ISSN:0041-9060

FACTORS GOVERNING THE APPLICATION OF THE BUSINESS JUDGMENT RULE: AN EMPIRICAL STUDY OF THE US, UK, AUSTRALIA AND THE EU

Carlos Andrés Laguado Giraldo[1]
Cámara de Comercio de Bogotá*

ABSTRACT

Briefly, the business judgment rule (BJR) can be defined as a doctrine that protects officers and directors from personal liability only if they have acted in good faith, with due care, and within the officer or director's authority. This paper intends to show what I have called different models of application of the BJR, that is, the implied-low model, the explicit-medium model and the statutory-high model. It examines factors that have led to these models of application and argues, based on this enquiry, that the chances of a uniform model of application of the BJR are very slim. The paper also argues that modern corporate trends of accountability and economic efficiency may lead the corporate systems to implement a medium or high model of application of the BJR.

In the first chapter of this paper we discuss the basic elements and rationales of the BJR. In the second chapter, the construction of the rule in the US, the UK, Australia and the EU is addressed. In the third chapter, we determine the core and marginal factors that influence the adoption of the different models of application of the BJR. Finally in

Fecha de recepción: 28 de marzo de 2006
Fecha de aceptación: 10 de de abril de 2006

1 Abogado Pontificia Universidad Javeriana. LL.M. International Business and Trade Law, Erasmus University Rotterdam, the Nederlands. Profesor de la Universidad de La Sabana. Asesor jurídico de la Cámara de Comercio de Bogotá.

* Avenida Eldorado # 68D-35, Bogotá-Colombia, vicepresidencia jurídica.

the fourth chapter we determine whether it is plausible to adopt a uniform model of application of the BJR and if the trends of accountability and economic efficiency call for a specific model of application of the BJR.

Key words: business judgment rule, models of application of the business judgment rule, business judgment rule in UK, business judgment rule in Australia, business judgment rule in the US, business judgment rule in the EU, factors that affect the models of application of the business judgment rule.

FACTORES QUE GOBIERNAN LA APLICACIÓN DE LA REGLA DEL JUICIO COMERCIAL: UN ESTUDIO COMPARADO DE LOS ESTADOS UNIDOS, EL REINO UNIDO, AUSTRALIA Y LA UNIÓN EUROPEA

RESUMEN

Brevemente, la regla del juicio comercial (Business Judgment Rule en inglés y en adelante BJR) puede definirse como una doctrina que protege a los administradores y directores de compañías contra imputaciones contra su responsabilidad personal siempre y cuando hayan actuado de buena fe, con el debido cuidado y dentro de los límites de su autoridad. Este trabajo describe lo que yo he llamado modelos de aplicación de la BJR, siendo éstos: el modelo implícito-bajo, el modelo explícito-medio y el modelo estatutario-alto. Examina los factores que influencian dichos modelos de aplicación y arguye que, basado en el mencionado examen, las posibilidades de aplicar el mismo modelo de BJR en las distintas jurisdicciones que se estudiaron son escasas. El trabajo también sostiene que las tendencias modernas hacia la responsabilidad de los empresarios y hacia la eficiencia económica pueden conducir a los sistemas corporativos a implementar modelos medios o altos de aplicación de la BJR.

En el primer capítulo de esta disertación exponemos los elementos y la justificación de la BJR. En el segundo, la construcción que se *ha hecho de ésta en Estados Unidos, el Reino Unido, Australia y la Unión Europea. En el tercer capítulo, determinamos los factores centrales y marginales que influencian la adopción de los diferentes modelos de aplicación de la* BJR. *Finalmente, en el cuarto capítulo definimos si es plausible adoptar un modelo uniforme de aplicación de la regla y si las tendencias modernas que claman por la responsabilidad de los administradores y por la eficiencia económica sugieren algún modelo en especial.*

Palabras clave: *regla del juicio comercial, modelos de aplicación de la regla del juicio comercial, regla del juicio comercial en el Reino Unido, regla del juicio comercial en Australia, regla del juicio comercial en Estados Unidos, regla del juicio comercial en la Unión Europea, factores de los modelos de aplicación de la regla del juicio comercial.*

SUMMARY

INTRODUCTION

After corporate cataclysms such as Enron[2], Worldcom[3], the definition of a uniform and unequivocal standard of director's liability, has become an urgent issue. In this respect, two trends have emerged. The first seeks greater accountability. Accordingly, authorities have hardened the level of directorship accountability adopting regulations that appear very close to the provisions of the Sarbanes Oxley Act[4]. On the other hand is the quest for economic efficiency. In between these two trends (accountability and economic efficiency) exists a rule that looks for a proper balance: the Business Judgment Rule (hereafter referred to as the BJR). The increased interest in director accountability, makes the BJR a topic of international interest and of the most practical relevance.

Briefly, the BJR can be defined as a doctrine that protects officers and directors from personal liability only if they have acted in good faith, with due care, and within the officer or director's authority. The BJR becomes a shield for directors against liability imputations. The essence of the rule is that judges should not second guess director's decisions, unless certain conditions are fulfilled. Even though the understanding of the rule is very similar in the countries that have recognized it, its model of application may vary substantively. Accordingly, this paper intends to show what I have called different models of application of the BJR, that is, the implied-low

2 See report of investigation, by the special investigative committee of the board of directors of ENRON corp. February 1°, 2002 at:
http://news.findlaw.com/hdocs/docs/enron/sicreport/

3 For full documentation, reports and filings on Worldcom see http://news.findlaw.com/legalnews/lit/worldcom/

4 Sarbanes-Oxley Act of 2002, H.R. 3763.

model, the explicit-medium model and the statutory-high model. It examines factors that have led to these models of application and argues, based on this enquiry, that the chances of a uniform model of application of the BJR are very slim. The paper also argues that modern corporate trends of accountability and economic efficiency may lead the corporate systems to implement a medium or high model of application of the BJR.

In the first chapter of this paper we discuss the basic elements and rationales of the BJR. In the second chapter, the construction of the rule the US, the UK, Australia and the EU is addressed. These countries have been chosen because they are, as will be seen, good examples of the typical cases of different models of application (implied, explicit and statutory) of the BJR.

In the third chapter, we determine the core and marginal factors that influence the adoption of the different models of application of the BJR. Finally in the fourth chapter we determine whether it is plausible to adopt a uniform model of application of the BJR and if the trends of accountability and economic efficiency call for a specific model of application of the BJR.

1. THE BUSINESS JUDGMENT RULE

"Never before in Australian history had so much money been channeled by so many people incompetent to lend it into the hands of so many people incompetent to manage it".

TREVOR SYKES

1.1. Definition

It is the mission of company directors to make and implement all operations and decisions that allow the companies to develop its social and commercial purposes. They oversee the performance of the corporation; they appoint and remove the senior managers; they draw and execute the company's financial objectives and in general the major operations of the company[5].

5 The general functions and competences of directors are usually defined in the by-laws of companies and in the law that disciplines the corporate system of each jurisdiction. See generally, BRAINBRIDGE, STEPHEN M., "The Business Judgment Rule as Abstention Doctrine", *Vanderbilt Law Review*, 57 *Vand. L. Rev*. 83, 2004; GREENHOW, ANNETTE, *The statutory Business Judgment Rule: Putting The Wind Into Directors', School of Law*, Bond University, 1999. GARRIGUEZ, J., *Responsabilidad de consejeros y altos cargos de sociedades de capital* / J & A Garrigues abogados, McGraw-Hill, Madrid, 1996; GARRIGUEZ, JOAQUÍN, "Panorama actual de problemas en la sociedad anónima", *Revista del Derecho Comercial y de*

In almost all common and civil law jurisdictions, the law has established that in the decision making, directors must act in accordance with the duties that each legal frame work establishes, which in general is built on the duties of care and loyalty[6]. Especially in common law countries, the judiciary has created doctrines to determine whether or not directors have acted beyond the boundaries of their duties and consequently entered into misconduct. One of these doctrines[7] is the business judgment rule (BJR), which was recognized by the US courts in the early years of the last century[8] articulating that decisions of corporate directors,

> "will not be reviewed or scrutinized" should they have proceeded "in good faith and for what they believed to be the advantage of the corporation and all its stockholders"[9].

The BJR can be outlined as 'a standard of non-review, entailing no review of the merits of a business decision corporate officials have made'[10]. Therefore, as some

las Obligaciones, Depalma, vol. 2, n° 7-12, Buenos Aires, (1969); GALGANO, FRANCESCO, *Diritto commerciale. Le società. Contratto di società. Società di persone. Società per azioni. Altre società di capitali. Società cooperative*, Zanichelli, Roma, 2004; H. HANSMANN and R KRAAKMAN, "Agency Problems and Legal Strategies", in R, KRAAKMAN, P, DAVIES, HANSMANN, H, HERTIG, C, KOPT, K.J, KANDA, H and ROCK E.B. in *Anatomy of Company Law: a comparative and functional approach*, Oxford University Press, 2002.

6 See RIDGELEY HORSEY, HENRY, "The Duty of Care Component of the Delaware Business Judgment Rule", 1994 Delaware Law School of Widener, University, Inc. *Delaware Journal of Corporate Law*, in some Civil Law countries is not hard to identify certain similarity with the common law formulation (care and loyalty). In Spain, e.g., the *Ley de Sociedades Anónimas* refers to the duties of *diligencia* (diligence) *y lealtad* (loyalty). The same can be said about Germany (*GmbH Act*), France (*Loi of July 24 1966*) Argentina (*Ley* 19550 de *Sociedades Comerciales*), Italy (*Codice Civile*) and Colombia (*Ley 222 de 1995* and *Código de Comercio*). None the less, there are also significant differences among the conception of the duties in each country. In Germany and in France, e.g., the notion of the duties of loyalty and care are assessed as more high than in English law, in part because they are conceived as objective standards whereas in England "the extent of the duty, and the question whether it has been discharged, must depend on the facts of each particular case, including the director's role in the management of the company" (Re Barings Plc & Others [1999] 1 B.C.L.C. 433.) Abstract from ARSALIDOU, DEMETRA, *Objectivity vs. Flexibility in Civil Law Jurisdictions and the Possible Introduction of the Business Judgment Rule in English Law*, Company Lawyer, 2003, pag. 230.

7 Among these doctrines can be mentioned the standards of good faith, prudence, negligence, gross negligence, waste and fairness. EISENBERG, MELVIN A., *Whether the Business-Judgment Rule Should be Codified*, California Law Revision Commission, May 1995, vol. 28, pag. 35.

8 There are also earlier references of the rule, like in Percy *v.* Millaudon 8 Mart (NSW) 68 (1829) where concern was expressed that 'persons of reason, intellect and integrity would not serve as directors if the law exacted from them a degree of precision not possessed by people of ordinary intellect and integrity'. GREENHOW, *supra* note. 4, pag. 2, precisely footnote 13.

9 1927 Delaware Supreme Court holding in Bodell *v.* General Gas & Electric Corp. 140 A. 264, 267 (Del. 1927), see VEASEY, E. NORMAN and SEITZ, JULIE M.S., "The Revised Model Business Corporation Act: Comment and Observation: the Business Judgment Rule in the Revised Model Act", the Trans Union Case, and the ALI Project. *63 Tex. L. Rev*. 1483 May, 1985.

10 BRANSON, DOUGLAS M., "The Rule That Isn't a Rule - The Business Judgment Rule", 36 *Val. U.L. Rev*. 631 2002.

have sustained[11], the BJR, is not properly a rule, but a standard of judicial review; it does not impose concrete mandates of "do's" or "don'ts" but it sketches a test that judges must follow when considering reviewing a director's business decision. In other words, as a standard of non-review it establishes the test that courts should apply when reviewing an actor's conduct to determine whether to impose liability or grant injunctive relieve[12].

Further, for the purposes of this work, statutory BJR will be understood as the legal precept that has been introduced into a legislative piece, approved by the competent legislative body. It will be seen (Infra 2.1.2.) that in the US there are two formulations of the BJR, one of which (ALI's formulation) has been drafted with the technique of statutory law. However, that formulation is not properly an act or a legislative instrument, it is merely prudential regulation, which may or may not be adopted by a federal legislature or by a court.

1.2. Traditional and modern arguments for a business judgment rule

Academics and courts tend to agree on some arguments that justify the necessity of a BJR. Almost universally accepted, there are traditional grounds for the rule, that date since the origins of the doctrine. Other motives, more contemporary, rely on economic and managerial reasons.

Two reasons have been exposed as traditional[13] explanations for the necessity of a BJR. Firstly, the inadequacy of courts to review business decisions[14]:

> "The reasons usually advanced for the rule are that a court is ill-equipped to make business decisions and should not second-guess directors of substitute its judgment for that of the directors.

11 Branson, *ibidem.* and Brainbridge, *ibídem.*

12 Eisenberg, Melvin A., see note 6 It at. 35.

13 See, among many authors, Greenhow, *supra* note 4; Veasey and Seitz, *supra* note 8: Brainbridge, *supra* note 8; Greenhow, *supra* note 4; Branson, *supra* note 9.

14 Against this position see Brainbridge that comments: "the adage that "judges are not business experts" cannot be a complete explanation for the business judgment rule", and proofs how, for instance, Delaware Courts have shown and detain dine expertise in Business and Corporate Law. and, moreover "Delaware chancellors sit at "the center of the corporate law universe". Brainbridge, *supra* note 4. It should be clarified that in no way Brainbridge denies that for many years this argument has been exposed as a strong rationale of the rule, his emphasis is that this is not a true and unique explanation for the rule.

> Questions like "should we buy a new truck today?" or "should we give Joe a raise?" are simplistically, types of business judgments which the rule was developed to protect. Courts have no place substituting their judgments for that of the directors"[15].

And, it must be noted, Courts cannot replace the role of corporate directors, because they not only do not have the experienced and particular knowledge suitable for taking business decisions, but also because the corporate system supposes that it is the board and the managers who are the individuals in charge of running the company. Justices are not specialists in running companies, they are lawyers, not business managers, and thus they are not competent for managing human and physical resources, financial portfolios or specific commercial transactions.

Secondly, in the words of GREENHOW,

> "the fact that there was no objective standard by which the correctness of the corporate decision may be measured, was the foundation of the rule"[16].

Besides those traditional arguments for the rule, some other rationales have been built, found mainly on the theory of risk allocation, judicial practice and modern corporate structure.

For the American Law Institute's Principles of Corporate Governance the business judgment is necessary to protect

> "directors and officers from the risks inherent in hindsight reviews of their business decisions"

and avoid

> "the risk of stifling innovation and venturesome business activity"[17].

