



Business Judgment Rule and Fairness Standards in the West: A Theoretical Review

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Abstract:

The application of the Business Judgment Rule (BJR) in the United States has also been increasingly tightened by the necessity of carrying out the duties and authority of directors based on the principle of prudence and efforts to fulfill proper information (transparency and fully disclosure) before the directors take action or decision. In a number of countries, the Business Judgment Rule (BJR) doctrine has been used quite extensively in their legal systems. One of them is in the United States. Basically there are two concepts applying the provisions applied by the American Law Institute (ALI). Second, the provisions that took place in the Delaware court. These provisions have been adopted by several courts. Overall, the Business Judgment Rule and fairness standard are separate research standards used by the court, and one does not feel confused with one another. The Business Judgment Rule analysis does not include a fair analysis, because the duty of care does not require unauthorized transactions to be the object of court examination concerned with fairness standards, only the director acts in good faith, with caution with an information base for that interest, and it does not violate wisdom.

Keywords:

business judgment rule; USA; the West; limited liability company; PT; corporate

I. Introduction

In Indonesia, as in the West (America and Europe), a limited liability company in carrying out business transactions can be a loss. However, these losses may not necessarily be borne by the Directors. Article 97 paragraph (5) of Law No. 40 of 2007 concerning Limited Liability Companies states that members of the Board of Directors cannot be held responsible for losses as referred to in paragraph (3) if they can prove:

- a. the loss is not due to an error or omission;
- b. has taken care of in good faith and prudence for the benefit and in accordance with the aims and objectives of the Company;
- c. does not have a conflict of interest either directly or indirectly for the management action which results in a loss; and
- d. has taken action to prevent the loss arising or continuing.

Elucidation of Article 97 paragraph (5) letter d states that what is meant by "taking actions to prevent losses arising or continuing" includes steps to obtain information on management actions that may result in losses, including through a Board of Directors meeting forum.

Furthermore Article 114 paragraph (5) of Law No. 40 of 2007 concerning Limited Liability Companies states that members of the Board of Commissioners cannot be held responsible for losses as referred to in paragraph (3) if they can prove:

- a. has supervised in good faith and prudence for the interests of the Company and in accordance with the aims and objectives of the Company;
- b. does not have personal interest either directly or indirectly over the management actions of the Board of Directors which results in losses; and
- c. has given advice to the Directors to prevent such losses arising or continuing.

The articles mentioned above are known as the Business Judgment Rule. The duties of the Board of Directors in managing or managing Limited Liability Company (PT) business activities and managing the limited Liability Company (PT) activities above cannot be separated from each other. Because the management of PT's assets must support the implementation of PT. With this directors only have 2 (two) tasks, namely, management and representatives of PT. For the implementation of the two tasks of the Board of Directors, it is necessary to pay attention that PT management is essentially the duty of all members of the board of directors without exception (*Collegiale bestuursverant woordelijkheid*). Hereby the duty and authority to manage the PT is the duty and authority of each member of the Board of Directors.

There are 2 (two) reasons regarding the directors' personal responsibility in the joint responsibility. First, PT is an independent legal subject. Second, PT as a legal creation absolutely requires directors assigned to manage and represent it. Means the directors' responsibility in managing the PT is a result of the duties and authority entrusted to him. So as long as the directors carry out their obligations within the limits of authority in carrying out their duties it is borne by PT. This principle applies in various countries, both countries that adopt the common law system and the civil law system.

If the directors in carrying out their duties are outside the limits of their authority (violating the provisions of the Articles of Association), then all members of the Board of Directors are personally responsible. In this case PT is not responsible, because directors who violate the Articles of Association are not binding on PT. In Indonesia in this case regulated in article 85 paragraph (2) UUPT.

The responsibility of directors personally does not occur simply because of their position as directors, but to be charged these responsibilities, the directors must have done things to the company's actions. First, the directors allowed the act. Second, the directors ratified the act. Third, the directors participated in any way in the act.

II. Review of Literature

In Corporation Law in the United States, American states regulate the Business Judgment Rule a little differently. The State of Delaware, for example, has not been a single, nearly two-century formulation of this Business Judgment Rule. However, since 1984 the Delaware formulation is probably very well known. Delaware standards have shifted in recent years, since the Delaware Supreme Court has consistently set the characteristics of the Business Judgment Rule as:

A presumption that in making a business decision the directors of a corporation acted on an informal basis, in good faith and in the honest belief that the action was taken in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts, with the burden of being on the party challenging the decision to establish the facts rebutting the presumption.

