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Re-examining the law and economics of the business judgment rule: notes for its implementation in non-US jurisdictions

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ABSTRACT
The business judgment rule, as it has been traditionally understood, seems to be based on three underlying assumptions that make this rule economically desirable. First, directors are subject to a credible threat of being sued for a breach of the duty of care. Second, the primary role of the corporation is to maximise shareholder value. Third, shareholders want the directors to pursue those investment projects with the highest net present value regardless of their volatility. This article challenges these assumptions and argues that the business judgment rule might not be desirable in some jurisdictions outside the United States and even in many US corporations. Moreover, it points out that the implementation of the business judgment rule may actually create new, unintended costs. By re-examining the law and economics of the business judgment, this article draws conclusions about the most efficient way to implement the business judgment rule across jurisdictions.

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1. Introduction

Several countries have implemented, or are planning to implement, the business judgment rule as a way to improve their corporate governance practices. In this article, I seek to assess whether the implementation of the business judgment rule is economically desirable and, if so, how it should be implemented in a particular jurisdiction. The article is divided as follows. Section 2 analyses the origins and transplantation of the business judgment rule from the United States to other legal systems. Section 3 seeks to explain the 'traditional' law and economics of the business judgment rule, in order to understand the rationale behind the protection of managers in their business decisions. Section 4 re-examines the law and economics of the business judgment rule by both challenging some of its underlying

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assumptions and pointing out other weaknesses of the rule. Section 5 discusses the most efficient way to implement (if so) the business judgment rule in non-US jurisdictions. Section 6 concludes with a summary of policy considerations about the possible implementation of the business judgment rule across jurisdictions.

2. The origins and transplantation of the business judgment rule

The business judgment rule has been classified as one of corporate law's central doctrines.[1] This rule prevents judges from second-guessing business decisions made by corporate directors and (depending on the jurisdiction) executive officers, provided that some requirements are met – usually, making a business decision in good faith, with no conflict of interests, with a reasonable level of information, and in the best interest of the corporation.

This doctrine finds its earliest expression in the first half of the nineteenth century in the United States.[2] In a well-known decision,[3] the Supreme Court of Louisiana decided to protect the managers in a business decision made in good faith and with no conflict of interests.[4] According to the court's view, it is irrelevant whether a business decision may end up being a failure or success. Courts should just focus on how the decision was made. Otherwise, if the court focused on the outcome instead of the process in which the decision was made, honest and qualified people would be discouraged from acting as corporate directors; or if so, they would not take any risk, they would require a higher pay, or the company would have to pay a higher insurance premium. In all of these scenarios, value would be destroyed for the shareholders and society as a whole.[5]

This decision was followed by other courts in the United States,[6] and, more recently, by other countries.[7] Nevertheless, and even though the rationale behind this rule is quite similar, the way the business judgment rule has

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[1]See Stephen M. Bainbridge, 'The Business Judgment Rule as Abstention Doctrine' [2004] 57 Vanderbilt Law Review 83.

[2]S. Samuel Arsht, 'The Business Judgment Rule Revisited' [1979] 8 Hofstra Law Review 93, 97

[3]The first application of the business judgment is usually associated with *Percy v Millaudon*, a case decided by the Supreme Court of Louisiana in 1829.

[4]Unless otherwise is stated, this paper will use the terms 'managers' and 'directors' as synonyms.

[5]Arguing that investors' wealth would decrease if the managers were subjected to a strict scrutiny by courts, see Frank. H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (Harvard University Press 1991) 93.

[6]See *Godbold v. Branch Bank*, a case decided by the Supreme Court of Alabama in 1847.

[7]Just to mention various cases, Australia adapted the business judgment rule as a statutory rule in 2000 in the section 180(2) of the Corporations Act. For an empirical analysis of the implementation of the business judgment rule in Australia, see Jenifer Varzaly, 'Protecting the Authority of Directors: An Empirical Analysis of the Statutory Business Judgment Rule' [2012] 12 Journal of Corporate Law Studies 429. In Brazil, the business judgment rule seems to be implicitly recognised in the article 159 § 6.° of the Corporations Act enacted in 1976. See the resolutions of the Brazilian Stock Exchange Commission No 25/2003, 21/2004, and 24/2006. For a more detailed analysis of civil liability of directors and the business judgment rule

been implemented differs across jurisdictions.[8] On the one hand, there are jurisdictions where the business judgment rule has been adopted as a *non-statutory rule* either in a soft or a strong manner.[9] On the other hand, there are

under Brazilian Law, see also Mariana Pargendler, 'Responsabilidade Civil dos Administradores e Business Judgment Rule no Direito Brasileiro' [2015] 953 Revista do Tribunais 51. In Colombia, even though a kind of 'soft' business judgment rule seems to be recognised under the duty of acting as a 'good business man' (see, for example, the Resolution of the Superintendence of Companies No 2014-801-054), the business judgment rule was proposed to be codified in 2015. See http://www.supersociedades.gov.co/noticias/Documents/2015/Septiembre/Libro%20proyecto%20de%20reforma.pdf. Germany incorporated the business judgment rule as a *codified rule* in 2005 in section 93 (1) para. 2 AktG. However, the rule seems to be applied since *ARAG/Garmenbeck* was decided in 1997. For an analysis of the business judgment rule in Germany, see Markus Roth, 'Corporate Boards in Germany', in Paul Davies, Klaus Hopt, Richard Nowak and Gerard van Solinge (eds.) *Corporate Boards in Law and Practice: A Comparative Analysis in Europe* (Oxford University Press 2013) 321–2. In Italy, a kind of 'soft' business judgment rule seems be applied under the doctrine of the 'immunity of business decisions' (see the decision of the Supreme Court of Italy on 24 March 2004). For further analysis, see Gian Giacomo Peruzzo, *Business judgment rule e responsabilità degli amministratori di S.p.A (Aracne, 2016)*; Danilo Semeghini, 'Il dibattito statunitense sulla business judgment rule: spunti per una rivisitazione del tema' [2013] 2 Rivista di Diritto Societario 206; Bartolomeo Quatraro and Emilio Tossi, *Il controllo giudiziario delle società* (Giuffrè 1997) 12. In Japan, even though the business judgment rule seems to be recognised by both courts and academics, it was expressly applied in *Apamanshop,* a case decided by the Supreme Court of Japan on 15 July 2010. For an analysis of this case, and the business judgment rule in Japan, see Dan W. Puchniak and Masafumi Nakahigashi, *Corporate Law, Business Judgment Rule – Derivative Action – Supreme Court 15 July 2010 – 'Apamanshop' with comment,* in Moritz Bälz et al (eds.), *Business Law in Japan: Cases and Comments* (Wolters Kluwer 2012) 215–26; Tomotaka Fujita, 'Revising the managerial liability regime in Japan', in Hideki Kanda, Kon Sim-Kim and Curtis J. Milhaupt (eds.) *Transforming Corporate Governance in East Asia* (Routledge 2008) 28–30. In Spain, the business judgment rule was implemented as a statutory rule in 2014. However, before its codification, Spanish courts already applied a 'soft' business judgment rule. See Aurelio Gurrea-Martínez, 'La cuestionada deseabilidad económica de la business judgment rule en el Derecho español' [2014] Working Paper, available at <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2445545> accessed on 12 January 2017. In the United Kingdom, a 'soft' non-statutory business judgment rule seems to be applied since *Howard Smith Ltd v Ampol Petroleum* in 1974. See Luca Enriques, Henry Hansmann, and Reinier Kraakman, 'The Basic Governance Structure: The Interests of Shareholders as a Class', in Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, Oxford University Press 2009) 79–80. In the United States, a strong form of non-statutory business judgment rule has been applied since *Percy v Millaudon*. For a detailed analysis of the business judgment rule in the United States, see Dennis J. Block, Nancy E. Barton and Stephen A. Radin, *The business judgment rule: fiduciary duties of corporate directors* (5th edn, Aspen Law & Business 2002). For a detailed discussion about the nature and rationale of the business judgment rule in the United States, see Melvin A. Eisenberg, 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' [1993] 62 Fordham Law Review 437; William Allen, Reinier Kraakman and Guhan Subramanian, *Commentaries and Cases on the Law of Business Organization* (4th edn, Wolters Kluwer, 2011) 227–35; William Allen, 'The Corporate Directors' Fiduciary Duty of Care and the Business Judgment Rule under US Corporate Law', in Klaus Hopt, Hideki Kanda, Mark Roe, Eddy Wymmersch and Stefan Prigge (eds.), *Comparative Corporate Governance: The State of Art and Emerging Research* (Oxford University Press 1998) 307–31; Bainbridge (n 1).