This position fits perfectly with an economic goal to grant freedom and expediency to a director decision under the consideration that its efficient behavior improves shareholders' investment. The result of this achievement is an efficient corporate governance structure that allows boards the freedom to drive the company forward within a framework of effective accountability[18].

---

15 VEASEY and SEITZ, *supra* note. 9.

16 GREENHOW, *supra* note 5.

17 BRAINBRIDGE, It. *supra* note. 5, quoting WILLIAM J. CARNEY, "The ALI's Corporate Governance Project: The Death of Property Rights?", *61 Geo. Wash. L. Rev*. 898, 898 (1993).

18 *Ibidem*. See also GREENHOW, for whom 'The need for Australian companies to remain competitive in the global market and share in the benefits of competition and innovation was high on the Treasurer's

Moreover, the appliance of the BJR has also to do with the due respect for shareholder's will, according to which, first, it is the Directors —-and not the courts, who are called to take business decisions[19], and second, it is the shareholder's choice to invest in the company that is being governed by those directors[20].

From a judicial practical appraisal, some tribunals have recognized the difficulty of reconstructing the decision's environment around each case[21], letting the BJR to substitute that troublesome enquiry.

Lastly, some courts and academics[22] affirm that the risk allocation theory, bounded rationality and the need for cohesion among rational governance teams, are more accurate justifications for a BJR. These are the reasons that we call modern arguments for a BJR.

This position is raised on what they call, 'directors sovereignty,' a corporate policy that was recognized in the famous case Smith *v.* Van Gorkom:

> "The business judgment rule is the offspring of the fundamental principle … [that] the business and affairs of a Delaware corporation are managed by or under its board of directors. ... The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. In other words, the rule ensures that the default is deference to the board's authority as the corporation's central and final decisionmaker"[23].

Let's remember that directors have the legal obligation to maximize shareholders investment that is maximizing profits. For complying with this obligation, directors have to take risky and expedient decisions, sometimes without neither complete nor perfect information. It would be unfair and unsustainable to ask for total accountability when directors face that lack of perfect information.

---

agenda'. This issue was critical and determinant in the moment of considering a statutory BJR in Australia. *Supra* note 5, pag. 2.

19 That main principle has been codified in s.141(a) of the General Corporation Law of the State of Delaware, see ARSALIDOU, *supra* note. 6, pag. 231.

20 In Joy *v.* North, the court held that shareholders voluntarily invest in the challenged company. 692 f2D 880 (1982) extracted in O'KELLEY C. and THOMPSON R., *Corporations and Other Associations,* Little, Brown & Company (1993) 263, in GREENHOW, *supra* note 5.

21 Joy *v.* North, *ibidem.*

22 Joy *v.* North, *ibidem.* That was partially one of the rationales brought by in Joy *v.* North, *ibidem*; see also BRAINBRIDGE, note 5.

23 Abstract of BRAINBRIDGE, see *supra* note 5.

BRAINBRIDGE sustains:

> "At this point, the well-known hindsight bias comes into play. There is a substantial risk that shareholders and judges will be unable to distinguish between competent and negligent management because bad outcomes often will be regarded, ex post, as having been foreseeable and, therefore, preventable ex ante. If liability results from bad outcomes, without regard to the ex ante quality of the decision and/or the decision-making process, however, managers will be discouraged from taking risks. If it is true that "lack of gumption is the single largest source of agency costs", as some claim, rational shareholders will disfavor liability rules discouraging risk-taking"[24].

Moreover, BRAINBRIDGE has introduced the argument of bounded rationality of judges and directors as part of the justification for a BJR:

> "Behavioral economics contends that the limitations of human cognition often result in decisions that fail to maximize utility"[25].

None of them can have perfect knowledge about business, therefore, reliance on good faith and disinterestedness shall be enough ground for granting releasing injunctions. He indicates:

> "Justice JACKSON famously observer of the Supreme Court: "We are not final because we are infallible, but we are infallible only because we are final". Neither courts nor boards are infallible, but someone must be final. The question then is simply who is better suited to be vested with the mantle of infallibility that comes by virtue of being final-directors or judges?"[26].

But, nonetheless these answers should be complemented with the true aim of avoiding intrusions of the courts in corporate governance boards, which could harm the natural collegial function of the body. At the apex of the decision making scheme there is a multi-member-committee (the board of directors) that decides by consensus and can be called a relational team[27].

---

24 BRAINBRIDGE, STEPHEN, Conference the Business Judgment Rule as an Abstention Doctrine, at Syracuse University. January 23, 2004.

25 BRAINBRIDGE, *ibidem.*

26 Bainbridge, *ibidem*

27 See BRAINBRIDGE, who attributes to Oliver Williamson the development of the notion of relational teams, *supra* note 5 at its Foot note 243, pag. 125

> "Such teams may well make superior decisions than individuals acting alone. Individuals are subject to the constraints of bounded rationality and the temptations to shirk or self-deal. Group decision making responds to bounded rationality by creating a system for aggregating the inputs of multiple individuals with differing knowledge, interests, and skills"[28].

External review of the decisions and this relational team can be not only difficult but also harmful to the whole structure of the board. The efficiency and synergy of boards highly depends on idiosyncratic relationships and ways of working that members develop producing sure equilibrium. Each member, within time, plays a fundamental and unique role in the team, whose dismissal can cause critical impairment to the functioning of the board. Thus why an outside review, as for example, a tribunal, rather than internal control and reward systems (combination of mutual motivation, peer pressure, and internal monitoring[29]), should be rejected. The essential task of the BJR is to reduce external interference in board's activity and protect the corporate structure and unity of the board of directors, limiting it to the cases where the synergy and the confidence among the members have already been broken, such as in fraud and self interested transactions, when members usually act alone betraying the other members.

2. THE BUSINESS JUDGMENT RULE IN THE US, UK, AUSTRALIA AND THE EUROPEAN UNION

"Some people are fortunate since they have never heard of the business judgment rule".

BAILES MANNING,
former dean of Stanford Law School

In pursuing the objective of defining the convenience and reasonableness of adopting a statutory BJR, it appears appropriate to review the treatment that some legal systems have given to the rule. The insertion and the role that the BJR plays in each jurisdiction depends on the legal and practical framework that governs some issues of the

28 *Ibidem.*

29 Examples of non-legal control systems can be seen in FAMA, EUGENE F. and JENSEN, MICHEL C., Separation of Ownership and Control. Journal of Law and Economics, Vol. XXVI, June 1983, and Foundations of Organizational Strategy, Harvard University Press, 1998.

corporate system[30]. The BJR brings balance into the triangular relationship among the following issues:

1. the duty of care,

2. the degree of litigation and the judicial resources offered by a legal system against directors and

3. the judicial doctrine upheld by the Courts in this particular regard.

If, for instance, the degree of litigation in a jurisdiction is so intense that it may deter qualified directors to accept any designation, the BJR can smooth down the practice and feature a shelter for hesitant directors. Or, the discouragement that the proliferation of law suits can generate may be reduced if the judicial doctrine entails reluctance for second guessing directors' judgments.

2.1. The business judgment rule in the US

2.1.1. The american framework for a business judgment rule

Some crucial elements of a corporate system are determinant factors of the place that the BJR occupies in a jurisdiction. Among others, the most influential factors in the US were (a) the duty of care, (b) the derivative litigation and (c) Courts legal position towards the liability of directors before the Court's bench.

Firstly, it must be noted, that in comparison with Australia, and along with the English traditional formulation of the duty of care, the American standard of care[31] may be described as relatively low[32]. It is patent, since Aronson *v.* Lewis (1984),

---

30 See ARSALIDOU, DEMETRA, *Objectivity vs. Flexibility in Civil Law Jurisdictions and the Possible Introduction of the Business Judgment Rule in English Law*. 2003 Sweet and Maxwell Limited and Contributors; HEMRAJ, MOHAMMED B., *Company Directors: The Defence of Business Judgment Rule*, 2003 Sweet and Maxwell Limited and Contributors; PASBAN, MOHAMMED R., CAMPBELL, CLARE, BIRDS, JOHN, "Section 727 and the Business Judgment Rule: a Comparative Analysis of Company Directors' Duties and Liabilities in English and United States Law", *Journal of Transnational Law* & Policy - Florida State University, 1997, 6 J. Transnat'l L. & Pol'y 201; BRANSON, *supra* note 6, HORSEY, HENRY, Ridgely. *supra* note 6, MORAN, J.P., "Business Judgment Rule Or Relic?: Cede *v.* Technicolor and the Continuing Metamorphosis of Director Duty of Care", *Emory Law Journal Emory University School of Law*, 1996.

one of the landmarks regarding the BJR case-law, that the standard of care is one of gross negligence[33]. For some commentators[34]:

> "Under Aronson, the business judgment rule protects directors if they have informed themselves "prior to making a business decision, of all material information reasonably available to them" and that "[h]aving become so informed, they … then act with the requisite care in the discharge of their duties." (Aronson *v.* Lewis, 473 A.2d 805, 812 (Del. 1984) Concerning the decision-making process, the Aronson Court concluded that "under the business judgment rule director liability is predicated upon concepts of gross negligence".

Nevertheless, it is precisely this low standard of care requirement that paves the way for the institution of a series of legal actions that allow shareholders to actively demand director's accountability[35]. In the US the low standard of care is set off by the active threat of litigation. In corporate legal practice, a shareholder's derivative action constitutes one of the major concerns for directors, since it is a jurisdiction clearly open to these proceedings[36]. The derivative action is an equitable remedy

---

31 The duty of care is the director's or officer's duty to "exercise that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances". Robert Charles Clark, Corporate law 639-74 (1986) (providing a general discussion about shareholders' suits), in Fontana, Primo. CERCLA Derivative Suits, 27 B.C. *Envtl. Aff. L. Rev*. 741, 2000 Boston College Law School.

32 Arsalidou, *ibidem*, pag. 229. Veasey, *supra* note 9 At. 1486.

33 Moran, J.P., Business Judgment Rule or Relic?: Cede *v.* Technicolor and the Continuing Metamorphosis of Director Duty of Care. Emory Law Journal Emory University School of Law, 1996 A reference to Aronson *v.* Lewis (473 A.2d 805 n.6 (Del. 1984) may be found in almost any article related to the BJR or with the duty of care.

34 Veasey and Seitz, *supra* note 9.

35 Example of that can be seen in media headlines saying: 'Recent shareholder suits may be opening cracks in the protection afforded by the business-judgment rule' (Kris Frieswik, CFO Magazine February 01, 2004

http://www.cfo.com/article.cfm/3011471/c_3046605?f=insidecfo), 'The court for most US companies has been toughened up by waves of crime and reform' BUSINESSWEEK, March 22, 2004 http://www.businessweek.com/magazine/content/04_12/b3875070.htm, 'Rush to re-judgment' Porcher L. Taylor III, cited in Laguado, Carlos and Díaz, María, "Modern Conception of the Business Judgment Rule: a case study on Delaware Jurisprudence", *Review of International Law*, Pontificia Universidad Javeriana, 2005 (in press).

36 Hemraj, Mohammed B., *Company Directors: the Defense of Business Judgment Rule*, 2003 Sweet and Maxwell Limited and Contributors; Pasban, Mohammed R., Campbell, Clare, Birds, John, "Section 727 and the Business Judgment Rule: A Comparative Analysis of Company Directors' Duties and Liabilities in English and United States Law", *Journal of Transnational Law* & Policy-Florida State University, 1997. 6 J. Transnat'l L. & Pol'y 201 at 218-220. Generally, "The Federal Rules of Civil Procedure and all state procedural codes contain instructions for how such litigation is to be conducted. The derivative complaint must be verified and must allege that (1) the plaintiff was a shareholder at the time of the transaction of which the plaintiff complains or that the plaintiff's shares thereafter devolved on the plaintiff by operation of law and (2) that the action is not a collusive one to confer jurisdiction on a federal Court. In United States derivative litigation, it is not necessary that the

which allows a shareholder to assert a claim on behalf of the company against any internal or external wrongdoer in those cases in which the company has decided not to or cannot assert it by herself[37]. In America the threat of derivative actions is great primarily because there is strong motivation for lawyers to encourage shareholders to bring such actions. The law recognizes generous contingency fees (fees based on "no win no fee")[38], rising even to one third or even more of the recovery obtained in litigation for the successful attorneys[39].

Moreover, American Courts have been generous and flexible regarding the way that loyal and in good-faith company directors can run the office[40]. Since the XIX century, Courts have shown reluctance to second guess directors' business decisions and, therefore, have supported a judicial deference towards the directorship.

> "Indeed, support for judicial deference toward directors can be found in nineteenth-century cases and early twentieth-century cases which base discussions around concepts of judgment, risk, and discretion rather than a "presumption"[41]

in the procedural sense of the word. For example, in an old Louisiana[42] case that is cited as one of the first examples of the emergence of the business judgment principle in American jurisprudence, the Court stated that adopting a rule other than one of judicial deference would

> "suppose the possession, and require the exercise of perfect wisdom in fallible beings. No man would undertake to render a service to another on such severe conditions" (8 Mart. (n.s.) 68, 77-78 (La. 1829).

---

actions complained of be ones that could not be ratified by shareholder vote. Thus, derivative actions can be brought for mismanagement or negligence". Special Symposium Issue: Political Structure and Corporate Governance: Some Points of Contrast between the United States and England, in Frontera and Ma, Derivative Litigation- A comparative approach. At 2, 2004 http://frg.sin-online.nl/channel/index.html.

37 Díaz Olivo, Carlos, *Corporaciones*, pag. 276, Publicaciones Puertorriqueñas, www.whafh.com/aboutderivative.htm San Juan 2000, in Frontera and Ma, *ibidem*.

38 Hemraj, *supra* note 36.

39 Special Symposium Issue: Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England, pag. 10, in Frontera and Ma, Frontera, José and Ma, Chao, Derivative Litigation- A comparative approach, 2004, http://frg.sin-online.nl/channel/index.html

40 As examples in the case-law see 11 Ala. 191 (1847), 126 A. 46-48 (Del Ch. 1924), Cole *v.* National Cash Credit Ass'n 156 A. 183 (Del. Ch. 1931), Donald *v.* American Smelting & Refining Co., 48 A. 786, 788 (N.J. Ch. 1901), Jones *v.* Missouri-Edison Elec. Co., 199 F. 64 (8th Cir. 1912).

41 Since the rule was conceived, it was clear that the essence of the doctrine should be based on granting enough freedom to directors to perform efficiently and expediently. Contrarily, the construction of a rule, as a presumption— as Delawer's conception, is quite modern.

42 Quoted by J.P.Moran, unfortunately without the proper reference of the case. Moran, *supra* note 33, pag. 354.

In 1847, the Alabama Supreme Court enunciated the same approach:

> "To exact such extreme accuracy of knowledge from this or any other class of agents, to whom of necessity a large discretion in the choice of means must be entrusted, would be manifestly wrong. [11 Ala. 191 (1847)]"[43].

