assured by preserving the decision-making powers and authority of the board and by avoiding the distortion of these under the pretext of judicial examination.

The Business Judgment Rule has therefore a special importance because it is an essential mechanism for identifying directors' determinations for conducting their analysis and in order to identify whether they have complied with the core functions entrusted to them.

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[57] M. Siems, *Die Konvergenz der Rechtssysteme im Recht der Aktionäre: ein Beitrag zur vergleichenden Corporate Governance in Zeiten der Globalisierung*, Ed. Mohr Siebeck, Tübingen, 2005, p. 331

If the Business Judgment Rule is reduced to the Abstention Doctrine, court review will most often be the exception than the rule, and the courts will limit themselves at determining whether the decision was stained by the self-dealing of managers or by other fraudulent acts, therefore judges will not evaluate the quality of the business decision. If the Board of Directors indeed exercised reasonable diligence and prudence will irrelevant to the courts, if these view the Business Judgment Rule as a barrier to resist the temptation to examine the merits of the boards' decision.

It is obvious that authority and liability are in constant tension. The tendency to holding account directors for their decisions inevitably reduces the corporate decision-making efficiency. On the contrary, the respect for authority of the board implicitly determines the opportunism risks and negligence. Choosing the right balance between authority and liability is the central problem of the absence of the application of the Business Judgment Rule

Once we determine the competing notions of authority and accountability as the core problem of liability in the Business Judgment Rule case law, the fact that this bears a misnomer in the nomenclature of the law becomes visible. The distinction between rules and standards has become very common. The main legislative reform that could follow from this analysis would guiding the courts to strike a balance between authority and responsibility and between the advantages and disadvantages of abusing each of this. This would determine the reasons for which the courts consider that the balance tilted in a certain concerned it is appropriate or not.

Abstention regarding operational decisions is appropriate because most of these decisions do not reflect a very deep conflict between the interests of managers and those of the shareholders. Given the fact that, for example, a director seems to have preferred the social and the community interests to the interests of shareholders, the question is the determination of his selfish interests. The likelihood is that the manager tried to comply with his vision of proper business ethics. Even if the administrator had eccentric ideas, claimants will have to prove that his personal interest was in conflict with the interests of shareholders. Given the long life of companies, they often plan their activity on a long-term and accordingly, directors can follow the plans that are in the best interest of the company and the long-term interests of shareholders with respects to a fixes investment purview.

Operational decisions are species that economists call *repeated transactions.* In situations where the parties expect repeated transactions, the risk of self-dealing by one of the parties is limited by the threat that the other party will penalize the incorrect partner in future transactions. As noted, disciplining directors by the shareholders is just one of the extra-judicial constraints, which, as whole, give directors the possibility of conducting a diligent and prudent decision-making process. Indeed these forces don’t prevent errors committed by directors. Managers will obviously fail occasionally. But precisely this type of error is the type that should by-pass the evaluation of a court under a traditional corporate law dispute.

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