As a practical matter, the assumption held by the Business Judgment Rule is impossible to master, at least in cases where the director does not have a conflict of interest. In that context shareholders as plaintiffs are required to indicate whether the challenges to the substance of the business decisions are appalling that "no sensible businessperson will make that decision" or the board of directors has made a major omission in informing himself of all reasonable material information available before he acts.

In the Delaware Business Judgment Rule, many have put down unattractive business decisions through legal research. In other jurisdictions, the protection that can be achieved by company officials and directors with the Business Judgment Rule may not be that strong. For example, the American Law Institute has the principle of Corporate Governance which states that a director who makes business decisions fulfills his prudential duties towards the company only if he is "informed with respect to the subject of the business judgment to the extent he reasonably believes to be under the circumstances" and he "rationally believes that business judgment is in the best interest of the corporation". Likewise, the new section 8.31 of the Revised Model Business Corporation Act specifies that a director can be held accountable to the company or shareholders for good faith, a business decision that is not desirable if "the director does not reasonably believe" that the decision "is in the best interest good for the company", or "the director was not informed to the extent that the director reasonably believed appropriate in the circumstances".

The method that can only be done by shareholders is to sue the director for his mistake in running a company, namely through a derivative action lawsuit, if in Indonesia Article 97 paragraph (6) of Law No. 40 of 2007 concerning Limited Liability Companies, that on behalf of the Company, Shareholders who represent at least 10% of the total shares with voting rights can file a lawsuit through the District Court against members of the Board of Directors who due to errors or negligence have caused losses to the Company. Meanwhile derivative action will, in theory, promote director accountability. Analysts question whether it offers shareholders benefits or a real inspection of the director's power.

III. Discussion

In an effort to disclose this, Minnesota Corporate Law, like many jurisdictions, treats several barriers to filing a derivative lawsuit. The first obstacle is rule 23.06 of the Minnesota Rules of Civil Procedure which requires shareholders who intend to submit derivative claims to ask the company's board of directors to file a lawsuit first. Failure to enforce this rule before entering a derivative claim is a reason for not agreeing to the lawsuit. The second obstacle is the more difficult to meet. If the board of directors refuses to participate in a proposed derivative suit, the Minnesota courts appoint the decision and do not approve the derivative suit which has no evidence or allegation that the board of directors acted in bad faith.

Courts in the United States, applying two standards in research, were born out of Delaware Law to determine whether the director would be responsible for decisions that affect the company and harm shareholders - the Business Judgment Rule two fair standards. In general, decisions made in good faith must always and continue to be protected by the Business Judgment Rule, where mistakes require strict Court research set by fair standards.

In the shadow of recently bankrupt companies such as Enron, Worldcom, Westars because of various scandals, shareholders and the courts seem to prefer directors to run high

standards. The scandal of these companies is an exception, there are still many honest directors. Business Judgment Rule must remain unchanged.

It must be recognized that company directors make honest mistakes, and the consequences if the directors transact themselves, are involved in fraud, or criminal acts. Changes in the application of the Business Judgment Rule may cause honest directors to rethink the risks of their position and not encourage an effective willingness to work and leadership. The Delaware Court responded to the corporate scandals that occurred by continuing to apply the Business Judgment Rule.

Directors have "duty of care" and "duty of loyalty", "obligation to be careful" and "obligation to be loyal" to companies and shareholders. There are differences between the two that are run by the directors of the company and its shareholders. To determine whether a director violates the obligation to be careful, the court uses the Business Judgment Rule and fairness standards. The court analyzes the two obligations differently, depending on whether the transaction that is a challenge involves an unauthorized director, or an interested, self-dealing director.

If the director is not interested, the Business Judgment Rule is applied to determine whether the director concerned violates his duty of care; but if the director is interested, the presumption of business judgment rule is rebutted and the fairness standard is applied to determine the director violates his duty of loyalty. The directors always have this obligation to the company and its shareholders.

The duty of care determines that directors have an obligation to notify themselves, before making a business decision, all "material information" that is reasonably available to them. Being so aware, they must act with caution in carrying out their duties. Obligation or duty to be careful (duty of care) encourage directors to act blindly; directors must inform themselves through research of the business decisions they will make, and they must ensure that all members of the board of directors receive that information.

