BUSINESS JUDGMENT AND THE COURTS

End of Project Report

THE PROJECT

The courts and academics have stated that the exercise of business judgment by directors is and should be immune from judicial review. Yet exactly what a business judgment is, and why it should be protected has never been closely examined.

In October 2016 an interdisciplinary research team was awarded £281,516 by the Arts and Humanities Research Council for the project 'Business Judgment and the Courts' (AHRC project number: AH/N008863/1) to explore these issues and investigate the extent to which directors' business judgment are, and should be, protected from review.

The team comprised Professors Joan Loughrey and Andrew Keay, and Dr Francis Okanigbuan from the Centre for Business Law and Practice, University of Leeds, and Professor Terry McNulty and Ms Abigail Stewart from the University of Liverpool Management School. The work included an analysis of case-law involving business judgment, and fieldwork that took the form of focus groups and interviews involving judges, legal practitioners, directors, company secretaries and legal counsel, investors, and other professionals involved in board related recruitment and development services. The respondents' experience covered jurisdictions of the UK, the US and Australia. Access to 110 persons for this study was, in part, facilitated by the Institute of Directors, ICSA, and Eversheds Sutherland.

WHAT IS A BUSINESS JUDGMENT?

The first task was to define what business judgment means. Although the term is frequently used in jurisdictions that have a 'business judgment rule' (a rule that protects directors' decisions from court review) the courts have not provided a definition.

One possibility is that every *judgment* directors make is business judgment: what other kinds of judgments would business people make? But we found that case-law, and a number of our interviewees, recognised, albeit not clearly or consistently, that there are different types of judgment.

Courts use the term judgment in two senses. The first means having experience and ability, as in, 'to have good judgment', and business judgment in this sense was likely to refer to entrepreneurial ability. The second equates judgment with 'decision-making'. This is not so much an event, like a final decision to enter into a sale of an asset of the company, but more of a process that leads up to a decision.

The courts described the following as business judgments: transactional decisions with third parties such as buying, selling, borrowing; determining whether to allow a company in financial difficulties to continue trading; laying off staff; deciding not to pursue opportunities that were not consistent with the business plan; organising how work is divided up in a company.

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The following were not: actions taken without exercising judgment; the suspension of a chairman by a managing director in breach of the constitution; in the US decisions about whether to comply with the law are not business judgments. Some interviewees thought that judgments that are self interested and do not further the company's interests were not business judgments. The courts will find directors liable for such judgments, though whether they regard them as business judgments or not is unclear.

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It was also not clear whether delegation, supervision, monitoring of management and staff were business judgments (Australia and the US take contradictory positions on these), or transfers of shares in the company and alterations to its register of members.

Is there any way to make sense of this? One way is to view directors' decisions as contributing to wealth creation as well as corporate governance. The courts appear most comfortable with treating decisions more obviously linked to the wealth creation role as business judgment, and less certain about decisions that are more closely linked to corporate governance, such as monitoring decisions.

Recognising that there are distinctive roles for boards which imply different types of judgment (whether or not we term some or all as 'business judgments') is important because the reasons for respecting or reviewing them could vary. Thus the need to protect entrepreneurial risk taking might be relevant in the context of decisions about whether to embark on major acquisitions, but less so in relation to more 'corporate governance' decisions such as whether sound risk management and internal control systems are in place. This is not to say that the latter should be easier to judicially challenge: but arguments for and against review will differ. Being able to articulate what is beneficial about the different types of judgment that directors make, and why they should, or should not, be protected, is important, given societal concerns with director accountability.

THE COURTS' TREATMENT OF BUSINESS JUDGMENT

In order to assess the judicial approach to business judgment, a database search, using Lexis and Westlaw, of cases which involved directors' business judgment was conducted. 130 relevant cases were identified, though the number of cases searched was substantially higher. The cases identified covered actions (causes of action) for breach of duty of care, wrongful trading, breach of the duty to promote the success of the company/duty to act in good faith in the best interests of the company, breach of the duty to take into account creditors' interests, unfair prejudice and director disqualification. The earliest case in the database dated from 1742 and the latest was December 2017. The cases were grouped into 5 time bands. The bands were determined by the occurrence of major judicial or legislative developments. There were 26 cases analysed up to 1924 (band 1); 13 cases in 1925 – 1991 (band 2), 17 cases in 1992-1998 (band 3); 30 cases in 1999-2004 (band 4); 44 cases in 2008-December 2017 (band 5). Directors were held liable in 82 cases of the cases in the database and they succeeded in defending claims in 48 cases. A study of the database divulged the following major points:

- The great majority of claims involved private companies, and of these most were owner-managed.
- There were claims made in relation to the affairs of six listed public companies, and eleven unlisted public companies, but the directors of public companies largely remain immune from claims and liability.
- Apart from Time Band 1, in all bands the number of cases in which directors were found liable exceeded the number where they have not been held liable.
- Since Time Band 2 there has been an increase in numbers of cases in which directors have been found liable, with a large increase in Time Band 3, and an even more significant increase in the most recent Time Band (5).
- The increase in liability can be seen to be a consequence of the fact that over the past 30 years we have experienced the gradual inclusion in the law of new causes of action or a revision of existing ones
- Liquidators have brought the greatest number of claims, followed by the Insolvency Service (proceedings for disqualification), indicating that most claims occur in relation to insolvent companies.
- Greater numbers of insolvencies in the last 30 years are likely to have led to more actions by liquidators and administrators, and this will have a significant effect on overall levels of claims brought against directors
- Apart from disqualification, the cause of action that was most successfully employed against directors across all time bands was breach of the duty of care.
- Although there have not been large numbers of claims commenced for wrongful trading, there has been greater liability for wrongful trading in Time Bands 4 and 5 where cases have been initiated.
- There has been a clear increase in the number of cases where directors have been held liable when failing to take into account the interests of creditors, and in Band 5 it was, apart from a breach of the duty of care, the main reason for liability.
- The cases suggest that the proposition that judges defer to the business judgments of directors is incorrect as there are many instances, and across all time bands, and in relation to all causes of action analysed, where challenges to business judgment were brought, and liability imposed, following a review of business judgment by judges.