[8]Some authors have argued that the business judgment rule has been implemented at different levels across jurisdictions. For instance, see Carlos Andrés Laguado Giraldo, 'Factors Governing the Application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU' [2006] 111 Vniversitas 115. In this paper, the author suggests several levels of application of the business judgment rule: (i) low, when there is only an implied business judgment rule applied by courts; (ii) medium, when the business judgment rule is strongly supported by courts; and (iii) high, when the business judgment rule has been codified.

[9]Some examples of this 'soft' application of the business judgment rule can be found in the UK, Italy, or Spain before 21 December 2014. Likewise, this soft interpretation of the business judgment rule also seems to exist in Brazil and Japan. For Brazil, see Pargendler (n 7). For Japan, see Puchniak and Nakahigashi (n 7) 215–26. The strong application of the business judgment rule as a non-statutory rule would be exemplified in the law of the United States.

jurisdictions where the business judgment rule has been implemented as a *codified rule*, normally with the purpose of enhancing legal certainty.[10] In these latter jurisdictions, however, the business judgment rule has not been adopted in the same way. For example, while some jurisdictions have implemented the business judgment rule as a *presumption* in favour of corporate directors – as it has been the traditional model followed by Delaware[11] – other jurisdictions have implemented the rule as a 'safe harbour', so the directors have to prove that they made the decision fulfiling certain requirements. Otherwise, they cannot get the protection of the business judgment rule.[12]

3. The rationale for protecting managers in their business decisions

3.1. Innovation, firm value, and managerial risk aversion

Most rewarding decisions in life imply risks. In business, the ability to take risks not only may generate gains for the shareholders ('microeconomic benefits of risk') but, more importantly, it can also promote innovation, entrepreneurship, and development ('macroeconomic benefits of risks'). In the context of a corporation, three main factors may encourage shareholders to take risks. First, as a result of *limited liability*, shareholders are not required to bear the potential losses generated by a corporation. Their exposure is just limited to the total amount invested in the company's share capital. Second, shareholders receive *variable returns* on their investment. Therefore, the more money the company makes, the more cash-flows the shareholders will be entitled to receive. Thus, while, due to limited liability, shareholders will be 'hedged' against the company's downside, they will be able to get the gains associated

[10]See the memorandum of the Bill to amend the Corporation Act in 1998. Likewise, defending the codification of the business judgment rule in jurisdictions – such as California – where the business judgment rule is not clearly supported by courts, see Melvin A. Eisenberg, Background Study for the California Law Revision Commission on Whether the Business-Judgment Rule Should Be Codified (May 1995).

[11]This is the situation, for example, in Australia, where the business judgment rule seems to be a *presumption* in favour of corporate directors (section 180(2) of the Australian Corporations Act 2001). The business judgment as a presumption in the United States can be founded in *Aronson v. Lewis* (Supreme Court of Delaware, 1984).

[12]In Germany, for example, the implementation of the business judgment rule has followed a different approach. Unlike the United States (especially in Delaware), where the business judgment rule has been traditionally understood as a presumption in favor of corporate directors, Germany understands the business judgment rule as a 'safe harbour' for directors. Therefore, while the United States imposes the burden of proof on the plaintiff, Germany imposes the burden of proof on the directors. See Roth, 'Corporate Boards in Germany' in Paul Davies, Klaus Hopt, Richard Nowak and Gerard van Solinge (eds.) *Corporate Boards in Law and Practice: A Comparative Analysis in Europe* (Oxford University Press 2013) 321–22. Germany, therefore, follows the approach proposed by the American Law Institute. For an analysis of the business judgment rule proposed by the American Law Institute, see Douglas M. Branson, 'The Rule that Isn't a Rule – The Business Judgment Rule' [2002] 36 Valparaiso University Law Review 631; Melvin A. Eisenberg, 'Overview of the Principles of Corporate Governance' [1993] 48 Business Law 1271.

with a potential upside. Third, since Markovitz's seminal work,[13] the financial community is aware of the virtues of *diversification*. Through diversification, shareholders not only may reduce their total exposure to risk, but they will also be able to reduce their natural *risk aversion*.[14] Therefore, diversification is desirable for the shareholders, since it will encourage them to put their money in those investment projects with the highest net present value no matter their volatility.[15] Likewise, by reducing the problem of risk aversion, shareholders will have more incentives to invest in valuable and sometimes innovative projects, even if they are too risky. Therefore, diversification generates benefits not only for the shareholders but also for society as a whole.[16]

In corporations, however, business decisions are not made by shareholders but by *managers*.[17] And unlike the shareholders, managers *do* have incentives to be risk-averse.[18] Firstly, their reputation and job may be at risk if a project (or the company itself) fails. Secondly, if shareholders are dispersed and rationally apathetic, managers can take advantages of the asymmetries of information and collective action problems faced by shareholders; and if so, they may be incentivised to pursue safer but less profitable projects in order to reduce the risk of being sued.[19] After all,

[13]Harry M. Markovitz, 'Portfolio Selection' [1952] 7 The Journal of Finance 77.

[14]Analysing and testing the problem of risk aversion, see Daniel Bernoulli, 'Exposition of a New Theory on the Measurement of Risk' (English Translation by Louise Sommer) [1954] 22 Econometrica 23; John W. Pratt, 'Risk Aversion in the Small and in the Large' [1964] 32 Econometrica 122; Daniel Kahneman and Amos Tversky, 'Prospect Theory: An Analysis of Decision Under Risk' [1979] 47 Econometrica 263.

[15]John Armour and Jeffrey Gordon, 'Systematic Harms and Shareholder Value' [2014] 6 Journal of Legal Analysis 35, 35–37.

[16]Other benefits generated by promoting diversification may be associated with the ability to provide finance to a higher number of business activities. Therefore, diversification may solve an 'underinvestment problem'.

[17]There are exceptions in small businesses, or in countries in which shareholders are allowed to give instructions to the managers even for business decisions.

[18]Let us suppose that the managers have to choose between two investment projects. The first project yields a net present value of $100 in case of success, and a net present loss of −$50 in case of failure. Success and failure may occur with the same probability (50%). The second project yields a net present value of $20 *for sure*. Which project will likely be chosen by the managers? In the absence of any mechanism to reduce the problem of managers' risk aversion, they will likely prefer project 2, even though this project may generate an opportunity loss for the shareholders equal to $5. Indeed, in terms of expected value, the first project will create a net present value equal to $100\times0.5 + (-50)\times0.5 =$ $25, while the second project will generate a net present value equal to $20. Therefore, the first project creates more value for the shareholders. However, as the result of the problem of managers' risk aversion, the second project will be probably chosen by the managers.

