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Aurelio GURREA-MARTINEZ
Singapore Management University, aureliogm@smu.edu.sg

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Re-examining the business judgment rule from a comparative perspective: Is it really in the shareholders' interests?

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Aurelio Gurrea-Martínez

One of the most remarkable features of US corporate law–at least, from the perspective of a foreign scholar–is the power given to the board of directors. Under current US corporate law (especially, in Delaware), the authority of the board of directors is not in significant question. Several arguments have been given to explain this reality; and various policy justifications may even support the lack of substantive checks on board discretion.

From the shareholders' perspective, this authority of the board of directors means that they will virtually have no powers to intervene in the business affairs of the corporation, even with regard to some 'hybrid' decisions such as a hostile takeover, where heightened agency problems may arise between managers and shareholders. The authority of the board of directors extends beyond shareholders. The business judgment rule largely insulates the substantive decisions of the board even from judicial review. A number of reasons have been offered for limiting judges' ability to hold boards accountable for the consequences of their decisions.

First, as shown by several studies, people–and judges are not an exception–are subject to hindsight bias. Therefore, by allowing judges to review a business decision ex post, directors may suffer from a biased (and likely harmful) judgment. Thus, honest and qualified people may be discouraged from acting as corporate directors, or if they do so, it would be at a higher cost for the corporation.

Second, judges are experts in law. However, they do not usually have a background in business, economics or finance. Moreover, even if they did have this background (as they are starting to get in some jurisdictions), they will unlikely have the *expertise* to make a decision on a particular business.

Third, investors invest in a company when, among other factors, they trust those people who are in charge of running the business. Therefore, if we delegate this decision to a third party whose managerial expertise is unknown and likely non-existent, investors may be more reluctant to provide capital. Moreover, judges–unlike the directors–do not have proper incentives to make *efficient* business decisions. On the one hand, they cannot be rewarded by an efficient business decision. On the other hand, they will not be punished if the make a decision that, being legally sounded, it is not in the best interest of the corporation. Hence, potential shareholders may be concerned about the efficient use of their money, and thereby they might be reluctant to provide funds to the corporation.

Finally, and perhaps more importantly for our purposes, the business judgment rule also helps maximize the value of the firm by reducing the problem of managers' risk aversion. Namely, the existence of the business judgment rule encourages directors to pursue those projects with a

higher net present value, no matter their volatility–that is, their chances of being a business failure or success. However, these assumptions–generally made by legal and finance scholars–might *not* work in many non-US jurisdictions, and even in many US corporations.

Indeed, there are jurisdictions with many family businesses and concentrated ownership structures where shareholders *do* have incentives to be risk averse, since most of their wealth (including human capital) is invested in the family business. Therefore, they are not diversified, or, at least, in the way traditional finance predicts.

Second, there are jurisdictions where the main role of the corporation is not exclusively identified with the interest of the shareholders but also with the interest of other stakeholders. Hence, regardless of the desirability of this 'stakeholder approach', since it does exist in several jurisdictions, it might make sense for a corporation to pursue other goals beyond the maximization of the value of the firm.

Third, 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.

Fourth, directors in many jurisdictions are not subject to a credible threat of being sued for a potential breach of the duty of care. Hence, since there is not enforcement of the duty of care, the implementation of the business judgment rule may encourage the directors to 'over-request' expert opinions–at the expense of the shareholders' wealth–in order to make sure they will be fully protected from a potential though likely non-existent lawsuit.

Therefore, the most efficient way to implement (if so) the business judgment rule should depend, among other factors on (i) the divergences in corporate ownership structures; (ii) the level of enforcement of the duty of care; and (iii) the main role of a corporation. In jurisdictions where the primary role of the corporation is to maximize the value of the firm, shareholders are usually diversified, and managers are subject to a credible threat of being sued for a potential breach of the duty of care, the business judgment rule might be socially desirable. Nevertheless, even in these situations, we would suggest to give the shareholders the ability to *opt out* the rule–as it is unclear that may happen in the United States, where, despite having the ability to waive the duty of care, the shareholders have nothing to say about a general rule traditionally applied by courts. By contrast, in those jurisdictions where shareholders are not usually diversified (normally, due to the existence of many family businesses), the primary role of the corporation is not associated with the maximization of the value of the firm, or managers are not subject to a credible threat of being sued for a breach of the duty of care, the business judgment rule should be implemented as an *opt-in* rule. Thus, unless informed and coordinated shareholders decide to protect the managers in their business decisions (and by doing so, to indirectly allow them to bear a higher level of risk), the business judgment rule will not be applied.

The preceding post comes to us from Aurelio Gurrea Martínez, Executive Director of the Ibero-American Institute for Law and Finance. The post is based on his article, which is entitled "The Law and Economics of the Business Judgment Rule: Notes for Its Implementation in Non-US Jurisdictions" and available here.