

The Business Judgment Rule in Kansas: From Black and White to Gray

[*Gray v. Manhattan Medical Center, Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001)]

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I. INTRODUCTION

A once easily understood principle of corporate law has evolved into a three-headed monster that shields corporate directors, amuses the courts, and haunts shareholders. While the purpose of the business judgment rule is to provide latitude to corporate directors when making business decisions,¹ it is a source of criticism and controversy. In light of a recent Kansas Court of Appeals decision, it does not appear that this versatile monster will be tamed nor will the turmoil that travels with it.²

In *Gray v. Manhattan Medical Center, Inc.*,³ the Kansas Court of Appeals clouded the business judgment rule in Kansas. The court affirmed the district court decision, which was based on other grounds, by carelessly throwing the business judgment rule into its analysis. The court of appeals followed the Delaware standard for the business judgment rule and examined whether the corporate directors had been grossly negligent.⁴

The Kansas Court of Appeals has done Kansas corporations and shareholders a disservice by using the business judgment rule when another avenue was appropriate to resolve the case. In addition, the court failed to articulate the rule in a manner that solidifies it for future cases. The merit and usefulness of the business judgment rule as a tool for business law is not underestimated. However, the gross negligence standard set forth, and the application of the business judgment rule to this case, will leave both advocates and critics scratching

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1. 18B AM. JUR. 2d *Corporations* § 1703 (2000).

2. See *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001) (holding that the business judgment rule protected corporate directors' decision).

3. *Id.*

4. See *id.* at 297-98. Gross negligence has not been firmly established as the Kansas standard for the business judgment rule. See *infra* text accompanying notes 52-57. In fact, Kansas imposes "a very strict fiduciary duty on officers and directors of a corporation . . ." *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1143 (Kan. 1978).

their heads.⁵ The Kansas Court of Appeals has made the creature unrecognizable to everyone.

II. CASE DESCRIPTION

Dr. Thomas F. Gray, an audiologist and hearing aid dispenser, practiced at the Manhattan Medical Center (“M.M.C.”)⁶ in Manhattan, Kansas.⁷ Dr. Gray was also a shareholder of M.M.C.⁸ In 1993, Dr. Gray signed a lease with M.M.C., which provided that “[n]o TENANT shall employ or associate with a person licensed to practice the person’s profession until such person has been approved by the LANDLORD in accordance with Article VIII of its By-laws, or any amendments thereto.”⁹ The referenced section of the bylaws explained that a renter’s specialty must be one that was not available at M.M.C.¹⁰

Dr. John M. Barlow and Dr. Benjamin C. Pease, ear, nose, and throat specialists, also practiced at M.M.C.¹¹ In 1998, Dr. Barlow and Dr. Pease hired a masters-level audiologist specifically for their practice.¹² The audiologist conducted hearing tests and dispensed hearing aids, similar to the services Dr. Gray provided.¹³ Prior to hiring the audiologist, Dr. Gray received approximately fifty referrals per month from Dr. Barlow and his associates.¹⁴ After the masters-level audiolo-

5. “[I]t is difficult to pin a precise meaning upon the term gross negligence.” Frank A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage of Misguided Notion?*, 67 S. CAL. L. REV. 287, 298 (1994). However, “most individuals would have no trouble understanding that gross negligence entails some worse level of dereliction than ordinary negligence.” *Id.* at 300.

6. Manhattan Medical Center, Inc. referred to itself as “MMC” throughout its brief. Brief of Manhattan Medical Center, Defendant/Appellee, *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001) (No. 00-85141-A). The Kansas Court of Appeals referred to Manhattan Medical Center, Inc. as “MMCI” throughout its opinion. *Gray*, 18 P.3d at 295-99.

7. *Gray*, 18 P.3d at 295.

8. *Id.*

9. *Id.* at 296.

10. *See id.* The restrictions “protect the other tenants within the Center from unwanted competition.” Brief of Appellant at 9, *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001) (No. 00-85141-A).

11. *See Gray*, 18 P.3d at 295. There is some discrepancy as to whether Dr. Pease was a shareholder and tenant of M.M.C. Manhattan Medical Center stated that Barlow and Pease were stockholders and tenants of M.M.C. Brief of Manhattan Medical Center, Defendant/Appellee at 1, *Gray* (No. 00-85141-A). However, the Kansas Court of Appeals explained that at the time of this litigation, Dr. Pease had not signed a lease and was only approved to be a tenant and future shareholder. *Gray*, 18 P.3d at 295. In his affidavit dated January 10, 2000, Dr. Pease stated, “I have not at any time signed a lease with the Manhattan Medical Center,” and “I paid in the required capital contribution to become a stockholder in the Manhattan Medical Center in August 1999.” Brief of Appellees, John M. Barlow, M.D. and Benjamin C. Pease, M.D. at Appendix E, *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001) (No. 00-85141-A).