Therefore directors cannot claim themselves that they do not know material facts, because the duty of care requires the director to make a decision until he considers all. All material facts are available in common sense. According to the American Law Institute, the principle of good corporate governance (principle of corporate governance), directors or company officials have a duty or obligation to the company to carry out the functions of directors and officers in good faith, and he believes according to common sense, to be the best thing for the benefit company, and with caution, that as an ordinarily prudent person will be expected to carry out his position and in the same situation. The duty of caution includes the obligation to investigate, but does not treat the obligation that he must be loyal to the company.

In the State of Kansas, the task of carefully requiring directors to act on an "informed basis" and fulfill the responsibilities of "delegation of oversight" for example, in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court found that directors who were being questioned had violated the principle of duty of care, they failed to get information that was reasonably available to them. In their decision to approve "a cash-out merger", the directors were based solely on the 20-minute oral explanation given by other members of the Board of Directors. The presentation was not followed by a written conclusion. None of the other directors had any prior knowledge of the meeting, that the purpose of the meeting was to approve a "cash-out merger". The court ruled that this violated the "duty of care", because

the directors relied only on short presentations without further investigation of the material before agreeing to "a cash-out merger".

The principle of duty of loyalty prevents directors from using their trusted positions and beliefs for their personal interests. This requires the directors that the director has no interests and self-dealing. The director deals in self-dealing if he is involved in both parties to the transaction, as opposed to profits for the company or shareholders. The director is said to be "interested - interested" if he is a party to the transaction, or a person to whom the director or official has a business, financial or family relationship, he has pecuniary interests or the director or company official is the subject of supervision, is the party of the transaction or person who has pecuniary interest in that.

Investigation about whether a director has an interest is based on facts, and requires the court to see his allegations regarding directors who have an interest case by case. Once a court decides a director has an interest, he will not always cancel the self dealing transaction, but he examines the transaction with a closed legal investigation.

One of the classic self dealing transactions is if the director receives profits by leaving the other in the same situation. In the context of parent and subsidiary transactions, by virtue of the dominance of subsidiary subsidiaries acting in this way, that the parent company receives something from the subsidiary by putting aside, detriment to, minority shareholders of the subsidiary. In the case of the Delaware Supreme Court, *Krasner v. Moffett*, 826 A.2d 277 (Del. 2003), the court ruled that directors who recommended a merger were "interested" because they acted as the Board of Directors for the two merged companies.

A director may obtain personal benefits from transactions or distribution of company assets without affecting duty of loyalty, as long as the profits are not different from or disproportionate to the same benefits as shareholders. For example in *Sinclair Oil Corp. v. Levian*, 280 A.2d 717 (Del. 1971), the parent company, Sinclair, dominates and supervises the directors of the subsidiary, Sinven, and causes dividend payments by the subsidiary, which results in a large transfer of money to the parent company of the subsidiary. The plaintiff accused the Director of Sinven of "having an interest", because they were motivated by Sinclair's need for cash. Sinven minority shareholders receive "the money proportionately", and therefore the parent company's profits are the same as those of the shareholders.

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The Business Judgment Rule is a research standard, its usefulness to prevent the court from alleging both merits of a business decision that turns bad, unless the decision is unreasonable. It is a presumption in favor of the director of the company being used as a defense / defense against derivative claims filed by shareholders who do not agree with the director's decision. The Delaware Court applied the Business Judgment Rule for many years, back in the 19th century.

In the Principles of Corporate Governance the American Law Institute devised its own version of the Business Judgment Rule. As a Delaware Court articulation, The Common Law Business Judgment Rule is a presumption that in making business decisions the company director acts on information, in good faith and honesty, believing that the steps taken are the best decisions for the company. In the absence of a policy violation, the judgment will be respected by the court. The burden of proof is on the challenging side, providing the fact of rebutting the presumption.

Business Judgment Rule is a research standard, as opposed to a standard of conduct (standard of conduct). The standard of conduct specifies how a person must behave, the standard research test applied by the court if his research shows that person's behavior determines responsibility. Duty of care involves both standards of conduct and standards of review (research standards). Standard of conduct is applied to directors who are not interested based on duty of care including including "the duty to monitor, the duty of inquiry, the duty to make prudent or reasonable decision ... and the duty to employ a reasonable process to make decisions".

In the meantime the Business Judgment Rule is a standard of court research applied to establish whether a director violates the standard of conduct as required by duty of care. The demand, which has applied the standard of review, the Business Judgment Rule, is "much less demanding". Major negligence is necessary before responsibility is carried out based on a standard of review. In other words the Business Judgment Rule protects unreasonable decisions, as long as they are not irrational.