2.1.2. Current formulations[44] of the business judgment rule in the US

There are two common formulations of the BJR in America[45]. On the one hand is the American Law Institute's (ALI) formulation which has been adopted by several high State Courts[46] and on the other, is Delaware case-law formulation.

ALI's formulation, which in principle is nothing else than a recommendation drafted by the American Law Institute, but which's influence on federal law is unquestionable, states in § 4.01(c) of the Business Corporations Act:

> "(…) (c) A director or officer who makes a business judgment in good faith fulfills the [duty of care] if the director or officer:
>
> (1) is not interested in the subject of his business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation"[47].

Briefly, according to ALI's proposal, for the rule to apply, first, the director must have made a decision; second, he or she must be free of self interest in the judgment; third, he or she must adopt the decision under informed basis; and lastly, the director must have had a rational basis for the decision[48]. The many comments about section

---

43 MORAN, J.P., *supra* note. 33, pag. 354.

44 There is a new concept of a Modified BJR applicable to takeover defenses; the scope of this work, however, is limited to the traditional formulation of the BJR. For a more concrete study on the Modified Business Judgment Rule for Takeover Defenses, see KIRCHNER, CHRISTINA and PAINTER, RICHARD W. Towards a European Modified Business Judgment Rule for Takeovers law. *European Business Organizations Law Review*, http://ssrn.com/abstract=247214

45 BRANSON, *supra* note 9, pag. 634.

46 *Ibidem.*

47 American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994).

48 BRANSON, *supra* note 10.

4.01(c) of the ALI Project are outside the scope of this paper; it will be sufficient to stress that under this formula, the BJR constitutes a 'safe-harbor' to which directors can apply if they can prove that the requirements of the rule are fulfilled. Note that the burden of proof is on the directors[49].

Delaware case-law developed[50] the other common formulation of the BJR. The seminal cases[51] throughout which the doctrine of the BJR has been underlined are Aronson *v.* Lewis, Trans Union and Cede.

In one of the most quoted statements of corporate law, in Aronson *v.* Lewis, (1984) the Delaware Court affirmed that the BJR is:

> "a presumption that in making a business decisions the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. Absent an abuse of discretion, that judgment will be respected by the Courts. The burden is on the party challenging the decision to establish facts rebutting the presumption"[52].

---

49 Branson, *ibidem* at 636.

50 Notwithstanding, there is notice of the rule since 1927. See *supra* note. 9.

51 Other well known cases, that without varying the precedent set out in Aronson, add tangential details are Disney (In Re Walt Disney Co., C.A. n° 15452 (Del. Ch. Oct. 7, 1998), 1998 Del. Ch. LEXIS 186. Notice of Appeal was filed with the Supreme Court of Delaware on Nov. 4, 1998) and Oracle [In re Oracle Corp. Derivative Litigation, 824 A.2d 917 (Del. Ch. 2003)], (See Veasy, Norman in *CFO Magazine*. Judgment Calls, at http://www.abanet.org/buslaw/blt/2003-09-10/nonbindingopinions. html, September 9 2003.) Disney (Brehm *v.* Eisner) "a case involving The Walt Disney Company's very large severance payment to its former president Michael Ovitz, the Delaware Supreme Court repeated the traditional formulation of the business judgment rule as "a presumption that in making a business decision the directors … acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation". The Court went on to say that "directors' decisions will be respected by Courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available".

(http://www.debevoise.com/publications/pubsdetail.asp?pubid=1455206192003&typeid=4 Meredith M Brown and William D Regner, *What's Happening to the Business Judgment Rule*? June 19, 2003). In Oracle, "a SLC was appointed to study a complaint against Oracle's directors, including the CEO Larry Ellison, for insider trading. The appointed SLC was composed by individuals closely related to Stanford University and found no motives for bringing the directors to Court. The Court of Chancery, denied SLC's resolution noting that its independence was in doubt. To Chancellor Strine, "the connections suggested that 'material considerations other than the best interests of Oracle could have influenced the SLC's inquiry and judgments'" The Court agreed on this ruling because the two SLC members were professors at Stanford University and three of the four defendants were either major donors to or professors at Stanford, such that the SLC was not independent" Laguado and Díaz *supra* note 34.

52 Aronson *v.* Lewis, 473 A.2d 805, 812 (Del. 1984).

> (…) "It is presumed that decisions of disinterested directors are made in good faith for a rational business purpose, with due care, and in the honest belief that they are acting in the best interests of stockholders (473 A.2d 805)"[53].

Less than a year after Aronson, in Smith *v.* Van Gorkom[54] also known as Trans Union,

> "The Court held that the Board's September 20 decision approving the proposed cash-out merger 'was not the product of an informed business judgment'. In so holding, the Court found adequate evidence that the directors had not availed themselves of all the information reasonably necessary to make an informed decision. Thus, the presumption of reasonable care[55] was overcome"[56].

Trans Union holding bonds the lack of sufficient information to the presumption of reasonable care, thus, when directors failed to give the proper steps for entering into the details of a transaction, they where considered to act without reasonable care. The critic points in Trans Union are, first, that the Court left untouched the core-substance of the board's decision, and focused its analysis on the procedural steps that preceded the adoption of the merger, achieving, on one side of the balance, director's accountability, and on the other, a policy for avoiding discouraging adventuresome and risk-taking directors[57]. And, secondly, that

> "[t]he decision contributed to the devastating insurance crisis which was already underway. While the VAN GORKOM decision was supposed to be "a perilous time for corporate directors, "or the explosion of a bomb which "shocked the corporate world", it turned into a historic opportunity for corporate directors who, through their lobbies, successfully pressed the legislature to introduce the most protective provision in the history of American corporate law. This opportunity was the amendment of section 102(b)(7)[58] of the Delaware General Corporation Law in June of 1986, which has eliminated

53 In VEASEY, *supra* note 9.

54 For a complete factual background see WAGNER THOMAS C. Corporate Law —The Business Judgment Rule Imposes Procedural requirements On Corporate Directors— Smith *v.* Van Gorkom, 488 A.2d 858 (Del. 1985) *Florida State University Law Review*, 14 *Fla. St. U.L. Rev*. 109.

55 The Court affirmed that the Directors, by failing to gather the merely reasonable information, consciously acted blindly, amounting the Court to deny the existence of good faith, and in consequence, rebutting the presumption of reasonable care that the BJR granted.

56 WAGNER, *supra* note. 54.

57 PASBAN , *et al supra* note 30, pag. 201-2.

58 Section 102(b)(7) of the Delaware General Corporation Law provides: a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct

directors' liability for gross negligence. This path has been followed by most other jurisdictions in the United States"[59].

Last but not least, in Cede & Co. *v.* Technicolor, Inc. (CEDE) (1993)[60], Cinerama, Inc. and Cede Co.'s shareholders sued Technicolor's directors on the grounds of breach of the duty of care and unfair dealing due to an inaccurate and imprecise pricing of the shares within the context of a cash-out merger. In CEDE, the Court

> "moved from a standard in Trans Union that would require directors to have 'informed themselves, prior to making a business decision, of all material information reasonably available to them,' to a requirement in Cede that directors conduct 'a prudent search for alternatives,' take an 'active and direct role in the context of the sale of a company from beginning to end,' and not be 'passive instrumentalities during merger proceedings"[61].

After CEDE, a new requirement was added to the rule. Directors were obliged to look further and examine alternatives for their operations, e.g., another bidder in a tender offer, a different settlement of a retirement agreement or a distinct valuation method of the share price. Directors' accountability, therefore, was enhanced. The rationales of the BJR, as seen in the previous chapter of this work are well justified. The rule will grant relief to directors and officers that fear the risks inherent to hindsight reviews of their business decisions as long as they acted in informed basis, under the scope and with the additional requirements set in CEDE [62].

In shorthand, the fundamental difference between the two mentioned formulations is that whereas in ALI's proposal the burden of proving the elements of the rule relies on the defendants (the directors), in Delaware's doctrine, the rule acts as a presumption in favor of them, according to which it is the charge of the plaintiff to rebut the existence of those elements. That means that Delaware's doctrine is far more generous to directors. The existence of a presumption in Delaware's doctrine, vis-à-vis ALI's proposal, is clear. In Aronson the Court in defining the BJR held that it was

> "as a presumption that in making a business decisions the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company",

or a knowing violation of law; (iii) under § 174 of this title [the section dealing with conflict of interest]; or (iv) for any transaction from which the director derived an improper personal benefit. Del. Code Ann. tit. 8, § 102(b)(7) (1996).

59 PASBAN, *et. al*, *supra* note 30 at. 203.

60 Cede & Co. *v.* Technicolor, Inc., 634 A.2d 345, 368-71 (Del. 1993).

61 MORAN, *supra* note 30 at 372.

62 *Op. cit.*

whereas such precision does not evolve from the wording of § 4.01(c) of the Business Corporations Act nor from the subsequent interpretations of the mentioned provision.

2.2. The business judgment rule in the UK

England does not contemplate a statutory BJR. That can be explained by several reasons.

Firstly, the duties of care and skill, as defined in Re City Equitable Fire Insurance Co Ltd[63] (1925) are subjective, as they are based on the directors' personal skills[64]. In the mentioned case, it was upheld that:

> "a) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. […]
>
> b) He is not bound to give continuous attention to the affairs of his company.
>
> c) Subject to the articles and business practice, a reasonable delegation of duties to officials is justified"[65].

Commentators suggest that in this landmark case Romer J. and Neville J.

> "were offering the required flexibility that may be necessary when the commercial realities witness a change and that they were careful in selecting the right terminology that would enable the Courts to adjust to changing circumstances(…)"[66].

---

63 [1925] Ch 407.

64 Some authors note that nowadays the standard of City Equitable is questionable due to the date when the doctrine was formulated (1925). Instead they suggest that the standard should be constructed under more modern premises, in particular Section 214 of the Insolvency Act 1986 which imposes liability on directors for wrongful trading, that is, for directors that continued trading after clear signals of financial distress or clear notice of liquidation. This standard is, by contrast, subjective and objective. "The test laid down in s 214 is a statutory one for a statutory purpose but it is increasingly taken to be an accurate reflection of the modern standard of care and skill in all circumstances and not jus for the purpose of liability under s214. Certainly it must be borne in mind when considering the application of older cases to modern circumstances". Re D'Jan of London Ltd, Copp *v.* D'Jan (1994) BCLC 591, Norman *v.* Theodore Goddard (1991) BCLC 1028, both quoted in THORNE, JAMES and WALMSLEY, KEITH, *Company Law*, Butterworths, Third edition, 1995, pags. 167-8; AIMAN NARIMAN MOHD SULAIMAN, "Revising the directors' duty of care, skill and diligence in Malaysia", *Australian Journal of Corporate Law*, AJCL LEXIS 23, 2004.

65 ROSE, FRANCIS, *Company Law*, Sweet & Maxwell, Third edition, London, 1995, pag. 76.

66 ARSALIDOU, *supra* note 30.

Directors are supposed to be judged on their personal skills[67], on the facts of each particular case and on the director's role in the management of the company (Re Barings Plc & Others [n° 5][68]. It is noted, therefore, that the English duties of care and skill are flexible standards that should be determined through an analysis of the size and type of company and, especially, the precise role of the individual director in the management of the corporation. Moreover, as it occurs in the US, mere negligence does not amount to liability for a director; as accentuated in Sheffield and South Yorkshire Permanent Building Society *v.* Aizlewood (1890) (44 Ch. D. 412),

> "directors are not trustees in the ordinary sense of the word but are "commercial men managing a business for the benefit of themselves and the other members"[69].

So, as long as they have acted in good faith and without clear misfeasance they will not be liable for mistakes[70].

Secondly, in England the exercise of a derivative action is far more complex and way less profitable than it is in the US[71]. If shareholders want to bring a derivative action against a director, two requirements should congregate:

> "(1) The corporation is in the control of wrongdoers and (2) the breach complained of is not ratifiable by the shareholders. The scope of the derivative remedy in England depends, in part, on how "wrongdoer control" is interpreted. In Prudential Assurance Co. *v.* Newman Industries, Ltd., the Court indicated that the "wrongdoer" element could be satisfied by evidence of effective control even if the defendants did not control a majority of the voting shares. And the requirement that the breach complained of not be ratifiable by the shareholders is also a potential impediment to a derivative action. While claims involving misappropriation of company assets or similar illegal conduct cannot be ratified, claims of negligent mismanagement can be. Thus, a derivative action will not ordinarily lie in England for breach of the duty of care, at least when other aspects of self-dealing are not present"[72].

---

67 It must be clear, however, that though the individual director might have greater knowledge and experience than others in the same office, it may suffice if he exercises the care that may reasonably be expected of a person discharging the relevant functions: Norman *v.* Theodore Goddard (1991). See Rose, *supra* note 64, who unfortunately does not provide the exact citation of the case.

68 [1999] 1 BCLC 433, in Arsalidou, *supra* note 30.

69 Quoted by Arsalidou, *ib*. At. 230.

70 *Ib*. At 230.

71 Hemraj, *supra* note 30 at 197.

72 Geoffrey Miller, Special Symposium Issue: Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England, 1998 *Colum.Bus.L.Rev*. 51, pag. 7, in Frontera, José and Mao, Chao, *supra* 39. The rationale of the test meets basic principles of corporate law

Now, turning the attention to another point, in UK —contrary to what occurs in the US, there are no contingency fees for the attorneys that represent the interests of shareholders'. This, in practice, may reduce the effective initiation of this kind of law suits[73].

Therefore, in a jurisdiction where the standard of review for company directors is low, and where there is a lesser threat of active litigation, there seems less need to design an additional artifact to stimulate directors to undertake their managerial tasks with venturesome and quickness.

Thirdly, as a matter as fact, other judicial resources seem more straightforward and efficient than derivative actions; such is the case of actions against D&O (Directors and Officers) policy insurers who must cover for any damages for breach of duties arising from director's negligence (except for gross negligence and recklessness)[74]. As from 1989, Directors have received some protection against these statutory liabilities with the amendment of section 310 of the Companies Act 1985 that allows companies to provide their directors with insurance policies[75]. Quite efficiently, the possibility of personal liability is covered not by the BJR but by a contract, the insurance contract.