[19]This problem has been traditionally associated with the US and, to a lesser extent, UK corporations, where there is a higher separation between ownership and control. See Rafael La Porta, Florencio López de Silanes and Robert Vishny, 'Corporate Ownership Around the World' [1999] 54 Journal of Finance 471. Challenging this generally assumed assertion in US corporate law, however, see Clifford G. Holderness, 'The Myth of Diffuse Ownership in the United States' [2009] 44 The Review of Financial Studies 1377. In any event, the rise of shareholder activism and institutional investors is changing the ownership structure of many companies around the world. Thus, the traditional 'Berle-Means' corporation has evolved into something different, and therefore the traditional agency costs between managers and shareholders associated with publicly held corporations (especially in the United States have also changed). Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' [1976] 3 Journal of Financial Economics 305; John Armour and Brian Cheffins, 'The Past, Present and Future of Shareholder Activism by Hedge Funds' [2012] 37

the shareholders, under these circumstances, will unlikely be able to know that the managers invested in a safer but less profitable project. Therefore, even if stock option plans and other compensation tools may encourage managers to take more risks, they will still have incentives to be more risk-averse than diversified shareholders. A conflict of interests between managers and shareholders may arise then: (i) on the one hand, rational and diversified shareholders want the managers to pursue more risky projects, provided that these projects yield higher returns; (ii) on the other hand, managers have incentives to undertake safer projects, even if they are less profitable for the shareholders.

There are several ways to reduce the misalignment of incentives potentially existing between managers and shareholders in these situations.[20] One of the most successful (or at least most commonly used) methods, however, not only in the United States but also worldwide has been the business judgment rule.[21] By applying this rule, courts will not second-guess *business* decisions, provided that certain conditions are met.[22] Therefore, since managers would be protected from the potential liability associated with reasonable but unfortunate decisions, not only will there be more honest and qualified people willing to serve as corporate directors, but they will also be incentivised to pursue more valuable projects even if they imply a higher level of risk.

3.2. The 'institutional problem' generated by letting judges act as business decision-makers

A second argument in favour of the business judgment rule is usually associated with the role of judges as business decision-makers. Namely, this rationale relies on the fact that, even though judges are experts in law, they do not

Journal of Corporation Law 51; John C. Coffee Jr. and Darius Palia, 'The Impact of Hedge Fund Activism: Evidence and Implications' [2014] ECGI – Law Working Paper No. 266/2014; Ronald J. Gilson and Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights [2013] 113 Columbia Law Review 863. John Armour and Jeffrey N. Gordon, 'The Berle-Means Corporation in the Twenty-First Century' [2008] Working Paper, available at http://www.law.upenn.edu, accessed 25 January 2017. Aurelio Gurrea Martínez, New Agency Problems: New Legal Rules? Rethinking Takeover Regulation in the US and Europe, 'Instituto Iberoamericano de Derecho y Finanzas' [2016] Working Paper Series 3 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2766208), accessed 23 June 2017.

[20]See Allen, Kraakman and Subramanian (n 7) 218–36.

[21]There is a strong connection between law and finance in the context of the business judgment rule. See Ronald J. Gilson, 'The Law and Finance of the Business Judgment Rule', in Arnold W. Sametz and James L. Bicksler (eds.), *The Battle for Corporate Control: Shareholder Rights, Stakeholder Interests, and Managerial Responsibilities* (Business One Irwin 1991) 157.

[22]Although these conditions may differ across jurisdictions, most jurisdictions require that the decision has to be made in good faith, with no conflict of interest, and in the best interest of the corporation. Therefore, instead of focusing on the *result* generated by the decision, the business judgment rule focuses on the *process* leading to the decision. These conditions ensure that the business judgment rule neither creates moral hazard nor acts as a 'blank check' for corporate directors.

usually have enough knowledge of economics, business, and finance.[23] Moreover, even if they were trained in these areas, they will unlikely have expertise in the particular business in which they may have to make a decision. Therefore, it may seem reasonable that, instead of judging ex post the business decision made by corporate directors, they should just focus on the *process* leading to the decision.[24] Furthermore, unlike corporate directors (who can be removed by the shareholders, so their salary and reputation may be at risk), courts cannot be 'punished' for making a poor business decision, provided that it is legally sound. Therefore, the use of judges as business decision-makers may be socially undesirable, taking into account that they have neither the knowledge nor the incentives to make efficient business decisions.

3.3. Hindsight bias

The application of the business judgment rule also allows to reduce the so-called hindsight bias, that is, the inclination, after an event has occurred, to think that the outcome was predictable, despite the fact that there was no objective basis for that at the moment of making the decision.[25] Hence, people –and judges are not an exception – tend to bias their judgments in favour of the *outcome*. Therefore, as managers will likely be sued only when a business decision was unsuccessful, the hindsight bias will put the directors in a worse position than they would have been in a world without this cognitive bias. As a result, it will be easier that the court finds the managers personally liable for a breach of the duty of care, even if the decision was reasonably made ex ante.[26]

[23]Cándido Paz-Ares, 'La responsabilidad de los administradores como instrumento de gobierno corporativo' [2003] 4 Indret, 32; Luca Enriques, 'Do Corporate Law Judges Matter? Some Evidence from Milan' [2002] 3 European Business Organization Law Review 756; Easterbrook and Fischel (n 4) 94; Daniel R. Fischel, 'The Business Judgment Rule in the Trans Union Case' [1985] 40 Business Lawyer 1437, 1439–1440.

[24]Andreas Engert and Susanne Goldlücke, 'Why agents need discretion: The business judgment rule as optimal standard of care' (2013), University of Mannheim, Working Paper, available at http://goldluecke.vwl.uni-mannheim.de/fileadmin/user_upload/goldluecke/working_papers/BJR2013-01-20.pdf, accessed 12 February 2017. The authors distinguish between liability for lack of effort in preparing a risk-taking decision (*process due care*) and liability for the decision itself (*substantive due care*). They argue that as long as courts administer liability in the effort dimension reasonably well, they should be reluctant to second-guess managerial decisions.

[25]Emphasizing this argument in the context of the business judgment rule, see Melvin A. Eisenberg, 'The Divergence of Standards of Conduct and Standards of Review in Corporate Law' [1993] 62 Fordham Law Review 437. For a definition of hindsight bias, see Neal J. Roese and Kathleen D. Vosh, 'Hindsight Bias' [2012] 7 Perspectives on Psychological Science 411. See also Baruch Fischhoff, 'Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty' [1975] 1 Journal of Experimental Psychology 288; Daniel Kahneman, *Thinking Fast and Slow* (Farrar, Straus and Giroux 2011), 202–4. Baruch Fischhoff, 'For Those Condemned to Study the Past: Heuristics and Biases in Hindsight' in Daniel Kanheman, Paul Slovic and Amos Tversky (eds.), *Judgment under uncertainty: Heuristics and biases* (Cambridge University Press 1982) 325–52.

[26]See Enriques, Hansmann, and Kraakman (n 7) 79.

This unfavourable judgment against corporate directors may create several costs for society. First, it may discourage honest and qualified people from acting as corporate directors. Second, even if qualified people accept to act as corporate directors, the shareholders can still be worse off, since the directors will be incentivised to take a suboptimal level of risk and/or they will require a higher pay, and these costs will be borne by the shareholders.

