

Memorandum 95-33

Business Judgment Rule: Policy Issues

INTRODUCTION

The Commission in 1993 was authorized by the Legislature to study whether the standard under Section 309 of the Corporations Code for protection of a director from liability for a good faith business judgment should be revised.

This authority had been requested by the Commission, which noted that California law in this area is confused and has been a factor in the decision of some California corporations to reincorporate in Delaware. “The business judgment rule of Delaware and other jurisdictions should be examined to determine whether they may offer useful guidance for codification and clarification of the law in California.” *Annual Report for 1992*, 22 Cal. L. Revision Comm’n Reports 831, 845 (1992).

The Commission retained Professor Melvin A. Eisenberg of the University of California, Berkeley, School of Law to prepare a background study on the matter. Professor Eisenberg delivered the background study in May 1995, “Background Study for the California Law Revision Commission on Whether the Business-Judgment Rule Should Be Codified” (cited in this memorandum as *Background Study*). Availability of the background study has been publicized, and the study has been made available to interested persons and organizations for review and comment. A copy is attached to this memorandum.

SYNOPSIS OF BACKGROUND STUDY

Professor Eisenberg’s study notes that corporate directors and officers are held to a standard of careful conduct. In California, the standard of careful conduct is codified in Corporations Code Section 309(a), which requires a director to act in good faith in a manner the director believes to be in the best interests of the corporation and shareholders, and “with such care, including

reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.”

However, in applying the standard of careful conduct to determine the reasonableness of a decision made by a director or officer, the courts have used a lower standard of review, provided the director or officer did not have a financial interest in the decision, made the decision in good faith, and used a reasonable decision-making process in arriving at it. The lower standard of review applied in such circumstances is called the “business judgment rule”.

There are various formulations of the business judgment rule. One standard that has been applied is subjective — whether the director or officer has acted in good faith. A more common standard is objective — whether the decision of the director or officer is rational, as opposed to prudent.

The reason for the business judgment rule is that business decisions inherently involve risk. It would be unfair to penalize a director or officer for a risky decision made in what the director or officer rationally and in good faith believes to be in the corporation’s interest, just because the risk materializes. This would make the director or officer in effect an insurer of the corporation’s acts, and would tend undesirably to promote risk-averse decision making by directors and officers.

California’s formulation of the business judgment rule is unclear. Some cases enunciate a standard of reasonableness, others have articulated a good faith standard, and other cases seem to equate the two concepts. California’s codification of the standard of careful conduct in Corporations Code Section 309(a) could be read to overturn the business judgment rule by its failure to create a business judgment exception to the statutory standard.

Professor Eisenberg concludes that, “Given the justifications and importance of the business judgment rule, and the uncertainty of its status and formulation in California, it would be desirable to codify the rule legislatively.” *Background Study* at 19. He suggests amendment of Corporations Code Section 309 to codify the business judgment rule in the form provided in the ALI Principles of Corporate Governance § 4.01(c) (1992). This formulation would state that a good faith judgment made by a director or officer satisfies the standard of careful conduct if the director or officer is not interested in the subject of the decision, is reasonably informed concerning the subject of the decision, and rationally believes the decision is in the best interests of the corporation. The burden of proof would be on the person challenging the conduct of the director or officer

(i.e., the director or officer would be rebuttably presumed to have acted properly and in accordance with the requirements of the standard of careful conduct or of the business judgment rule).

DESIRABILITY OF BUSINESS JUDGMENT RULE

The standard of careful conduct of corporate directors evolved from basic fiduciary concepts. This can still be seen today in the statutory formulation of the standard found in Corporations Code Section 309(a):

A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

It is worth asking at the outset whether the business judgment rule is necessary or proper, given the fact that other fiduciaries are held to a standard of prudence and due care. In fact, an extensive recent inquiry along these lines is made in Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 So. Cal. L. Rev. 287 (1994). Professor Gevurtz concludes that corporate directors are not unique in the types of decisions they make, and should not receive special treatment.

However, Professor Gevurtz' argument can as easily be used in support of liberalizing the law as to fiduciaries generally as it can be to deny liberalization for corporate directors. And in fact, the trend in the law is to recognize that some risk is inherent in sound decision making. For example, the Uniform Prudent Investor Act provides that in determining whether a trustee has used reasonable care, the trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but "as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." UPIA § 2(b). This has been enacted into law in California on recommendation of the Commission. See Prob. Code § 16047(b) (effective January 1, 1996).

The standard justification for the business judgment rule, though, is that a corporate director is not in the same situation as a trustee. "The business judgment rule grows out of the fact that the prudence requirement for corporate directors and officers itself was derived from the prudent man standard applied

to trustees and was expected in the case of trustees to disallow risk taking. Corporate directors and officers are expected to take risks, but obviously will not do so if they are to be liable for losses growing out of transactions judged in hindsight to be imprudently risky. It is by virtue of the business judgment rule that director liability for business decisions, and judgment calls generally, is rather rare in situations that do not involve conflicts of interest.” Protecting Corporate Officers and Directors from Liability (CEB Prog. Hndbk. 1994).

The considerations that favor protecting directors of nonprofit corporations from liability differ somewhat from the considerations involved in business corporations. Risk-taking and business decision-making are less important in the nonprofit corporation context. However, because of the liability exposure of nonprofit corporation directors, who are often volunteers, added protection may be necessary to encourage participation on the board. There is a patchwork of recently-enacted legislation providing various types of liability protection for nonprofit corporation directors. This legislation responds to the holding in *Frances T. v. Village Green Owners Assn.*, 42 Cal. 3d 490 (1986), refusing to apply the business judgment rule to protect nonprofit corporation directors from tort liability. A description of the hodge-podge of provisions may be found in Sproul, *Director and Officer Liability in the Nonprofit Context*, 15 *Business Law News* 7 (Spring 1993).

CONSIDERATIONS RELATING TO CODIFICATION

The business judgment rule is a case law development. No state has codified the rule.

A relevant consideration in determining the desirability of codification of the business judgment rule in California is the status of Delaware law. One of the reasons for the Commission’s study of this matter is to determine whether codification of the rule would make the California business environment more hospital to corporations.

It is generally thought that the California and Delaware business judgment rules are basically similar. However Professor Eisenberg indicates that the California law is subject to some confusion. One attraction of Delaware law for many corporations is the substantial body of law that has developed in Delaware, offering useful guidance to corporate directors.

The Delaware Law Study Group of the State Bar Business Law Section's Corporations Committee provides this comparison:

Both California and Delaware cases apply the business judgment rule to protect good faith diligent business decisions of directors where there is no conflict of interest, even where, in hindsight, the decision was wrong. The business judgment rule does not protect against grossly negligent decisions, although this is a factual determination. See *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985); *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965). There is far more case law in Delaware on this issue, and California courts may, and do, consider these Delaware cases as persuasive authority under appropriate circumstances.

How Section 2115 Affects Your Delaware Clients: A Comparison of Delaware and California Law Applicable to Quasi-California Corporations, 15 Business Law News 28-29 (Summer 1993)

A significant benefit to codification of the business judgment rule in the form of the ALI Principles of Corporate Governance, as proposed by Professor Eisenberg, is that besides clarifying California law, it will pick up an instant body of interpretation in the form of official commentary and reporter's notes. See Exhibit pp. 1-29. This would resolve any concern about discrepancies between California and Delaware law on this matter.

We have received a note from Professor Dan Dykstra of UCD Law School, who agrees with our consultant's conclusion that California should codify the business judgment rule. See Exhibit p. 30.

ISSUES IN CODIFICATION

Professor Eisenberg recommends codification in California in the following terms (slightly edited by staff to conform to California statutory drafting conventions):

309. (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) A director or officer who makes a business judgment in good faith fulfills the duty under this section if all of the following conditions are satisfied:

(1) The director or officer is not interested in the subject of the business judgment.

(2) The director or officer 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.

(3) The director or officer rationally believes that the business judgment is in the best interests of the corporation.

(c) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented.

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence.

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(e) (d) A person challenging the conduct of a director or officer under this section has the burden of proving a breach of the duty of care, including the inapplicability of the provisions as to the fulfillment of duty under subdivision (a) or (b), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.

(e) A person who performs the duties of a director in accordance with subdivisions (a) and (b) this section shall have no liability based upon any alleged failure to discharge the person's obligations as a director. In addition, the liability of a director for monetary damages may be eliminated or limited in a corporation's articles to the extent provided in paragraph (10) of subdivision (a) of Section 204.

Application to Directors and Officers

The codification would apply to officers as well as directors of a corporation. Most of the development of the law relating to business judgments has occurred in connection with directors, particularly in derivative action litigation. However,

where the issue has come up, the courts have applied the rule to corporate officers as well.

It should be noted that the formulation of the rule here is in terms of the duty “under this section”, which is ostensibly limited to corporate directors. In fact, there is some indication that courts may hold officers to a higher duty than directors. 1 Ballantine & Sterling, California Corporation Laws § 102.02 (4th ed. 1993). For these reasons, the staff would **eliminate the references to corporate officers** from the codification of the business judgment rule. Alternatively, we could **codify the business judgment rule as a separate section**, e.g., Section 309.5, applicable to both directors and officers. This would have the added benefit of keeping the section short, in a body of law characterized by run-on statutes.

Disinterested Director

The business judgment rule only applies where the director “is not interested in the subject of the business judgment.” Under the ALI draft, a director is “interested” in a transaction or conduct in any of the following circumstances:

(1) The director or an associate of the director is a party to the transaction or conduct.

(2) The director has a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would reasonably be expected to affect the director’s judgment with respect to the transaction or conduct in a manner adverse to the corporation.

