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Business Judgment Rule and Board Liability

Stephen Lasser · Friday, January 29th, 2021

Whether you are a managing member of a limited liability company, a director of a large company, a director and owner of a small closely held family business, a volunteer board member of a cooperative, condominium, homeowners association or charitable foundation or you work with boards, you should have an understanding of the legal responsibilities of board members and how the case law doctrine known as the Business Judgment Rule can protect corporate decisions from being overturned by courts in New York and how to shield board members from personal liability.

Regardless of the size and corporate structure of a business entity, board members are elected or appointed to make decisions on behalf of the business entity and have a fiduciary duty to the shareholders or members of the business entity. To satisfy this fiduciary duty, board members have an obligation to put the needs and interests of their shareholders and members before their own individual interests, and must fulfill their board duties in good faith and with that degree of care which an ordinary prudent person in a like position would use under similar circumstances. What is a prudent business decision can be difficult to determine and what may seem prudent at the time a decision is made, may not seem like a good decision with the benefit of hindsight.

In order to reduce second guessing of decisions made by corporate board members, the highest appellate court in New York ruled in 1912 that as long as a corporation board's decision (1) is made for a legitimate corporate purpose; (2) in good faith; and (3) within a board's authority, a court should uphold a board's decision that is challenged, regardless of whether the decision was a good decision or a bad decision. Subsequently, thousands of cases have been decided based on this case law three-prong test, which is now known as the Business Judgment Rule. And over the last century, New York courts have applied the Business Judgment Rule to limited liability company managing members and the board members of cooperatives, condominiums, homeowners associations and other non-profit corporate entities.

In order to satisfy the first prong of this test, a board's decision must be for a legitimate corporate purpose. This prong provides boards broad latitude, but board members must not be acting in a way that could be perceived as self-dealing for their own financial gain at the expense of the corporation or this prong will not be met.

The second prong of good faith means that a board cannot make decisions in a way that discriminates against a particular shareholder or group of shareholders. In other words, actions taken to punish or disenfranchise specific shareholders may be open a board's decision to judicial scrutiny.

The third prong of acting within a board's authority is where volunteer boards probably most commonly make decisions that take their actions out of the protection of the Business Judgment Rule. A board's actions cannot exceed the authority granted under its corporate entity's governing documents, such as an operating agreement or by-laws. A simple way for a board to make sure it is not acting in violation of its governing documents is to consult with legal counsel prior to making corporate decisions, particularly if the decision is potentially controversial or may be disliked by certain members or shareholders.

In addition, it should be noted that there are statutes which specifically limit the personal liability of board members if they make their decisions in reliance upon information provided by their attorneys, accountants and other professionals. Consequently, board members should consult with their professional advisors as part of their decision making process to insulate themselves from potential personal liability and shield their decisions via the Business Judgment Rule from being overturned by a court.

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