In the wake of corporate bankruptcies, government bailouts, and shareholder losses resulting from the economic downturn of 2008, shareholders are increasingly turning to derivative suits in an effort to hold someone responsible for their financial losses. Corporate directors stand in a fiduciary relationship of trust and confidence with the corporation and its shareholders. As fiduciaries, corporate directors owe the corporation and its shareholders fiduciary duties of diligence and fidelity in performing their corporate duties. These fiduciary obligations include the duty of care and the duty of loyalty. “In essence, the duty of care consists of an obligation to act on an informed basis; the duty of loyalty requires the board and its directors to maintain, in good faith, the corporation’s and its shareholders’ best interests over anyone else’s interests.” *Shoen v. SAC Holding Corp.*, 137 P.3d 1171, 1178 (Nev. 2006) (citing *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360-61 (Del. 1993)).

In bringing shareholder derivative suits, shareholders seek to impose liability on corporate directors for failing to carry out their corporate duties in accordance with this standard of care. An important and powerful defense to such derivative suits lies in the common law “business-judgment rule.”

**What Is a Shareholder Derivative Suit?**

A shareholder derivative action is not a cause of action in and of itself, such as breach of contract or breach of fiduciary duty. It is merely an acknowledgment under the applicable law that a shareholder of a corporation may be permitted to bring a lawsuit on behalf of the corporation, which the corporation has failed to bring. *Klopstock v. Sup. Ct.*, 17 Cal. 2d 13, 16-17 (1941). The rights to be vindicated in a shareholder derivative suit are those belonging to the corporation, not those of the plaintiff. *Gall v. Exxon Corp.*, 418 F. Supp. 508, 514-15 (S.D.N.Y 1976). As stated in Pomeroy’s Equity Jurisprudence and by the Delaware Supreme Court:

> The stockholder does not bring such a suit because his rights have been directly violated, or because the cause of action is his, or because he is entitled to the relief sought; he is permitted to sue in this manner *simply in order to set in motion the judicial machinery of the court* . . . . In fact, the plaintiff has no such direct interest; the defendant corporation alone has a direct interest; the plaintiff is permitted, notwithstanding his want of interest, to maintain the action *solely to prevent an otherwise complete failure of justice.*


Shareholder derivative suits evolved as an equitable device to allow courts to protect corporations and minority shareholders against the “frauds of the governing body of directors,” and “to place
in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of "faithless directors and managers."

Kamenv. Kemper Fin. Servs., Inc., 500 U.S. 90, 95 (1991) (quoting Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949)). These actions typically arise when a shareholder sues the corporation’s directors for a “wrong” that the directors have inflicted upon the corporation itself, and only indirectly or “incidentally” upon the shareholders solely by virtue of their relation to the directors through the corporation. See, e.g., Jones v. Ahmanson, 1 Cal. 3d 93, 105-08 (1969). Thus, any damages recovered in a derivative action are paid to the corporation, not to individual shareholders. See Avikian et al. v. WTC Fin. Corp., 98 Cal. App. 4th 1108, 1115 (2002); see also Bader v. Anderson, 179 Cal. App. 4th 775, 801 (2009) (corporation is the “ultimate beneficiary” of any relief sought in a derivative complaint). Therefore, a shareholder derivative complaint must allege damages to the corporation, not to the shareholders’ investments.

Inside the Standard
The business-judgment rule is a standard of judicial review of corporate director conduct; it is not a standard of conduct in itself. 2 Model Bus. Corp. Act Annotated Official Comment at 8-225 (4th ed. 2008). The rule sets forth a presumption that, “in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was in the best interest of the company.” In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) overruled on other grounds). Thus, the business-judgment rule is “a rule of law that insulates an officer or director of a corporation from liability for a business decision made in good faith if he is not interested in the subject of the business judgment, is informed with respect to the subject of the business judgment to the extent he reasonably believes to be appropriate under the circumstances, and rationally believes that the business judgment is in the best interests of the corporation.” Am. Soc’y for Testing & Materials v. Corrpro Cos., 478 F. 3d 557, 572 (3d Cir. 2007) (internal quotations omitted). The business-judgment rule protects “well-meaning directors who are misinformed, misguided, and honestly mistaken” from judicial second-guessing, except in rare case where “a transaction may be so egregious on its face that board approval cannot meet the test of business judgment.” FDIC v. Castetter, 184 F.3d 1040, 1046 (9th Cir. 1999), Aronson, 473 A.2d at 815. “A hallmark of the business judgment rule is that, when the rule’s requirements are met, a court will not substitute its own judgment for that of the corporation’s board of directors.” Lamden v. La Jolla Shores Condo. Homeowners Assn., 21 Cal. 4th 249, 257 (1999) (citing Katz v. Chevron Corp., 22 Cal. App. 4th 1352, 1366 (1994)).

While the business-judgment rule is based in common law, many states have chosen to codify these important principals of corporate liability. For example, in California, the business-judgment rule is codified in section 309 of California’s Corporations Code. Section 309(a) of California’s Corporations Code requires directors to perform their duties “in good faith” and “as an ordinarily prudent person in a like position would.” Cal. Corp. Code § 309(a). Further:

In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by any of the following:

1. One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented.
2. Counsel, independent accountants or other persons as to matters which the director believes to be within such person’s professional or expert competence.
3. A committee of the board upon which the director does not serve, as to matters within its
designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances without knowledge that would cause such reliance to be unwarranted.