Additionally, there is no statutory BJR in England because of the general judicial doctrine that upholds similar rationales of the BJR and leads Courts to reduce at maximum the intervention in business decisions. English Courts, in several cases[76], without the need of an explicit declaration or enactment, have recognized what U.S Courts and Australian Law have tried to achieve with the implementation of the BJR; they redress their judgments under the premise that Court intervention in management decision should be restrained to cases where there is lack of bona fide[77]. In examining if the UK should codify the BJR, ARSALIDOU manifested:

according to which acts that involve the private interest and the will of the parties can be ratified whereas acts that may implicate *ordre public*, public policy or legality can not be object of any ratification. Therefore, the courts can reduce case load by giving the first judgment to party autonomy.

73 *Ibidem*, At pag. 62 order.

74 HEMRAJ, *supra* note 30, at pag. 201.

75 PASBAN *et al., supra* note 30, at pags. 201-2.

76 ARSILADOU, *supra* note 30.

77 In the words of Trabilcock: "provided any judgment which a director is required or permitted to exercise under the company's constitution has been exercised bona fide [in good faith and in the interest of the company], there is no liability for the consequences of faulty judgment", quoted by HEMRAJ, supra 30, at pag. 194.

> "The Law Commissions' Report on the duties of company directors clearly states that a statutory business judgment rule should not be adopted in the United Kingdom on the main grounds that currently, the Courts do not review the decisions taken by the directors in good faith, or "judge them with the wisdom of hindsight". The Report emphasizes that the best argument for introducing a statutory business judgment rule was if empirical research indicated that directors were concerned about a statutory statement of the duty of care, or if there was evidence that the rule would manage to raise the standard of behavior by directors. Indeed, clearly the idea behind the business judgment rule is not foreign to the approach followed by the Courts in the United Kingdom. The question to address at this stage is whether it is worth adopting the rule in a country where already, there is an "implied" or "unwritten" business judgment rule to be found in the Courts' reluctance to review management decisions which were made in good faith and for a proper purpose"[78].

Furthermore, research[79] on the judicial case load has revealed that in practice directors are more frequently sued by omissions rather than by commissions. Since the BJR only applies to positive actions[80], according to Manning,

> "astonishingly ... given the realities of the way boards operate, the business judgment rule would not operate at all in respect of ninety percent of what directors are actually engaged in"[81].

Finally, it can be affirmed that Section 727 of Companies Act 1985[82] provides for similar relief, as the offered by the BJR[83]. Section 727 reads:

> "If in any proceedings for negligence, default, breach of duty or breach of trust against an officer of a company ... it appears to the Court hearing the case that the officer ... is or may be liable in respect of the negligence, default, breach of duty or breach of trust, but that he has acted honestly and reasonably, and that having regard to all the circumstances

78 ARSALIDOU, *ib*. At pag. 231.

79 See D. ARSALIDOU, The Impact of Modern Influences on the Traditional Duties of Care, Skill and Diligence of Company Directors, *op. cit*., pag.173, as quoted in ARSILADOU, *supra* note 30.

80 The rule may apply if there is an express decision or judgment, that is when there has been a positive act and an appraisable manifestation of will. When there is no such explicit manifestation of will the application is not so straightforward; however, if it is clear that the director has decided to make no decision and let the silence act and produce its effects, the rule will be relevant See BRANSON, *op. cit.* note 10. The reference, given in his note 28, comes from Brane *v.* Roth, 590 N.E.2d 587, 592 (Ind. Ct. App. 1992) ("The rule does not protect directors who have abdicated their position or absent a conscious decision, failed to act").

81 B. MANNING, "The Business Judgment Rule and the Director's Duty of Attention: Time for Reality", *op. cit*., at 1493. In ARSALIDOU *supra* note 30, At pag. 232.

82 Companies Act 1985 c6.

83 PASBAN, *et al*, *supra* note 30. At pag. 220.

> of the case (including those connected with his appointment) he ought fairly to be excused for the negligence, default, breach of duty or breach of trust, that Court may relieve him, either wholly or partly, from his liability on such terms as it thinks fit"[84].

Despite the absence of enough case-law on this matter (the approach of Section 727), there is a clear difference between the BJR as conceived in America (*supra* 2.1) and Australia (*infra* 2.3) that consists on the mandatory application of the rule in the mentioned jurisdictions. Contrarily, Section 727 does not compel the judge to grant relief; the section may not be put into practice if, on the discretion of the judge, he considers the director has not acted 'honestly and reasonably'.

> "As *Gore-Browne* points out, while the first two requirements can be proven, the third one, which is left to the Courts' discretion, is not easy to prove. The case of *DKG Contractors, Ltd.*, (…) is a good example, where the Court dismissed the respondents' application for a relief not because the relief was inoperative in a wrongful trading case but mainly because, in the Court's view, they had not acted reasonably"[85].

Commentators do not agree on the convenience of codifying a BJR in England. For some, there is no need to, since, as explained, there are several remedies, judicial and contractual, that adequately offer a relief to directors, and, further, there is still not a completely clear understanding of the rule, which will make the task of incorporation a still premature goal[86]. But, on the other hand, others consider that the example of Australia, which recently adopted a statutory BJR, should be followed[87].

2. 3. The business judgment rule in Australia

In Australia there was a common anxiety that the corporate failures of the 1980's were a result of the inadequately low standards of care recognized in the statutory law and in the common law. As a response, the early 1990's showed attempts, from the Courts and from the legislature to clarify corporate duties of directors, which finally introduced a civil penalty system under the Corporations Law (1993)[88].

84 *Ibidem* pags. 201-4.

85 *Ibidem*, At pags. 212-13.

86 Among many see ARSALIDOU, above note 6; HEMRAJ, note 36.

87 PATON, TRICIA, "Codification of Corporate Law in the United Kingdom and European Union: the Need for the Australian Approach", *International Company and Commercial Law Review 2000*, 11(9), 309-317 Copyright (c) 2000 Sweet & Maxwell Limited and Contributors. See also GREENHOW, *supra* note 5.

88 JOHNSTONE, ELIZABETH and KORNER, NICHOLAS, "Company directors and the new statutory business judgment rule", http://www.bdw.com.au/publications/issues/articles/Issues1-JudgmentRule.pdf

For many years the Australian legislature considered the codification of the BJR.

> "A number of reasons were submitted as to why the rule did not find its way into the Corporate Reform Acts of the past. One reason for the delay was the thought that the most appropriate forum for the development and application of the rule was the Courts[89]. Another reason was the argument that there was already sufficient protection available under the discretionary relief provisions in the Corporations Law, namely ss 1318 and 1317JA. A further reason was the reluctance expressed by the Courts in scrutinizing business judgments made by the board"[90].

It was also sustained that it was inconvenient to adopt a figure that was engendered in a completely different corporate system, and that Section 1338 was sufficient protection for directors[91]. Moreover, some criticized the relatively low level of litigation in comparison with more active forums, such as the American, to the extent that a BJR resulted unnecessary[92].

In March 13, 2000, Australia enacted a statutory BJR. The rule was introduced into the system after 10 years of debate and discussion; through the Corporate Law Economic Reform Progress Bill of 1998 (hereby CLERP) it found reception under Section 180 of the Corporation Law[93].

Reasons that explain the incorporation of the BJR can be noted as follows: firstly, the general favorable opinion of the approach that American corporate system had embraced towards the rule under the two common formulations of the BJR (*supra* 2.1). The American understanding of the rule suited the main objective of the reform, according to which, the modification of the corporate regime must 'promote optimal

89 Explanatory Memorandum (1992) 89.

90 GREENHOW, *supra* note. 5. at pag. 1.

91 ROSE, Allan, Secretary of the Attorney-General's Department in 1992. In GREENHOW, *ibidem*.

92 Redmond, quoted by GREENHOW, without complete reference. See above note 5.

93 In much, as noted by some academics, the incorporation took great attention to the American experience and precedents. HEMRAJ pointed out: "The Connie Committee in Australia recommended a BJR to be expressly incorporated into Australian company law. This was to be based on the "well-known precedents from Delaware and other United States jurisdictions and embodied in the ALI draft restatement". The proposed provision states that "a director or officer who makes a business judgment rule in good faith fulfils his duty [of care] if: (a) a director is not interested in the subject of his business judgment; (b) a director is informed with regard to the subject to the extent that he reasonably believes to be appropriate under the circumstances; and (c) a director rationally believes that his judgment is in the best interest of the corporation." The only clause of the US enactment mentioned above which Australia intends to embrace is (b), and this makes sense; whereas as far as clauses (a) and (c) are concerned, clause (a) is redundant and clause (c) is bound to create more problems, as the following discussion appears to suggest". HEMRAJ, *supra* note 36.

corporate governance structures without compromising director's flexibility and innovation'[94]. As GREENHOW writes,

> "The Government has attempted to balance the rights of the shareholders, on the one hand, with the commercial reality of corporate governance and risk taking, on the other. The Commonwealth Treasurer, Mr. PETER COSTELLO, has stated that the reforms seek to strike the balance between companies maximizing the return to shareholders by making innovative business decisions while maintaining investor confidence in management and governance structures encouraging further investment"[95].

The reporters comment that with the rule, directors were addressees of a message to avoid the fear in taking commercial risks.

In addition, the Courts have had clear approaches to what finished being the statutory BJR, influencing in a fundamental way the final drafting of the rule in the Corporation Law. The decisions of Rogers CJ at first instance in AWA Ltd *v.* Daniels[96] was the impetus for reform and codification[97]. The case-law, especially after the decision of AWA Court of Appeal left nothing but uncertainty regarding the duty of care.

But for the CLERP to be coherent and not invite for non-accountability of directors, the whole conception of the fiduciary duties[98] and access to legal actions in favor of shareholders against directors, had to be reviewed. Accordingly, the duty of care was also redefined (making it clearer and more comprehensible)[99] and set as an objective one, however taking into account the particularities of the company. And, as should follow, to assure for director's accountability, within a generous agenda of freedom, the derivative actions where redesigned as a non complex artifact, proceeding when:

94 Corporate Law Economic Reform Program 1998, 'Commentary on Draft Provision', 37. in GREENHOW, *supra* note 5.

95 Press Release n° 112 'Encouraging Business Innovation and Protecting Investors' 20 October 1997, in GREENHOW, *ibidem.*

96 (1992) 10 A.C.L.C. 933.

97 GREENHOW, *supra* note 5.

98 The CLERP amended section 2342 (4) of the Corporations Law requiring the exercise of powers and discharge of duties with the degree of care and diligence that a reasonable person would show. Diligence has been limited to mean what may reasonably be expected of a director in the circumstances. (Byrne *v.* Baker [1964] VR 443 at 450.), in GREENHOW, *ibidem.*

99 JOHNSTONE, ELIZABETH and KORNER, NICHOLAS, *supra* note 30; furthermore, KIRBY, MICHAEL, "Ac Cmg, The Company Director: Past, Present and Future. In the Australian Institute of Company Directors, Tasmanian Division" 31 March 1998. http://Www.HCourt.Gov.Au/Speeches/ KIRBYj/ KIRBYj_Company.Htm#FOOTBODY_14

"there has been inaction by the company; and the applicant is acting in good faith; and the action appears to be in the best interests of the company; and there is a serious question to be tried; and the applicant has given 14 days written notice to the company of the intention to apply for leave"[100].

2.3.1. *Case law that preceded the incorporation of the rule*

In AWA Ltd *v.* Daniels[101] it was clear for the Supreme Court of New Wales that not all directors play the same mission in the company. Executive directors, are usually full time employees of the corporation, and dedicate their whole time to the developing of their functions. Unlike that,

"non-executive directors are part-time directors and are appointed for their experience and qualifications, and their appointment may bring status and prestige to the composition of the board. They usually attend company board meetings and can contribute to the BJR in the following ways:

(a) by having a proper debate and looking at the pros and cons in decisions involving future policy matters of the company;

(b) their expertise in specific areas is useful in guiding the company and in enhancing its performance; and

(c) by monitoring the operation of the company and providing necessary expertise to guide the board in the right direction"[102].

In the first instance of AWA (1995)[103], Justice Rogers sustained that the differences between the functions and roles of executive and non-executives directors justified

100 Part 2F.1A Corporations Law

101 (1992) 10 ACLC 933

102 AWA Ltd *v.* Daniels (1992) 10 ACLC 933, in HEMRAJ, *supra* note 36.

103 FLINT summarizes the factual backgrounds of the case as follows: "AWA was a long established Australian company whose business included importing and exporting electronic equipment. The company decided to hedge against currency fluctuations by engaging in forward purchases of foreign currency against contracts for imported goods. Koval was employed to manage the foreign exchange operations. Koval's dealings caused the company to incur losses approaching $50 million. Koval managed to conceal the fact of these losses. During the period of Koval's employment, the company's auditor, Deloitte Haskins & Sells, conducted two audits. In neither audit was Koval's activities fully disclosed to the AWA Board, although the auditor had noted the defects in the company's system of internal control. AWA's failure to establish adequate internal controls and record and account keeping had allowed the losses to be concealed. AWA sued the auditor for negligence for failing to draw attention to these deficiencies and to qualify the audit reports. The auditor denied any breach of duty to AWA and cross-claimed against it and, inter alia, the non-executive directors for contributory negligence.

a differential treatment regarding their fiduciary duty of care. Then, the standard applicable to the first ones should be an objective one, whereas the second ones should be subjective[104].

However, Roger's decision was reversed by the Court of Appeal, shaping that all directors were bounded by an objective duty of care and that their standard was far from being as low as gross negligence. The reaction, evidently, was alarm[105] from non-executive directors, whose behavior was going to be looked upon with a magnifying glass and with a harder judicial policy. Within this context, any non-executive director would find very appropriate and do every possible to lobby[106] for the introduction of a BJR into the legal system.

2.3.2. Business judgment rule in the corporation law

Section 180 of the Corporation Law states:

> "180 Care and diligence – directors and other officers
>
> A director or other officer of a corporation must exercise their powers and discharge their duties with the degree of care and diligence that a reasonable person would exercise if they:

It is the claim against the non-executive directors that is of immediate interest". FLINT, GEOFFREY. Non-Executive Directors' General Law Duty of Care and Delegation of Duty: But do we Need a Common Law Duty of Care? Bond Law Review, Volume 9, n° 2, December 1997. At http://www.bond.edu.au/law/blr/vol9-2/contents9-2.htm.

104 *Ibidem*, see also GREENHOW, *supra* note 5.