3.4. Certainty

Finally, the implementation of the business judgment rule could also enhance certainty for both shareholders and managers.[27] From the shareholders' perspective, the business judgment rule may allow investors to know ex ante both the identity and expertise of those people in charge of managing their wealth. Based on that information, they will be able to adjust their decisions ex ante. From the directors' perspective, the business judgment rule may also promote certainty. Namely, it makes the duty of care more objective, since the standard of care will not be judged based on some 'subjective' conditions assessed by the court, but rather on whether the directors made the decision based on several requirements known ex ante. Moreover, the business judgment rule may allow managers to pursue more risky but also profitable and long-term projects without being worried about short-term demands.[28] In fact, in the absence of the business judgment rule, managers might be incentivised to pursue safer but less profitable (and perhaps more short-term) projects, as a way to either preserve their jobs or avoid the risk of being sued by the shareholders.

4. Problems and limitations

4.1. The underlying assumptions of the business judgment rule

Protecting managers in their business decision may reduce a problem of risk aversion, and it may ultimately lead to increase value for the shareholders (at a micro-level perspective) and to promote innovation and growth (at a macro-level perspective). However, this economic justification for the business judgment rule seems to rely on three underlying assumptions. First, directors are subject to a credible threat of being sued for a breach of the duty of care. Second, the primary role of the corporation is to maximise shareholder value. Third, shareholders are not risk-averse, and therefore they just want

[27]This argument was used to justify the implementation of a statutory business judgment rule in Australia. See the Explanatory Memorandum of the Corporate Law Economic Reform Program Bill 1998 (https://www.comlaw.gov.au/Details/C2004B00269/Explanatory%20Memorandum/Text).
[28]See Reading and Co v Trailer Co [1984], decided by the Supreme Court of Delaware.

the directors to pursue those investment projects with the highest positive net present value regardless of their volatility.[29]

Nevertheless, these underlying assumptions are not always valid. Starting by the first assumption, managers are unlikely be subject to a credible threat of being sued for a breach of the duty of care in jurisdictions with no derivate litigation either because of the particular features of the legal system (e.g. inefficient courts, inexistence of class actions, etc.) or, more likely, because of the existence of controlling shareholders.[30] Indeed, in countries with controlling shareholders, derivative litigation is usually rare, since the existence of controlling shareholders reduces agency costs between managers and shareholders – even though it may generate other agency problems.[31] Moreover, even if the managers (who are usually very

[29]These latter assumptions can be summarized in *Gagliardi v. Trifoods International, Inc*., where Chancellor Allen stated that '[…] Shareholders don't want (or shouldn't rationally want) directors to be risk-averse. Shareholders' investment interests, across the full range of their diversifiable equity investments, will be maximized if corporate directors and managers honestly assess risk and reward and accept for the corporation the highest risk adjusted returns available that are above the firm's cost of capital … But directors will tend to deviate from this rational acceptance of corporate risk if in authorizing the corporation to undertake a risky investment, the directors must assume some degree of personal risk relating to ex post facto claims of derivative liability for any resulting corporate loss'. Likewise, in *Joy v North*, Judge Winter stated that '[…] Because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that the law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit. Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others. Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally'. Therefore, as Armour and Gordon point out, '[…] the structure of corporate governance arrangements, at least in the USA, is explicitly directed towards encouraging managers to undertake the highest-NPV projects available to them, regardless of their level of risk […]'. See Armour and Gordon (n 15) 53.

[30]For an analysis of derivative litigation in the UK and Continental Europe, see Arad Reisberg, *Derivative Actions and Corporate Governance* (Oxford University Press 2007); Martin Gelter, 'Why do Shareholder Obstacles to Derivative Suits Remain Rare in Continental Europe?' [2012] ECGI – Law Working Paper N° 190/2012. For a comparative analysis of derivative litigation in Asia, see Dan W. Puchniak, Harald Baum and Michael Ewing-Chow (eds.), *The Derivative Action in Asia: A Comparative and Functional Approach* (Cambridge University Press 2012). For an empirical analysis of Japanese derivative actions, arguing that the rise of shareholder activism and the lower cost of filing a lawsuit led to an increase in derivative litigation, see Curtis J. Milhaupt, 'A Lost Decade for Japanese Corporate Governance Reform? What's Changed, What Hasn't, and Why' [2003] Columbia Law and Economics Working Paper No. 234, 12. A general overview about the situation in Latin America can be found in the *White Paper on Corporate Governance in Latin America prepared* by the OCDE in 2003. See also Mierta Capaul, 'Corporate Governance in Latin America' [2003] Whither Latin American Capital Markets, LAC Regional Study Background Paper, 15–6.

[31]In jurisdictions with controlling shareholders, the traditional conflict between managers and shareholders is not generally an issue. Instead, these jurisdictions usually suffer from a problem of 'tunnelling' or 'horizontal agency problems' in which the controlling shareholder may expropriate minority investors. See Rafael La Porta, Florencio López de Silanes, Andrei Shleifer, and Robert Vishny, 'Law and Finance' [1998] 106 The Journal of Political Economy 113; Simon Johnson, Rafael La Porta, Florencio López de Silanes, and Andrei Shleifer, 'Tunneling' [2000] 90 The American Economic Review 22; Mark Roe, 'The Institutions of Corporate Governance', in Claude Ménard and Mary M. Shirley (eds.), *Handbook of New Institutional Economics* (Kluwer 2005).

close to the controlling shareholders or they are controlling shareholders themselves) failed to perform their duties, minority shareholders might not have incentives to sue the directors, taking into account that most of the recoveries potentially obtained in a successful lawsuit will go back to the corporation and therefore to the controlling shareholder. Moreover, they may have to bear some litigation costs. So these factors may discourage derivative lawsuits.

The second assumption behind the business judgment rule can also be challenged, due to the fact that in many jurisdictions, the primary role of a corporation is not exclusively identified with the interests of the shareholders but also with the interest of other stakeholders.[32] Therefore, unless the legislator in these latter jurisdictions consciously decides to switch part of its attention from the stakeholders to the shareholders, the implementation of the business judgment rule may achieve an outcome potentially *unwanted* by a particular jurisdiction. This circumstance may occur when, instead of conducting a deep economic analysis of the rule applied to a particular country, the business judgment rule is implemented just because it is 'in fashion' in other jurisdictions.

Moreover, even if it is assumed that, as a general matter, the primary role of a corporation in a particular jurisdiction is associated with the maximisation of shareholder value, this goal should be pursued *unless* otherwise is provided by the shareholders.[33] In other words, as a corporation is a contract, or at least is formed by contract, the purpose of this contract should be left to the parties who initially entered into this contract – that is, the shareholders. Therefore, the shareholders should be allowed to decide the primary role of the company either directly (e.g. in the bylaws) or indirectly (e.g. by incorporating the company in a more 'stakeholder-oriented' or 'shareholder-oriented' jurisdiction, or, for example, by forming a B corporation). However, defining this

[32] An example of these jurisdictions can be found in Japan and, to a certain extent, in Germany. For a traditional discussion about the primary role of a corporation, see Adolf Berle, 'Corporate Powers as Powers in Trust' [1931] 44 Harvard Law Review 1049; E. Merrick Dodd, 'For Whom Corporate Managers Are Trustees: A Note' [1932] 45 Harvard Law Review 1365. Summarizing the debate, see William Allen, 'Our Schizophrenic Conception of the Business Corporation' [1992] 14 Cardozo Law Review 261; Mark J. Roe, 'The Shareholder Wealth Maximization Norm and Industrial Organization' [2001] 149 University of Pennsylvania Law Review 2063; William W. Bratton and Michael L. Wachter, 'Shareholder Primacy's Corporatist Origins: Adolf Berle and The Modern Corporation' [2008] 34 Journal of Corporation Law 99; Martin Gelter, 'Taming or Protecting the Modern Corporation? Shareholder-Stakeholder Debates in a Comparative Light' [2010] ECGI Law Working Paper No. 165/2010; Michael C. Jensen, 'Value Maximization, Stakeholder Theory, and the Corporate Objective Function' [2002] 12 Business Ethics Quarterly 135.