(3) The director, an associate of the director, or a person with whom the director has a business, financial, or familial relationship, has a material pecuniary interest in the transaction or conduct (other than usual and customary directors’ fees and benefits) and that interest and (if present) that relationship would reasonably be expected to affect the director’s judgment in a manner adverse to the corporation.

(4) The director is subject to a controlling influence by a party to the transaction or conduct or a person who has a material pecuniary interest in the transaction or conduct, and that controlling influence could reasonably be expected to affect the director’s judgment with respect to the transaction or conduct in a manner adverse to the corporation.

See Draft § 1.23.

This definition is integral to the business judgment rule, and should be incorporated into it. The **definition could be included in the Comment** to the section, but a better approach would be to **set it out in the section** itself. This would be manageable if the business judgment rule were stated in its own section.

Application to Other Business Entities

Robert K. Hillison of Fresno has written to suggest that the business judgment rule should be extended to partnerships (general and limited) and limited liability companies. He notes that case law has applied it to protect a general partner in a limited partnership. “Given the variety of available business associations, it would seem that there should be no distinction between officers and directors of corporations and managing general partners or others assuming similar managerial responsibility.” Exhibit p. 31.

The staff believes we should solicit Professor Eisenberg’s opinion on the policy issues involved in this suggestion. However, as a political matter, the staff believes **it would be better to establish the codification first as to corporations**, where the business judgment rule is well accepted. Then, if it appears appropriate to extend the codification to other business entities, this will be more easily achieved as a logical progression of the law.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

THE AMERICAN LAW INSTITUTE

**PRINCIPLES OF
CORPORATE GOVERNANCE:
ANALYSIS AND RECOMMENDATIONS**

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Part IV

DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

Introductory Note

Section

- 4.01 Duty of Care of Directors and Officers; the Business Judgment Rule
 - 4.02 Reliance on Directors, Officers, Employees, Experts, and Other Persons
 - 4.03 Reliance on a Committee of the Board
-

Introductory Note:

a. Basic approach. Historically, courts rather than legislatures have played the central role in shaping the law regarding the duty of care of corporate directors and officers. In the past 25 years, however, over two-thirds of the states have enacted statutory provisions concerning the duty of care.

Part IV articulates the duty of care obligations of directors and officers (§ 4.01(a)), and associated standards involving business judgments (§ 4.01(c)), legal cause (§ 4.01(d)), and reliance (§§ 4.01(b), 4.02, and 4.03), in a manner that is generally consistent with articulations in current statutes and judicial decisions. It should be emphasized at the outset, however, that these are general legal standards and that their application, in most instances, will involve subtle evaluations of specific facts and circumstances. The complexity and scale of many modern corporations—and unavoidable uncertainties and complexities related to the roles of directors and officers—caution against unrealistic, harsh applications of Part IV's general standards.

Directors and officers obviously should not be required to insure that every potential corporate problem is anticipated or that every instance of wrongdoing (e.g., looting by an employee) is prevented. Indeed, the complexity and scale of many modern corporations compel directors and officers to rely heavily on other directors or officers, employees, experts, other persons, and committees of the board. Under §§ 4.01(b), 4.02, and 4.03, directors and officers have no obligation to look behind information, opinions,

reports, statements, decisions, judgments, and performances on which they are relying unless suspicious circumstances or other unusual facts would make it unreasonable not to make further inquiry. In general, courts applying duty of care standards should recognize that reliance is essential in many corporate contexts and that there are inherent dangers in judging a failure by directors or officers to act or foresee in the stark light of hindsight.

Part IV also contemplates that directors and officers will be afforded the broad latitude to allocate the corporate functions provided for in §§ 3.01–3.02. Part IV is not intended to prevent wide variations in corporate governance or to inhibit flexibility or experimentation.

Special note should be taken of the application of duty of care standards (§ 4.01(a)) to business judgments under the business judgment rule (§ 4.01(c)). See Comment *d* to § 4.01. The business judgment rule provides special protection to informed business decisions as distinguished, for example, from continued inattention to directorial obligations. The basic policy underpinning of the business judgment rule is that corporate law should encourage, and afford broad protection to, informed business judgments (whether subsequent events prove the judgments right or wrong) in order to stimulate risk taking, innovation, and other creative entrepreneurial activities. Shareholders accept the risk that an informed business decision—honestly undertaken and rationally believed to be in the best interests of the corporation—may not be vindicated by subsequent success. The special protection afforded business judgments is also based on a desire to limit litigation and judicial intrusiveness with respect to private-sector business decisionmaking.

The fact that directors (and sometimes officers) act as a group has important practical and legal implications. In becoming informed with respect to the subject of a business judgment, for example, directors, in addition to drawing on their own backgrounds, may learn from, or rely on, the discussions of their fellow directors as well as management presentations. The different backgrounds of individual directors, the distinct role each plays in the corporation, the value of maintaining board cohesiveness, the magnitude of the matter under consideration, the time frame in which a decision must be made, and similar factors are all relevant when determining whether a director “is informed with respect to the subject of the business judgment to the extent the director . . . reasonably believes to be appropriate under the circumstances.” Section 4.01(c)(2).

Since the business judgments of the board of directors or of a committee are not decisions of individuals, and since oversight obligations rest on the board as a whole (see § 3.02(a)(2)), difficult causation issues will often arise. When Part IV states that a director or officer has "committed a breach" of the duty of care, or is "subject to liability" for a failure to fulfill the duty of care, no implication is intended that liability will be imposed. That question depends on whether the acts or omissions were the legal cause of any damage to the corporation. See §§ 4.01(d), 7.18. A director who fails to perform an oversight obligation, for example, may have caused no damage to the corporation because the failure was rendered harmless by the care of other directors.

Finally, it should be remembered that in large measure directors and officers properly carry out their functions because of motives unrelated to their legal obligations, including a personal sense of responsibility, economic and career incentives, pride, professionalism, peer pressures, and the discipline instilled by competitive markets and tender offers. For well over one hundred years, however, courts and legislatures have considered legal standards with respect to duty of care to be a necessary protection for corporations and their shareholders. As is true of professionals and almost all others in our society, the accountability of directors and officers is a legitimate public policy concern. Part IV reflects this concern as well as a recognition of the need to encourage individuals with vision, ability, and expertise to serve corporations. Fairness to those who are willing to serve as directors and officers is clearly an essential value.

b. The relationship between articulated duty of care standards and limitations on damages. Historically, courts have not applied duty of care standards harshly. Judges have recognized the dangers inherent in making post-hoc judgments about the care exercised by directors and officers and have allowed them considerable leeway. Relatively few cases have imposed personal liability for damages. See Reporter's Note 17 to § 4.01(a), first paragraph.

Nevertheless, since 1985, more than 30 states have adopted legislation aimed at reducing or eliminating the exposure of directors (and, in a few instances, of officers) to personal liability for monetary damages for certain kinds of violation of the duty of care. See Reporter's Note 4 to § 7.19. Under the dominant approach, initiated by a Delaware statute, shareholders are authorized to adopt a certificate provision eliminating or limiting the financial liability of directors, except with respect to certain categories of extremely offensive behavior. See Del. Gen. Corp. Law § 102(b)(7).

Uncertainties related to the application of reasonable care standards, and the possible enormity of monetary liability for failure to use reasonable care, argue in favor of making a fair and proportionate remedial scheme available. This subject is dealt with in § 7.19 of these Principles, which permits shareholders, even in a state that has not adopted a statutory authorization of the type referred to above, to limit the monetary liability of directors and officers, except in specified, extreme circumstances. Part IV and § 7.19, in combination, are intended to harmonize two basic public policy concerns: first, the need to establish standards of care that encourage accountability and effective corporate leadership and management; and second, the need to encourage well-qualified directors and officers to serve and to avoid the counterproductive effects (e.g., risk aversion and diminished efficiency) that disproportionate penalties could produce.

c. The relationship between duty of care and duty of fair dealing. The legal obligations of directors and officers have traditionally been divided into the categories of duty of care and duty of loyalty; the latter is referred to in Part V of these Principles as the duty of fair dealing. *The Corporate Director's Guidebook* (pp. 1599-1600) properly distinguishes between the two as follows:

I. Duty of Loyalty

By assuming his office, the corporate director commits allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interest of his own. The basic principle to be observed is that the director should not use his corporate position to make a personal profit or gain other personal advantage....

II. Duty of Care

In addition to owing a duty of loyalty to the corporation, the corporate director also assumes a duty to act carefully in fulfilling the important tasks of monitoring and directing the activities of corporate management.

Neglect, mismanagement, and intentional decisions to do wrongful acts are dealt with in the duty of care and business judgment provisions in Part IV. But fraud, self-dealing, misappropriation of corporate opportunities, improper diversions of corporate assets, and similar matters involving potential conflicts between a director's or officer's interest and the corporation's welfare are considered in Part V. Issues related to the applicability of duty of care and business judgment standards to decisions by directors and

officers during hostile takeover attempts and other "transactions in control" are considered in Part VI. Issues related to the settlement or termination of shareholder derivative actions are considered in Part VII.

d. The coverage of Part IV. Except as specifically indicated to the contrary, §§ 4.01-4.03 are intended to cover business corporations of all types and sizes. Because the functions and obligations of a director or officer may vary with the circumstances, such as the director's or officer's position, the tasks that the director or officer has voluntarily taken on for the benefit of the corporation, and the complexity and scale of the corporation, § 4.01 is drafted flexibly to take account of such variations. See Comments *b*, *e*, and *h* to § 4.01(a), first paragraph.