12. Order on Mot. for Summ. J. at 2, in the Dist. Ct. of Riley County, Kan., Mar. 22, 2000; Case No. 99 C 119.

13. *See Gray*, 18 P.3d at 296.

14. Brief of Appellant at 14, *Gray* (No. 00-85141-A).

gist was hired, Dr. Gray received approximately eleven referrals for audiology and hearing aid services.¹⁵

Dr. Gray believed that Dr. Barlow and Dr. Pease violated the lease and bylaws of M.M.C.¹⁶ He presented his concerns to the Board of Directors on three occasions, seeking corrective action by M.M.C.¹⁷ On all three occasions, the Board chose to take no action against Dr. Barlow and Dr. Pease.¹⁸ Dr. Gray subsequently filed suit against M.M.C., Dr. Barlow, and Dr. Pease.¹⁹ Dr. Gray based his claim on two theories: a shareholder derivative theory²⁰ and a third-party beneficiary theory.²¹ All parties filed motions for summary judgment.²²

The Riley County District Court granted summary judgment to the defendants.²³ The court found that the shareholder derivative suit could not be maintained because there was no “wrong” to M.M.C. and, alternatively, there was no improperly neglected “right” that the Board failed to exercise.²⁴ The district court interpreted the lease and bylaws and found that they had not been breached.²⁵ Additionally, the court held the third-party beneficiary claim to be moot.²⁶ At no

15. *Id.* at 14-15. The eleven referrals presumably occurred from August 1998, when the audiologist was hired, until July 1999, when Dr. Gray filed a petition. *See id.* at 3, 14-15. Dr. Gray explained that he only received referrals when the masters-level audiologist was unavailable. *Id.* at 15. Dr. Barlow claimed he had become dissatisfied with Dr. Gray's work. Brief of Appellees, John M. Barlow, M.D. and Benjamin C. Pease, M.D. at 6, *Gray* (No. 00-85141-A).

16. *Gray*, 18 P.3d at 296 (Kan. Ct. App. 2001). Dr. Gray also asserted that Dr. Barlow and Dr. Pease were attempting to “increase their business by providing a broader range of services; services that they [were] not legally licensed to provide.” Brief of Appellant at 13, *Gray* (No. 00-85141-A).

17. *See Gray*, 18 P.3d at 297-98.

18. On the first occasion, July 14, 1998, Dr. Gray presented his written complaint to the Board. Brief of Appellant at 3, *Gray* (No. 00-85141-A). Dr. Barlow also appeared before the Board at that time. *Id.* On the second occasion, July 28, 1998, the Board heard from the parties and voted to take no action. *Id.* The members of the Board of Directors who were present and voted were: Dr. Devine (President), Drs. Haun, Peak, Pettie, Meek, and Dreiling. *See* Brief of Appellees, John M. Barlow, M.D. and Benjamin C. Pease, M.D. at Appendix C, *Gray* (No. 00-85141-A). Dr. Biberstein was excused. *Id.* By a five to one vote, the directors chose to take no action. *Id.* On the third occasion, January 12, 1999, the Board again considered Dr. Gray's complaint. Brief of Appellant at 3, *Gray* (No. 00-85141-A). The Board maintained its July 28 decision and did not take action against Dr. Barlow and Dr. Pease. *Id.* The Board of Directors found that the lease and the bylaws had not been violated. *Gray*, 18 P.3d at 296.

19. *Gray*, 18 P.3d at 295.

20. *Id.* The shareholder derivative action pertained to M.M.C. while the third-party beneficiary theory applied to Dr. Barlow and Dr. Pease. Brief of Manhattan Medical Center, Defendant/Appellee at 1, *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001) (No. 00-85141-A). A shareholder derivative action is an “action brought by one or more stockholders of a corporation to remedy or prevent a wrong against a corporation.” 19 AM. JUR. 2d *Corporations* § 2243 (2000).

21. *Gray*, 18 P.3d at 295.