[33] Jonathan R. Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2008) 2. This is also consistent with the decision of the US Supreme Court in *Hobby Lobby*, holding that corporate law does not mandate that business corporations limit themselves to pursuit of profit but rather to pursue any lawful purpose decided by the shareholders in the charters. This lawful purpose may consist of the maximization of shareholder value, the maximization of the interests of a specified group of stakeholders, or – if the shareholders want to give a blank check to the managers – the maximization of the interests of 'society' by letting the managers decide what is best for society.

objective may be costly, not only for the collective action problems associated with coordinating shareholders' actions and preferences but also because it will be difficult to define a *specified* corporate goal other than the maximisation of the value of the firm. For this reason, it seems desirable to assume, as a *default rule*, that the primary goal of a corporation is to maximise the value of the firm.[34]

The third underlying assumption of the business judgment rule is identified with an old idea existing in corporate law and finance: shareholders are not risk-averse, due to their variable returns, their limited liability, and their ability to hold diversified portfolios. Therefore, they just want the managers to pursue those projects with the highest net present value no matter their volatility.[35] This rigid assumption can also be challenged, since many corporations may have non-diversified shareholders. Namely, even though non-diversified shareholders can be found in any company or jurisdiction, it will be more common to find non-diversified shareholders in jurisdictions with many family businesses, concentrated ownership structures, and underdeveloped capital markets.[36] In these countries, as the shareholders might not be fully diversified, they might want the directors to be risk-averse. In other words, they will *care* about the volatility of an investment project. Thus, the implementation of the business judgment rule may exacerbate the misalignment of incentives potentially existing between managers and shareholders.[37]

Hence, when deciding about the implementation of the business judgment rule in a particular jurisdiction, the legislator should assess whether

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[34]Arguing that firms should maximize shareholder welfare and not market value, see Oliver Hart and Luigi Zingales, 'Companies Should Maximize Shareholder Welfare Not Market Value' [2017] 2 Journal of Law, Finance, and Accounting 247.

[35]Arguing that this is one of the most important ideas in modern corporate governance, see Armour and Gordon (n 15) 51–52.

[36]For the relation between family businesses, concentrated ownership structures, and lack of appropriate diversification, see Gouchang Zhang, 'Ownership Concentration, Risk Aversion and the Effect of Financial Structure on Investment Decisions' [1998] 42 European Economic Review 1751; Enrico M. Cervellati, Pierpaolo Pattitoni and Marco Savioli, 'Entrepreneurial Under-Diversification: Over Optimism and Overconfidence' [2013] Riemini Centre for Economic Analysis. Working Paper 9; Teodora Paligorova, 'Corporate Risk Taking and Ownership Structure' [2010] Bank of Canada Working Paper 2010/3; Ronald C. Anderson and David Reeb, 'Founding-Family Ownership, Corporate Diversification, and Firm Leverage' [2003] 46 Journal of Law and Economics 653; Mara Faccio, Maria Marchica and Roberto Mura, 'Large Shareholder Diversification and Corporate Risk-Taking' [2011] 24 Review of Financial Studies 3601; Alexander Dyck and Luigi Zingales, 'Private Benefits of Control: An International Comparison' [2004] 59 The Journal of Finance 537; Sabri Boubaker, Pascal Nguyen and Wael Rouatbi, 'Multiple large shareholders and corporate risk-taking: Evidence from French family firms' [2016] European Financial Management (forthcoming). However, the situation is quite different in countries with concentrated ownership structures where the blockholders are not families but *institutional investors*. In these situations, this assumption might *not* apply, since these institutional investors will probably be diversified. Recent studies show that many US corporations respond to this model. See Gilson and Gordon (n 19); Armour and Gordon (n 19).

[37]Showing other *unintended costs* created by the implementation of the business judgment rule (at least as a codified rule), see Jenifer Varzaly, 'Protecting the Authority of Directors: An Empirical Analysis of the Statutory Business Judgment Rule' [2012] 12 Journal of Corporate Law Studies 429.

the shareholders *generally* existing in that country may be more or less risk-averse. Since this is a difficult assessment, the legislator should look at other variables that may provide some *indicia* about the level of risk aversion potentially desired by the shareholders existing in a particular jurisdiction. For instance, it could be relevant to analyse the development of capital markets in a particular country, as well as the level of concentration of share ownership and the type of investors holding shares. In countries with more *developed capital markets*, it will be easier for investors to hold diversified portfolios. Likewise, in countries with *concentrated ownership structures*, it seems relevant to determine whether the existence of blockholders is due to the presence of family businesses or, by contrast, to institutional investors.[38] In the former case, there will be reasons to believe that the shareholders might not be diversified – or, at least, fully diversified – since most of their wealth (including human capital) will likely be invested in the family business. Therefore, the interest of the shareholders will likely be more aligned with the interest of the directors, since none of them will have incentives to bear a high level of risk.[39] In these circumstances, the application of the business judgment rule may not be desirable, since it may encourage the managers to bear a level of risk that might not be desired by the shareholders. Therefore, even though – as it will be explained below – non-diversified controlling shareholders may decide not to implement the business judgment rule (assuming that this decision is left to the company, rather than being imposed by the legislator as a mandatory rule) the business judgment rule may exacerbate the misalignment of incentives potentially existing between managers and shareholders.[40] The situation, however, may be quite different in countries where blockholders are institutional investors. In these circumstances, as the shareholders will likely

[38]The United Kingdom and the United States are good examples of jurisdictions with institutional investors. Therefore, the business judgment rule may work best in these jurisdictions, since this type of investors are usually diversified. For an analysis of the evolution of share ownership in the United Kingdom and the United States, see John Armour and David Skeel, 'Who Should Write Hostile Takeovers, and Why? The Peculiar Divergence of US and UK Takeover Regulation' [2007] 95 Georgetown Law Journal 1727. For the United States, see Gilson and Gordon (n 19). For an international survey of family business groups around the world, see Ronald W. Masulis, Peter K. Pham, and Jason Zein, 'Family Business Groups around the World: Financing Advantages, Control Motivations and Organizational Choices' [2011] 24 Review of Financial Studies 3556.

[39]While shareholders of family businesses may have incentives to be risk-averse because most of their wealth will be invested in the family business, managers will have incentives to be risk-averse as a result of the fear of losing their jobs, salaries, and private benefits of control.

[40]Emphasizing the role of corporate law in the alignment of incentives between managers and investors, see Klaus Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation' [2011] 59 American Journal of Comparative Law 1; Jonathan R. Macey, *Corporate Governance: Promises Kept, Promises Broken* (Princeton University Press 2008); Jensen and Meckling (n 19). As it will be discussed below, though, this misalignment of incentives will not be *that* relevant in countries with concentrated ownership structures. In these countries, the primary conflict potentially existing when implementing the business judgment rule may arise between the controlling shareholder (that may prefer the business judgment rule or not depending on the level of diversification of its *own* portfolio) and some minority shareholders.

be diversified, the implementation of the business judgment rule may make more sense.

In countries with controlling shareholders, the business judgment rule will likely be adopted *only if* the controlling shareholder is diversified, or the controlling shareholder also acts as a corporate director. By contrast, if the controlling shareholder is not diversified, the business judgment rule will unlikely be implemented, even if the minority shareholders hold diversified portfolios and therefore have more appetite for risk. This situation, then, may generate a conflict *among* shareholders. Namely, it may lead to a type of opportunism of controlling shareholders vis-à-vis minority shareholders, since the former may have incentives to implement the business judgment rule only when it can be beneficial for their own portfolio.