Similarly, no basic distinction is drawn between banks (or other financial institutions) and industrial corporations with respect to duty of care provisions. Court precedents have, at times, suggested that bank directors, for example, are expected to exercise a higher degree of care and prudence than the directors of other business corporations. However, whatever merits they may have had near the turn of the century, today differentiations based solely on the distinction between a "financial institution" and an "industrial corporation" are unjustified and anachronistic. See Reporter's Note 18 to § 4.01(a), first paragraph.

ANALYSIS AND RECOMMENDATION

§ 4.01 Duty of Care of Directors and Officers; the Business Judgment Rule

(a) A director or officer has a duty to the corporation to perform the director's or officer's functions 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. This Subsection (a) is subject to the provisions of Subsection (c) (the business judgment rule) where applicable.

(1) The duty in Subsection (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the

director or officer reasonably believes to be necessary.

(2) In performing any of his or her functions (including oversight functions), a director or officer is entitled to rely on materials and persons in accordance with §§ 4.02 and 4.03 (reliance on directors, officers, employees, experts, other persons, and committees of the board).

(b) Except as otherwise provided by statute or by a standard of the corporation [§ 1.36] and subject to the board's ultimate responsibility for oversight, in performing its functions (including oversight functions), the board may delegate, formally or informally by course of conduct, any function (including the function of identifying matters requiring the attention of the board) to committees of the board or to directors, officers, employees, experts, or other persons; a director may rely on such committees and persons in fulfilling the duty under this Section with respect to any delegated function if the reliance is in accordance with §§ 4.02 and 4.03.

(c) 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 [§ 1.23] 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.

(d) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care, including the inapplicability of the provisions as to the fulfillment of duty under Subsection (b) or (c), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.*

* For a more detailed statement of the legal cause standards of these Principles, see § 7.18.

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Comment:

*a. General comparison with present law.** The black letter set forth in the first paragraph of Subsection (a) is consistent with the duty of care standards articulated in most jurisdictions today. See Comment *a* to § 4.01(a), first paragraph. Almost all current duty of care formulations consist solely of the type of broad standard set forth in this paragraph. For purposes of clarity, however, Subsection (a)(1) has been added and sets forth an "inquiry" obligation that is generally recognized in the case law and commentaries. See Comment *a* to § 4.01(a)(1)-(a)(2). Subsection (a)(2) has also been added for clarity and is believed to be generally consistent with the law as it would be interpreted in most jurisdictions today, but it provides broader protection than present law in the ways specified in Comments *d*, *e*, and *g* to § 4.02. See Comment *a* to §§ 4.01(a)(1)-(a)(2), 4.02, and 4.03.

Similarly, Subsection (b) is believed to be generally consistent with the law as it would be interpreted in most jurisdictions today, but it provides broader protection than present law in the ways specified in Comments *e* and *g* to § 4.02. See Comment *a* to §§ 4.01(b), 4.02, and 4.03.

Subsection (c)'s articulation of the business judgment rule is believed to be consistent with present law as it would be interpreted in most jurisdictions today, and each of the rule's basic elements (§ 4.01(c)(1)-(3)) is supported by substantial precedential authority. See Comment *a* to § 4.01(c).

Subsection (d) is believed to be generally consistent with the law as it would be interpreted in almost all jurisdictions today. See Comment *a* to § 4.01(d).

It should be noted that Subsections (a), (c), and (d) of § 4.01 deal with both directors and officers. Although most precedents and statutory provisions deal solely with directors, it is relatively well settled, through judicial precedents and statutory provisions in at least 18 states, that officers will be held to the same duty of care standards as directors. Sound public policy points in the direction of holding officers to the same duty of care and business judgment standards as directors, as does the little case authority that exists on the applicability of the business judgment standard to officers, and the views of most commentators support this position. See Reporter's Notes to § 4.01(a) and § 4.01(c). When it comes to the application of these formulations, of course, full-time officers will

* Comments *a-h* are general commentaries to § 4.01; specific commentaries on Subsections (a)-(d) follow the general commentaries.

generally be expected to be more familiar with the affairs of a corporation than outside directors. Officers will be expected to be more familiar with business affairs under their direct supervision than officers who do not have such responsibility.

b. Implementation. Section 4.01 can be implemented by judicial decision. The duty of care standards set forth in the first paragraph of § 4.01 would also be an appropriate subject for legislative action in connection with a general modernization of a state's corporation statute. Section 4.01(a)(1)-(d), however, might be better implemented by judicial decision than by legislative codification.

c. Duty of care standards as applied to delegation by the board. Subsection (b) recognizes a well-accepted reality of corporate governance, namely, the authority of the board of directors to delegate functions and powers to committees of the board, individual directors or officers, employees, and other persons. See Comment *b* to § 4.01(b). As to any delegated function, the focus for duty of care purposes is on the reasonableness of the board's reliance on the person or persons to whom a matter has been delegated. See §§ 4.02-4.03. Subsection (b) provides that the board may delegate a function or power to, and rely on, committees of the board and various persons in fulfilling the duty of care obligations with respect to that function if the reliance is in accordance with §§ 4.02-4.03, subject to the board's ultimate responsibility for oversight in performing its functions. The delegation may encompass both decisionmaking and non-decisionmaking functions.

d. Duty of care standards as applied to business judgments. In order to protect directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and to avoid the risk of stifling innovation and venturesome business activity, § 4.01(c) particularizes how the duty of care concept, as expressed in statutes, cases, and § 4.01(a), should be applied to business judgments. The business judgment rule (set forth in § 4.01(c)) is a judicial gloss on duty of care standards that sharply reduces exposure to liability. See Comment *f* to § 4.01(c). See Comment *e* below with respect to the scope of protection the business judgment rule provides for transactions in which the decisionmaker's judgment meets the standards of § 4.01(c).

If a director or officer acts in good faith and in accordance with § 4.01(c)(1) and (2) with respect to a business judgment, the standard in § 4.01(c)(3) will provide insulation from liability unless the director or officer does not rationally believe that the business judgment is in the best interests of the corporation. This standard

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is intended to provide directors and officers with a wide ambit of discretion. It is recognized that the word "rational," which is widely used by courts, has a close etymological tie to the word "reasonable" and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable," and to give a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonable" but are not so removed from the realm of reason when made that liability should be incurred. Stated another way, the judgment of a director or officer will pass muster under § 4.01(c)(3) if the director or officer believes it to be in the best interests of the corporation and that belief is rational. See Comment *f* to § 4.01(c).

In summary, the duty of care provisions in Subsection (a) of § 4.01 interact with the business judgment rule in Subsection (c) in the following ways: If a director or officer has complied with the business judgment criteria set forth in § 4.01(c) with respect to a business judgment, the director or officer will be free of liability under § 4.01. If, however, a challenging party can sustain the burden of proving that a director or officer was not acting in good faith or with disinterest (in accordance with the standard of § 4.01(c)(1)) or was not informed (in accordance with the standard of § 4.01(c)(2)) with respect to a business judgment, then the safe harbor provided by § 4.01(c) will not be available, and the director or officer will be judged under the duty of care standards set forth in § 4.01(a) or the standards set forth in Part V. For example, the liability of an interested [§ 1.23] director or officer in connection with a transaction entered into with the corporation will be judged under the standards set forth in § 5.02. See Comment *d* to § 4.01(c). Finally, if a challenging party can sustain the burden of proving that a director or officer did not actually believe, or did not rationally believe, that a business judgment was in the best interests of the corporation (§ 4.01(c)(3)), then the protection provided by § 4.01(c) would again not be available. A director or officer who has made a decision with a belief that lacks rationality will also have failed to meet the higher standard set forth in the first paragraph of § 4.01(a), namely, the obligation to make a decision in a "manner that he or she reasonably believes to be in the best interests of the corporation." Thus, the director's or officer's duty of care will not have been met. This follows from the fact that the "rationally believes" test provides a significantly wider range of discretion than the "reasonably believes" test.

In any event, no liability for damages will occur unless a challenging party also sustains the burden of proving that a breach of duty of care standards was the legal cause of loss to the corporation. See §§ 4.01(d), 7.18.

e. Application of § 4.01 to enjoining or setting aside an action or transaction. Part IV addresses factual situations in which a finding that a breach of the duty of care has occurred could lead to the imposition of various kinds of remedies. Among those remedies could be an injunction preventing the consummation of a transaction or equitable relief setting aside a transaction. Section 4.01 deals with standards of care for purposes of determining whether these remedies are potentially available against directors and officers, just as it deals with standards of care for purposes of determining whether monetary damages may be imposed.

Normally an effort to enjoin a pending transaction, or to set aside a consummated transaction, not involving a conflict of interest such as an interested director's transaction (Part V) or a transaction in control (Part VI), will involve Subsection (c), since any corporate transaction of importance is likely to have taken place as a consequence of an exercise of business judgment. The substantive issue would be whether the corporate decisionmaker has met the standards of § 4.01(c). However, a different substantive standard for injunctive relief would be applicable in certain cases involving conflicts of interest or transactions in control (see, e.g., §§ 5.02 and 6.02).