The rational reasoning behind the Business Judgment Rule is persuasion. *Joy v. North*, 692 F.2d 880 (2d Cir.1982), outlining the policy reasons for the rule. First, shareholders are not guaranteed to be rewarded. They take risks when they buy shares, one of which is the possibility of shares going down in value as a result of bad business decisions. Shareholders make investment choices in certain companies, always based on the management of the company concerned. However, the directors of the companies concerned "exercise sound or brilliant judgment, shareholders are likely to profit; when they fail to do so, share values are likely to fail to appreciate. Allowing shareholders to profit from favorable decisions that sue decisions that do not reverse (as long as the elements of the Business Judgment Rule meet) will treat double standards.

Second, "the court recognized that after the fact litigation was the most imperfect tool for evaluating a company's business decisions". The courtroom will oversee the environment, and it is easier to examine the decision after the fact and decide whether or not it is wise, than when the decision was made. The Business Judgment Rule recognizes that directors are more qualified to make business decisions than judges because businessmen have the expertise, information and judgment not possessed by court research and because of the large social uses to encourage asset allocation and evaluation and assumptions of economic risk by those skilled and informed, courts are forever reluctant to estimate the two healthy decisions, if they make them in good faith. The directors must make various business decisions every day, even

though they appear to be wise in all circumstances when the directors make them, will be opened to be unwise and detrimental to the company in the end. If the court looks back at making business decisions after the fact, it may be difficult for them to "distinguish between bad decisions and the right decisions that turn bad:"

Without the business judgment rule, there exists the possibility that hindsight bias—"a systematic defect in cognition" -- will taint the fact-finder's review of corporate decisions that turn out badly. In hindsight people "consistently exaggerate the ease with which outcomes could have been anticipated". People who know that a director's decision turned out badly will "overestimate the extent to which the outcome was predictable" and therefore find the decision maker more at fault for making the decision. People have a hard time disregarding information they know about the outcome. Therefore, a judge or jury looking back at a director's decision making process will review it based on information known about the outcome of the decision, and ignore the circumstances that existed at the time the director made the decision. The business judgment rule works to protect against this bias.

Furthermore, it benefits shareholders if the director makes a risky business without fear of responsibility. In *Joy*, the Court noted that it was more dependent on the interests of shareholders, that the law did not create incentives for excessive corporate vigilance to make decisions. "This is because potential profits always go hand in hand with potential risks", and therefore regulations that penalize options that estimate risk may not be in the interests of the general shareholders. *Joy* points out that dismissing decisions is always associated with greater and more profitable rewards, while less estimating alternatives is always associated with lack of profits.

Without the Business Judgment Rule of presumption in favor of good faith, informing the decision of the directors of interest, the director may be overly vigilant, to the detriment of shareholders in the long run. Business Judgment Rule neutralizes, or vice versa is an estimate to always take conservative decisions. Shareholders can divide their investments to neutralize risky investments.

The court must not interfere and help shareholders bear the investment risk if the investment suffers losses. Finally, the Delaware and Kansas State regulatory framework supports the trust of directors not shareholders, or governs corporate matters. The directors have the power of rules to make the kind of decisions that the law creates the protecting Business Judgment Rule. Delaware Code Sections 141 (a) and Sections 17-1301 of the Kansas Act authorize it by saying that:

"The business and affairs of every corporation are organized under [the statute] shall be managed by or under the direction of a board of directors." The judicial creation of the business judgment rule and legislative grant are related because the business judgment rule is evolved to give recognition and deference to directors' business expertise when exercising their managerial power under 141 (a). " For this reason, the business judgment rule "precludes a court from imposing itself unreasonably on the business and affairs of a corporation." Not applying the business judgment rule when applicable would defeat the purpose of the Kansas statute.

The Delaware and Kansas laws give shareholders the power to elect the directors they want to lead the company. Shareholders have the authority to choose who they like to lead the company, and therefore they must jointly live with the decisions made by the directors. As

long as the directors do not violate their duties to the company and shareholders. They also have the power to decide on the dismissal of directors which makes them unhappy.