One possible solution to address this potential conflict among shareholders could consist of prohibiting controlling shareholders from *voting* when deciding about the implementation (or non-application) of the business judgment rule in the bylaws. Nevertheless, as this rule would indirectly prohibit controlling shareholders from choosing their preferences in terms of risk and returns, it could discourage many investors from financing corporations as controlling shareholders. Therefore, this solution may harm the development of capital markets and, more generally, firms' access to finance.

A more desirable solution to protect minority investors may consist of requiring companies with the business judgment rule in place to disclose this information not only in the bylaws but also in other corporate documents, such as the notes to the financial statements. Thus, by providing an *enhanced disclosure* of this information potentially relevant for the shareholders, the protection of minority shareholders can be improved. Moreover, as the controlling shareholder will likely seek to raise external finance, this enhanced disclosure will also incentivise controlling shareholders to choose the most efficient solution (that is, implementing or not the business judgment rule). Therefore, the interest of the controlling shareholders will be relatively aligned with the interests of minority investors.

4.2. Other weaknesses of the business judgment rule

It was argued that the fact of letting judges act as ultimate business decision-makers may create several problems such as hindsight bias and the so-called institutional problem. However, these problems may exist in almost every situation in which a court has to decide a case.[41] Indeed,

[41] As stated by Easterbrook and Fischel, traditional explanations for the business judgment rule such as the lack of competence of judges in making business decisions provide helpful but not sufficient arguments

when a judge has to decide about an aircraft crash due to technical problems, the judge does not probably have any expertise in aerospace engineering. Moreover, it also has to decide ex post. So the institutional problem and the hindsight bias also exist in these cases. Therefore, these arguments do not seem to be powerful enough to support the implementation of the business judgment rule.[42]

Finally, the argument that the business judgment rule may enhance certainty for both investors and directors does not seem very convincing either. From the perspective of investors, judges can be seen as *ultimate* decision-makers. Moreover, since investors may infer which particular court will be competent to decide a case based on the company's place of incorporation or, if so, the company's real seat, they will also be able to adjust ex ante the quality of the court. Therefore, it is not clear that, in the absence of the business judgment rule, investors will be exposed to higher uncertainty.

Likewise, from the perspective of corporate directors and the risky, valuable, and long-term projects that they may pursue under the protection of the business judgment rule, some concerns may also arise. On the one hand, it is not clear that preventing judges from second-guessing business decisions may encourage directors to pursue long-term value. On the other hand, even if it does so, this outcome can also be achieved in a better way

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to justify the rule. As these authors point out, these arguments do not explain '[…] why the same judges who decide whether engineers have designed the compressors on jet engines properly, whether the farmer delivered pomegranates conforming to the industry's specifications, and whether the prison system adversely affects the mental states of prisoners cannot decide whether a manager diligently failed to sack a subordinate who made improvident loans […]'. See Easterbrook and Fischel (n 4) 94. Actually, while judges do not usually have any knowledge or expertise in topics such as medicine or engineering (and they make decisions on these issues), they are starting to get training in economics, business, and finance in many jurisdictions. For example, in Spain, judges specialized in commercial matters have to prove some training in economics, accounting, and finance before being appointed to a commercial court. In the United States, many judges such as Frank H. Easterbrook and Richard Posner have a deep knowledge of economics and finance. In Colombia, the former judge in charge of solving corporate disputes at the Superintendence of Companies, Dr José Miguel Mendoza, has a PhD in law and finance.

[42]In my opinion, however, there is a more plausible explanation for letting judges review *non*-business decisions. As pointed out in this paper, one of the most powerful arguments to support the implementation of the business judgment rule is that it may reduce the problem of managers' risk aversion. Therefore, it may promote risk-taking and the maximization of the value of the firm. Moreover, by doing so, the business judgment rule may also create a positive externality for society: the promotion of innovation and development. Nevertheless, the same argument might *not* apply to other fields (such as engineering, architecture, or medicine) in which a judge also has to second-guess decisions. For engineers, architects, or doctors, society, under some circumstances, society can be better off if these actors act more conservatively. In other words, while taking risks may create value in the context of business decisions, a higher level of risk-taking when an engineer builds a bridge, a doctor operates a patient, or an architect designs a skyscraper may create some negative externalities. Therefore, while it may be socially desirable to prevent judges from second-guessing *business* decisions as a way to promote risk-taking, innovation, and development, it may be justified to review decisions potentially made by engineers, doctors, or architects. An alternative hypothesis, however, could be simply that the lobby of corporate directors has been more influential than the lobby of other professions, such as doctors, engineers, or architects.

through many other devices such as executive compensation based on long-term performance. Therefore, this argument in favour of the business judgment rule is relatively weak.

5. The implementation of the business judgment rule

5.1. Are the managers subject to a credible threat of being sued for a breach of the duty of care?

Despite the benefits generally associated with the business judgment rule, this legal device might not even be needed in a particular jurisdiction to protect corporate directors in their business decisions. Namely, the business judgment rule might not be necessary in jurisdictions where directors are not subject to a *credible threat* of being sued for a potential breach of the duty of care. And this situation will likely occur in countries with no derivative litigation either because it is not incentivised from a procedural perspective or because of the presence of controlling shareholders.

5.2. Unintended costs created by implementing the business judgment rule

If the managers are not subject to a credible threat of being sued, the legislator should think twice about the effects and desirability of implementing the business judgment rule. Namely, it should take into account that, while the business judgment rule might not create a *clear* gain, it may generate some costs.

On the one hand, the implementation of the business judgment rule may actually increase, rather than decrease, the number of lawsuits associated with a breach of the duty of care. Indeed, since the protection of the business judgment rule is usually granted only when directors make their business decision in line with certain requirements,[43] the shareholders will have the ability to challenge the decision when the directors fail to satisfy any of these requirements. And as some of these requirements may imply a certain degree of subjectivity (e.g. 'good faith', 'reasonable' level of information, etc.), the implementation of the business judgment rule may actually increase the level of litigation against corporate directors, especially in countries in which the business judgment rule has not been implemented as a 'presumption' (as it is understood under Delaware law) but as a 'safe harbour' (as it is shaped in Germany). Under this scenario, the implementation of the business

[43]This aspect will depend on whether the business judgment rule is implemented as a presumption in favour of corporate directors (as it is applied under Delaware law) or as a 'safe harbour' (as it is applied, for example, in Germany). In the former case, the burden of proof will be on the plaintiff, while the directors will bear the burden of proof in jurisdictions where the business judgment rule is implemented as a 'safe harbour' for corporate directors.

judgment rule may actually increase uncertainty for corporate directors.[44] As a result, not only would they be subject to a threat that did not exist before, but, perhaps more importantly, value can be destroyed for the shareholders and society as a whole, since many honest and qualified people can be discouraged from acting as corporate directors; or if they do so, it would be at a higher cost for the corporation.

On the other hand, the implementation of the business judgment rule may encourage directors to make 'over-informed' business decisions, as a way to make sure that they will be fully protected in case of a potential lawsuit. This situation may lead to two potential costs. First, it may make the decision-making process more inefficient and time-consuming, even for non-material business decisions. Second, and more importantly, the directors may have incentives to 'over-request' expert opinions – paid by the shareholders – due to the fact that a higher level of information will put the directors in a better position in case a court reviews whether they met the conditions generally required to enjoy the protection of the business judgment rule. So the implementation of the business judgment rule may end up making the shareholders as a whole worse off.

