Lee Burgess: Welcome back to the Law School Toolbox podcast. Today, we're doing another in our "Listen and Learn" series. This one is on Corporations, specifically the duty of care and the business judgment rule. Your Law School Toolbox hosts are Alison Monahan and Lee Burgess, that's me. We're here to demystify the law school and early legal career experience, so you'll be the best law student and lawyer you can be. We're the co-creators of the Law School Toolbox, the Bar Exam Toolbox, and the career-related website CareerDicta. Alison also runs The Girl's Guide to Law School. If you enjoy the show, please leave a review or rating on your favorite listening app. And if you have any questions, don't hesitate to reach out to us. You can reach us via the contact form on LawSchoolToolBox.com, and we'd love to hear from you. And with that, let's get started.

Lee Burgess: Hello, and welcome back to the "Listen and Learn" series. Today, we're discussing Corporations, and specifically the duty of care and the business judgment rule. This is one of the more commonly-tested topics within Corporations, so it is worth diving into!

Lee Burgess: The duty of care and the business judgment rule go hand in hand. Directors and officers are fiduciaries of a corporation, and that means they owe a duty of care to the corporation. This means that they must act in good faith, in a manner they reasonably believe to be in the best interests of the corporation, and with the care that a reasonably prudent person in a like position would reasonably believe appropriate under the circumstances.

Lee Burgess: The business judgment rule is a rebuttable presumption that a director acted in good faith and in an informed manner in the best interests of the corporation. In short, it is a presumption that a director upheld his or her duty of care to the corporation.

Lee Burgess: If the director beaches the duty of care, he or she may be held personally liable to the corporation for any loss suffered as a result. The effect of the business judgment rule is therefore to protect the director from that personal liability. In other words, even if a director made a mistake, or made a decision that ended up harming the corporation, a court will not question that decision if it was made in good faith and in an informed and reasonable manner.

Lee Burgess: The business judgment rule is a presumption in favor of the director, but it can be rebutted. That means that, in order to hold a director personally liable, the burden is on the shareholder or plaintiff who is bringing the action to show that the business judgment rule does not apply. This can be done by showing that the director acted in bad faith, or acted unreasonably, or otherwise violated his or her duty of care.

Lee Burgess: There are a variety of different scenarios in which a director's actions might be used to rebut the presumption of the business judgment rule. Evidence of fraud, illegal activity, self-dealing, or conflicts of interest are all red flags that suggest a director is acting in bad faith, which can prove a breach of the duty of care and rebut the business judgment rule.

Lee Burgess: Notice that the duty of care requires both that the director is acting in a manner they reasonably believe to be in the best interests of the corporation, and with the care that a reasonably prudent person in a like position would reasonably believe appropriate under the circumstances. It is not enough for the director himself or herself to believe the action is in the best interest of the corporation. That belief must be reasonable – and a reasonably prudent person in a similar position would need to also believe they were acting with sufficient care.

Lee Burgess: Evidence that a director was not acting in an informed manner can point to the possibility that the director was acting unreasonably, which indicates a breach of the duty of care. Keep in mind, however, that director may rely on the reasonable advice of advisors, so long as, one, such reliance was reasonable; and two, the advisor or committee was qualified to provide such advice. If the director was acting recklessly or with gross negligence, that could also overcome the business judgment rule.

Lee Burgess: Let's get into our first hypo to start seeing how the business judgment rule works in practice. This is adapted from the July 2015 California bar exam:

Lee Burgess: "Online, Inc. was duly incorporated as an Internet service provider. Online's board of directors is composed of Jane, Sam, and Harry. Jane is also the Chief Executive Officer.

Lee Burgess: Looking to expand its operations, Online sought to enter a strategic partnership with LargeCo, Inc. Jane had learned about LargeCo through Harry's wife, who she knew was the majority shareholder of LargeCo. Jane directed Harry to negotiate the terms of the transaction with LargeCo.

Lee Burgess: In the course of Harry's negotiations with LargeCo, LargeCo offered to acquire the assets of Online in exchange for a cash buy-out of $1,000,000. Harry telephoned Jane and Sam; Jane and Sam agreed with Harry that the offer was a good idea, and Harry accepted LargeCo's offer.

Lee Burgess: A shareholder has sued Jane, Sam, and Harry for violations of the duty of care."

Lee Burgess: Remember, the duty of care requires directors to act in good faith, in a manner they reasonably believe to be in the best interests of the corporation, and with

the care that a reasonably prudent person in a like position would reasonably believe appropriate under the circumstances.

Lee Burgess: Under the business judgment rule, the shareholder will need to rebut the presumption that the actors acted in accordance with their duty of care. So let's break down all of the ways in which Jane, Harry, and Sam may have violated this duty.

Lee Burgess: Let's look at Jane first. Jane directed Harry to negotiate the transaction with LargeCo, even though Jane knew that Harry's wife was the majority stakeholder. Even if Jane herself reasonably believed this was in the best interest of the corporation, it is highly unlikely that a reasonably prudent person in Jane's position would have believed it was appropriate to assign Harry – spouse of LargeCo's majority stakeholder – to lead this negotiation.

Lee Burgess: The shareholder therefore has a strong case that Jane failed to act reasonably, that she violated her duty of care, and that she can therefore be held personally liable for any harms suffered by the corporation and its shareholders as a result of this acquisition.

Lee Burgess: Next, let's take a look at Harry's duty of care. Remember, evidence of a conflict of interest should always be a red flag for possible bad faith. In this case, there's a clear conflict of interest, since Harry is negotiating a massive deal with his wife's company. The shareholder has a very strong claim that Harry acted in bad faith and he violated his duty of care to the corporation, and that he is therefore not protected by the business judgment rule, and so can be held personally liable.