22. *See id.*

23. *See id.*

24. *Id.* at 296. The district court derived this language from *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1970 (Del. Ch. 1985). Order on Mot. for Summ. J. at 7, in the Dist. Ct. of Riley County, Kan., Mar. 22, 2000; Case No. 99 C 119. The district court explained that “[a] shareholder may only litigate as an individual if the wrong to the corporation inflicts a distinct and disproportionate injury on the shareholder, or if the action involves a contractual right of the shareholder which exists independently of any right of the corporation.” *Id.*

25. Order on Mot. for Summ. J. at 9.

26. *Gray*, 18 P.3d at 296.

point in its decision did the district court apply the business judgment rule.²⁷ Dr. Gray appealed the district court's decision to the Kansas Court of Appeals.²⁸

III. BACKGROUND

The business judgment rule is deeply rooted in American common law and continues to be at the forefront of corporate and business law. In 1917, Justice Louis D. Brandeis introduced the business judgment rule in *United Copper Securities Co. v. Amalgamated Copper Co.*²⁹ According to Justice Brandeis, business questions were "ordinarily a matter of internal management" and thus were "left to the discretion of the directors . . ."³⁰ Furthermore, he stated:

Courts interfere seldom to control such discretion intra vires the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment.³¹

Justice Brandeis's idea that "courts interfere seldom" remains in statutes and cases today.³²

A. *The Business Judgment Rule At Common Law*

The business judgment rule has been a facet of corporate law for over 150 years.³³ Its principles are applied to the directors of financial institutions and corporations. The directors of these two entities had different standards of care at common law.³⁴ Typically, financial institutions carried a higher standard than corporations.³⁵

At common law, the standard for bank director liability was ordinary negligence because of the relationship between banks and the general public.³⁶ This was a higher standard of care because directors were personally liable for ordinary negligence. Corresponding to the

27. See Order on Mot. for Summ. J. at 1-9. The district court briefly mentioned that it should not "substitute its own judgment for that of the officers . . ." *Id.* at 6 (quoting *Cron v. Tanner*, 229 P.2d 1008, 1013 (Kan. 1951)).

28. See *Gray*, 18 P.3d at 295.

29. 244 U.S. 261, 263-64 (1917), cited in Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 457 & 509 n.7 (1985).

30. *Id.*

31. *Id.*

32. *Id.*

33. S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 93 (1979). See also Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 456-57 (1985).

34. See Steven A. Ramirez, *The Chaos of 12 U.S.C. Section 1821(k): Congressional Subsidizing of Negligent Bank Directors and Officers?*, 65 FORDHAM L. REV. 625, 643 (1996).

35. See *id.* at 644.

36. See *id.* Professor Ramirez explained that the reason for this historic difference was that banks (and other financial institutions) held public funds and depositors had to be protected. See *id.*

higher standard of care, there was actually “little, if any, allowance for the operation of the business judgment rule” to bank directors.³⁷

The standard for corporate director liability was described in terms of the banking standard, yet was lower than the standard for bank directors.³⁸ Thus, it can be assumed that the standard for corporate director liability at common law was gross negligence. Statutes and case law changed the common law standard of director liability significantly.

B. *The Business Judgment Rule As Statutory Authority*

Statutes are of little help in deciphering the business judgment rule. The only federal business judgment rule statute applies to bank directors who are grossly negligent.³⁹ Statutory authority addressing corporate director liability is limited.

Both the Model Business Corporation Act (“Model Act”) and the Delaware General Corporation Law allow companies to insulate directors by including a provision for the business judgment rule in articles of incorporation.⁴⁰ The Model Act provides that a company’s articles of incorporation may include “a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director”⁴¹ The Delaware General Corporation Law contains identical language.⁴² These statutes do not address the confusion of the business judgment rule. In effect, the statutes allow a corporation to create its own business judgment rule for directors. Consequently, the courts are bound by this provision when included in the articles of incorporation.⁴³

37. *Id.* at 646.

38. *See id.* at 643 n.103, 644.

39. *See* 12 U.S.C. § 1821(k) (2001). This statute does not preempt federal common law causes of action existing before the statute was enacted, nor does it prevent the FDIC from pursuing a claim under state law for a lower standard of care. *See* Resolution Trust Corp. v. Gladstone, 895 F. Supp. 356, 365-66 (1995). In Kansas, a state law claim would not be possible because bank director liability is limited to gross negligence. *See* KAN. STAT. ANN. § 9-1132(b) (2000).

40. *See* MODEL BUS. CORP. ACT ANN. § 2.02(b)(4) (3d ed. Supp. 1998-99); DEL. CODE ANN. tit. 8, § 102(b)(7) (2000). Delaware is the most common state of incorporation in the United States. WILLIAM L. CARY & MELVIN ARON EISENBERG, CORPORATIONS, CASES AND MATERIALS 125 (7th ed. 1995). Thus, Delaware corporation law is persuasive in other jurisdictions dealing with business law issues. *See* J. Mark Meinhardt, *Investor Beware: Protection of Minority Stakeholder Interests in Closely Held Limited-Liability Business Organizations: Delaware Law and Its Adherents*, 40 WASHBURN L.J. 288, 289 (2000).