5.3. How should the business judgment rule be implemented?

Let us assume that, needed or not, a jurisdiction decides to implement the business judgment rule. In these situations, there are several ways in which the rule can be implemented: (i) statutory (or codified) rule vs. non-statutory rule; (ii) mandatory rule vs. default rule; (iii) opt-in rule vs. opt-out rule; and (iv) as a presumption in favour of corporate directors vs. as a 'safe harbour'. Likewise, and especially in jurisdictions in which directors owe fiduciary duties to corporate creditors even outside of insolvency, the legislator should also consider how the business judgment rule may affect creditors.

Regarding the first aspect, it seems more reasonable to implement the business judgment rule as a *codified rule* in jurisdictions where managers have not been traditionally protected in their business decisions.[45] This argument will be even stronger in civil law countries, where court decisions are not formally considered a source of law. Therefore, the implementation of the business judgment rule as a codified rule will make more sense in civil law countries with no tradition of protecting managers in their business decisions. That does not mean that a common law jurisdiction should not implement a

[44]This actually seems to be the case in Australia. For an excellent empirical analysis of the implementation of the business judgment rule in Australia, and how the rule generated some unintended costs, see Jenifer Varzaly, 'Protecting the Authority of Directors: An Empirical Analysis of the Statutory Business Judgment Rule' [2012] 12 Journal of Corporate Law Studies 429. This study shows that the statutory business judgment rule did not achieve one of the primary purposes of the Australian legislator: to enhance legal certainty and protect corporate directors in their business decisions.

[45]Eisenberg (n 10).

codified business judgment rule. In fact, it might make sense to do so if the authority of directors is not clearly protected by courts (as it seemed to happen in Australia and, to some extent, in California). But the case for implementing the business judgment rule as a codified rule will be even stronger in civil law countries without a clear case law protecting managers in their business decisions.

The second step should consist of deciding whether the business judgment rule should be implemented as a *default rule* or as a *mandatory rule*. As a general matter, most provisions in corporate law are (or should be) default rules, due to the contractual nature of the corporation. Indeed, as it was mentioned, corporations are, or at least are formed by, contracts. Therefore, unless a potential 'market failure' occurs,[46] shareholders should be allowed to set up the terms that regulate the relationship between all the parties involved in the corporate contract (mainly the relationship between managers and shareholders, and the shareholders among themselves). Otherwise, they might be discouraged from either entering into (ex ante) or 'joining' (ex post) these contracts, which basically means that they would have less incentives to form and finance business enterprises.

Mandatory rules, then, are (or should be) the exception in corporate law. In the context of the business judgment rule, it could be argued that the asymmetries of information, collective action problems, or even lack of diversification faced by many shareholders may act as a 'market failure' that may justify a mandatory response by the legislator. Moreover, as the business judgment rule may also create a positive externality in society (e.g. innovation, diversification, and development), from a macroeconomic perspective, it may seem desirable to impose the business judgment rule as a *mandatory* rule.

However, there are reasons to be sceptical about these arguments. First, in countries with controlling shareholders and concentrating ownership structures (i.e. most countries around the world), the aforementioned market failures might not exist, or their magnitude might be too small to justify this regulatory intervention. Indeed, in countries with concentrated ownership structures, it will be relatively easy to coordinate shareholders' actions. So this market failure will not be a big issue.[47] And even if a jurisdiction has traditionally had dispersed ownership (as the United Kingdom and the United

[46] Jeffrey N. Gordon, 'The Mandatory Structure of Corporate Law' [1989] 89 Columbia Law Review 1549; Melvin A. Eisenberg, 'The Structure of Corporate Law' [1989] 89 Columbia Law Review 1461; Michael J. Trebilcock, *The Limits of Freedom of Contract* (Harvard University Press 1993). As pointed out by Armour, Kraakman and Hansmann, mandatory terms may also serve a useful *standardization function,* in circumstances (such as accounting rules) where the benefits of compliance increase if everyone adheres to the same provision. See John Armour, Henry Hansmann and Reinier Kraakman, 'What is Corporate Law?' in Kraakman et al, *The Anatomy of Corporate Law: A Comparative and Functional Approach* (3rd edn, Oxford University Press 2009) 22.

[47] For a survey of corporate ownership structures around the world, see La Porta, López de Silanes, and Vishny (n 19).; Mara Faccio and Larry H. Lang, 'The Ultimate Ownership of Western European Corporations' [2002] 65 Journal of Financial Economics 365; and Stijn Claessens, Simeon Djankov and Larry H.P. Lang,

States), and therefore some of these problems might exist, the rise of shareholders activism and the concentration of share ownership in the hands of institutional investors has also reduced this 'market failure'.[48] Second, even if, from a macroeconomic perspective, the legislator may want to promote innovation, diversification, and shareholder wealth, the implementation of the business judgment rule as a mandatory rule might not be the best way to do so. In fact, it could generate the opposite result if the legislator ends up imposing a solution potentially *unwanted* by many shareholders. In these circumstances, many shareholders (especially non-diversified shareholders) would be discouraged from investing in a corporation, since these investments might not meet their preferences in terms of risks and returns. Therefore, the imposition of the business judgement rule may harm the development of capital markets and firms' ability to raise capital. For these reasons, the optimal way to implement the business judgment rule should be as a *default rule*.

The third key question to be asked when deciding about the implementation of the business judgment rule should turn into the design of the default rule. Namely, the legislator should decide what is best to maximise both the advantages associated with the business judgment rule (discussed in section 3) and the general benefits associated with default rules, that is: (i) to reduce contracting costs by providing what most shareholders would have probably bargained ex ante[49]; and (ii) to serve as 'informational penalties' for parties with superior information who may want to alter the default.[50]

In my opinion, this question should be answered, once again, according to the primary role of the corporation and the level of risk aversion potentially characterising most shareholders in a particular jurisdiction. In jurisdictions with more diversified shareholders (usually because of the existence of institutional investors and developed capital markets), and/or jurisdictions where the primary role of the corporation is to maximise shareholder value, it makes more sense to implement the business judgment rule as an *opt-out* rule. Therefore, the rule should apply unless shareholders state otherwise.[51] By contrast, in jurisdictions with more non-diversified shareholders (usually because of the existence of many family businesses, non-developed capital markets, and non-sophisticated investors), and/or in which the primary role

'The Separation of Ownership and Control in East Asian Corporations' [2000] 58 Journal of Financial Economics 81.

[48]Explaining how the rise of shareholder activism and the concentration of share ownership in the hands of institutional investors are changing the traditional agency problems existing in large corporations in the United States and Europe, see Gilson and Gordon (n 19) and Gurrea-Martínez (n 19).

[49]Easterbrook and Fischel (n 4) 34–5.

[50]Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' [1989] 99 Yale Law Journal 87; Yair Listokin, 'What do Corporate Default Rules and Menu Do? An Empirical Examination' [2009] 6 Journal of Empirical Legal Studies 279.

[51]This option would not be possible in countries with a *non-statutory* business judgment rule, since the shareholders have nothing to say about the way a rule is interpreted by courts.

of the corporation is not generally identified with the maximisation of shareholder value, it makes more sense to implement the business judgment rule as an *opt-in* rule.

A fourth aspect to assess when implementing the business judgment rule should consist of whether, following the German approach, the rule is designed as a 'safe harbour' or, by contrast, as a *presumption* in favour of corporate directors like in Delaware.[52] The Delaware rule, compared to the German rule, may reduce the level of litigation, since the plaintiff will have fewer incentives to file a lawsuit. In countries with more *powerful minority shareholders* (like in the United States and the United Kingdom, as a result of the wide presence of institutional investors), or jurisdictions in which derivative suits can easily be exercised, it might make sense to impose the burden of proof on the plaintiff. Nevertheless, in countries with more retail investors, and/or in which the use of derivative actions is not quite common, it would seem more desirable to follow the German approach and thereby impose the burden of proof on the directors.