105 For an Honorable Justice of the Supreme Court of Australia: "Superficial reading of the Court of Appeal's decision led to panic in some quarters in corporate Australia. However, more reflective comments suggested that, if the decisions of Australian Courts over the past decade were fairly analyzed, they would show two trends. First, a growing judicial impatience with "sleeping" or passive directors on the boards of Australian companies 14. Secondly, a realistic appreciation that directors could not assume all the functions of managers, auditors and systems controllers of companies. Those directors who had exercised their powers and carried out their duties honestly and conscientiously to the best of their ability would normally not be held to have breached their duty of care. They would be exempt from personal liability." KIRBY, KIRBY, MICHAEL Ac Cmg, The Company Director: Past, Present and Future. In The Australian Institute of Company Directors , Tasmanian Division. 31 March 1998. Http://Www.HCourt.Gov.Au/Speeches/ KIRBYJ/ KIRBYJ_Company.Htm#FOOTBODY_14

106 The Australian Institute of Company Directors gave an important hand in that regard. JOHNSTONE, ELIZABETH and KORNER, NICHOLAS, *supra* note 99; farther see TOMASIC, ROMAN. The theoretical foundations of Australian Corporations Law Reform: Some Lessons for Reformers. Journal of International Commercial Law, 1(3) 323-349. Ashgate Publishing Limited, 2003

were a director or officer of a corporation in the corporation's circumstances; and occupied the office held by, and had the same responsibilities within the corporation as, the director or office.

Business Judgment Rule

A director or other officer of a corporation who makes a business judgment is taken to meet the requirements of subsection (1), and their equivalent duties at common law and in equity, in respect of the judgment if they:

make the judgment in good faith for a proper purpose; and

do not have a material personal interest in the subject matter of the judgment; and

inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate; and

rationally believe that the judgment is in the best interests of the corporation.

The director's or officer's belief that the judgment is in the best interests of the corporation is a rational one unless the belief is one that no reasonable person in their position would hold.

Note: This subsection only operates in relation to duties under this section and their equivalent duties at common law or in equity (including the duty of care that arises under common law principles governing liability for negligence) – it does not operate in relation to duties under any other provision of this Law or under any other laws.

In this section:

business judgment means any decision to take or not take action in respect of a matter relevant to the business operations of the corporation"[107].

If the following conditions are met, a director and officer may enjoy of the protection of the rule: (a) the directors must make the decision in good faith and for proper purpose; (b) the directors must not have a material conflict of interest; (c) the directors must be reasonably informed; and (d) the directors must believe that the judgment is in the interest of the company and has been arrived at rationally.

107 GREENHOW, *supra* note 5, pags. 4-5.

The rule has been drafted similarly to the ALI's formulation (*supra* 2.1), and, in general, the reality of its novelty should lead the Courts and academics to critically look into American Courts[108] to fill any legal vacuums.

The reform, accordingly to what Justice Rogers proposed, established a subjective duty of care for non-executive directors[109], and stated that the standard of review would be gross negligence[110]. It also pivots on a different basis from what occurs in the US, since the duty of care and its scope have been clarified and introduced into the written law, which suggests that in the further evolution of the Australian case-law, the reference to American precedents in this specific respect cannot be taken independently and without any reserve[111].

Certainly, despite the fact that the American BJR played a crucial task in the drafting of the statutory Australian BJR, the pillars beneath each corporate system are different and, accordingly, they may not necessarily lead to the same judicial outcomes.

> "It is questionable as to how far the Australians would be able to borrow and apply the BJR developed in the United States, the reason being that the US corporate system is not only larger and more complex than the Australian system, but it is also based entirely on a different company law regime. The Australian judiciary may therefore need to develop a BJR which suits their corporate system"[112].

108 HEMRAJ, *supra* note 36.

109 See MORPHET, JACINTA, "Corporate Governance Issues", June 30 2003, at http://www.mckeanpark.com.au/newsite/publications/articles/JACINTACGJune2003.pdf who sustained: "Section 180(1) was designed to incorporate both objective and subjective tests in determining whether an officer has acted with the appropriate care and diligence. The reference to a reasonable person is intended to indicate that the standard of care is an objective one. This is consistent with the modern development of fiduciary duty (see AWA Ltd *v.* DANIEL). However, given the distinctions made between executive and non-executive officers and the chairperson of the board, the court should take into account the position held at the time of any alleged breach. Further a uniform objective standard is not suitable given the diversity of the types of companies (for example, size) and their businesses and therefore such specific matters need to be taken into account (see Daniels *v.* Anderson)".

110 HEMRAJ, *supra* note 30.

111 JOHNSTONE, ELIZABETH and KORNER, NICHOLAS, "Company directors and the new statutory business judgment rule",

http://www.bdw.com.au/publications/issues/articles/Issues1-JudgmentRule.pdf

112 HEMRAJ, *supra* note 30 at. 200.

2.4. The business judgment rule in the European Union

In the European legal system there is not a community instrument that explicitly refers to the BJR. Before the enactment of the Thirteenth Directive for takeover bids, a discussion forum was open to consider whether a modified BJR[113] should be adopted within the context of takeover bids, in place of a strict neutrality rule[114]. After the adoption of the Directive the debate calmed down since the European Parliament did not accept the modified BJR[115] and, instead, gave course to the neutrality principle (Article 9)[116]. As far as we are concerned, since then, the harmonization

113 See VEASEY, *supra* note 9 at pag. 1488. For references about the case law, and very specific application of the BJR in takeover defenses see Petty *v.* Penntech Papers, Inc., 347 A.2d 140 (Del. Ch. 1975); Condec Corp. *v.* Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967); Bennett *v.*Propp, 41 Del. Ch. 14, 187 A.2d 405 (Del. 1962); see also Panter *v.* Marshall Field & Co., 646 F.2d 271, 297 (7th Cir.), all quoted in VEASEY and SEITZ in their notes 23 and 24. Regarding the European experience see, KIRCHNER, CHRISTINA and PAINTER, RICHARD W., "Towards a European Modified Business Judgment Rule for Takeovers law", *European Business Organizations Law Review*, http://ssrn.com/abstract=247214

In the milestone case, Unocal Corp *v.* Mesa Petroleum Co the Delaware Supreme Court held that as a conclusion of the modified BJR, in a takeover defense scenario, directors have the burden of proving (1) that a good faith and reasonable investigation led them to perceive that a threat to corporate policy and effectiveness from a hostile acquirer and (2) that the defensive measures deployed were reasonable in relation to the threat posed, 493 A. 2d. at 955 in KIRCHNER and PAINTER, *supra* note 44.

114 The neutrality rule obliges directors to abstain of any conduct (specially a takeover defense such a poison pill, sale of important assets, or looking for a white knight) without the express approbation of the shareholders. See KIRCHNER and PAINTER, *ibidem.*

115 The mentioned disadvantages of adopting it were the difficulties with importing a rule based on common law into civil law countries, and the risk that the modified BJR could be too pro management in its implementation by a European judiciary where the mandate of wealth maximization of shareholder's is not as straightforward as it is in the US. KIRCHNER and PAINTER, *Ibidem.*

116 Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (Text with EEA relevance), *Official Journal* L 142, 30/04/2004 pags. 0012-0023 Obligations of the board of the offeree company: Article 9: 1. Member States shall ensure that the rules laid down in paragraphs 2 to 5 are complied with. 2. During the period referred to in the second subparagraph, the board of the offeree company shall obtain the prior authorization of the general meeting of shareholders given for this purpose before taking any action, other than seeking alternative bids, which may result in the frustration of the bid and in particular before issuing any shares which may result in a lasting impediment to the offeror's acquiring control of the offeree company. Such authorization shall be mandatory at least from the time the board of the offeree company receives the information referred to in the first sentence of Article 6(1) concerning the bid and until the result of the bid is made public or the bid lapses. Member States may require that such authorization be obtained at an earlier stage, for example as soon as the board of the offeree company becomes aware that the bid is imminent. 3. As regards decisions taken before the beginning of the period referred to in the second subparagraph of paragraph 2 and not yet partly or fully implemented, the general meeting of shareholders shall approve or confirm any decision which does not form part of the normal course of the company's business and the implementation of which may result in the frustration of the bid. 4. For the purpose of obtaining the prior authorization, approval or confirmation of the holders of securities referred to in paragraphs 2 and 3, Member States may adopt rules allowing a general meeting of shareholders to be called at short notice, provided that the meeting

of a BJR for all member states has been out of the agenda of the parliament[117]. Undoubtedly it will remain as an interest of every member state to analyze the convenience and reasonableness of espousing a BJR. Some Member States e.g., Germany, France[118], Spain and the Netherlands[119], given their civil law systems, the understanding of the duty of care, the level of litigation and other national implications, do not utilize the BJR as a standard of judicial review[120].

It is not the purport of the work to expatiate a theory on the fiduciary duties of directors in the countries that have been mentioned. Nonetheless, as the conception of the mentioned duty is a fundamental factor for the existence of a BJR, it should be noted that among the different EU countries there is not an identical appreciation about the scope of the duty. French duty of care, e.g. is declared to be a flexible one, whereas in Germany it is strict and objective[121].

For instance, in Germany, even though the duty of care, compared to countries as England and France, is relative high, there is no culture of litigation[122] (AktG, paras 112 and 147), which suggests that directors do not face a discouraging fear in running their offices. Therefore, it has been affirmed that when more cases reach the Courts the strict objective standards will relax to some extent[123]. So no BJR seems to be needed.

does not take place within two weeks of notification's being given. 5. The board of the offeree company shall draw up and make public a document setting out its opinion of the bid and the reasons on which it is based, including its views on the effects of implementation of the bid on all the company's interests and specifically employment, and on the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the company's places of business as set out in the offer document in accordance with Article 6(3)(i). The board of the offeree company shall at the same time communicate that opinion to the representatives of its employees or, where there are no such representatives, to the employees themselves. Where the board of the offeree company receives in good time a separate opinion from the representatives of its employees on the effects of the bid on employment, that opinion shall be appended to the document. 6. For the purposes of paragraph 2, where a company has a two-tier board structure «board» shall mean both the management board and the supervisory board.

117 http://europa.eu.int/eur-lex/es/search/search_lif.html. Also see, Schuit, Steven R, *et al*. Corporate Law and Practice of the Netherlands. Allen & Overy Legal Practice. Kluwer Law International, The Hage, 2002.

118 French Law relies on the *action en responsabilité*, "intentée contre les professionnels qui n'épargne pas le dirigeants de sociétés. Ensuite, l'action en responsabilité civile constitue l'une des réponses offertes aux associes pour lutter contre les dérives constatées dans la gestion de certaines sociétés". Cozian, Maurice, Viandier Alain et Deboissy Florence, *Droit de Sociétés*, Litec, 16eme édition, Paris, 2003, pag. 149.

119 Schuit, *supra* note 116.

120 See Footnote 30.

121 Arsalidou, *supra* note 30.

122 Arsalidou, *supra* note 30. Also, when actions have been brought against directors, the outcomes have not been favorable to shareholders. Kirschner and Painter, *supra* note 44.

123 *Ibidem*.

In the Netherlands

> "the statutory requirement to 'properly perform'[124] management or supervisory duties, as the case may be, requires each director to discharge his duties with care, skill and diligence. His tasks include properly implementing the provisions of the law and the articles, as well as actions initiated by the shareholders. It is not sufficient for a board member to argue that he performed his tasks to the best of his ability. On the other hand, he is not expected to guarantee the success of his actions. Each individual action must be judged on its own merits. There is no general standard similar to the 'business judgment rule' in the United States. However, Courts are generally not inclined to second-guess actions that under similar circumstances could reasonably have been taken by other, well-informed and diligent executives in similar positions in similar types of industry or trade (Judgment of 6 June, 1996, HR, 1996 NJ n° 695). In addition, the Courts are not allowed to judge management conduct with the benefit of hindsight"[125].

In general, the corporate environment of the civil law Member States of the EU, is different from the system of the US or Australia, where there is a case law or a statutory BJR. Particular coincidences in regard of specific issues seem not to be enough for the national governments to look for a BJR. And, the Member States' legal systems would suffer a strong shake if a typically common law institution is inserted without a harmonization period or reform of the corporate structures. European Courts would need time and expertise in the management of a foreign doctrine that has rationales that may not fit with the local reality and legal body[126]. It will surely be hard for German or French judges to overrule and forget the extensive body of case law that has grown up around the duties of directors (Section 242 of German Civil Code and French Laws of July 24, 1966 and NRE of May 15 2001[127]).

3. FACTORS THAT AFFECT THE MODELS OF APPLICATION OF THE BUSINESS JUDGMENT RULE

Directors are merely the parsley on the fish or the ornaments on a corporate Christmas tree.

LORSCH and MAC IVER[128]

124 This is the expression of the duty of care in Dutch Law.

125 SCHUIT STEVEN R., et. al., Corporate law and practice of the Netherlands, Allen Overy Legal Practice, Kiuwer Law International, the Hague, 2002, pág. 143.

126 KIRSCHNER and PAINTER, *supra* note 43.

127 COZIAN, MAURICE, VIANDIER ALAIN et DEBOISSY FLORENCE, *Droit de Sociétés*, Litec, 16eme édition, Paris, 2003.

128 JAY W. LORSCH with ELIZABETH MACIVER, *Pawns or Potentates: The Reality of America's Corporate Boards,* Harvard Business School Press, Boston, 1989, pag. 4.

3.1. Three models of application of the business judgment rule

The comparative analysis that has been proposed indicates that each of the jurisdictions has special socioeconomic and legal characteristics that give grounds for what I have called *models of application of the BJR*. These models depend of the way the rule is recognized by the legal operators, thus, implicitly, explicitly or statutory. I have qualified these different models of application of the BJR as *low*, *medium* and *high*. The models of application of the BJR must be assessed under two considerations. First, the models describe the approach that the legal order appraises in recognizing the existence of the rule. And, second, it represents a determined level of psychological certainty, which accompanies the directorship in its managerial activity.

Accordingly, a low model of application of the BJR is the one embraced by the UK where, despite the inexistence of a legal structure called 'the business judgment rule', its elements, and the general understanding of its functioning have been implicitly recognized by the courts, providing, at least facially and psychologically, the lowest degree, of certainty[129] to the directors. The US BJR represents a medium model of application, where it is not only a common doctrine among the judiciary but there is an explicit acknowledgment of a rule, evidenced in a systematic and coherent case-law. Finally the high model of application finds reception in the Australian statutory provisions, incorporated into the positive law (see *supra* 2.3.) (Business Corporation Act).

The models of application of the BJR have a direct relation with the psychological impact that a company director may experience towards the shelter that the legal order provides before possible claims for accountability. A high model of application of the BJR provides a subjective and psychological positive effect on director's impression, which sees in a statute an immediate response of the government to a reasonable fear of running offices when he can be sued for his mistakes. The Australian Treasurer considered that

> "Amongst the proposals included in the Treasurer's announcement are two of great importance to company directors. One is a proposal to enact a "*new business judgment rule to provide more certainty for directors"*.