41. MODEL BUS. CORP. ACT ANN. § 2.02(b)(4) (3d ed. Supp. 1998-99). This section is subject to exceptions. *See* Ramirez, *supra* note 34, at 689 n.30.

42. *See* DEL. CODE ANN. tit. 8, § 102(b)(7).

43. *See, e.g.,* Arnold v. Soc’y for Sav. Bancorp., Inc., 650 A.2d 1270, 1290 (Del. 1994) (holding that articles of incorporation shielded directors from liability for disclosure violations).

The American Law Institute (“A.L.I.”) has also proposed a version of the business judgment rule in its *Principles of Corporate Governance*. Section 4.01(c) states the following:

A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer: (1) is not interested . . . in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation.⁴⁴

While the A.L.I. version provides a systematic, check list style analysis for the business judgment rule, it does not limit directors’ personal liability to acts of gross negligence.⁴⁵

C. *The Business Judgment Rule In Kansas*

The business judgment rule is an established principle in Kansas. Kansas courts have applied the business judgment rule in both banking and corporate contexts. This distinction holds true in both case law and statutes.

One of the first cases involving the business judgment rule in the banking context was *Cron v. Tanner*.⁴⁶ In *Cron*, the Kansas Supreme Court loosened the strict, common law standard of care for bank directors by holding them liable for gross negligence rather than ordinary negligence.⁴⁷ Almost fifty years later, in *Wichita Federal Savings & Loan Ass’n v. Black*,⁴⁸ the Kansas Supreme Court tightened the standard, holding directors liable for ordinary negligence rather than gross negligence.⁴⁹

In 1993, the Kansas Legislature introduced a statute that essentially overruled *Wichita Federal*.⁵⁰ The legislature clearly stated that

44. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c), reprinted in CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS, at 1131 (Melvin Aron Eisenberg ed., 2000). The duty of the director or officer is to perform in “good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.” *Id.* § 4.01(a), at 1130.

45. *See id.* § 4.01, at 1130-31.

46. 229 P.2d 1008 (Kan. 1951).

47. *See Cron*, 229 P.2d at 1013. The Kansas Supreme Court explained that the courts would only interfere “when the officers [were] guilty of willful abuse of their discretionary power or of bad faith, neglect of duty, perversion of the corporate purpose, or when fraud or breach of trust [were] involved . . .” *Id.* At common law, bank directors were liable for ordinary negligence. *See Ramirez, supra* note 34, at 634.

48. 781 P.2d 707 (Kan. 1989).

49. *See Wichita Fed.*, 781 P.2d at 711. In *Wichita Federal*, a financial institution sued its former president and chairman of the board for negligence. *See id.* Since *Cron* had established a gross negligence standard for banking directors, and there were no allegations of gross negligence, the court could have disposed of the case by utilizing the business judgment rule. *See Cron*, 229 P.2d at 1013. The court found the former president liable but mentioned nothing about gross negligence. *See Wichita Fed.*, 781 P.2d at 713.

50. *See KAN. STAT. ANN.* § 9-1132(b) (2000). “An officer or director of a bank or national banking association shall have *no personal liability* . . . except . . . for: acts or omissions which

bank directors are not held to a strict standard of liability. Thus, there is no longer any question about the standard for bank directors. A bank director will be held personally liable only when guilty of gross negligence.⁵¹

The standard for bank director liability ultimately evolved into a statutory standard of gross negligence. In contrast, the standard for corporate director liability has always been the strict standard of ordinary negligence. In *Newton v. Hornblower, Inc.*,⁵² the Kansas Supreme Court discussed the strict standard for corporate directors in Kansas.⁵³ It explained that “Kansas has always imposed a very strict fiduciary duty on officers and directors of a corporation”⁵⁴ Indeed, the standard for Kansas is stricter than many other jurisdictions.⁵⁵ In *Richards v. Bryan*,⁵⁶ the Kansas Court of Appeals used similar language.⁵⁷ Until *Gray*, the standard for corporate director liability was ordinary negligence.

The only statute relating to the business judgment rule in the corporate context is Kansas Statutes Annotated section 17-6002(b)(8). Section 17-6002(b)(8) is identical to the Delaware statute.⁵⁸ Both allow a corporation’s articles of incorporation to eliminate or limit a director’s personal liability.⁵⁹ While the Kansas Legislature loosened the standard for bank directors, it has left the higher standard for corporate directors untouched. Until recently, there was no need to statutorily modify the standard for corporate director liability because case law held ordinary negligence as the standard.⁶⁰

The Kansas General Corporation Code “has been patterned after, and at times contains identical provisions of, the Delaware general corporation law.”⁶¹ The Kansas Legislature looks to Delaware for guidance when dealing with “novel issues of corporation law.”⁶² The bill that added section 17-6002(b)(8) was the result of an amendment

constitute willful or gross and wanton negligent breach of the officer’s or director’s duty of care.” *Id.* (emphasis added).

