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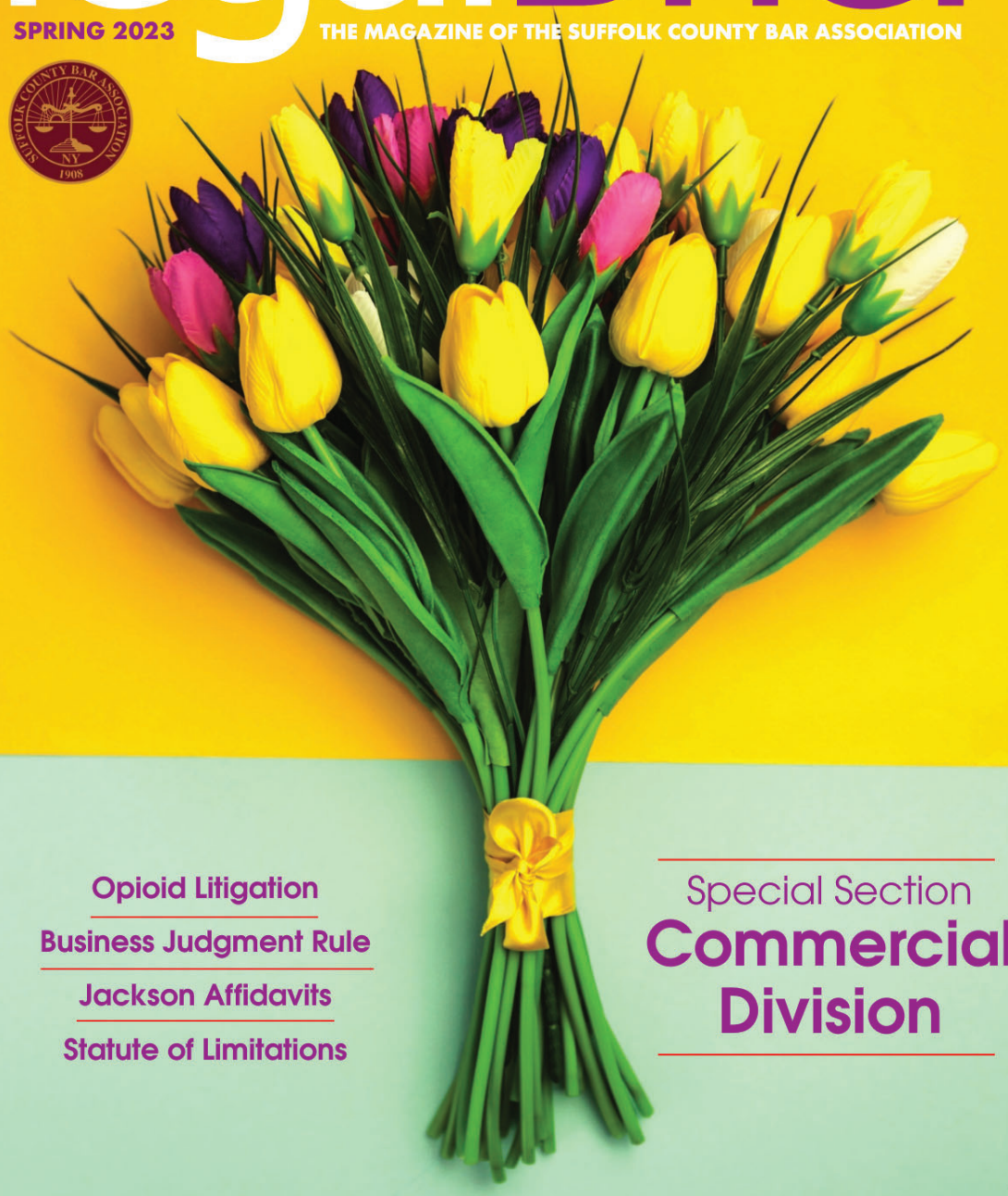

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Where Does the Business Judgment Rule End and a Breach of Fiduciary Duty Begin?

by Paul Millus, Esq.