Id. at § 309(b). Directors who follow these provisions are shielded from liability: “A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability upon any alleged failure to discharge the person's obligations as a director.” Id. at § 309(c); see also Lee v. Interinsurance Exch. of the Auto. Club, 50 Cal. App. 4th 694, 711 (1996). In other words, the business-judgment rule insulates directors from liability so long as the directors acted in good faith, without conflicts of interest, and did what they believed to be in the best interest of the corporation. Castetter, 184 F.3d at 1044 (affirming trial court’s decision to grant directors’ motion for summary judgment on the basis that plaintiffs' generic and conclusory allegations regarding the directors’ alleged breach of fiduciary duty were insufficient to rebut the business-judgment rule).

An illustrative example of the court’s application of the business-judgment rule as a presumption against director liability can be found in Berg & Berg Enterprises v. Boyle. In Berg, plaintiff sued the former directors of an insolvent corporation for breach of fiduciary duty. 178 Cal. App. 4th 1020, 1024 (2009). After several successful demurrers, the trial court sustained the directors’ demur to plaintiff’s third amended complaint without leave to amend. Id. at 1033. On appeal, plaintiff challenged the trial court’s decision to sustain the demur on the basis that plaintiff had stated a viable claim for breach of fiduciary duty and had pled facts sufficient to rebut the business-judgment rule. ld. at 1033-34. However, the California Court of Appeal disagreed, and affirmed the trial court’s decision. The court held that plaintiff failed to plead a cognizable claim for breach of fiduciary duty against the individual directors because in support of his claim, plaintiff alleged conclusions, not facts, and such conclusory allegations are insufficient to state a claim for breach of fiduciary duty. Id. at 1044-47. The court further held that even if the cognizable claim had been alleged, in the absence of factual allegations establishing fraud, bad faith, overreaching, or an unreasonable failure to investigate, the business-judgment rule insulated the directors from liability as a matter of law. ld.

As the court in Berg explained, “the business judgment rule has two components—immunization from liability that is codified at Corporations Code section 309 and a judicial policy of deference to the exercise of good-faith business judgment in management decisions.” Id. at 1048. “The rule requires judicial deference to the business judgment of corporate directors so long as there is no fraud or breach of trust, and no conflict of interest exists Desai goudar v. Meyercord, 108 Cal. App. 4th 173, 183 (2003) (emphasis added).

[This judicial policy of deference] is based on the premise that those to whom the management of a business organization has been entrusted, and not the courts, are best able to judge whether a particular act or transaction is helpful to the conduct of the organization’s affairs or expedient for the attainment of its purposes. The rule establishes a presumption that directors’ decisions are based on sound business judgment, and it prohibits courts from interfering in business decisions made by the directors in good faith and in the absence of a conflict of interest. ‘A hallmark of the business-judgment rule is that a court will not substitute its judgment for that of the board if the latter’s decision can be attributed to any rational business purpose.’

Berg, 178 Cal. App. 4th at 1045 (citations omitted).
Thus, the business judgment rule protects “well-meaning directors who are misinformed, misguided, and honestly mistaken” from judicial second-guessing. Castetter, 184 F.3d at 1046. “[T]he presumption created by the business judgment rule can be rebutted only by affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts.” Berg, 178 Cal. App. 4th at 1046 (citations omitted).

Pleading an Exception to the Presumption Against Director Liability
While the business judgment rule sets forth a heightened pleading standard that plaintiffs must overcome and provides a robust defense to breach of fiduciary duty claims against corporate directors, it is not without limits.

In order to overcome the presumption afforded by the business-judgment rule to corporate directors, a plaintiff must plead fraud, breach of trust, conflict of interest, oppression, corruption, improper motive, bad faith, overreaching, complete abdication of corporate responsibility, or a failure to investigate that was “clearly unreasonable under the circumstances known to them at the time.” Castetter, 184 F.3d at 1046; Berg, 178 Cal. App. 4th at 1045-46; Frances T. v. Vill. Green Owners Assn., 42 Cal. 3d 490, 509 (1986). But to plead one of these exceptions to the business judgment rule’s presumption that a decision by a corporation’s directors was based on sound business judgment, a plaintiff must allege sufficient facts to establish the exception; “conclusory allegations of improper motives and conflict[s] of interest” are insufficient. Berg, 178 Cal. App. 4th at 1045 (citations omitted) (emphasis added).

Moreover, a plaintiff’s beliefs, considering matters after the fact, that decisions made by corporate directors were substantively wrong or even ignorant, provide no basis for liability so long as the process employed by the directors in making the allegedly wrongful decisions was rational or employed in good faith. Castetter, 184 F. 3d at 1044-46; see also 1st Valley Credit Union, et al. v. Bland, et al., No. 10-cv-01597-GW (MANx), 2010 WL 8757250 (C.D. Cal. Dec. 20, 2010) (dismissing breach of fiduciary duty claim against outside directors where plaintiffs allegations attacking the content and results of the directors’ decisions, rather than the process employed in making the decisions, failed to rebut business-judgment rule); Official Comm. of Bond Holders of Metricom, Inc. v. Derrickson, et al., No. C-02-04756 JF, 2004 WL 2151136, (N.D. Cal. Feb. 25, 2004). Interference with the discretion of corporate directors is not warranted in doubtful cases. Castetter, 184 F. 3d at 1046.

Conclusion
In an age of prevalent shareholder derivative lawsuits for breach of fiduciary duty, the business-judgment rule provides an important defense to corporate directors, and may often provide a legal basis on which to dismiss such suits at the pleading stage. The practitioner would be well-advised to become familiar with the business-judgment rule, its exceptions, and its application.