51. While the word “gross” packs a significant punch, what is considered “grossly negligent” in the banking industry becomes an interesting question in itself. “When courts use the term gross negligence in connection with banks it could well reflect the application of a more rigorous ordinary care standard.” See Ramirez, *supra* note 34, at 689 n.115 (citing HENRY W. BALLENTINE, *BALLENTINE ON CORPORATIONS* 158 (2d ed. 1946)).

52. 582 P.2d 1136 (Kan. 1978).

53. See *Newton*, 582 P.2d at 1143.

54. *Id.*

55. See *id.*

56. 879 P.2d 638 (Kan. Ct. App. 1994).

57. See *Richards*, 879 P.2d at 646.

58. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2000).

59. See *id.*; KAN. STAT. ANN. § 17-6002(b)(8) (2000).

60. See *supra* text accompanying notes 52-57.

61. *Achey v. Linn County Bank*, 931 P.2d 16, 21 (Kan. 1997).

62. Charles D. Lee, *Rights, Obligations and Liabilities of Promoters, Stockholders, Officers, Directors, and Successor Corporations*, in *KANSAS CORPORATION LAW & PRACTICE* § 7.40 at 7-14 (Steven A. Ramirez ed., 4th ed. 1998).

to the Delaware General Corporation Law.⁶³ Kansas courts are similarly influenced by Delaware decisions.

D. *Delaware Law As It Applies To Kansas Corporate Law*

Delaware courts have established a definite business judgment rule. In 1967, a Delaware court equated the business judgment rule with a gross negligence standard.⁶⁴ Delaware courts have maintained the gross negligence standard throughout a long line of cases.⁶⁵ One commentator believes that “in an appropriate case, it is not unreasonable to expect Kansas courts to adopt a business judgment rule based upon Delaware authority.”⁶⁶

While there is no precedent that indicates that Kansas courts have followed the Delaware gross negligence standard regarding corporate director liability, Delaware decisions are persuasive.⁶⁷ The use of Delaware authority has led to what critics call the “race to the bottom.”⁶⁸ Nonetheless, it is true that “[t]he pronounced trend away from a standard of liability conducive to director liability for negligence has manifested itself in many jurisdictions through an explicit adoption of a gross negligence standard of liability, most notably in Delaware.”⁶⁹ There is no dispute that the Kansas and Delaware corporation codes are similar.⁷⁰ However, Kansas court decisions have not paralleled Delaware’s when it comes to the business judgment rule for corporate directors.⁷¹ Kansas courts did not use Delaware’s gross negligence standard for the business judgment rule until *Gray*.

The Kansas Court of Appeals blindly followed Delaware law and confused the business judgment rule for Kansas corporations and shareholders. The court failed to follow the precedent of Kansas case law. As a result, the business judgment rule has been molded into an

63. See S.B. 26, Supplemental Note, 1987 Leg., (Kan. 1987). The bill was recommended by the Special Committee on Tort Reform and Liability Insurance. *Id.*

64. See Arsh, *supra* note 33, at 102 (discussing *Meyerson v. El Paso Natural Gas Co.*, 246 A.2d 789 (Del. Ch. 1967)).

65. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Arsonson v. Lewis*, 473 A.2d 805 (Del. 1984). See also *Gevurtz*, *supra* note 5, at 298 (explaining that Delaware has settled the gross negligence standard for the business judgment rule).

66. Lee, *supra* note 62, at 7-14.

67. *Id.*

68. “Race to the bottom” is the theory that, in order to compete with Delaware, states must relax their regulations to “make their jurisdictions more attractive to managers who make incorporation decisions” Meinhardt, *supra* note 40, at 290 n.15 (quoting A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099, 1100, n.5 (1999)). Others approvingly call this a “race to the top.” This is the theory that “Delaware’s dominance in the corporate arena demonstrates that its enabling approach to corporate regulation is the most efficient approach.” *Id.* at 290 n.16.

69. Ramirez, *supra* note 34, at 689 n.115.

70. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2000); KAN. STAT. ANN. § 17-6002(b)(8) (2000) (containing identical language that a company’s articles of incorporation may insulate directors from liability).

71. See *supra* text accompanying notes 52-57, 62.

inferior approach to governing the rights of shareholders and the protection of corporate directors in Kansas.

IV. ANALYSIS

In *Gray v. Manhattan Medical Center, Inc.*,⁷² the Kansas Court of Appeals made the business judgment rule in the corporate context confusing and inconsistent. Rather than stating the business judgment rule in a manner uniform with precedent, the court opted to trail-blaze into what will undoubtedly be pandemonium for future decisions.