SANCTIONING AND EXCULPATING DIRECTORS FOR BUSINESS JUDGMENT

These findings show that the decisions of directors are not protected from judicial scrutiny or review, and neither are directors' immune from liability. However it is judicial attention to the process of director judgment that mediates the accountability of directors at law and verdicts of liability or non-liability. The law assesses a director's decisions through a process-based categorization of director behaviour in context (rather than just a categorization of a certain type of decision that may or may not constitute a business judgment).

In all bar one of the 130 cases analysed, judges engaged in a systematic review of the director's business judgment, that includes the substantive decision matter, but more significantly, with close attention to detail, the review of the processes of judgment. The imposition of liability is more likely when the process has gone wrong, by that we mean that the judge identifies process failures around decision-making, indicators of which are for example, that directors overlooked a factor, or failed to consider an issue, failed to take advice, or seek information. Judges also consider the absence of process, where the director acts without having exercised any judgment at all, or takes no action where action was required. In other cases, a judge's review of process identifies irrationality in directors' actions, manifesting in recklessness, blind optimism, and the refusal to accept reality. And in some instances of review, we see the judge combines these failures to support the finding of liability.

Consequently, the courts sanction the following conduct by directors that they:

- Inappropriately relied on others or others' advice, such as that of management, or external advisors;
- Failed to take advice from the appropriate professionals and experts;
- Acted recklessly;
- Disregarded the position of the company's creditors;
- Had exercised no judgment and had failed to act.

From the judicial review of process and judgment which resulted in a finding of no liability, the types of conduct that exculpated directors, included where the directors were found to have:

- Been properly informed;
- Tried their best and acted responsibly;
- Sought advice from advisors such as lawyers, accountants, insolvency specialists;
- Reasonably relied on others both within the firm and outside, such as external advisors;
- Acted in good faith;
- Delegated appropriately;
- Reduced expenditure when in financial difficulties;
- Caused the company to cease trading.

By probing data about conduct sanctioned and exculpated, the study reveals the importance of board process to the treatment of business judgment by the courts. Process is used here to refer to more than formal governance compliance and the formality of board procedure, for example, minutes, papers, and other aspects of the formal board meetings etc. Board process include (judges attention to) directors' deliberations, that is, how judgments and decisions were reached, including signs of thought and action, advice sought or rejected and motive.

There is a very practical point here in that these findings about process shift the central question in the relationship between director accountability and discretion at law from one about assessing 'what is a business judgment' to 'how and why did directors do what they did'. This is a matter for all boards and directors and takes in matters of director skill and competence. Many directors and company secretaries adverted to the importance of Chairs of boards in ensuring effective board decision-making.

In these findings it is also important to note that many interviewees accepted the fact that judges should be able to undertake some form of review of directors' decisions especially where they were egregious. Notwithstanding that directors and judges recognised the problems that are associated with hindsight, all respondents including many directors accepted that judges should be able to review.

The Courts' treatment of business judgment

The proposition that judges defer to the business judgments of directors is incorrect. There were many instances, across all causes of action, where courts reviewed business judgment.

Interviews with directors and judges reveal a shared view that directors should be held to account but subject to the very careful consideration of the context and process of their actions. Some though remained concerned that it was difficult for the courts to assess directors' judgment out of context, and that review could deter able people from becoming directors and contribute to risk-adverse decision-making. However, there seems to be an acceptance that the courts should and can legitimately hold directors to account. Support for review and accountability was strongest when serious harm has been caused and when stakeholders, such as creditors, were harmed when a company becomes insolvent.

In fieldwork with directors we have also been taken beyond the original focus, to a concern about other modes of accountability, for instance:

- Most directors were not overly concerned about being brought before the civil courts. They were more concerned with criminal liability than civil liability
- There was however palpable concern, especially in financial services, about regulatory intrusion and review, in effect, regulators playing judge and jury. In fact, they preferred review by the courts rather than regulators.
- It was also clear that directors already felt exposed to scrutiny as a result of the media and regulators. There was some protestation about trial by public opinion, via the media and even politicians.

OTHER FINDINGS

- Directors were generally not conversant with their general duties provided for in the Companies Act 2006.
- Section 172 of the Companies Act 2006 was a matter of significant concern to directors.
- However there was generally a low level of awareness of section 174 Companies Act 2006, the duty to act with reasonable care anf skill.

PUBLICATIONS AND PAPERS FROM STUDY SO FAR

- A Keay and J Loughrey, 'The Concept of Business Judgment' forthcoming *Legal Studies* 2019
- T McNulty & A Stewart, "Making and Regulating Business Judgment: Judicial Practice, Logics and Orders" (*forthcoming*) in (eds, T. Reay, & Zilbur, T), *'Perspectives on Process Organization Studies'*. Oxford University Press
- J Loughrey and T McNulty, 'Too Much Expected of Section 172?' Governance August 2018 Issue 288, 6-8.
- A Keay, J Loughrey, T McNulty, F Okanigbuan, A Stewart, 'Business Judgment and Director Accountability: a Study of Case-Law Over Time' *under review*

- Further publications will appear on the study website: **www.law.leeds.ac.uk/research/projects/business-judgment-and-the-courts**

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