A final aspect to consider when implementing the business judgment rule (especially, in jurisdictions in which corporate directors also owe fiduciary duties toward creditors, even outside the zone of insolvency) is how the rule is going to affect creditors. In the case of 'adjusting creditors',[53] that is, creditors with the ability to adjust the terms of their contracts (typically sophisticated lenders), no special protection should be provided by the legislator. Markets forces will encourage shareholders to decide what is best for the corporation. For that purpose, while the business judgment rule may encourage risk taking, and therefore it may lead to more value-creating projects for the shareholders, the decision to adapt the rule will also depend on the potential reaction of the company's lenders. If the lenders perceive that the business judgment rule may lead to more risky projects (increasing the likelihood of default) or it may reduce the variety of legal actions potentially exercised by the creditors to enforce their claims, the lenders may respond with an increase in the cost of debt. And if so, the shareholders may be incentivised to *opt out* of the rule in order to have better access to finance.[54] Therefore, with regard to 'adjusting creditors', the adoption of the business judgment rule should not be an issue. The market will create private incentives to achieve an optimal outcome.

[52]See Roth (n 7) 321–2.

[53]For an analysis of the concept of 'adjusting' and 'non-adjusting' creditors, see Lucian A. Bebchuk and Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' [1996] 105 Yale Law Journal 857; and Lucian A. Bebchuk and Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and A Reply to Critics' [1997] 82 Cornell Law Review 1279.

[54]Under this scenario, the shareholders should have to balance the *potential* benefits of the business judgment rule (e.g. innovation, higher returns, etc.) with its potential costs (e.g. lower access to finance and other unintended costs for shareholders).

The problem arises when dealing with 'non-adjusting creditors'[55] (e.g. tort claimant), especially when the company has decided to implement (or 'opt in') the business judgment rule. In these circumstances, sophisticated lenders should *not* be allowed to exercise a direct claim for a breach of the duty of care, provided that the directors fulfil the conditions generally required to be protected in their business decisions. Nevertheless, unless other alternative devices are implemented to protect non-adjusting creditors (e.g. insurance, priority in bankruptcy, unlimited liability of shareholders toward these creditors, etc.), this type of non-sophisticated creditors *should* be allowed to sue the managers for a potential breach of the duty of care, *even if* the business judgment rule is adopted.[56] Therefore, if the directors harm a particular non-adjusting creditor while making a business decision, the creditor should preserve its right to exercise a *direct action* against the directors.

The situation should differ, however, when the harm is not directly generated to a *particular* non-adjusting creditor but to the corporation itself. In these cases, some countries allow creditors, under certain conditions,[57] to file *derivative actions* against corporate directors. In these circumstances, and consistently with the argument mentioned above, non-adjusting creditors would preserve their right to sue for a breach of the duty of care even if the business judgment rule has been adopted. In the case of sophisticated lenders, however, the situation should change with respect to what it has been argued with regard to direct claims. Indeed, when it comes to derivative actions, it should be kept in mind that the company's creditors sue the managers *on behalf of* the corporation. Therefore, the recoveries potentially obtained from the managers would not go to the creditors themselves but to the company's assets. Thus, by limiting the right to sue only to non-adjusting creditors, the legislator would actually decrease, rather than increase, the protection of non-adjusting creditors. For this reason, in derivative actions, sophisticated lenders should have the right to sue, even if the business judgment rule is in place.

Finally, it cannot be forgotten that the business judgment rule only protects corporate directors from *business* decisions. Therefore, even if a creditor has the right to sue (as it has been proposed for non-adjusting creditors exercising *direct claims*, and any creditor filing a *derivative action*), the court should make sure that the harm inflicted by the directors is a causal consequence of a

[55]Lucian A. Bebchuk and Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' [1996] 105 Yale Law Journal 857.

[56]It is unclear that corporate law should be the right place to protect non-adjusting creditors. Moreover, even if it is the most efficient place to do so, it does not seem to be very effective. For this reason, some authors have proposed a variety of devices to protect non-adjusting creditors outside of corporate law. See Allen, Kraakman and Subramanian (n 7) 151. Proposing unlimited liability of shareholders toward tort claimants, see Reinier Kraakman and Henry Hansmann, 'Toward Unlimited Shareholder Liability for Corporate Torts' [1991] 100 Yale Law Journal 1879.

[57]These conditions may include a situation of insolvency. In these situations, as the creditors become the 'residual claimants' of the firm, they may have the right to sue the directors for a breach of fiduciary duties, provided that the shareholders do not do so.

business decision. And this is not always the case, especially when it refers to non-adjusting creditors exercising a direct claim.

6. Conclusions

Many jurisdictions have implemented, or are planning to implement, the business judgment rule as a way to improve their corporate governance practices. However, despite the benefits generally associated with the business judgment rule, this article argues that several circumstances may make this rule potentially undesirable for some corporations, especially outside the United States. It has been argued that the business judgment rule, as it has been traditionally understood, seems to be based on three underlying assumptions. First, directors are subject to a credible threat of being sued for a potential breach of the duty of care. Second, the primary role of the corporation is to maximise shareholder value. Third, due to several factors (e.g. limited liability, variable returns, and portfolio diversification), shareholders are not risk-averse, and therefore they just want the directors to pursue those projects with the highest net present value regardless of their volatility.

However, these underlying assumptions might not be held in some jurisdictions outside the United States, and even with respect to many US corporations (e.g. family businesses or B corporations). Moreover, many corporations may require, depending on their stage or type of business, a more or less risky investment strategy. Therefore, the application of the business judgment rule may encourage the directors to bear a level of risk that, in some circumstances, might not be desired by the shareholders. In addition, the implementation of the business judgment rule may create other unintended costs for the shareholders, such as those generated by 'over-requesting' expert opinions.

In my opinion, the most efficient way to implement (if so) the business judgment rule in a particular jurisdiction will depend, among other factors, on the corporate ownership structure prevailing in the country, the level the enforcement of the duty of care, the type of investors and capital markets existing in a particular jurisdiction, the quality of courts, and the primary role of a corporation. In any case, it has been argued that, even if the business judgment rule is implemented, its application should be decided at a firm-level. Namely, it has been suggested that the business judgment rule should be implemented as an *opt-out* rule in jurisdictions where the primary role of the corporation is the maximisation of shareholder value, investors are usually diversified (normally because of the existence of institutional investors and developed capital markets), the quality of courts may be low in terms of either independence or expertise, and/or directors *are*

subject to a credible threat of being sued for a potential breach of the duty of care (usually as a result of a higher level of derivative litigation).

By contrast, it has been proposed that the business judgment rule should be implemented as an *opt-in* rule (that is, a rule that will not apply, unless the shareholders decide otherwise) in jurisdictions where shareholders are not generally diversified (usually, as the result of the existence of many family businesses, non-developed capital markets, and non-sophisticated shareholders), the primary role of the corporation is not exclusively associated with the maximisation of shareholder value, the quality of courts is relatively high in terms of both independence and expertise, and/or directors are not subject to a credible threat of being sued for a potential breach of the duty of care (normally because of the lack of derivative litigation).

And while some factors justifying the implementation of the business judgment rule as an opt-in rule will be found in countries exhibiting features that may suggest the implementation of the business judgment rule as an opt-out rule and the other way around, this article provides guidance on where, how and why the business judgment rule may make more or less sense.

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