A. *The Parties' Arguments and the Court's Holding*

Dr. Gray asserted only one issue on appeal. He claimed that M.M.C.'s lease and bylaws precluded Dr. Barlow and Dr. Pease from hiring an audiologist to perform tasks similar to his own.⁷³ Dr. Gray argued that the board of directors was required to take action against Dr. Barlow and Dr. Pease for breach of the corporate lease and bylaws.⁷⁴ The business judgment rule was never mentioned in Dr. Gray's brief nor in his reply brief.⁷⁵

M.M.C. based its argument on the business judgment rule. M.M.C. argued that "it [was] irrelevant whether the terms of the lease and bylaws were breached because MMCI's decision not to take the corrective action sought by Gray was a discretionary and protected business judgment."⁷⁶ M.M.C. based its argument regarding the business judgment rule on Delaware authority.⁷⁷

The Kansas Court of Appeals, persuaded by M.M.C.'s argument, upheld the district court's decision to grant summary judgment on the shareholder derivative claim.⁷⁸ The court did not analyze the lease or bylaws; instead, it relied on the basic principles of Delaware law regarding the application of the business judgment rule to insulate the board from attack.⁷⁹ The court explained that the business judgment

72. 18 P.3d 291 (Kan. Ct. App. 2001).

73. See Brief of Appellant at 2, *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001) (No. 00-85141-A).

74. See *Gray*, 18 P.3d at 298.

75. See Brief of Appellant, *Gray* (No. 00-85141-A); Reply Brief of Appellant, *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001) (No. 00-85141-A).

76. *Gray*, 18 P.3d at 296.

77. See *id.*

78. See *id.* at 298. The court agreed that Dr. Gray was not a third-party beneficiary to the lease between Dr. Barlow and M.M.C. because he had not been named as an intended third-party beneficiary. See *id.* at 299. In addition, the court indicated that the district court's findings of fact and conclusions of law were complete. See *id.*

79. *Id.* at 297.

rule presumes that directors are disinterested, act in good faith, are fully informed, and act in the company's best interests.⁸⁰

The court reasoned that “[b]ecause Gray [did] not contend any of the MMCI directors had a personal interest in the outcome or that any was grossly negligent, we must determine if there was evidence to assist Gray in demonstrating that the directors were ill informed.”⁸¹ The court cited only Delaware law as authority for the gross negligence standard.⁸²

B. *The Court Should Not Have Applied the Business Judgment Rule*

The Kansas Court of Appeals erred when it used the business judgment rule to dismiss Dr. Gray's shareholder derivative claim. The court should have interpreted the lease and the bylaws. Alternatively, the court should have given special consideration to M.M.C.'s structure and its similarity to a close corporation.

This case involved the interpretation of a corporation's lease and bylaws. The Kansas Court of Appeals should have interpreted these documents as the district court had done.⁸³ Its review of these written documents would have been de novo, hence the court was not bound by the district court's interpretation.⁸⁴ Instead of evaluating the documents presented, the Kansas Court of Appeals hastily remedied this case via a business judgment rule analysis.

There has been considerable commentary regarding the business judgment rule as it applies to closely held corporations.⁸⁵ Although M.M.C. was not a “close corporation” in Kansas,⁸⁶ it nonetheless possessed the requisite characteristics.⁸⁷ The business judgment rule has

80. *See id.* at 296-98. It appears that the Kansas Court of Appeals was following A.L.I.'s business judgment rule, even though the court did not say that it was. *See id.*

81. *Id.* at 297.

82. *See id.*

83. *See id.* at 298.

84. *See Anderson v. Employers Mut. Cas. Ins. Co.*, 6 P.3d 918, 923 (Kan. Ct. App. 2000) (indicating that an appellate court may independently construe a written agreement to determine its legal significance).

85. *See, e.g., Meinhardt, supra* note 40; *Peeples, supra* note 33. A close corporation has the following characteristics: “(1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation.” *Id.* at 466 (discussing the Massachusetts Supreme Court's definition of a close corporation).

86. *See KAN. SEC'Y OF STATE, KANSAS ONLINE CORPORATION SEARCH*, at <http://www.accesskansas.org/corporations> (last visited Sept. 16, 2001). Kansas has a special close corporation code. *See KAN. STAT. ANN.* § 17-7202 (1995).

87. There were a small number of stockholders. *See Brief of Appellees, John M. Barlow, M.D. and Benjamin C. Pease, M.D.*, at Appendix C, *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291 (Kan. Ct. App. 2001) (No. 00-85141-A). Because the evidence suggested that M.M.C.'s doctors were the stockholders and directors, there was significant overlapping of the management, direction, and operations of M.M.C. *See id.* It is not unusual for close corporations to organize under general corporation laws. *See Meinhardt, supra* note 40, at 291.

special considerations and limitations when it is applied to close corporations.

