

# The Business Judgment Rule: How Corporate Directors Can Sleep Better At Night

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## What is the Business Judgment Rule?

The North Carolina Business Corporation Act (the "Act") imposes certain requirements on corporate directors to ensure that they act in the best interest of the corporation when making decisions. More specifically, directors must act in the best interest of the corporation by acting in good faith, with the care an ordinarily prudent person in a like position would exercise in similar circumstances and in a

manner the director reasonably believes is in the best interest of the corporation. These fiduciary obligations are described as the duty of good faith, the duty of due care and the duty of loyalty. The Business Judgment Rule (the "Rule") insulates directors who properly exercise their fiduciary duties from being held personally liable for their actions. Put simply, the Rule provides that, as long as the directors of a corporation act with due care and in good faith with an honest belief that the actions they take are in the best interest of the corporation at the time the decision is made, they cannot be held personally liable for any action or omission based on that decision.

## Why Does it Matter?

North Carolina courts review the behavior and intentions of the corporate directors with a focus on the process, rather than the results. The Rule prevents courts from exercising "twenty-twenty hindsight" about director decisions and instead focuses on the actions leading up to those decisions. This means that board members don't have to be right when they make a decision; they just have to act in a manner consistent with their required fiduciary duties.

## What's the Catch?

The Business Judgment Rule doesn't provide directors with free reign to act however they want; they are still subject to fiduciary duties. The Rule provides an assumption that directors acted in accordance with their fiduciary duties and forces anyone challenging this assumption to prove otherwise. But, like any good assumption, the Rule can be rebutted.

## **A Cautionary Tale**

In order to overcome the Rule, the opposing party must show that the directors (1) did not act on an informed basis (i.e., they failed to avail themselves of all reasonably available information), (2) acted in bad faith or (3) did not honestly believe they were acting in the best interest of the corporation.

In F.D.I.C. ex rel., the Fourth Circuit explicitly rejected the application of the Rule to shield personal liability for bank officers who were approving loans without exercising proper diligence in reviewing loan applications. For example, officers did not review relevant documents prior to approving loans and were following credit administration and audit processes that were significantly flawed. These officers failed to act in accordance with generally accepted industry practices and therefore did not exercise due care when considering the loan applications and approvals. Consequently, the court found that they could no longer rely on the Rule to justify those actions and could be found personally liable for their actions.

## **What Does This All Mean?**

The Business Judgment Rule is an important evidentiary presumption in North Carolina. It allows corporate directors to shield themselves from personal liability if they've acted in good faith, with due care and in the best interest of the corporation. The Business Judgment Rule encourages volunteers and high net-worth individuals to serve on corporate boards. More importantly, the Business Judgment Rule allows directors to make responsible decisions without the fear of being held liable if that decision happens to be wrong.

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