129 See generally Daniel Berkowitz, Katharina Pistor, Jean-François Richard, "The Transplant Effect", The American Society of Comparative Law, Inc., *American Journal of Comparative Law* 51 Am. J. Comp. L. 163, 2003, pags. 163 and 171.

The other is a proposal for "new shareholders' rights to take action on behalf of companies"[130].

A practical exercise of comparing the low model of application with a high model results quite helpful to understand the rationale of this classification. Suppose a director that may be on the verge of being sued because of a management mistake. For him, the evident content of the section of a law that establishes a BJR, e.g., Section 180 Corporations Law (high model of application), will probably grant him more tranquility than expecting the courts to honor the implied doctrine (low model of application) that, like in the UK, have traditionally adopted.

Before presenting some points upon the viability of a uniform model of application of the BJR it will be necessary to make one comment. As KRAAKMAN[131] pointed out in his Anatomy of Corporate Law, corporate law cannot provide solutions that uniformly adapt to every country. Despite the possibility of transplanting foreign institutions, tests or concepts into a legal system, each country has its own legal pillars, corporate idiosyncrasy, and a unique economic reality that makes the art of legal transplantation a strenuous task. Accordingly, it is not convenient to draw universal solutions in relation with the necessity of adopting a statutory BJR.

The comparative analysis presented in the former chapter unveiled that there are three issues that surround the framework that lead to the adoption, codification, or disregard of a BJR. These three key topics are: (1) the conception of the duty of care, (2) (a) the degree of derivative litigation (b) the effective initiation of those means against them, and (3) the judicial doctrine upheld by the courts to avoid second guessing or reviewing business judgments. In addition, there are other issues that might play a secondary role in determining the need or convenience for a statutory BJR.

3.2. The core factors

The core factors that influence the model of application of the business judgment rule are: the conception of the duty of care, the degree and effective initiation of derivative litigation and the judicial doctrine upheld by the courts to avoid reviewing directors decisions.

---

130 The Hon Justice MICHAEL KIRBY AC CMG. The Company Director: Past, Present and Future. The Australian Institute of Company Directors.Tasmanian Division. Luncheon Address Hobart, Tasmania 31 March 1998.

<http://www.hcourt.gov.au/speeches/kirbyj/kirbyj_company.htm>

131 H. HANSMANN and R KRAAKMAN, *supra* note 5.

Chart 3.1, which's justifications were expatiated in the previous chapter, may explain how (1) the conception of the duty of care, (2) (a) the degree of derivative litigation and (b) the effective initiation of those means against them, and (3) the judicial doctrine upheld by the courts to avoid second guessing or reviewing business judgments, lead to different models of application of the BJR[132] within each particular jurisdiction[133] .

CHART 3.1.

	(1) Low standard of duty of care	(2a) Availability of derivative actions	(2b) Effective high level of execution of Derivative Actions	(3) Judicial abstention doctrine	Model of application of the BJR[134]
US	Yes[135]	Yes[136]	Yes	Yes[137]	Medium-Explicit BJR
UK	Yes[138]	No[139]	No	Yes	Low-Implicit BJR
Australia	No	Yes	No[140]	Yes	High-Statutory BJR
EU	No	Yes	No	No	None- No BJR

132 The information of the chart corresponds to the state of the legal and practical framework after the passing of the latest legislation, like Australian Corporations Law (*supra* 2.3.2.).

133 In short, as was shown earlier, when the instruments for protection of shareholder rights, e.g. derivative litigation, *action en responsabilite*, *acción social de responsabilidad,* invite to a indiscriminate and numerous initiation of law suits against directors, the BJR can show up to lesser the fear of directors for running the office with adventuresome and innovative mood. Nevertheless, the empirical research that has lead to this outcome has been focused on the Derivative Action, which has appeared as the most, not to say the only, popular means of protection for shareholders. See ARSALIDOU, *supra* note 30.

134 *Supra* 2.5.

135 Aronson vs. Lewis, *supra* 2.1.

136 FRONTERA and MA, *supra* note 39.

137 See BRAINBRIDGE, *supra* note 5.

138 Sheffield and South Yorkshire Permanent Building Society *v.* Aizlewood (1890) (44 Ch. D. 412).

139 It is to be clarified that despite the existence of derivative actions in the UK, the true effectiveness of the instrument can be questioned by the reasons given in the latest chapter. *Supra* 2.2.

140 Before and even after the reform of the Australian Corporations Law (*supra* 2.3.2.) there wasn't an active tension for litigation. However, it still remains to be seen if the new legal order, which ease the requirements of derivative actions will encourage shareholders to bring more law suits against the

The topic of the derivative litigation has been split into two: the (2a) availability of derivative actions in favor of shareholders and (2b) the effective level of execution of those actions. The distinction had to be made because in jurisdictions like Australia, despite the availability of provisions that acknowledge of derivative actions, there is not an effective utilization of those procedures[141].

This systematization allows us to draw up some inferences. First of all, the only common factor that all the countries that embrace BJR (US, UK and Australia) posses is a judicial abstention doctrine towards second guessing directors' decisions (Factor 3). Then, since in the EU, there is not an uniform abstention doctrine it is unlikely that Civil Law Member States, like the majority of the EU and Latin America, may welcome a BJR into its legal assets[142]. It is more likely for the functioning of a corporate law system that seeks to introduce a high model of application of BJR, if courts have the inclination to reduce at minimum the evaluation of corporate director's acts.

Secondly, the derivative litigation factor does not offer a uniform or very clear tendency; presumably, when either the availability of derivative actions (Factor 2a) or the effective initiation of those means (Factor 2b) is present, the more transparent recognition of a BJR is produced and High and Medium models of application of the BJR seem appropriate. As a result, UK's unavailability of remedies for protection of shareholders' rights—Factor (2a), makes the Low model of application of BJR a sufficient shelter for directors and invites implicit model of application of BJR to be undertaken.

However, Australia with the highest model of application of BJR, does not count with an effective level of derivative litigation (Factor 2b)[143]. Further, and

directorship. If one follows the behavior that took place in the American corporate history after the development of the derivative actions, joined by the capacity of active and powerful shareholders to bring actions to the courts, it could be feasible that Australia may experience the same wave of lawsuits that brought up in the US.

141 See *supra* 2.2.

142 That will explain, according to BERCOWITZ, PISTON and RICHARD, the complexity of transplanting a BJR into a system where legal operators, e.g. judges and attorneys, are not familiar with it, which creates what they call a lack of demand for the legal instrument. They sustain: "Our basic argument is that for law to be effective, a demand for law must exist so that the law on the books will actually be used in practice and legal intermediaries responsible for developing the law are responsive to this demand. (...) By contrast, countries that receive their formal legal order from another country have to come to grips with what was often a substantial mismatch between the preexisting and the imported legal order". DANIEL BERKOWITZ, KATHARINA PISTOR, JEAN-FRANÇOIS RICHARD, "The Transplant Effect. The American Society of Comparative Law, Inc.", *American Journal of Comparative Law* 51 Am. J. Comp. L. 163, 2003 pags. 163 and 171.

143 Australian legislators may have foreseen that the clarification of the duty of care and the facilitation of remedies for protection, product of Section 180 of the Australian Corporation Act, as happened in the US after the introduction of the derivative actions, would enhance the level of effective litigation. See *supra* 2.1 and 2.3.

paradoxically, in the US, the purest example of a jurisdiction where derivative litigation is a directors' true fear, the BJR model of application is only medium. These two cases suggest that there might be no direct relationship between the models of application of the BJR and the core factors that have been mentioned.

In the near future the situation presented in Chart 3.1. could be subject to change. As mentioned herein and as far as the author is concerned, the latest Australian corporate history has still not proven a generation of law suits against company directors. However, the corporate trends, and the American experience[144] may indicate that an increase on the derivative litigation level is likely to take place. If that may occur, which is merely a supposition, Chart 3.1 will vary as Chart 3.2 proposes, in which case, besides the Low standard of care (1), the US and Australia will coincide in the other factors.

CHART 3.2.

	(1) Low standard of duty of care	(2a)Availability of Derivative Actions	(2b)Effective high level of execution of Derivative Actions	(3) Judicial Abstention doctrine	Model of application of BJR
US	Yes	Yes	Yes	Yes	Medium-Explicit BJR
UK	Yes	No	No	Yes	Low-Implicit BJR
Australia	No	Yes	Yes	Yes	High-Statutory BJR
EU	No	Yes	No	No	None- No BJR

Should that happen, the attention must be focused on the low standard of care, current in Australian legislation and which constitutes the only core feature that

144 See LAGUADO and DÍAZ, *supra* note 35, note that in the 80's the propagation of mergers, acquisitions and in general, complex corporate transactions in the US and litigants who were financially capable of bringing the matters to judicial resolution incremented the number of derivative actions brought against directors.

differs from the system of the US. Such situation will suppose that, when the duty of care is high, there are available means of protection in favor of shareholders, accompanied by an intense level of litigation, the model of application of the BJR must be the highest: it must be a Statutory BJR.

Notwithstanding that preliminary conclusion, this presumption depends of a contingency that cannot be taken for granted.

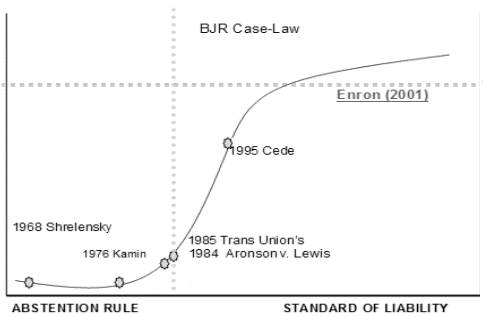
It appears to be that the systematization of the corporate law features may suggest what model of BJR a corporate legal system should apply. However, the practical reality, and the paradoxes shown by the American and Australian systems suggest that these three core factors are not enough to determine the model of application of BJR. On one side, the American system, despite having all the three factors, has only implemented a medium model of application of BJR. And, on the other, the Australian case, demonstrates that even without a high level of derivative litigation the law upholds a high model of application of BJR. These paradoxes may indicate that some other specific and marginal factors can materially influence the model of application that a country upholds.

3.3. Marginal factors[145]

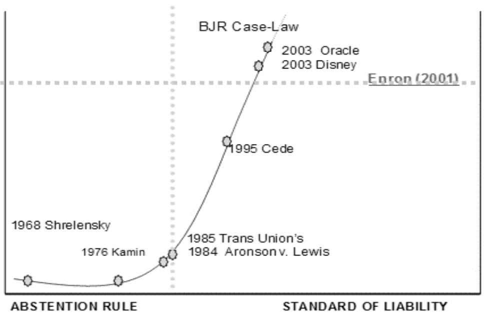
Chart 3.1 has summarized the main features of corporate law that directly impact the BJR. The inconsistencies in the American and Australian cases suggest that the effective level of litigation and the judicial doctrine towards second guessing director's decisions do not constitute, per-se, safe guidelines for establishing a model of application of the BJR. The marginal factors that will be mentioned further can, in some degree, come into play and influence the model of application of the BJR.

These issues are derived from the circumstances involving the BJR in the countries where it is applied. They are not only legal concepts or institutions; they also correspond to the particular corporate peculiarities of a jurisdiction. Lastly, the following list is not exhaustive and other factors can be found in specific nations and in specific historical moments.

Graph 1.



Graph 2.



It must be stressed, however, that these marginal factors, do not lead, *per-se*, to uniform solutions. They interact with each other and additional considerations that, according to each country's corporate idiosyncrasy, design, and reality, might produce different outcomes.

145 These factors are also convenient for understanding the developments that the BJR might have had in a particular jurisdiction. LAGUADO and DÍAZ, supra note 35, within the context of the Delaware conception of the BJR, observed that, internally, some of these issues tempted to impact the formulation of the rule. Their study revealed that, even after important corporate clashes, the local formulation of the rule remained, essentially, unvaried. In the study they proved that, nevertheless the pressures of the media, Enron and the following failures did not turn the BJR into a standard of liability that allowed judges to enter into the substance of the decisions. In the following Graph 1, LAGUADO illustrates the erred conclusion that newspapers and reviews forecasted affirming that after Enron, Worldcom, and Global Crossing Inc. the BJR would become closer to a standard of liability—that is with a shifting of the curve to the right, towards the right edge that represents a standard of liability; graph 2, on the other hand, reveals the real state of case law after the rendering of decisive decisions such as Oracle (2003) and Disney (2003). The curves represent the position of the rule within the case law and in-between the two columns, as an abstention doctrine (left) and as a standard of liability (right). When the curve (that represents the precedent line) shifts to the right, it moves towards a standard of liability, whereas if it shifts to the left it comes closer to an abstention doctrine.

3.3.1. The Current Economic Policy

The reform in Australia[146] is an excellent example of how the current economic policy impacts directly the corporate framework of a nation and, consequently, the understanding of the model of application of the BJR. It was seen[147] that one of the key considerations for the enactment of the Corporation Law (1993) was to 'promote optimal corporate governance structures without compromising director's flexibility and innovation'[148]. As such, whether the BJR model of application should be low, medium or high depends on the degree of importance that the promotion of effectiveness and competition plays in the public policy underneath. The more interest in promoting economic efficiency, the higher the model of application of the BJR. Correlatively, if for a system the objective of economic performance is (or will become) not the most significant, a low or medium model of application of BJR can be suitable. The convenience of a high model of application of BJR (Statutory) for the precise objective of economic efficiency has its roots in the psychological effect of the rule upon a fearsome directorship and managers afraid of being sued for taking revolutionary business decisions[149]. In a nutshell, an economy can be pulled by adventuresome directors that, sheltered by a high model of protection (medium or high models of application of the BJR), will undertake their office with creativity, expediency and innovation.

Besides the policy of market efficiency, a new policy has lately been exposed, that is, the policy of corporate accountability and transparency. One of the many available demonstrations is the enactment of the Sarbanes Oxley Act 2001 in the United States, the, up to date, strictest corporate reform of the century[150]. When the strictness of the statutory provisions may constrict the creativity and expediency of the corporate decisions, a high model of application seems likely to be appropriate.

146 Despite all the countries that implement a BJR participate of this objective, the express declarations of the CLERP are manifest, *supra* 2.1 and 2.2.

147 *Supra* 2.3.

148 Corporate Law Economic Reform Program 1998, 'Commentary on Draft Provision', 37. in GREENHOW, *supra* note 5. Also see the OECD Principles, where an example of a doctrine that embraces this economic policy can be found: "The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities. "The corporate governance framework should be developed with a view to its impact on overall economic performance, market integrity and the incentives it creates for market participants and the promotion of transparent and efficient markets". OECD Principles of Corporate Governance, at http://www.oecd.org/dataoecd/32/18/31557724.pdf

149 See *supra*, BERKOWITZ note 129.

150 See LAGUADO, CARLOS, "Sarbanes-Oxley Act y el Proyecto de intervención económica sobre estándares internacionales de contabilidad, auditoría y contaduría", Superintendencia de Valores http://www.supervalores.gov.co/ley_estandares_contables.htm. 2004

If no guarantee is offered for directors, they may resign and abandoned their appointments, or will refuse to occupy new positions.