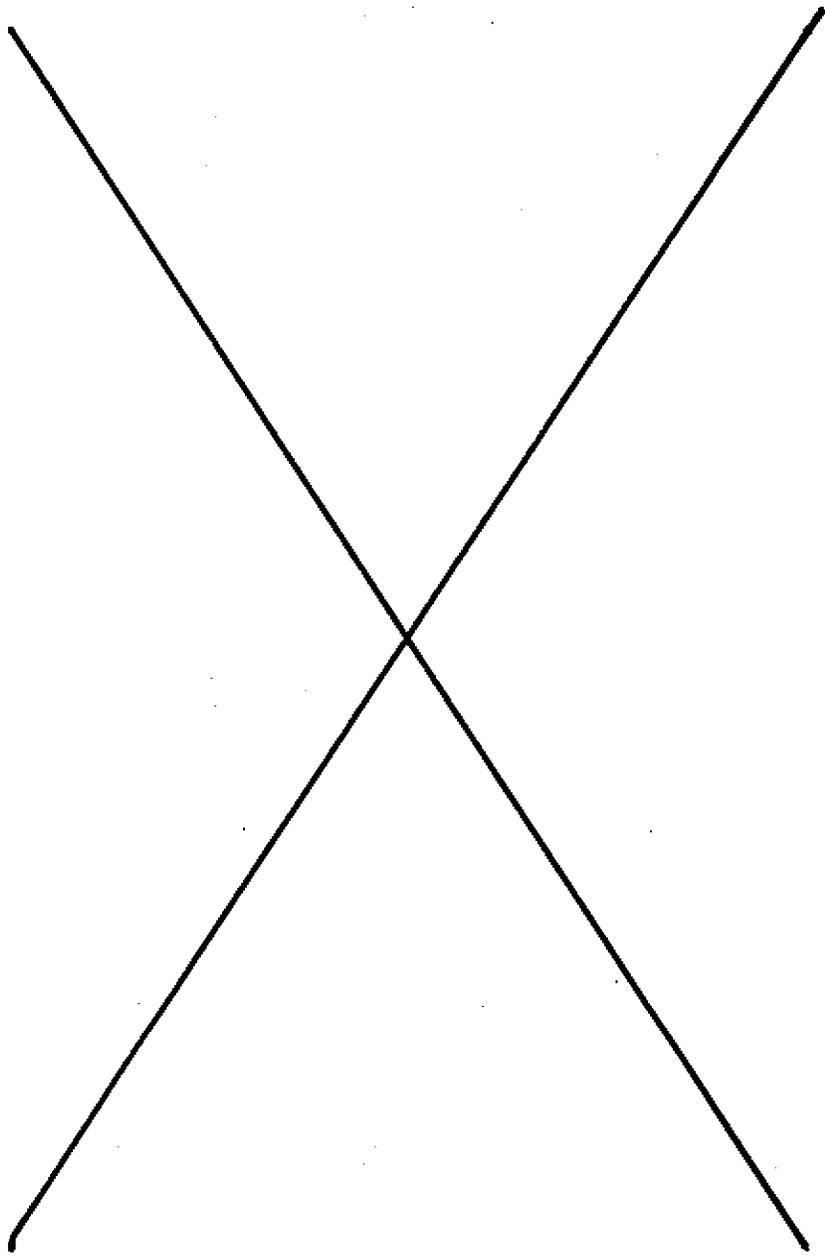
f. Application to third parties. The duty of care standards set forth in § 4.01 involve duties owed directly to the corporation. It should be emphasized that § 4.01 is not intended to create new third-party rights (e.g., for tort claimants or government agencies) against directors or officers. The standards set forth in Part IV apply only to relationships among directors, officers, shareholders, and their corporations.

g. Burden of proof. Under § 4.01, a person challenging the conduct of a director or officer has the burden of proving the failure of the director or officer to comply with the duty of care obligations under Subsection (a) and the inapplicability of the provisions concerning the fulfillment of duty under Subsection (b) or (c). The safe harbor provided by the business judgment rule in Subsection (c) may be inapplicable, for example, because a director was not informed in accordance with the standard of § 4.01(c)(2) or did not have a rational belief that a business judgment was in the best interests of the corporation.

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Courts, when applying the business judgment rule, have often stated that a "presumption" exists in favor of the propriety or regularity of the actions of directors and officers. This correctly signifies that no inference of dereliction of duty can or should be drawn, for example, from the fact that a corporation has suffered a business reversal. These Principles agree with the observation that directors and officers generally act properly. Section 4.01 does not use the word "presumption," which is imprecise and subject to misinterpretation, because, for example, the concept might be misinterpreted so that it is thought to be irrebuttable or to establish a special evidentiary standard. Section 4.01 does, however, specifically recognize the general propriety of actions by directors and officers (including, in the case of the business judgment rule, an assumption that the directors or officers acted on an informed basis and met the other prerequisites of § 4.01(c)) by placing the burden of proof on persons challenging conduct under this Section. See Comment *a* to § 4.01(d).

h. Use of the term "reasonable care." For convenience, the standards of care set forth in § 4.01(a) are sometimes referred to herein as "reasonable care" standards or it is stated that a director or officer must use "reasonable care." However, the use of this term, which serves the law applicable to many fields of human conduct and behavior, is not intended to minimize the special characteristics of service as a director or officer of a business corporation. See Comments *b*, *e*, *g*, and *h* to § 4.01(a), first paragraph. The application of duty of care standards is not only heavily fact oriented, but is also shaped by evidence of what can reasonably be expected of directors and officers in the context of the functioning of the modern corporation. The duty of care standards applicable to directors and officers, as set forth in § 4.01(a), should be interpreted in the light of the commentary in Part IV. In the sense that there are the special characteristics referred to above, the term "reasonable care," as used herein, could also be referred to as "requisite care."



Comment to § 4.01(c):

“... (c) 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 [§ 1.23] 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."

a. Comparison with present law. There are no statutory formulations of the business judgment rule. The business judgment rule has been developed by courts and is well established in the case law. Judicial formulations of the rule have varied. The formulation of the business judgment rule set forth in § 4.01(c) is believed to be consistent with present law as it would be interpreted in most jurisdictions today, and each of the rule's basic elements (§ 4.01(c)(1)-(3)) is supported by substantial precedential authority.

Although courts have not expressed it this way, the business judgment rule has offered a safe harbor for directors or officers who make honest, informed business decisions that they rationally believe are in the best interests of their corporations. Section 4.01(c) articulates this safe harbor concept. The business judgment rule has often been stated as a "presumption" that directors or officers have acted properly. Subsections (c) and (d) of § 4.01, by placing the burden of proof on persons challenging a business judgment, also assume that directors or officers have acted properly. See Comment *a* to § 4.01(d).

Confusion with respect to the business judgment rule has been created by the numerous varying formulations of the rule and the fact that courts have often stated the rule incompletely or with elliptical shorthand references. The relatively precise formulation of the business judgment rule set forth in § 4.01(c) avoids confusion and helps cover the myriad factual contexts in which business judgment issues arise.

b. Scope of coverage. The business judgment rule set forth in § 4.01(c), insofar as it shields directors and officers from personal liability, is intended to cover most of the different kinds of judgments that are made by directors and officers. For areas of inapplicability, see, e.g., Comment *e* to § 4.01; Comment *d* to § 4.01(a), first paragraph; Part V; § 6.02; and § 7.10. Most business judgment cases deal with "risky" or "economic" decisions, which, of course, are the type that most often come before courts. There are, however, cases that apply the business judgment rule to such matters as compensation and the termination of litigation. Part IV does not limit the application of the business judgment rule to "risky" or "economic" decisions, but instead—for reasons of policy and practicality (see the Introductory Note to Part IV)—also

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affords protection to directors and officers who make a wide variety of decisions running from the selection and removal of personnel, through the setting of strategic and policy goals, to the apportionment of responsibilities between the board and senior executives. See Comment *g* to § 4.01(a), first paragraph.

For example, § 3.02(a)(3) provides that the board need only review and, where appropriate, approve major corporate actions. Sections 3.01 and 3.02, 4.01(b), 4.02, and 4.03 provide the board with broad discretion to delegate and rely. If the board decides to delegate to senior executives responsibility for deciding what corporate actions are major, this decision, if made in accordance with § 4.01(c)(1)-(3), will be protected by the business judgment rule. See Comment *b* to § 4.01(b). The directors will be entitled to rely on the performance of the senior executives with respect to identifying "major" actions if the directors act in accordance with §§ 4.01(b) and 4.02.

Similarly, various "preparatory decisions" to the making of a business decision would also be protected by the business judgment rule. For example, a decision not to seek outside engineering or scientific advice (or, conversely, to seek such advice) in evaluating a new product or project, if made in accordance with § 4.01(c)(1)-(3), would be protected by the business judgment rule.

The "good faith" limitation on the applicability of the business judgment rule to knowing decisions that cause a corporation to violate the law is discussed in Comment *d* to § 4.01(a), first paragraph. The applicability of the business judgment rule to duty of loyalty issues is considered in Part V. The applicability of the business judgment rule to decisions made by directors and officers during hostile takeover attempts or involving other "transactions in control" is considered in Part VI. Issues related to the settlement or termination of shareholder derivative actions are considered in Part VII.

c. Prerequisite of a conscious exercise of judgment. Section 4.01(c) affords protection only to a "business judgment." This means that to be afforded protection a decision must have been consciously made and judgment must, in fact, have been exercised. For efficiency reasons, corporate decisionmakers should be permitted to act decisively and with relative freedom from a judge's or jury's subsequent second-guessing. It is desirable to encourage directors and officers to enter new markets, develop new products, innovate, and take other business risks.