Lee Burgess: Finally, remember that the business judgment rule can be overcome by a finding that the director failed to act in a reasonably informed manner. Here, there's a strong case to be made that Jane and Sam were not acting in a reasonably informed manner when they approved the deal. All we know for sure is that Harry called Jane and Sam to relay the offer, and Jane and Sam agreed, seemingly right away. Given the potential consequences of this acquisition, and the fact that Harry was clearly not a disinterested party, Jane and Sam arguably had a duty to investigate the pros and cons of this acquisition themselves before they could act in a reasonably informed manner. Their reliance on Harry's information, and failure to seek out additional information, likely constituted a failure to act in a reasonably informed manner, thus breaching their duty of care. If they failed to act in a reasonably informed manner, the business judgment rule can be rebutted and Jane and Sam can be held personally liable.

Lee Burgess: Let's check out one more hypo. This is adapted from the October 2020 California bar exam:

Lee Burgess: "Acme Inc. is a corporation that holds $20 million in cash in its treasury. Acme's board of directors consists of its Chief Executive Officer, its Chief Financial Officer, and ten other non-employee directors.

Lee Burgess: The board recently met to consider the best course of action with regard to the cash in its treasury. At this meeting, Acme's CEO and CFO strongly recommended that Acme pay a dividend to its shareholders. The board then heard a report from an outside consulting firm regarding the favorable prospects for Acme's expansion into a new line of business. After a lengthy discussion, the ten outside directors voted in favor of a resolution not to declare a dividend, and instead to hold the accumulated cash for the corporation's future use.

Lee Burgess: The entire board of directors next voted unanimously to make a $100,000 cash contribution to a private university. The CEO is a graduate of this university and a member of its board of trustees. The other Acme board members knew these facts at the time the board unanimously authorized the contribution.

Lee Burgess: One of Acme's many shareholders, Evan, filed a lawsuit against all of Acme's directors for violations of their duty of care."

Lee Burgess: Let's first look into the implications for the duty of care and the business judgment rule of the board's decision not to pay dividends to its shareholders. Remember, the duty of care requires directors to act in good faith, in a manner they reasonably believe to be in the best interests of the corporation, and with the care that a reasonably prudent person in a like position would reasonably believe appropriate under the circumstances. The business judgment rule creates a presumption that the directors did act in accordance with their duty of care, so the onus is on Evan here to rebut that presumption.

Lee Burgess: There's no evidence suggesting that the directors acted in bad faith, but Evan might argue that the directors failed to act in a reasonably informed manner when they relied on the opinion of the outside consulting firm to make their decision. Remember, though, it is okay to rely on the reasonable advice of advisors, so long as the reliance was reasonable and the advisor was qualified to provide such advice.

Lee Burgess: In this case, first of all, it's not clear that the directors necessarily did rely on the advice of the consulting firm. We know only that the firm presented on favorable prospects for expansion into a new business. Following that

presentation, the board had a lengthy discussion, the end result of which was the decision not to pay dividends to shareholders.

Lee Burgess: Even if the board did rely on the consulting firm's advice, however, Evan would still need to prove either that the consulting firm was not qualified to give advice, or that the board's reliance on that advice was unreasonable. Absent such evidence, Evan would be unlikely to overcome the business judgment rule's presumption that the directors acted in accordance with their duty of care. Again, there's no evidence here that any of the directors acted in bad faith, nor that they otherwise acted unreasonably.

Lee Burgess: Next, let's consider the board's decision to contribute $100,000 to the university. Again, it's up to Evan here to rebut the presumption that the directors acted in accordance with their duty of care. Remember, anytime you see something that's a plausible conflict of interest, or illegal, or fraudulent, or self-dealing – you should consider where there was bad faith. Here, Evan will presumably argue that the CEO has a conflict of interest in this decision. The donation is going to the university from which he graduated, and where he is currently a trustee. If this is a conflict of interest, then the CEO's decision to approve this donation was plausibly made in bad faith, which violates the duty of care and rebuts the presumption of the business judgment rule.

Lee Burgess: On the other hand, a majority of disinterested board members approved this decision, which would tend to point against this being a decision made in bad faith.

Lee Burgess: We really don't have enough information here to know if the decision was reasonable. $100,000 doesn't seem like all that much in the grand scheme of the $20 million in the corporation's coffers, but we don't have any information about why the board decided to authorize this donation. More information here could help us better assess whether the decision was a reasonable one.

Lee Burgess: In conclusion, Evan might have a claim that the duty of care was violated here and that at least the CEO should be held personally liable, but it's not a slam dunk and we'd probably need some more information to be certain about that assessment.

Lee Burgess: And that's all we have for you today! Hopefully you found these hypos to be helpful examples of how to work through the duty of care and the business judgment rule on an exam. If you enjoyed this episode of the Law School Toolbox podcast, please take a second to leave a review and rating on your favorite listening app. We'd really appreciate it. And be sure to subscribe so you don't miss anything. If you have any questions or comments, please don't

hesitate to reach out to myself or Alison at lee@lawschooltoolbox.com or alison@lawschooltoolbox.com. Or you can always contact us via our website contact form at LawSchoolToolBox.com. Thanks for listening, and we'll talk soon!

RESOURCES:

"Listen and Learn" series
California Bar Examination – Essay Questions and Selected Answers, July 2015
California Bar Examination – Essay Questions and Selected Answers, October 2020
Examples & Explanations: Corporations, by Alan R. Palmiter
Podcast Episode 282: Listen and Learn – Duty of Loyalty (Corporations)