The reader might consider that nowadays no other economic policy is foreseeable and that a corporate model where economic performance is not vital is unthinkable. However, the function of corporations in economy (and in history) is in permanent change. MARK[151] notices that:

> "…[t]he mix of methods for addressing the concerns raised by the entity has changes. In the days when the Church was the corporate entity central to society, the natural mode of inquiry was teleological, with history enlisted to buttress arguments about the legitimacy of organized hierarchy. During the seventeenth and eighteenth centuries corporate entities were primarily political tools, serving the expansionist aims of imperial powers, securing colonies and trade abroad and facilitating consolidation domestically by controlling currency, finance and infrastructure. The nineteenth century saw the corporate entity further evolve, nonetheless retaining an essential political component. (…) In the twentieth century, the corporation has largely shed its overt political character, at leas in the United States, and its economic role has been emphasized. Not surprisingly, by the late twentieth century the dominant tool for understanding the corporation has become economics, and history is again being deployed to buttress the dominant economic perspective".

Therefore, since the role of corporations within time has evolved[152], it is still to be seen what the future function of them will be. Following that revolution, the rationales of the BJR will have to be reviewed, and, further, the criterion that is upheld in a particular jurisdiction should be reappraised.

3.3.2. Trend for accountability - History of corporate failures

Corporate failures can impact decisively the model of application that a state desires to implement in its legislation. Some commentators relate that after the American corporate crisis of the 80's approximately 100.000 law suits were filed against corporate directors[153].

151 MARK A. GREGORY, *The role of the State in Corporate Law Formation, in International Corporate Law*, vol 1, Hart Publishing, Oxford, 2000, pags. 1-3.

152 See generally CARRIGAN, FRANK, "The role of capital in regulating the duty of care and business judgment rule", *Australian Journal of Corporate Law*, (c) Copyright 2002 Reed International Books, Australia Pty Limited trading as LexisNexis, 2002, AJCL LEXIS 12.

153 WALLACE, MARK DAVID, "Life in the Boardroom After FIRREA: a Revisionist Approach to Corporate Governance in Insured Depository Institutions", 46 *U. Miami L. Rev*. 1187, 1992, pags. 1189-90.

LAGUADO and DÍAZ commenting the impact of corporate cataclysms in the application that Delaware Courts embraced regarding the BJR[154] have remarked that:

> "The perspective judges decide to apply when deciding under the BJR has depended highly on the socioeconomic perceptions of the markets, the projection of corporate law, and, of course, the behavior of Directors. The BJR suffered its first cataclysm in the early 1980's.
>
> '[I]n 1983, Stuart R. Cohn, professor of law at University of Florida (…), after a similar study of case law involving claims of director breach of duty of care in the absence of self-interest or self-dealing found what he characterized as "a nearly universal judicial reluctance to apply diligence standards against well-intentioned, non-self-enriching directors and officers".

This reluctance came to an end with several cases decided by Delaware Courts and a swerve in the *stare decisis* took place. The tack was explained by the evolution of corporate law during the early 80's (propagation of mergers, acquisitions and in general, complex corporate transactions) and litigants who were financially capable of bringing the matters to judicial resolution[155]. (…)

Enron is the other cataclysm of corporate history. Hidden losses and inflated earnings reached billions of Dollars. WorldCom, Global Crossing, and Tyco followed Enron's bad luck. The fist to blame: directors. What should be done? Legislate and tighten director's liability standards and accountability? Certainly, the Sarbanes Oxley Act was issued in a rush. It drew new requirements for disclosure and established penalties, even criminally considered, for non-compliance.

Did the courts also enter in that rush and trigger judgments punishing directors and companies? There were enough judgments for a derailment of the precedent far from the original rationale of the rule (or as an abstention rule). One could think so if one remembers what *Aronson, Trans Union* and *Cede* had achieved and is not per se blameworthy because law is in nature mutable. However that is still to be seen. The press and the media seemed to react fiercely with headlines such as 'The court for most US companies has been toughened up by waves of crime and reform', 'Rush to re-judgment', 'Judges signal boards to take duties seriously',

154 LAGUADO and DÍAZ *supra* note 35, revealed that despite the strong demand for accountability that succeeded failures of companies such as Enron and Worldcom, the judiciary did not change the requirements and fundamental premises of the BJR. However, the analysis must be done also within the context of reforms when the legislative can be under pressure to react to a situation.

155 See *supra* 2.1.1. in this work and generally FRONTERA and MA, Derivative Litigation- A comparative approach. At 2, 2004 http://frg.sin-online.nl/channel/index.html

'What's happening to the business judgment rule', 'Recent shareholder suits may be opening cracks in the protection afforded by the business-judgment rule"[156].

The Australian[157] case is also a good example of how a legal order can react to crisis[158]. After AWA's antecedents[159], and despite the existent reluctant judicial doctrine for reviewing director's decisions (low model of application of the BJR), the government decided for a high model of application of BJR. Reasons for that can be that common-law (as a source of law) cannot be produced expediently and provide the legal instruments that a nation or a government demand. Courts need an actual controversy to render an opinion, which's proceedings can take years until a final decision is taken. When a national economy is claiming for a reform there is no time to wait for that decision. It certainly is easier to pass a bill. Furthermore, statutory provisions are self-executing and do not require amendments to the articles of association[160]. In shorthand, the political urgency may call for a statutory BJR.

---

156 LAGUADO and DÍAZ, *supra* note 35.

157 Trevor Sykes (The Bold Riders), cited by KIRBY, reminds us of the Australian litany: "The collapses included Australia's largest industrial group (Adelaide Steamship); the ninth largest enterprise in the nation measured by revenue (Bond Corporation); nearly half the brewing industry (Bond Brewing); all three major commercial television networks (Bond Media, Qintex, Channel 10); Australia's largest car renter (Budget); the second largest newspaper group (Fairfax); Victoria's largest building society (Pyramid); and Australia's largest textile group (Linter) ... Total writeoffs and provisions by banks and financiers amounted to $28b. Australia's three largest merchant banks (Tricontinental, Partnership Pacific and Elders Finance) had to be rescued by their parents. Two of Australia's four State Banks (State Bank of Victoria and State Bank of South Australia) suffered devastating losses and had to be investigated by Royal Commission ... The four major trading banks (Westpac, National, Commonwealth and ANZ) had to write billions of dollars off their loan books". KIRBY, MICHAEL, Ac Cmg, The Company Director: Past, Present and Future. In The Australian Institute of Company Directors, Tasmanian Division. 31 March 1998. Http://Www.HCourt.Gov.Au/Speeches/KIRBYj/ KIRBYj_Company.Htm#FOOTBODY_14. The US crisis in the 80's, described by WALLACE: "Not since the Great Depression has the United States faced a financial disaster as grave as the savings and loan crisis. Analysts estimate that the crisis will cost the Federal Government —and ultimately American taxpayers— $ 500 billion dollars. The fallout from the savings and loan disaster has stretched from Capitol Hill, the White House, and Wall Street to homeowners and depositors across the nation. WILLIAM SEIDMAN, former Chairman of the Federal Deposit Insurance Corporation, predicts over 100,000 lawsuits stemming from the crisis, many attempting to place liability on corporate officers and directors for the failure of individual thrift institutions. The literature on the crisis is voluminous, with commentators blaming industry failure on a variety of factors: deposit insurance, fickle regulatory policies, junk bonds, rising interest rates, brokered deposits, a stagnant real estate market, managerial abuse, even moral failure". WALLACE, *supra* note 153, pags. 1189-90.

158 The American legislation after Aronson *vs*. Lewis, adopted by several federal legislations, is also a good illustration. *Supra* 2.1.2. and further, WALLACE, *op.cit*. pag. 1242.

159 *Supra* 2.3.1.

160 WALLACE, note 153. pag. 1241.

3.3.3. Clarity in the construction of the duty of care

This factor may act as a requirement for adopting a medium and higher standard of BJR. Under the supposition that the directness of the medium and high model of application of BJR constitute a psychological inducement for directors[161], the fogginess and uncertainty that an unclear understanding of the duty of care (as asserted by some American critics in respect of the US theory[162]) could be matched with a medium or high BJR that grants sufficient tranquility to a fearful director. In the adoption of the statutory BJR, Australian legislature took great consideration of the level of uncertainty and insecurity that the AWA case had created with regard to the duty of care[163].

Similar suppositions were made within the context of Malaysian's latest corporate reform:

> "In 1999, the Malaysian High Level Finance Committee on Corporate Governance (the Finance Committee) recommended that: 'section 132(1) should not be amended to clarify that the standard of care imposed is with reference to the particular circumstances of the director'. The Finance Committee also recommended that s 132(1) be amended to specify that there is also duty of skill and diligence. The Finance Committee further recommended a codification of the business judgment rule. Since the business judgment rule is closely related to directors' duty of care, skill and diligence, attempts to codify the business judgment rule without concomitant efforts to clarify the duty of care, skill and diligence is bound to lead to problems of proper interpretation of the scope of the business judgment rule"[164].

3.3.4. Clarity in the construction of the BJR

It seams reasonable that, for codifying a legal precept, perfect understanding of it should have been already achieved. It can constitute a big inconvenience to introduce into the legal order a rule which's boundaries and elements are not well defined. This may be one of the reasons why the US has still not given the step for canvassing a higher model of application of the BJR[165].

161 *Supra* 2.5.

162 Horsey, Henry *supra* note 5.

163 *Supra* 2.3.1 and 2.3.2.

164 Aiman Nariman Mohd Sulaiman, "Revising the directors' duty of care, skill and diligence in Malaysia", *Australian Journal of Corporate Law*. AJCL LEXIS 23, 2004.

165 See generally HORSEY, *supra* note 5. Curiously, *vis-à-vis*, the CLERPA considered that the American developments of the rule constituted sufficient and solid grounds to enact a statutory BJR.

3.3.5. *Statutory and contractual limitations of liability and availability of directors & officers policies*[166]

The limitation of director's liability can influence the adoption of a certain model of BJR. If such limitations are welcomed by the legal system[167], low and medium BJR model of application can satisfy the needs of the directorial community. By contrast, when the availability of those instruments is restricted or expensive[168] a high (and even medium) standard of BJR can be suitable.

WALLACE affirmed:

> "Corporate communities in Delaware and across the nation soon felt the impact of *Trans Union.* The cost of liability insurance became prohibitive as premiums soared. Potential directors declined corporate positions to avoid liability and existing corporate directors resigned. Both feared extraordinary personal liability from decisions made in corporate service in exchange for frequently nominal compensation. Fearing the demise of Delaware's "corporate cradle" as a result of *Trans Union* and the liability insurance crisis it generated, the Delaware legislature enacted section 102(b)(7) of title 8 of the Delaware Code. The Delaware legislature sought to alleviate the director and officer liability crisis by limiting directors' liability in section 102(b)(7). Other state legislatures, following Delaware's lead, enacted a variety of measures limiting director liability to attract capable and qualified persons to board service".

4. TOWARDS A UNIFORM MODEL OF APPLICATION OF THE BUSINESS JUDGMENT RULE

In the analysis of the core factors of corporate law (duty of care, derivative litigation and judicial doctrine) throughout the corporate law in the US, UK, and Australia, we arrive at some misleading contradictions, e.g., medium model of application in the US and highest models in Australia.

---

166 *Supra* note. 2.2.

167 In the United States, Nevada, New Jersey, and Virginia have passed limitations on the monetary liability of officers, in addition to directors. Moreover, New Mexico allows limited liability for gross negligence. Further, states allow the corporation to cover a director's legal expenses, plus damages, even if the court finds that the director violated his duty. See Power and Accountability. The Director's New Clothes, http://www.lens-library.com/power/chapter3.html#fnref54

168 Authors indicate that cases like Van Gorkom triggered huge increases in insurance premiums for directors if, in fact, coverage was available. Increasingly, companies confronted an inability to purchase E&O (errors and omissions) insurance for directors at any price. Power and Accountability. The Director's New Clothes, *ibidem*.

Being so, the enunciation of the three main factors can only be accepted as a general and abstract scheme that, in some occasions, may fail in explaining particular phenomena. Any more specific approach must necessarily be complemented with elements that regard the special situation of each jurisdiction.

Rounding up, the definition of whether a country must uphold a high model of application (Statutory) of the BJR will depend of the result of an analysis of all core and marginal factors of the model of application. Therefore, a universal rule or a general recommendation for the adoption of determined model of application of the BJR does not exist. The examination must be done taking into account the legal order, the corporate idiosyncrasy and the core and marginal factors present in each jurisdiction.

Notwithstanding the impossibility of drawing a uniform model of application of the BJR the empirical research has evidenced that the following general and abstract patterns can be drawn:

a) Of all the core factors governing the model of the BJR, the only that is present in the three jurisdictions that recognize such a rule is the judicial abstention doctrine towards second guessing the directors decisions. Then, one may suggest that a judicial abstention doctrine is a prerequisite for considering the application of the BJR, in any of the models.

b) On the one hand, the real and forecasted[169] increase in the initiation of derivative litigation reveals that directors will be target of judicial scrutiny more often than before. And on the other, the legal reforms and transformations of systems such as the American[170] and the Australian[171] show that (at least in those countries) there is a clear trend for accountability. The passing of legislation such as the Sarbanes-Oxley Act and the Corporations Law (1993) are evidence of the trend for accountability. The presence of these two issues shows that in short hand are evidence of stricter accountability of the directorship, may be considered main or principal factors for the choosing of medium and high models of application of the BJR.

169 *Vid supra* the explanations accompanying graph 3.2.

170 *Vid supra* 2.1.

171 *Vid supra* 2.3.3., specially the facility to initiate derivative actions.

c) When the legal system does not provide for active stockholder derivative remedies, and in consequence, and at least in this specific point, the degree of accountability is not as high as in jurisdictions where the threat is imminent, medium or high models of application will rarely be seen.

d) Regarding the marginal factors, firstly, high and medium models of application of the BJR should develop within economies governed by both, a policy of efficiency and a trend for accountability. If one of them is not present, the BJR, and its balancing function, may appear unnecessary. Secondly, high and medium models of application of the BJR require for clarity in the construction of the duty of care and of the BJR itself. Thirdly, when the availability of statutory and contractual limitations of liability and D&O policies is restricted or expensive a high (and even medium) model of application of the BJR appears appropriate.