There is, however, no reason to provide special protection where no business decisionmaking is to be found. If, for example,

directors have failed to oversee the conduct of the corporation's business (§ 3.02(a)(2)) by not even considering the need for an effective audit process, and this permits an executive to abscond with corporate funds, business judgment rule protection would be manifestly undesirable. The same would be true where a director received but did not read basic financial information, over a period of time, and thus allowed his corporation to be looted. Cf. *Hoye v. Meek*, 795 F.2d 893 (10th Cir.1986); *DePinto v. Provident Security Life Insur. Co.*, 374 F.2d 37 (9th Cir.), cert. denied, 389 U.S. 822, 88 S.Ct. 48, 19 L.Ed.2d 74 (1967); *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (Sup. Ct. 1981). In these and other "omission" situations, the director or officer would be judged under the reasonable care standards of § 4.01(a) and not protected by § 4.01(c). See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 813 (Del.1984) ("the business judgment rule operates only in the context of director action. . . . [I]t has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."); *Arsht, The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 112 (1979); *Block & Prussin, The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 Bus. Law. 27, 33 (1981) ("The [business judgment] rule does not apply where the director has in fact made no decision").

Of course, whether there has been a conscious decision or inexcusable inattentiveness may, at times, not be readily discernible and may present close evidentiary questions. For example, in what might appear at first glance to be an "omission" situation, the directors might actually have carefully marshaled relevant information, appraised the risks, and then decided (with a rational belief) not to install a particular antitrust compliance program or a computer security program. In that event, assuming that they acted in good faith and were disinterested, the safe harbor provided by the business judgment rule would be available. Similarly, informed directors might have concluded that the effectiveness of a particular procedure or program need only be reviewed once every two years, and if they rationally believed that their decision was in the best interests of the corporation, the safe harbor provided by § 4.01(c) would again be available. It would, of course, also be possible to delegate authority for designing and overseeing the effectiveness of a particular program or procedure to corporate officers or a committee of the board, and the directors who made a decision to delegate authority would, if the decision was made in accordance with § 4.01(c)(1)-(3), be protected by the business judgment rule. See §§ 3.01 and 3.02, 4.01(b), 4.02, and 4.03.

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It is important to recognize that a business decision may involve a judgment either to act or to abstain from action. If the prerequisites of § 4.01(c) are met, the board of directors of a major computer manufacturer could, for example, decide to invest heavily, or abstain from investing, in a potentially profitable new computer product, and in either instance, the business judgment rule would be applicable.

Many decisions will involve a number of subsidiary issues. For example, the board's approval of a major commitment of corporate resources for a new product line might involve subsidiary issues with respect to the cost of new plants, the availability of skilled employees, the effectiveness of channels of distribution, and the quality of competitive products. The prerequisite in § 4.01(c) that there be an exercise of judgment does not require directors to focus collectively on each of these subsidiary issues. No burdensome "formal paper record" need be made. Section 4.01(c) simply requires that, in general, the directors become informed (in accordance with the standard of § 4.01(c)(2)) about this major commitment and then consciously reach a decision with regard to the overall issue. Reliance on written reports, opinions, and statements of officers and employees of the corporation (and of other persons) will, of course, often be both necessary and desirable. See §§ 4.01(b), 4.02, and 4.03.

In summary, as the court in *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del.Ch.1971), put it:

Application of the [business judgment] rule of necessity depends upon a showing that informed directors did, in fact, make a business judgment authorizing the transaction under review.... [It must be shown] that director judgment was brought to bear with specificity on the transactions.

d. Prerequisites of good faith and no interest. It is well settled that good faith and disinterested decisionmaking are prerequisites to entry into the business judgment rule's safe harbor. See, e.g., *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir.1980); *Lewis v. S.L. & E., Inc.*, 629 F.2d 764, 769 (2d Cir.1980) ("The business judgment rule presupposes that the directors have no conflict of interest."); Reporter's Note 2.

The obligations of directors and officers (e.g., as to required disclosure) and the standard under which their transactions are to be judged may be significantly different if there is a conflict between the personal interests of directors and officers and their corporation's welfare. For example, as the Second Circuit indicated in the *Treadway* case, once a person challenging the conduct of a

director has met the burden of proving the inapplicability of the business judgment rule because the director is interested, then the "burden shifts to the director to prove that the transaction was fair and reasonable to the corporation." 638 F.2d at 382.

The legal rules for transactions involving the duty of fair dealing and for conduct invoking fair dealing principles, are set forth in Part V. Except as expressly provided in Part V, the business judgment rule is inapplicable to matters where a conflict of interest exists.

The "good faith" limitation on the applicability of the business judgment rule to knowing decisions to cause a corporation to violate the law is discussed in Comment *d* to § 4.01(a), first paragraph.

e. Prerequisite of an informed decision. The great weight of case law and commentator authority supports the proposition that an informed decision (made, for example, on the basis of explanatory information presented to the board) is a prerequisite to the legal insulation afforded by the business judgment rule. In a much quoted statement, the court in *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944), observed: "When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised." See *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir.1980) (citing the *Woodruff* statement with approval). Professor Ballantine concluded: "[I]t is presupposed in this 'business judgment rule' that reasonable diligence and care have been exercised." H. Ballantine, *Law of Corporations* § 63a at 161 (rev. ed. 1946); see, e.g., *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274-75 (2d Cir.1986); *Fitzpatrick v. FDIC*, 765 F.2d 569, 576-77 (6th Cir.1985); *Joy v. North*, 692 F.2d 880, 886, 896 (2d Cir.1982), cert. denied, 460 U.S. 1051, 103 S.Ct. 1498, 75 L.Ed.2d 930 (1983); *Arsht, The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 111 (1979) (the business judgment rule should not be available to directors who do "not exercise due care to ascertain the relevant and available facts before voting"); cf. *Smith v. Van Gorkom*, 488 A.2d 858 (Del.1985) (requiring directors to inform "themselves 'prior to making a business decision, of all material information reasonably available to them,' " but applying a "gross negligence" test in determining whether a business judgment was "an informed one").

The informed decision prerequisite in § 4.01(c)(2) focuses on the preparedness of a director or officer in making a business decision as opposed to the quality of the decision itself. Fundamental to an understanding of the standard set forth in § 4.01(c) is the recogni-

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tion that the extent of the information required is that which the director or officer "reasonably believes to be appropriate under the circumstance." Here, as elsewhere in Part IV, the term "reasonably believes" has both an objective and a subjective content. See Comment *b* to § 4.01(a)(1)-(a)(2). In evaluating what is a reasonable belief in a particular situation, the "informed" requirement in § 4.01(c)(2) should be interpreted realistically and with an appreciation of the factual context in which the business judgment was made.

Some business decisions must be made under severe time pressure while others afford time for the orderly marshaling of material information. Section 4.01(c)(2) permits a director or officer to take into account the time that is realistically available in deciding the extent to which he or she should be informed. The time realistically available may compel risk taking, which includes the risk of not having all relevant facts concerning a proposed transaction as well as the risks related to the economic consequences of the transaction itself. A decision to accept the risk of incomplete information, so long as the director reasonably believes such informational risk taking to be appropriate under the circumstances, will be fully consistent with the application of the business judgment rule to decisions made with respect to the principal transaction. See Illustration 1 to § 4.01(c).

There is no precise way to measure how much information will be required to meet the "reasonable belief" test in given circumstances. Among the factors that may have to be taken into account in judging a director's reasonable belief as to what was "appropriate under the circumstances" are: (i) the importance of the business judgment to be made; (ii) the time available for obtaining information; (iii) the costs related to obtaining information; (iv) the director's confidence in those who explored a matter and those making presentations; and (v) the state of the corporation's business at the time and the nature of competing demands for the board's attention. The different backgrounds of individual directors, the distinct role each plays in the corporation, and the general value of maintaining board cohesiveness may all be relevant when determining whether a director acted "reasonably" in believing that the information before him or her was "appropriate under the circumstances."

Of course, the business or professional experience of directors or officers may help to inform them about a decision. They may also be informed by the general views or specialized experience of colleagues. Reliance on reports, representations, statements, and opinions prepared by officers and employees of the corporation and

by outside professionals and experts will often be necessary and will, in many situations, satisfy the informational requirement of § 4.01(c)(2). See §§ 4.01(b), 4.02, and 4.03. In other circumstances, however, further inquiry may be required. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del.1985) ("the directors were duty bound to make reasonable inquiry"). For an amplification of the "inquiry" concept, see Comment *b* to § 4.01(a)(1)-(a)(2). Illustrations 1, 2, and 6 in Comment *f* to § 4.01(c) are intended to indicate that business judgments must often be made on the basis of imperfect information and that a director's or officer's reasonable judgment as to how much information was "appropriate under the circumstances" should not be unfairly second-guessed.

f. The "rationally believes" requirement. If the requirements of "good faith" and § 4.01(c)(1)-(c)(2) are met, § 4.01(c)(3) will protect a director or officer from liability for a business judgment if the director or officer "rationally believes that the business judgment is in the best interests of the corporation." The term "rationally believes" has both an objective and a subjective content. A director or officer must actually believe that the business judgment is in the best interests of the corporation and that belief must be rational. This "rationally believes" test is the basis of the legal insulation provided by the formulation of the business judgment rule in Subsection (c). The same approach to providing legal protection to business judgments is found in a line of cases decided under Delaware law. See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir.1981) (courts will not disturb a business judgment if "any rational business purpose can be attributed" to a director's decision); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del.1985) ("any rational business purpose" test); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del.1971) ("rational business purpose" test). Compare *In re RJR Nabisco, Inc. Shareholders Litigation*, 556 A.2d 1070 n.13 (Del.Ch.1989) ("As I conceptualize the matter, such limited substantive review as the rule contemplates (i.e., is the judgment under review 'egregious' or 'irrational' or 'so beyond reason,' etc.) really is a way of inferring bad faith").