Company disagreements must be addressed within the company if they do not make mistakes, and "Shareholders ... not courts, should voice their disagreement with the substantive business decisions by electing different directors" and shift that is unsatisfactory. The elements of the Business Judgment Rule, the preconditions that must be met before a director can use it as a defense are:

1. business decisions;
2. not interested and independent (independent);
3. due care (caution);
4. good faith (good faith);
5. no abuse of direction (does not violate wisdom).

Those who oppose the director's behavior must prove that the director violates the principle of prudence (duty of care) and only needs to prove one of the elements that does not exist.

First, directors must make actual business decisions, because "the Business Judgment Rule runs only in the context of the director's actions". If the director in his ad fails to sell the company's assets, and the failure threatens the company, the director will not make a business decision as to where the rules apply, unless this is negligent, passive action. However, a conscious decision to refrain from acting may be nonetheless to be the right course of business judgment and enjoy the protection of the rules. For example, a conscious decision not to become a company asset, as opposed to negligence in failing to sell it, will qualify as a business decision, the director does not enjoy the presumption of business judgment rule.

Second, the director must not have the importance and independence. No interest means that there is no "a self-dealing" complex of interests within the director. Self-Dealing is the same recipe as situations where shareholders do not accept. If the director is not interested, the Business Judgment Rule will not be applied, because shareholders need protection.

Independent means that the director concerned is free from the influence of temporary persons or entities that have self-dealing interests. The Delaware Supreme Court explains independence in *Aronson v. Lewis*, 473 A.2d at 805, as: "Director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences". Aronson said that in seeing the director's decision to determine independence, "it is the care, attention and sense of individual responsibility to the performance of one's duties ... that generally touches on independence".

Third, directors must act with caution with respect to information data for decisions. The director must make an informed decision following a reasonable effort to become familiar with the relevant and available facts. The duty of care requires directors to inform themselves, through investigation and research of all material facts before making a decision or making a transaction. The research standard for whether the director has been adequately informed is a major omission. A director commits gross negligence if he acts with a "reckless indifference to or a deliberate disregard of the whole body of stockholders". On the basis of standards, negligence or negligence fails to be adequately informed is not enough to usurp the presumption that the director acts with caution.

Fourth, a director must have good faith, that the decision is in the best interest of the company. In the absence of adverse financial interests to the corporation, good faith is presumed. The actions of shareholders on good faith are not enough to usurp the presumption of good faith, the challenge must be to present a "non-conclusory allegations of bad faith" to state a cause of action. The court can infer bad faith if the court finds the decision is unreasonable that bad faith is only a possible reason for the decision. If the decision "can be attributed to any rational business purpose", the court will not find bad intentions. The precondition of good faith prevents rules from protecting the desired deviant behavior or knowing violations of the law.

Finally, there must be no violation of the policy regarding the substance or merits of decision. This means that business decisions, despite meeting the previous four elements, "may be so egregious on its face", that the Business Judgment Rule will not protect it. In other words, regulations will not protect major negligence or unreasonable decisions. This situation will rarely occur, because if the requirements of good faith and prudential information are met, the decision will not be egregious. So that this element might be "more theoretical and at an actual level" if four other elements of the rule are met.

IV. Conclusion

Overall, the Business Judgment Rule protects directors who make decisions that ultimately prove to threaten their company, as long as conditions are met. If not, strict legal standards for conducting research will be applied, because "Business Judgment Rule is not magic that allows directors to allow to justify an action or make a lawsuit disappear". The decision to guarantee more stringent research is an evaluation based on "fairness standards".

The Business Judgment Rule only protects the decisions of directors who meet the five elements above, and it is a presumption, a challenger may take it. To overcome the Business Judgment Rule, the challenger must "heavy burden" to prove enough facts to take the presumption. This includes introducing evidence of self-dealing, lack of good faith or lack of prudence. Once a contender rebuts the presumption, the burden of proof moves to the director making the decision opposed, and the director faces "an exating standard which requires rigorous judicial scrutiny of the transaction's fairness". This is the Fairness Standard of Common Law, and is an anti-thesis of the Business Judgment Rule. The Delaware Court sometimes points to fairness standards "as either fairness" or "intrinsic fairness". Standards applied to accuse the director of duty of loyalty and self dealing violations.

When directors do "self dealing", "they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness" of the transaction. *Sinclair Oil Corp. v. Levian*, 280 A.2d 717 (Del. 1971), offers an abnormality of transactions that are self-dealing and which are not. The previous example, the court applies the Business Judgment Rule to protect the decision to pay dividends that benefit all shareholders proportionally.

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