The business judgment rule is a formidable foe in an action brought by LLC members, or shareholders in a corporate setting, against their fellow members or shareholders. The rule's origin dates back to the 1829 Louisiana Supreme Court decision in Percy v. Millaudon. In that case, the court required a showing of error on the part of the Director "so gross of a kind that a man of common sense, and ordinary attention, would not have fallen into it."[1] The business judgement rule was developed in the context of commercial enterprise, prohibiting inquiry into actions of corporate directors "taken in good faith, and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes."[2] In sum, courts will defer to the unbiased, good faith determinations of corporate officers or LLC managing members that certain actions will promote the entities' best interest.[3]

Accordingly, if a shareholder/member can show even modicum of good faith and the action can be viewed, under a commonsense appraisal as potentially beneficial to the entity, the alleged wrongdoers generally get a pass.[4] Courts understand that they do not have the necessary expertise, experience, or history with the entity to sit in judgment on a decision made by shareholders, members, or directors and impose their judgment instead.

What are shareholders or LLC members to do when faced with actions which they believe causes them harm? There must be an avenue for litigants who simply cannot accept that the entity (or someone purportedly acting on its behalf) knows best. So, when does the business judgment rule meet its match?

First, the business judgment rule will not be a defense to a breach of contract action where the actions of one member or shareholder violate the express terms of a valid operating agreement or shareholder agreement.[5] The courts give deference to what parties agree to and will not interfere whether the agreement is fair or not.[6] Clearly, a direct breach of a written agreement cannot be deemed to be in "good faith."[7]

Oftentimes, however, LLCs and closely held corporations do not have written agreements—although they should—and thus many things are left to chance or the goodwill of one partner/member to another, which very often wains over time. In an LLC setting, a managing member owes a non-managing member a fiduciary, duty just as majority shareholders do to minority shareholders.[8]

The next best way of disposing with the business judgment rule is to establish self-dealing or fraud on the offending party's part, provided a factual basis exists to support such a claim.[9] Accordingly, the determination as to whether there has been a breach of fiduciary duty is severely fact sensitive.

Facts that would tend to prove that a member was frozen out of management certainly state a claim for breach of fiduciary duty.[10] Further, if a plaintiff can show discrimination, self-dealing, or blatant misconduct, the presumption afforded by the business judgment rule melts away. For example, when member or shareholder is singled out for harmful treatment, or when the managing member self-deals by manipulating a distributions protocol in place, proof of such will defeat a defense based on the business judgment rule.[11]

In sum, as fiduciary duties are broadly construed, connoting "[n]ot honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior," invocation of the business judgment rule is mere words in the face of demonstrated bad behavior.[12]

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1) Percy v. Millaudon, 8 Mart. (n.s.) 68 (1829)
2) Auerbach v. Bennett, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920 (1979) ("the exercise of their powers, for the common and general interest of the corporation may not be questioned, although the results show that what they did was unwise or expedient.").
3) The "business judgment rule" is codified in Limited Liability Company Law § 409(a)8 and Business Corporation Law § 717.
4) Max v. ALP, Inc., 165 AD.2d 522, 165 N.Y.S.2D 522, 524 (1st Dep't 2022) (conclusory allegations [of a breach of fiduciary duty] are . . . insufficient to overcome the "powerful presumptions" of the business judgment rule.")
5) Bonanni v. Horizon's Investor Corp., 50 Misc.3d 1227 (A), 2016 WL 9511972 * 11 (Suffolk Cty. 2016). (The business judgment rule only applies in the absence of fraud, bad faith, self-dealing, misconduct, or breach of fiduciary duty will not act a s defense to a breach of an operating agreement).
6) Pokoik v. Pokoik, 115 A.D.3d 428, 982 N.Y.S.d 67 (1st Dep't 2014)
7) Sacher v. Beacon Associates Management Corp, 27 Misc.3d 1221(A), 910 N.Y.S.2d 765 (Table), 2010 WL 1881951 *10 (Sup. Ct. Nassau Co. 2010).
8) Pokoik, 982 N.Y.S.d at 70; Lirosi v. Elkins, 89 A.D.2d 903, 906–907, 453 N.Y.S.2d 718 [2d Dept.1982].
9) Jones v. Surry Cooperative Apartments, 263 A.D.2d 33, 700 N.Y.S.2d 118, 122 (1st Dept. 1999).
10) North Fork Preserve, Inc. v. Kaplan, 31 A.D. 3d 403, 819 N.Y.S.2d 53, 56 (2d Dep't 2006).
11) Owen v. Hamilton, 44 AD3d 452, 456 (1st Dept 2007). Barbour v. Knecht, 296 A.D.2d 218, 224, 743 N.Y.S.2d 260 (1st Dep't 1994); Nathanson v. Nathanson, 20 A.D.3d 403, 799 N.Y.S.2d 83 (2d Dep't 2005).
12) Meinhard v. Salmon, 249 N.Y.