There have been varying approaches taken in the cases and by commentators to the proper standard for judicial review of business judgments. Some courts have stated that a director's or officer's business judgment must be "reasonable" to be upheld. See, e.g., *Meyers v. Moody*, 693 F.2d 1196, 1211 (5th Cir.1982); *McDonnell v. American Leduc Petroleum, Ltd.*, 491 F.2d 380, 384 (2d Cir.1974) (the Court, applying California law, concluded that the "business judgment rule protects only reasonable acts of a director or officer"). Similarly, the *Corporate Director's Guidebook* (p. 1604)

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speaks of the business judgment rule applying only to a director who acts "with a reasonable basis for believing that the action was in the lawful and legitimate furtherance of the corporation's purposes." On the other hand, a few cases have simply said that a director's or officer's judgment would be upheld if made with disinterest, in an informed manner, and in good faith. Both a "reasonableness" test and the "good faith alone" approach have been rejected in § 4.01(c), for the reasons expressed below.

Sound public policy dictates that directors and officers be given greater protection than courts and commentators using a "reasonableness" test would afford. Indeed, some courts and commentators, even when using a "reasonableness" test, have expressly indicated that they do not intend that business judgments be given the rigorous review that the word "reasonable" may be read to imply. In *Cramer v. General Tel. & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir.1978), cert. denied, 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979), for example, the Court used the word "reasonable," but concluded that directors' judgments must be "so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion" before the business judgment rule would become inapplicable. See *Corporate Director's Guidebook* (p. 1604).

The "rationally believes" standard set forth in § 4.01(c)(3) is intended to afford directors and officers wide latitude when making business decisions that meet the other prerequisites of Subsection (c). See Comment *d* to § 4.01. The approach taken in Subsection (c)(3) is consistent with the large majority of business judgment cases and with sound public policy. Many courts have used words like "reckless disregard" or "recklessness" to convey a similar sense of the wide latitude that directors or officers should be afforded. See Reporter's Note 4 to § 4.01(c). Delaware case law has been summarized as follows:

[A] court will interfere with the discretion vested in the board of directors upon a finding that the judgment of the directors was arbitrary, resulted from a reckless disregard of the corporation's and its stockholders' best interests, or is simply so removed from the realm of reason that it cannot be sustained.

Arsht & Hinsey, *Codified Standard—Same Harbor but Charted Channel: A Response*, 35 Bus. Law. ix, xxii (1980). See *Rabkin v. Philip A. Hunt Chemical Corp.*, 547 A.2d 963, 970 (Del.Ch.1986) ("Gross negligence is the standard to be applied in deciding ... whether the directors may be held liable for reaching the wrong decision [citing *Smith v. Van Gorkom*]. . . . In the corporate area,

gross negligence would appear to mean, 'reckless indifference to or a deliberate disregard of the stockholders' ... or actions which are 'without the bounds of reason'").

On the other hand, courts that have articulated only a "good faith" test may, depending on the court's meaning, provide too much legal insulation for directors and officers. A "good faith" test could be interpreted broadly to achieve the same result as the "rationally believes" standard. For example, in *Sam Wong & Son v. New York Mercantile Exchange*, 735 F.2d 653, 671, 678 n.32 (2d Cir.1984), Judge Friendly held that the rationality of a decision by the Board of Governors of the Mercantile Exchange was relevant in determining whether the Board had acted in good faith, and concluded that "[a]bsent some basis in reason, action could hardly be in good faith even apart from ulterior motive." See also *In re RJR Nabisco, Inc. Shareholders Litigation*, 556 A.2d 1070 n.13 (Del.Ch. 1989). Serious problems arise, however, if the phrase "good faith" is interpreted narrowly to mean only the absence of subjective "bad motives." There is no reason to insulate an objectively irrational business decision—one so removed from the realm of reason that it should not be sustained—solely on the basis that it was made in subjective good faith. The weight of authority and wise public policy favor barring from the safe harbor of § 4.01(c) directors and officers who do not believe, or do not *rationaly* believe, that their business judgments are in the best interests of the corporation. See Reporter's Note hereto. The need for clarity, certainty, and effective legal counseling also point to the advantage of clearly setting forth the "rationally believes" standard.

Under § 4.01, directors and officers have continuing obligations to act in the best interests of the corporation and to use reasonable care. Thus, if circumstances change so that a decision that was once a proper business judgment would, if made again in the current context, lack a rational basis, then the protection of the business judgment rule would not be available to a repetition of the same decision. Similarly, if circumstances change materially and a director or officer knows, or reasonably should know (within the scope of his or her oversight obligations), of these changed circumstances and is still in a position to change or modify a prior decision, then the protection of the business judgment rule would not be available if he or she makes a judgment not to change course and this judgment cannot pass muster under the "rationally believes" test. See Comment *d* to § 4.01.

Illustrations:

1. The board of X Corporation has to decide whether to make a tender offer for the shares of Y Corporation. X

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Corporation is approximately five times larger than Y Corporation. The shares of Y Corporation have traded in a range of \$32 to \$42 per share during the past year and are trading at \$39 per share now. Z Corporation has already made an offer for Y Corporation's shares at \$48 per share and the shareholders of Y must accept or reject this offer in two days. Just two days ago, the directors of Y Corporation told the officers of X Corporation that they considered a possible acquisition by X far more desirable than the offer from Z Corporation. The directors of Y Corporation own seven percent of Y's shares and are prepared to urge Y shareholders to accept X Corporation's offer.

X Corporation's officers have recommended to the board that X Corporation make an offer of \$49 per share for Y Corporation's shares. The officers' recommendation is based on an evaluation of Y Corporation's main product lines and of economies of scale they believe can be achieved in manufacturing and distribution if X and Y are combined. The officers of X concede, however, that they have not had time adequately to evaluate Y Corporation's research and development program and several other significant aspects of its business. Nevertheless, on balance, they believe that they know enough about Y Corporation's business to recommend that an offer be made. After presentations (by officers of X Corporation and outside financial consultants), questions, and discussion, the board of X Corporation authorizes the \$49 per share offer for Y's shares.

Whether or not the acquisition turns out successfully, X's directors will be protected by the business judgment rule. On the facts stated, X's directors acted reasonably in believing that they were informed to the extent appropriate under the circumstances. See § 4.01(c)(2). In this regard, the directors listened to presentations, asked questions, and considered each other's views. Although in a world of perfect information evaluations would have been made of Y Corporation's research and development program, and all other significant aspects of its business, this was not possible in the limited time in which X's decision had to be made. The need to make judgments with only imperfect information available, and other elements of risk taking, are often inherent in business decisionmaking. The evaluations of Y's main product lines, the economies of scale potentially to be achieved by a combination of X and Y, and Z Corporation's offer of an almost equivalent price per share, indicate that a person seeking to impose liability on X Corporation's directors because of their decision would not have sus-

tained the burden of proving that the directors did not rationally believe that their business judgment was in the best interests of X Corporation. See § 4.01(c)(3). Of course, the directors of X Corporation also could have decided not to make an offer for Y Corporation's shares, and this judgment too would have been proper under the "rationally believes" test. The "rationally believes" test is intended to afford directors and officers very broad discretion in making business judgments.

2. D, a senior executive [§ 1.33] of Z Corporation who is responsible for the purchasing of commodities, has just finished analyzing a complex set of actions by the government of Nation K. D believes that these actions will drastically reduce the availability of commodity Q and that the market for commodity Q is already reacting to the governmental actions. D, calling upon her experience and intuition, concludes that the price at which commodity Q is being offered is still favorable compared to the higher price expected in a matter of hours and, exercising authority previously delegated to D by the board, purchases for Z Corporation several million dollars worth of commodity Q. These purchases will cover Z Corporation's needs for commodity Q for a nine-month period. Assuming that D acted in good faith and was not interested (see § 4.01(c)(1)), D will be insulated from liability by the business judgment rule even if the purchases of commodity Q turn out badly. D was informed with respect to the subject of the business judgment to the extent D reasonably believed to be appropriate under the circumstances (§ 4.01(c)(2)), and the reliance on D's own experience and business intuition to gauge the likely movement in the price of commodity Q provided a proper basis for the business judgment under the "rationally believes" test. The same analysis would be made if D were a director who approved the purchase, rather than a senior executive.

3. The facts being otherwise as stated in Illustration 2, the members of the board of Z Corporation have been sued because the purchases of commodity Q have led to a substantial loss. It turned out that D's analysis of the likely impact of the actions of the government of Nation K was far too pessimistic and the production of commodity Q by nations other than Nation K was far higher than expected. The members of the board of Z Corporation will be protected by the business judgment rule. Although § 3.02(a)(3) states that the board should review and, where appropriate, approve major corporate actions, the board has broad discretion under the business

§ 4.01 PRINCIPLES OF CORPORATE GOVERNANCE Pt. IV

judgment rule both to decide which actions are "major" and to delegate decisionmaking authority in appropriate circumstances. On the facts given, Z Corporation's board appears to have a proper basis under the "rationally believes" test for concluding that commodity purchases of the type made should be delegated to a senior executive who is knowledgeable and able to act quickly.

4. The facts being otherwise as stated in Illustration 2, D is sued because of her failure to get an opinion from E, an expert on commodity Q who is a paid consultant to Z Corporation, before making the purchases in question. If D rationally believed that consulting E would not be in the best interests of Z Corporation (for example, because of added expense, loss of time, or limited confidence in E), D will not be liable. The decision not to seek an expert's advice is within the scope of the business judgment rule (see Comment *b* to § 4.01(c)).