Behind this preliminary assumption is the corporate trend for accountability and the economic efficiency policy. This tendency, which appears to have started ruling the contemporary corporate world, coupled with the also current economic efficiency policy, are revealed as the main shifting points between, in the one hand, a low model of application of the BJR, and, on the other, a medium and high model.

Therefore, despite the impossibility of drawing a universal model, it could be stated that the empirical research suggests that in the forthcoming years jurisdictions that welcome the trends for management accountability and economic efficiency will uphold high and medium models of application of the BJR.

CONCLUSIONS

The comparative analysis of the legal systems of the US, UK, Australia and the EU, indicates that each of these jurisdictions has special socioeconomic and legal characteristics that inform the adoption of what I have called different models of application of the BJR. These models show that the BJR is recognized either by implication, explicitly or statutorily within the chosen legal systems. I have graded these as the *low (implied)*, *medium (explicit)* and *high (statutory)* models of application of the BJR. A *low* model of application of the BJR is the one embraced by the UK where, despite the inexistence of a legal structure called ‘the business judgment rule’, its elements, and the general understanding of its functioning have been implicitly recognized by the courts. A *medium* model of application, like in the US, is the one where there is not only a common doctrine among the judiciary but also an explicit acknowledgment of the rule, evidenced in a systematic and coherent case-law. Finally the *high* model of application, finding reception in Australia, is represented in statutory provisions, incorporated into statutes, codes or acts, that clearly recognize the existence of the BJR.

The models of application of the BJR have a direct relation to the psychological impact on a company director. A high model of application of the BJR provides a subjective and psychologically positive effect on director's who see in such a statute an immediate response and desire of the legal order to protect him from being sued for his business judgments. A low model of application of the BJR, by contrast, affords less psychological protection since in those forums the doctrine is merely a general tendency of the judicial behavior.

This paper has shown that there are three core factors that influence the adoption of a model of application of the BJR. These three factors are: (1) the concept of the duty of care, (2) the degree and effective initiation of derivative litigation, and (3) the judicial doctrine upheld by the courts regarding the second guessing or reviewing of business judgments. The paper also shows that there are also other secondary issues that might play a complementary role in influencing the choice of model of application of the BJR. Those marginal factors are the current economic policy, the clarity in the construction of the duty of care, the clarity in the construction of the BJR and the statutory and contractual limitations of liability and the availability of Directors & Officers policies.

The empirical study of the US, UK and Australia, show that the only common factor that the countries which embrace the concept of the BJR (US, UK and Australia) posses, is a judicial abstention doctrine against the second guessing directors' decisions.

Australia, despite the fact that there is not very much derivative litigation within its court system, has the highest (statutory) model of application of the BJR. The US on the other hand has intensive levels of derivative litigation, yet, that it has a medium (made explicit by the courts and not by legislation) model of application. One would have expected Australia to appraise a medium model and the US a high one. This suggests that in determining the model of application of the BJR, the review of the three core factors identified in this paper is not a flawless guide. The determination of a model of application of the BJR must acknowledge therefore the importance of marginal factors such as the current economic policy, the trend towards corporate accountability, the clarity in the construction of the duty of care, the clarity in the construction of the BJR and statutory and contractual limitations of liability and availability of Directors & Officers (D&O) policies, all of which should be assessed before the idiosyncrasy and reality of every corporate legal and economical system.

Therefore, it is unlikely that a universal model of application of the BJR or a general recommendation for the adoption of determined model of application of the BJR can exist. However in view of the increasing demands for the corporate accountability and the economic efficiency and the fact that as these demands are the main factors influencing the preference for medium or high models of application of the BJR, the empirical research in this paper suggests that in the forthcoming years jurisdictions that welcome the trends for management accountability and economic efficiency will uphold high(statutory) and medium(explicit) models of application of the BJR.

REFERENCES

ARSALIDOU, DEMETRA, *Objectivity vs. Flexibility in Civil Law Jurisdictions and the Possible Introduction of the Business Judgment Rule in English Law*, Sweet and Maxwell Limited and Contributors, 2003.

BERKOWITZ, DANIEL; PISTOR, KATHARINA & RICHARD, JEAN-FRANÇOIS, "The Transplant Effect. The American Society of Comparative Law, Inc.", *American Journal of Comparative Law* 51 Am. J. Comp. L. 163, 2003.

BRAINBRIDGE, STEPHEN M., "The Business Judgment Rule as Abstention Doctrine", *Vanderbilt Law Review*, 57 Vand. L. Rev. 83, 2004.

BRAINBRIDGE, STEPHEN, Conference the Business Judgment Rule as an Abstention Doctrine, at Syracuse University, January 23, 2004.

BRANSON, DOUGLAS M., "The Rule that isn't a Rule - The Business Judgment Rule", 36 Val. *U.L. Rev*. 631, 2002.

BROWN, MEREDITH M and REGNER, WILLIAM D., "What's Happening to the Business Judgment Rule?", June 19, 2003.

http://www.debevoise.com/publications/pubsdetail.asp?pubid=1455206192003&typeid=4

CARNEY, WILLIAM J., "The ALI's Corporate Governance Project: the Death of Property Rights?", 61 Geo. *Wash. L. Rev*. 898, 898, 1993.

CARRIGAN, FRANK, "The role of capital in regulating the duty of care and business judgment rule", *Australian Journal of Corporate Law* (c) Copyright 2002 Reed International Books, Australia Pty Limited trading as LexisNexis, AJCL LEXIS 12, 2002.

CLARK, ROBERT CHARLES, "Corporate Law 639-74 (1986) in Fontana, Primo", CERCLA Derivative Suits, 27 B.C., Envtl, *Aff. L. Rev*, 741, Boston College Law School, 2000.

Commentary on Draft Provision, Corporate Law Economic Reform Program, 1998.

COZIAN, MAURICE; VIANDIER, ALAIN et DEBOISSY, FLORENCE, *Droit de Sociétés*, Paris, Litec, 16eme édition, 2003.

Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids (Text with EEA relevance), *Official Journal*, L 142, 30/04/2004, pags. 0012 – 0023, 2004.

DAVIS, KENNETH B., "Once More, the Business Judgment Rule", *Wisconsin Law Review*, 2000 *Wis. L. Rev*. 573, 2000.

EISENBERG, MELVIN A., *Whether the Business-Judgment Rule Should be Codified*, California Law Revision Commission, vol. 28, May 1995.

FAMA, EUGENE F. and JENSEN, MICHEL C., *Separation of Ownership and Control. Journal of Law and Economics*, vol. XXVI, June 1983, and Foundations of Organizational Strategy, Harvard University Press, 1998.

Find Law, Boardroom "Best" Practices are Changing: The Need to Demonstrate "Good Faith". 2003,

http://library.lp.findlaw.com/articles/file/00070/009201/title/Subject/topic/Business%20Organizations_Corporations/filename/businessorganizations_2_636

FLINT, GEOFFREY, "Non-Executive Directors' General Law Duty of Care and Delegation of Duty: But do we Need a Common Law Duty of Care?", *Bond Law Review*, vol. 9, n° 2, December 1997, http://www.bond.edu.au/law/blr/vol9-2/contents9-2.htm

FRONTERA, JOSÉ and MA, CHAO, "Derivative Litigation a comparative approach", 2004 http://frg.sin-online.nl/channel/index.html

FRIESWIK, KRIS, 'Recent shareholder suits may be opening cracks in the protection afforded by the business-judgment rule' (CFO *Magazine* February 01, 2004), http://www.cfo.com/article.cfm/3011471/c_3046605?f=insidecfo)

GALGANO, FRANCESCO, *Diritto commerciale. Le società. Contratto di società. Società di persone. Società per azioni. Altre società di capitali. Società cooperative*, Roma, Zanichelli, 2004.

GARRIGUEZ, J., R*esponsabilidad de consejeros y altos cargos de sociedades de capital*/J & A Garrigues abogados, Madrid: McGraw-Hill, 1996.

GARRIGUEZ, JOAQUÍN, "Panorama actual de problemas en la sociedad anónima", *Revista del derecho comercial y de las obligaciones*, Depalma, vol. 2, n° 7-12, Buenos Aires, 1969.

GREGORY, MARK A., *The role of the State in Corporate Law Formation, in International Corporate Law*, vol. 1, Hart Publishing, Oxford, 2000.

GREENHOW, ANNETTE, *The statutory Business Judgment Rule: Putting the Wind Into Directors'*, School of Law, Bond University, 1999.

HANSMANN, H. and KRAAKMAN, R., "Agency Problems and Legal Strategies", in R, KRAAKMAN, P, DAVIES, HANSMANN, H, HERTIG, C, KOPT, K.J, KANDA, H and ROCK E.B., in *Anatomy of Company Law: a comparative and functional approach*, Oxford University Press, 2002.

HEMRAJ, MOHAMMED B., *The Business Judgment Rule in Corporate Law*, Sweet & Maxwell Limited and Contributors, 2004.

JOHNSTONE, ELIZABETH and KORNER, NICHOLAS, "Company directors and the new statutory business judgment rule",

http://www.bdw.com.au/publications/issues/articles/Issues1-JudgmentRule.pdf

KIRBY, MICHAEL, Ac Cmg, The Company Director: Past, Present and Future. In The Australian Institute Of Company Directors, Tasmanian Division, 31 March 1998.

http://Www.HCourt.Gov.Au/Speeches/KIRBYj/KIRBYj_Company.Htm#FOOTBODY_14

KIRCHNER, CHRISTINA and PAINTER, RICHARD W., "Towards a European Modified Business Judgment Rule for Takeovers law", *European Business Organizations Law Review*, http://ssrn.com/abstract=247214, 2000.

LAGUADO GIRALDO, CARLOS ANDRÉS, "Sarbanes-Oxley Act y el proyecto de intervención económica sobre estándares internacionales de contabilidad, auditoría y contaduría", Superintendencia de Valores. http://www.supervalores.gov.co/ley_estandares_contables.htm 2004.

LAGUADO GIRALDO, CARLOS ANDRÉS and DÍAZ, MARÍA, "Modern Conception of the Business Judgment Rule: a case study on Delaware Jurisprudence", *Review of International Law*, Pontificia Universidad Javeriana, 2005.

LAGUADO GIRALDO, CARLOS ANDRÉS, *Condiciones generales del contrato de seguro*, 2005, in press.

LORSCH, JAY W. & MACIVER, ELIZABETH, *Pawns or Potentates: the Reality of America's Corporate Boards*, Harvard Business School Press, Boston, 1989.

MORAN, J.P., "Business Judgment Rule or Relic?: Cede V. Technicolor and the Continuing Metamorphosis of Director Duty of Care", *Emory Law Journal Emory University School of Law*, 1996.

MORPHET, JACINTA, "Corporate Governance Issues", June 30 2003, at http://www.mckeanpark.com.au/newsite/publications/articles/JACINTACGJune2003.pdf

O'KELLEY C. and THOMPSON R., *Corporations and Other Associations,* Little, Brown & Company, 1993.

PASBAN, MOHAMMED R., CAMPBELL, CLARE, BIRDS, JOHN, "Section 727 and the Business Judgment Rule: a Comparative Analysis of Company Directors' Duties and Liabilities in English and United States Law", *Journal of Transnational Law & Policy -Florida State University*, 6 J. Transnat'l L. & Pol'y 201, 1997.

PATON, TRICIA, *Codification of Corporate Law in the United Kingdom and European Union: the Need for the Australian Approach* ICCLR Sweet & Maxwell Limited and Contributors, 11(9), 2000.

Power and Accountability. The Director's New Clothes, http://www.lens-library.com/power/chapter3.html#fnref54

SULAIMAN, AIMAN NARIMAN MOHD, "Revising the directors' duty of care, skill and diligence in Malaysia", *Australian Journal of Corporate Law*, AJCL LEXIS 23, 2004.

Symposium: Current Issues in Corporate Governance: Conference Panel Discussion: the Business Judgment Rule, 45 Ohio St. L.J. 629. the panelists were moderator P. JOHN KOZYRIS, professor of Law, the Ohio State University; RICHARD M. BUXBAUM, professor of Law, University of California, Berkeley; TAMAR FRANKEL, professor of Law, Boston University; HARVEY GOLDSCHMID J., professor of Law, Columbia University; ROBERT W. HAMILTON, professor of Law, University of Texas; ALAN SCHWARZ, professor of Law, Rutgers University at Newark; PHILLIP C. SORENSEN, professor of Law, The Ohio State University; JAMES M. TOBIN, Partner, Squire, Sanders & Dempsey, Columbus, Ohio. 1984

RIDGELEY HORSEY, HENRY, "The Duty of Care Component of the Delaware Business Judgment Rule", Delaware Law School of Widener, University, Inc. *Delaware Journal of Corporate Law*, 1994.

ROSE, FRANCIS, *Company Law*, Sweet & Maxwell, Third edition, London, 1995.

PATON, TRICIA, "Codification of Corporate Law in the United Kingdom and European Union: the Need for the Australian Approach", *International Company and Commercial Law Review 2000*, 11(9), 309-317 Copyright (c) Sweet & Maxwell Limited and Contributors. 2000.

SCHUIT, STEVEN R, *et al.*, *Corporate Law and Practice of the Netherlands*, Allen & Overy Legal Practice, Kluwer Law International, The Hage, 2002.

'The court for most US companies has been toughened up by waves of crime and reform' *BUSINESSWEEK*, March 22, 2004.

THORNE, JAMES and WALMSLEY, KEITH, *Company Law*, Butterworths, third edition, London, 1995.

http://www.businessweek.com/magazine/content/04_12/b3875070.htm

TOMASIC, ROMAN, "The theoretical foundations of Australian Corporations Law Reform: Some Lessons for Reformers", *Journal of International Commercial Law*, 1(3) 323-349, Ashgate Publishing Limited, 2003.

VEASEY, E. NORMAN and SEITZ, JULIE M.S., "The Revised Model Business Corporation Act: Comment and Observation: the Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project. 63" *Tex. L. Rev*. 1483 May, 1985.

VEASEY, E. NORMAN, in CFO Magazine. Judgment Calls, at

http://www.abanet.org/buslaw/blt/2003-0910/nonbindingopinions html

September 9 2003.

WAGNER THOMAS C., "Corporate Law —The Business Judgment Rule Imposes Procedural requirements on Corporate Directors— SMITH V. VAN GORKOM", 488 A. 2d 858 (Del. 1985) *Florida State University Law Review*, 14 *Fla. St. U.L. Rev*. 109. 1985.

WALLACE, MARK DAVID, "Life in the Boardroom After FIRREA: a Revisionist Approach to Corporate Governance in Insured Depository Institutions", 46 U. *Miami L. Rev. 1187*. 1992.