W. Patrick Delaney

Legal Brief

W. Patrick Delaney is a senior partner at the law firm of MacDonald, Illig, Jones & Britton LLP and is the head of the firm's Commercial Litigation Department.

The Business Judgment Rule: For Better or For Worse?

Five years ago, Ivan's farm equipment manufacturing business, Ivanhoe Inc., had a shortage of cash. Rapid growth had required a build-up of inventory, and new customers were pushing payment terms to 45 and sometimes 60 days. Luckily, Ivan's brother-in-law, Stan, had available funds and became a 5-percent shareholder, with Ivan holding the other 95 percent of shares. Ivanhoe Inc.'s business is now stable. Orders are at good levels. The company has adequate cash. The only problem is that relations between Ivan and Stan have become strained.

In Stan's opinion, Ivan seemed distracted and was making bad decisions. He caused the company to purchase two expensive pieces of manufacturing equipment on the hope of attracting new business, and now those machines sat idle. Further, Ivan recently had announced that he was considering a corporate acquisition that would mean a big increase in debt and a new direction for Ivanhoe Inc. Stan sees his investment losing value, and it's Ivan's fault. Is there anything that can be done?

Fiduciary Duty

Unfortunately, Stan had not taken care to establish an exit arrangement or veto rights when he made his investment. He is not an officer or a director of Ivanhoe Inc. Since Ivan holds the majority of the company's shares and is the sole director of the company, he owes Stan a fiduciary duty. In other words, Ivan has a duty to act fairly, faithfully, and with Stan's interests in mind. But there are limits to Stan's ability to control Ivan or to seek legal remedies.

Business Judgment Rule

Corporate management is vested in the board of directors. When directors, such as Ivan, arrive at a decision, in good faith, and with an honest belief that it is in the best interests of the corporation, a court will not interfere with that decision. This is the Business Judgment Rule, a doctrine uniformly followed by courts for more than 100 years. It is based on the realization that decisions by corporate directors are based on complex business considerations, and judges are simply not qualified to substitute their own judgment for that of the company directors. Thus, Stan's opportunity to complain in court about Ivan's business decisions is very limited.

Exceptions to the Rule

However, like all doctrines, there are exceptions to the Business Judgment Rule. Ivan's decisions and actions must be in good faith. The Rule may not protect Ivan if it is determined that he was perpetrating a fraud or was engaged in self-dealing.

Suppose, for example, it is determined that those expensive machines Ivanhoe purchased were bought at a premium price, from a company in which Ivan was an owner. Or perhaps it is learned that this odd business acquisition Ivan wants the company to make involves a failing business owned by Ivan's son. These are likely examples of self-dealing. Should Stan seek relief in the courts, evidence of self-dealing will cause the protection of the Business Judgment Rule to disappear. The result will be that Ivan will now have the burden of persuading the court that the transactions are fair and reasonable. If he fails to do so, Ivan may find himself personally liable for losses that have been incurred.

Conclusion

The lessons, of course, apply to both Ivan and Stan. Careful planning, negotiation, and documentation can give an investor, who acquires a minority interest, protection and a voice in direction of the company. On the other hand, those in control of management must be aware that they represent all shareholders. While they have broad discretion to act, as demonstrated by the Business Judgment Rule, courts will intervene if they do not exercise that discretion in good faith. ⋆

For more information, contact Pat Delaney at MacDonald, Illig, Jones & Britton LLP at 814/ 870-7658 or pdelaney@mijb.com.

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