5. A Corporation requires large quantities of ball bearings in its manufacturing process. It can buy ball bearings of precisely equal quality from Supplier B or Supplier C, but Supplier C will charge 30 percent more per unit than Supplier B. Supplier C is owned by an alumnus of the same university which was attended by most of the directors of A Corporation. Solely because they wish to favor a fellow alumnus, and with no expectation of reciprocal business or other collateral benefits to A Corporation, the board of A Corporation approves a three-year exclusive supply contract with Supplier C. On these facts, a person seeking to impose liability on the directors of A Corporation because of their decision would be able to sustain the burden of proving that the directors did not rationally believe that their decision was in the best interests of A Corporation. The protection afforded by the business judgment rule would not be available to the directors of A Corporation. See Comment *d* to § 4.01.

6. P Corporation has engaged for a number of years in the manufacture and sale of a single patented device, but its patent has recently been declared invalid in a final court judgment. P Corporation's officers have concluded that the competition anticipated as a result of the judgment will shortly render manufacture and sale of the device unprofitable. P Corporation's research and development staff has developed a new product which appears to have consumer acceptance based on very limited market testing. However, the product will not be profitable unless it can be produced and sold promptly and in large quantities. Production in large quantities would re-

quire a very substantial capital expenditure and much of this investment would be lost if the new product fails. Based on the information available to it, the board of directors of P Corporation may exercise its business judgment to authorize the necessary capital expenditure. The decision is proper under the "rationally believes" test even though there is a high degree of risk and uncertainty whether the new product will succeed, and the directors are protected under § 4.01(c).

REPORTER'S NOTE

1. For general support of the proposition in Comment *a* that each of the basic elements in § 4.01(c)'s black letter formulation is supported by substantial precedential authority, see, e.g., *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274-75 (2d Cir.1986); *Fitzpatrick v. FDIC*, 765 F.2d 569, 576-77 (6th Cir.1985); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir.), cert. denied, 454 U.S. 1092, 102 S.Ct. 658, 70 L.Ed.2d 631 (1981); *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 382-84 (2d Cir.1980); *Abbey v. Control Data Corp.*, 603 F.2d 724, 728-30 (8th Cir.1979), cert. denied, 444 U.S. 1017, 100 S.Ct. 670, 62 L.Ed.2d 647 (1980); *Cramer v. General Tel. & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir.1978), cert. denied, 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979); *Smith v. Van Gorkom*, 488 A.2d 858 (Del.1985); H. Henn & J. Alexander, *Law of Corporations* § 242 (3d ed. 1983); *Arsht & Hinsey, Codified Standard—Same Harbor but Charted Channel: A Response*, 35 *Bus. Law.* ix, xx-xxiv (1980); *Arsht, The Business Judgment Rule Revisited*, 8 *Hofstra L. Rev.* 93 (1979); *Corporate Director's Guidebook* (pp. 1603-04).

2. For support of the proposition in Comment *d* that good faith and

disinterestedness are prerequisites to the use of the business judgment rule see, e.g., *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 380-83 (2d Cir.1980); *Lewis v. S.L. & E., Inc.*, 629 F.2d 764, 768-69 (2d Cir.1980); *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944); N. Lattin, *The Law of Corporations* § 78 at 273 (2d ed. 1971).

3. For authorities in support of the proposition in Comment *e* that a director or officer must be informed with respect to the subject of a business judgment to be afforded the legal insulation provided by the business judgment rule, see, e.g., *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274-75 (2d Cir.1986); *Fitzpatrick v. FDIC*, 765 F.2d 569, 576-77 (6th Cir.1985); *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980); *Schein v. Caesar's World, Inc.*, 491 F.2d 17, 18 (5th Cir.), cert. denied, 419 U.S. 838, 95 S.Ct. 67, 42 L.Ed.2d 65 (1974) (applying Florida law); *Evans v. Armour & Co.*, 241 F.Supp. 705, 713 (E.D.Pa.1965) (applying Pennsylvania law); *Casey v. Woodruff*, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944); 3A W. Fletcher, *Cyclopedia of Corporations* §§ 1039-1040 (perm. ed. 1986 & Supp. 1990); H. Henn & J. Alexander, *Law of Corporations* § 234 at

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662 (3d ed. 1983); Arsht & Hinsey, *Codified Standard—Same Harbor but Charted Channel: A Response*, 35 *Bus. Law.* ix, xxiv (1980); Arsht, *The Business Judgment Rule Revisited*, 8 *Hofstra L. Rev.* 93, 119-21 (1979); cf. *Smith v. Van Gorkom*, 488 A.2d 858 (Del.1985); *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984).

4. For support of the proposition stated in Comment *f* that the large majority of business judgment cases have afforded broader protection to directors and officers than a "reasonableness" test would provide, see, e.g., *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir.1986); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir.), cert. denied, 454 U.S. 1092, 102 S.Ct. 658, 70 L.Ed.2d 631 (1981); *Abbey v. Control Data Corp.*, 603 F.2d 724, 728-30 (8th Cir. 1979), cert. denied, 444 U.S. 1017, 100 S.Ct. 670, 62 L.Ed.2d 647 (1980); *Cramer v. General Tel. & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), cert. denied, 439 U.S. 1129, 99 S.Ct. 1048, 59 L.Ed.2d 90 (1979) ("so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion"); *Whittaker Corp. v. Edgar*, 535 F.Supp. 933 (N.D.Ill.1982); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del.1985) ("any rational business purpose" test); *Smith v. Van Gorkom*, 488 A.2d 858 (Del.1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del.1984) ("business judgment rule director liability is predicated upon concepts of gross negligence"); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del.1971) ("rational business purpose" test); *Warshaw v. Calhoun*, 43 Del.Ch. 148, 157-58, 221 A.2d 487, 492-93

(Sup. Ct. 1966) ("bad faith" or "gross abuse of discretion"); *In re RJR Nabisco, Inc. Shareholders Litigation*, 556 A.2d 1070 n.13 (Del.Ch. 1989); *Rabkin v. Philip A. Hunt Chemical Corp.*, 547 A.2d 963, 970 (Del.Ch.1986) ("In the corporate area, gross negligence would appear to mean, 'reckless indifference to or a deliberate disregard of the stockholders' ... or actions which are 'without the bounds of reason'"); *Appeal of Spering*, 71 Pa. 11 (1872) (unless "so gross as to appear absurd"); Arsht & Hinsey, *Codified Standard—Same Harbor but Charted Channel: A Response*, 35 *Bus. Law.* ix, xx-xxiv (1980) and citations contained therein; Arsht, *The Business Judgment Rule Revisited*, 8 *Hofstra L. Rev.* 93 (1979). But see *Meyers v. Moody*, 693 F.2d 1196 (5th Cir.1982), cert. denied, 464 U.S. 920, 104 S.Ct. 287, 78 L.Ed.2d 264 (1983); cf. *McDonnell v. American Leduc Petroleum, Ltd.*, 491 F.2d 380, 384 (2d Cir.1974). For cases omitting reference to the terms "reasonableness" and "rationally believes" in setting forth business judgment criteria, see *Auerbach v. Bennett*, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994 (1979); *Kamin v. American Express Co.*, 86 Misc.2d 809, 383 N.Y.S.2d 807 (Sup. Ct.), aff'd, 54 A.D. 2d 654, 387 N.Y.S.2d 993 (1st Dept. 1976).

5. For citations in support of the proposition that the business judgment rule is applicable to officers as well as directors, see H. Henn & J. Alexander, *Law of Corporations* § 242 at 663 (3d ed. 1983); *Kaplan v. Centex Corp.*, 284 A.2d 119, 124 (Del.Ch.1971) ("the decision of executive officers may also come within the [business judgment] rule").

Comment to § 4.01(d):

"... (d) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care, including the inapplicability of the provisions as to the fulfillment of duty under Subsection (b) or (c), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation."

a. Comparison with present law and rationale. The black letter formulation set forth in Subsection (d) is believed to be generally consistent with the law as it would be interpreted in almost all jurisdictions today. A person challenging the conduct of a director or officer has the burden of proving the failure of the director or officer to comply with the duty of care obligations under Subsection (a) and the inapplicability of the provisions concerning the fulfillment of duty under Subsections (b) and (c).

The business judgment rule (Subsection (c)) has often been stated as a "presumption" that a director or officer has acted properly. See, e.g., *Grobow v. Perot*, 539 A.2d 180, 187 (Del. Sup. Ct. 1988). The word "presumption" is not used in § 4.01 because it is imprecise and subject to misinterpretation. The concept might, for example, be misinterpreted so that it is thought to be irrebuttable or to establish a special evidentiary standard. See Comment *g* to § 4.01. However, Subsections (c) and (d) should produce the same result as, for example, Delaware's "presumption" because § 4.01 assumes that directors and officers have acted on an informed basis and met the other prerequisites of Subsection (c) through placing both the burden of coming forward with evidence and the burden of persuading the trier of fact on those challenging a business judgment. See Comment *g* to § 4.01. Thus, Subsections (c) and (d) use the same approach as appears to be used in the courts of Delaware; namely, both assume that each of the prerequisites of the business judgment rule has been met by placing the burden of coming forward with evidence (for example, specific facts showing that directors were not properly informed) and the ultimate burden of persuasion on persons challenging the business judgment of a director or officer. As a practical matter, because the burden of proof is on a person challenging a business judgment under both formulations, a motion to dismiss or a motion for summary judgment should be treated the same way under § 4.01 and in states with "presumption" formulations similar to that of Delaware.

§ 4.01 PRINCIPLES OF CORPORATE GOVERNANCE Pt. IV

See § 7.18 for a detailed statement of the legal cause standards of these Principles.