One consideration regarding close corporations and the business judgment rule is the presumption that the directors are disinterested.⁸⁸ In close corporations, a director's personal interests are intertwined with the corporation's best interests.⁸⁹ This undermines the basic idea behind the business judgment rule.

The business judgment rule presumes that disinterested directors make decisions.⁹⁰ Dr. Gray never alleged that the directors were interested.⁹¹ However, "potential conflicts of interest [were] always present" because directors also acted as shareholders, tenants, and practitioners.⁹² Thus, the presumption that the directors of M.M.C. were disinterested would not be accurate. In situations such as *Gray*, where an entity is not a close corporation per se, but does have qualities of a close corporation, the court should be wary of the business judgment rule. Since the directors were also doctors practicing at M.M.C., they may not have been able to separate their "personal interest[s] . . . from the corporate welfare."⁹³

C. *If the Rule Was Unavoidable, the Court Should Have Applied It Consistently With Precedent*

While the court should have avoided the business judgment rule, it chose to use *Gray* as a means to reinvent the rule's application to Kansas corporations. Since the court felt obligated to address the business judgment rule, it should have used the ordinary negligence standard rather than gross negligence standard.

1. *The Court Broke From Precedent When Applying the Gross Negligence Standard*

Gross negligence is not an acceptable standard for Kansas corporations. It was no accident that ordinary negligence was the standard for corporate director liability.⁹⁴ Kansas courts have boasted that this state has higher standards for director liability than other states.⁹⁵ In

88. "[T]he issue of what constitutes a 'disinterested' director has never been resolved in a consistent and satisfactory way . . ." Dennis J. Block & H. Adam Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, n.11 (1981).

89. See Peeples, *supra* note 33, at 485.

90. See *id.*

91. See *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291, 296-97 (Kan. Ct. App. 2001). See also *supra* note 18 (identifying members of M.M.C.'s Board of Directors).

92. Peeples, *supra* note 33, at 485.

93. *Id.*

94. See *supra* text accompanying notes 52-57.

95. See *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1143 (Kan. 1978); *Richards v. Bryan*, 879 P.2d 638, 646 (Kan. Ct. App. 1994).

Kansas, the trend has been to protect shareholders.⁹⁶ Directors should be accountable to shareholders; they should not be able to escape liability because of a complicated rule. It is unlikely that the average shareholder understands the rule or is even aware that the rule exists.⁹⁷ Kansas shareholders expect to be told the truth. The less restrictive standard of gross negligence simply does not fit with Kansas ideals.

Furthermore, corporate directors should be held to the same standard as other trusted professionals. For example, doctors and lawyers are held to a higher standard.⁹⁸ Corporate directors are not entitled to special treatment.⁹⁹

While “gross negligence” might be one standard for defeating the business judgment rule, it was not the Kansas standard until *Gray*. It is perplexing why the court jumped on the Delaware gross negligence bandwagon. Although a Delaware court admitted that its analysis regarding the business judgment rule left something to be desired,¹⁰⁰ the Kansas Court of Appeals appeared eager to loosen the Kansas standard and join the Delaware gross negligence followers.¹⁰¹ In *Gray*, the court suggested that the standard in Kansas was gross negligence and absent such a showing, the business judgment rule would insulate directors.¹⁰²

The Kansas Bar Association has contended that “in an appropriate case, it is not unreasonable to expect Kansas courts to adopt a business judgment rule based upon Delaware authority.”¹⁰³ In *Gray*, the court did not explain what made this an appropriate case.¹⁰⁴ In fact, the court did not even mention that it had changed Kansas precedent and used a different standard for corporate director liability.¹⁰⁵

When speculating as to why the court used a gross negligence standard, one might argue that the Kansas Court of Appeals was eager to join the “race to the bottom.”¹⁰⁶ In addition, there were public

96. See, e.g., *Hotchkiss v. Fischer*, 16 P.2d 531, 534 (Kan. 1932) (sympathizing with a shareholder who was not competent to interpret company's financial statements).

97. See generally *Gevurtz*, *supra* note 5, at 304 (suggesting that the business judgment rule confuses lay jurors). See also *Hotchkiss*, 16 P.2d at 536 (showing that a director could take advantage of a less than savvy investor).

98. See *Gevurtz*, *supra* note 5, at 288.

99. Law, medicine, and business all involve making decisions and acting on intuition and experience. See *id.* at 309. However, attorneys and doctors are still held to a strict standard of care. Corporate directors' positions are not unique. *Id.* at 312.

