Business Judgment Rule Offers No Protection to Corporate Officers

01.20.2012 | By Yuliya A. Oryol

A recent United States District Court (Central District of California) decision, *Federal Deposit Insurance Corporation, as receiver for Indymac Bank, F.S.B. v. Matthew Perry*, held that the California business judgment rule does not apply to a corporate officer as opposed to a corporate director. As a general matter, the business judgment rule insulates a corporate director from personal liability in making a decision if the director is disinterested and reasonably informed, acts in good faith, and rationally believes that the business judgment is in the best interests of the corporation and its shareholders. In *FDIC v. Perry*, the district court confirmed that under California law the business judgment rule does not similarly protect corporate officers.

Background

Federal Deposit Insurance Corporation ("FDIC"), as receiver for Indymac Bank, F.S.B. ("Indymac") filed an action against the former Chief Executive Officer ("CEO") of IndyMac alleging that the CEO was personally liable for his actions in connection with Indymac's generation of risky residential loans for sale into the secondary market. Specifically, FDIC alleged that between at least April and October 2007, the CEO negligently permitted the production of a pool of more than $10 billion in risky, residential loans intended for sale into a secondary market. Due to the volatility of the secondary market, Indymac was forced to transfer the loans into its own investment portfolio. FDIC further alleged that the CEO chose to aggressively gamble by investing in these risky loans beyond what a reasonable banker would have done under similar circumstances. As a result, the loans, which were transferred into Indymac's investment portfolio, generated substantial losses. IndyMac was ultimately closed by the Office of Thrift Supervision which appointed the FDIC as receiver for the bank.

Discussion

In response to the filing of the lawsuit, the CEO moved to dismiss the action, claiming that the California business judgment rule applied to him as a corporate officer and thus protected him from any liability for negligence. FDIC opposed Perry's motion arguing that since it sued the CEO only in his capacity as a corporate officer (he was also Chairman of the Board of Directors), rather than as a corporate director, the business judgment rule did not insulate Perry from personal liability.

The Court noted that the application of the business judgment rule to both corporate officers and directors has been the subject of much academic debate. The Court noted that the statutory business judgment rule contained in section 309 of the California Corporations Code expressly applied only to directors. According to the Court, the California legislature intentionally omitted officers in codifying the application of the business judgment rule to corporate directors and, as such, the courts cannot infer otherwise.

The Court then considered the non-statutory common law rule developed by California courts. The Court explained that this common law rule has two components. The first immunizes directors from personal liability if they act in accordance with its requirements. The second insulates management decisions from court intervention when made by directors in good faith in what is believed by the directors to be in the best interest of the corporation. Courts have applied the common law business judgment rule to shield corporate directors making qualifying decisions from personal liability. However, the Court confirmed that it would be unprecedented to also apply the common law business judgment rule to corporate officers. The Court further noted that when an individual is a corporate officer and director, such person may still be liable for particular conduct if that conduct is undertaken in his capacity as an officer.

The Court's ruling makes sense in light of the established distinction under modern corporate law and practice between the roles performed by corporate officers and directors on behalf of a corporation. Those who assume the role of a corporate director generally must "monitor" the conduct of the corporation's business. Corporate directors select, compensate, and replace the senior officers or executives of the corporation. In addition, corporate directors may be responsible for approving, modifying, or disapproving the corporation's financial objectives, major corporate actions, and choices concerning the auditing and accounting principles and practices of the corporation. Furthermore, corporate directors may be responsible for decisions related to other matters that are assigned to the board by law or by the articles of incorporation or by-laws, or assumed by the board under a board resolution or otherwise. But directors are not responsible for the day-to-day management of the corporation and have limited access to information compared to corporate officers. The business judgment rule recognizes this and provides a level of protection to directors to encourage their service on a corporate board.

Unlike directors, officers do not need the business judgment rule to induce service. Directors need liability protections to induce risk taking because their relatively small stockholdings and lack of incentive compensation give them little of the "upside" gains on investment projects. In contrast, corporate officers receive higher absolute levels of pay than do corporate directors, and a significant portion of that pay is based upon performance. Unlike directors, officers stand to reap substantial rewards for serving and taking risks. Officers work for the company full time, possess extensive knowledge and skill concerning company affairs, and have access to considerably more and better information than directors and exercise great influence over the lives of many people.

Conclusion

The Court's ruling confirms that corporate officers and directors are treated differently under California law with respect to actions each may take on behalf of a corporation. Unlike corporate directors, corporate officers may be personally liable for business decisions made in performing their duties. This ruling should serve as a caution to corporate officers to exercise proper care, skill, and diligence in performing their roles given that the business judgment rule may not be available to shield them from personal liability.