100. See *Aronson v. Lewis*, 473 A.2d 805, 813 n.6 (Del. 1984).

101. See *Gray v. Manhattan Med. Ctr., Inc.*, 18 P.3d 291, 296-98 (Kan. Ct. App. 2001).

102. The Kansas Court of Appeals cited only Delaware authority for using the “gross negligence” standard. See *id.*

103. Lee, *supra* note 62, at 7-14.

104. 18 P.3d at 296-98.

105. See *Gray*, 18 P.3d at 296-98.

106. William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974), cited in WILLIAM L. CARY & MELVIN ARON EISENBERG, *CORPORATIONS, CASES AND MATERIALS* 126 (7th ed. 1995). Cary explained that

policy considerations such as socio-economic factors, cultural factors, political factors, and institutional vulnerability at work.¹⁰⁷ It is likely that these undercurrents were playing a part in *Gray*, just as they have played a part in the “transmogrification of the business judgment rule”¹⁰⁸ in other states.

2. *The Court Incorrectly Applied Gross Negligence To the Business Judgment Rule*

Dr. Gray did not allege that the directors were grossly negligent in allowing the masters-level audiologist to be hired.¹⁰⁹ The Kansas Court of Appeals should have simply acknowledged that there were no allegations of gross negligence and then moved to the business judgment rule analysis. Instead, the court used gross negligence within its analysis of the business judgment rule.

The court reasoned that it only needed to consider whether the directors were informed because no allegations of director self-interest or gross negligence were made.¹¹⁰ By explaining the analysis this way, the court implied that gross negligence was one of the inquiries made in applying the business judgment rule.

The court mixed the requirements for applying the rule with what might be requirements for defeating the rule. Terms such as independence, good faith, informed judgment, and rational basis are all used to describe the requirement for applying the rule. This nomenclature creates a rebuttable presumption that directors are protected.¹¹¹ Terms such as clear and gross negligence, gross and palpable overreaching, and ordinary negligence are used to defeat the presumption.¹¹²

The Kansas Court of Appeals used the correct terms to apply the rule. In particular, it examined independence, informed judgment, and whether the decision was in the best interest of the corporation.¹¹³ However, by throwing the term “gross negligence” into its inquiry, the

Delaware has systematically attempted to generate huge franchise-tax revenues by designing its corporation law to attract managers; . . . Delaware has carried out its design by distorting its corporate law to favor managers, thereby leading a race to the bottom that other states feel constrained to join, resulting in a nationally low-grade corporation law.

Id.

107. For example, a directorship may be seen as an honor as opposed to a job. See Joseph W. Bishop, Jr., *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 *YALE L.J.* 1078, 1093 (1968). Thus, strict liability might seem unduly burdensome. Professor Steven Ramirez posited that politicians did not intend to insulate directors and officers from liability. See Ramirez, *supra* note 34, at 689.

108. Ramirez, *supra* note 34, at 689 n.115.

109. See *Gray*, 18 P.3d at 297-98.

110. *Id.* at 297.

111. See Peeples, *supra* note 33, at 459.

112. *Id.*

113. See *Gray*, 18 P.3d at 297-98.

court made its analysis foggy because that would be a standard for defeating the rule. Whether gross negligence is the Kansas standard is a crucial question.

In *Gray*, the Kansas Court of Appeals took on the task of redefining the business judgment rule. The court made three critical errors in its analysis. First, if the court felt compelled to address the business judgment rule, it should have explained its analysis without using the words "gross negligence." Second, the court should have established a clear standard of ordinary negligence, which would be the most equitable and logical standard for Kansas shareholders. Third, at the very least, it should have explained why the Delaware gross negligence standard was so appealing. Because of these oversights by the court, Kansas shareholders are in a vulnerable position.

As a result of *Gray*, the future use of the business judgment rule in Kansas is uncertain. Directors may claim greater latitude in business decisions because of the new gross negligence standard. Shareholders with legitimate claims based on ordinary negligence may lose a bid for judicial relief because the acts of the corporate directors do not rise to the level of gross negligence. The court's attempt to tame the business judgment rule monster failed. The decision in *Gray* has added to the confusion surrounding this illusive creature.

V. CONCLUSION

The Kansas Court of Appeals "grayed" the business judgment rule concept as it applies to corporate directors in Kansas. Intervention by the Kansas Legislature could create a well-defined rule regarding corporate director liability. At this time, there is no evidence that the legislature intends to tackle the issue. Therefore, Kansas courts must explain the business judgment rule and apply it consistently. Without a clearly defined standard, this wayward creature will continue to guard the gates to corporate directors against valid claims of shareholders.