REPORTER'S NOTE

1. For support of the proposition that the burden of proof of establishing a failure of a director's or officer's duty of care obligations is on the person challenging the conduct, see, e.g., *Hoye v. Meek*, 795 F.2d 893 (10th Cir.1986); *Anderson v. Akers*, 7 F.Supp. 924, 928 (W.D.Ky.1984), mod. sub nom., *Atherton v. Anderson*, 86 F.2d 518 (6th Cir.1936), mod. sub nom., *Anderson v. Atherton*, 302 U.S. 643, 58 S.Ct. 53, 82 L.Ed. 500 (1937); *Barnes v. Andrews*, 298 Fed. 614, 615-16 (S.D.N.Y.1924); *Spiegel v. Beacon Participations*, 297 Mass. 398, 411, 8 N.E.2d 895, 904 (1937); *Francis v. United Jersey Bank*, 87 N.J. 15, 39, 432 A.2d 814, 826 (Sup. Ct. 1981); *H. Henn & J. Alexander, Law of Corporations* § 234 at 625 (3d ed. 1983).

2. The business judgment rule has sometimes been expressed as a "presumption" in favor of the decisions of directors and officers and sometimes as a "defense." Under either characterization, courts have generally placed the burden on a plaintiff to prove the inapplicability of the business judgment rule. See, e.g., *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir.1980); *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del.1984); *Arsht, The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 130-33 (1979). In accord with precedent, and consistent with other Subsections of § 4.01, Subsection (d) places the burden of proof on a plaintiff to demonstrate that the special protection afforded by the business judgment rule is unavailable in a given case.

ANALYSIS AND RECOMMENDATION

§ 4.02 Reliance on Directors, Officers, Employees, Experts, and Other Persons

In performing his or her duties and functions, a director or officer who acts in good faith, and reasonably believes that reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other financial data), decisions, judgments, and performance (including decisions, judgments, and performance within the scope of § 4.01(b)) prepared, presented, made, or performed by:

(a) One or more directors, officers, or employees of the corporation, or of a business organization [§ 1.04] under joint control or common control [§ 1.08] with the corporation, who the director or officer reasonably believes merit confidence; or

DANIEL J. DYKSTRA

TELEPHONE (916) 752-3262

Law Revision Commission
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SCHOOL OF LAW
UNIVERSITY OF CALIFORNIA, DAVIS
DAVIS, CALIFORNIA 95616

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Dear Nat

Thank you very much for sending
me a copy of Prof Esentzug's study as
to whether the Business judgment rule
should be codified. I found it informative
and well done. Furthermore, I agreed
with his conclusion

Sincerely

Dan Dykstra

JUN 14 1995

CASWELL, BELL
HILLISON, BURNSIDE & GREER
ATTORNEYS AT LAW

File: _____

G. THOMAS CASWELL, JR.
JAMES M. BELL
ROBERT K. HILLISON
JAMES D. BURNSIDE, III
RUSSELL D. GREER
ROBERT A. WERTH
RANDOLF KRBECHER
BETH MAXWELL STRATTON

POST OFFICE BOX 5259
FRESNO, CALIFORNIA 93755-5259

AREA CODE 209
FACSIMILE 225-7912
TELEPHONE 225-6550

5200 NORTH PALM AVENUE
SUITE 211

W. RUSSELL HOSE
OF COUNSEL

FRESNO, CALIFORNIA 93704-2228

June 12, 1995

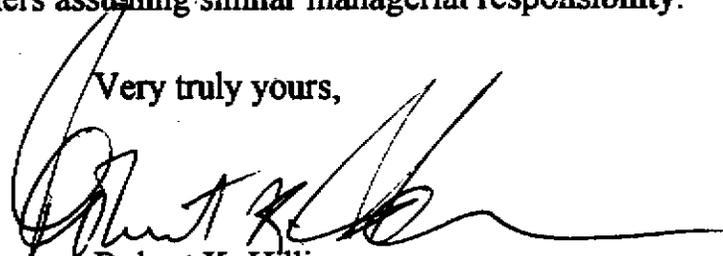
Professor Melvin A. Eisenberg
c/o California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, CA 94303-4739

Re: Study B-601
Whether the Business-Judgment Rule Should Be Codified

Dear Professor Eisenberg:

Please consider whether the California Law Revision Commission should recommend adding or amending (as applicable) statutes relating to partnerships (general and limited) and limited liability companies codifying the Business-Judgment Rule. In *Wylar v. Feuer* (1978) 85 Cal.App.3d 292, the court applied the Business-Judgment Rule to protect a general partner in a limited partnership. Given the variety of available business associations, it would seem that there should be no distinction between officers and directors of corporations and managing general partners or others assuming similar managerial responsibility.

Very truly yours,



Robert K. Hillison

RKH/ch

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

BACKGROUND STUDY

Whether the Business-Judgment Rule Should Be Codified

**Professor Melvin A. Eisenberg
School of Law
University of California, Berkeley**

May 1995

This background study was prepared for the California Law Revision Commission by Professor Melvin A. Eisenberg. No part of this background study may be published without prior written consent of the Commission.

The Law Revision Commission assumes no responsibility for any statement made in this background study, and no statement in this background study is to be attributed to the Commission. The Commission's action will be reflected in its own recommendation which will be separate and distinct from this background study. The Commission should not be considered as having made a recommendation on a particular subject until the final recommendation of the Commission on that subject has been submitted to the Legislature.

Copies of this background study are provided to interested persons solely for the purpose of giving the Law Revision Commission the benefit of their views, and the background study should not be used for any other purpose at this time.

**California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, CA 94303-4739**

**BACKGROUND STUDY FOR
THE CALIFORNIA LAW REVISION COMMISSION
ON WHETHER THE BUSINESS-JUDGMENT RULE SHOULD BE CODIFIED**

Professor Melvin A. Eisenberg
School of Law
University of California, Berkeley

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BACKGROUND STUDY FOR
THE CALIFORNIA LAW REVISION COMMISSION
ON WHETHER THE BUSINESS-JUDGMENT RULE SHOULD BE CODIFIED

I. INTRODUCTION: STANDARDS OF CONDUCT AND STANDARDS OF REVIEW IN CORPORATE LAW

The issue addressed in this report is whether the business-judgment rule should be codified in California. To fully analyze this issue, it is necessary to distinguish between standards of conduct and standards of review. A *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.

In many or most areas of law, these two kinds of standards are formulated in equivalent terms. For example, the standard of conduct that governs automobile drivers is that they should drive carefully and the standard of review in a liability claim against a driver is whether she drove carefully. Similarly, the standard of conduct that governs an agent who engages in a transaction with his principal is that the agent must deal fairly and the standard of review is whether the agent dealt fairly.

In corporate law, however, the standards of review pervasively diverge from the standards of conduct. A byproduct of this divergence has been the development of a great number of standards of review in this area. In the past, the major

standards of review have included good faith, business judgment, prudence, negligence, gross negligence, waste, and fairness.

Traditionally, the two major areas of corporate law that involved standards of conduct have been the duty of care and the duty of loyalty. The duty of care concerns the standards of conduct and review applicable to a director or officer in taking action, or failing to act, in a matter that does not involve his own self-interest. (I will refer to such action or inaction as disinterested conduct.) The duty of loyalty concerns the standards of conduct and review applicable to a director or officer in taking action, or failing to act, in a matter that does involve his own self-interest. (I will refer to such action or inaction as self-interested conduct.) At least in the past, the standards of review in these areas have for the most part been bipolar. At one pole have been standards of review that are very easy for a defendant to satisfy, such as the standards of waste and business judgment. At the other pole have been standards of review that are harder for a defendant to satisfy, such as the standards of prudence and fairness.

II. FUNCTIONS AND DUTIES OF DIRECTORS AND OFFICERS

The duty of care of corporate directors and officers is a special case of the duty of care imposed throughout the law under the general heading of negligence. Under the law of negligence, if a person assumes a role whose performance involves the risk of injury to others, she is under a duty to perform that role

carefully and is subject to blame if she fails to do so. For example, one who assumes the role of driver is under a duty to drive carefully; one who assumes the role of doctor is under a duty to practice medicine carefully; one who assumes the role of judge is under a duty to judge carefully.

Under modern corporate law and practice, the role of *officers* is to manage the business of the corporation. Those who assume the role of *director* have several distinct although related roles to perform. Directors must monitor or oversee the conduct of the corporation's business. Directors must select, compensate, and replace the principal senior executives. Directors must approve, modify, or disapprove the corporation's financial objectives, major corporate plans and actions, and major questions of choice concerning the corporation's auditing and accounting principles and practices. Finally, directors must decide any 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. See American Law Institute, Principles of Corporate Governance §§ 3.02-3.03 (1994).

The general standard of conduct applicable to directors and officers of California corporations in the performance of their functions, in relation to matters in which they are not interested, is set forth in Cal. Corp. Code § 309(a):

A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith,

in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

Presumably, this provision is applicable by analogy to officers.

A similar provision is found in many other statutes, including the Revised Model Business Corporation Act ("RMBCA"), on which a predecessor of Cal. Corp. Code § 309(a) was based:

§ 8.30. General Standards For Directors

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

- (1) In good faith;
- (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner he reasonably believes to be in the best interests of the corporation.

A similar principle was also adopted in American Law Institute, Principles of Corporate Governance §4.01(a) (1994):

A director or officer has a duty to the corporation to perform the director's or officer's functions 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. . .

¹Section 4.01(a) reads in full:

(a) A director or officer has a duty to the corporation to perform the director's or officer's functions 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.

Cal. Corp. Code § 309(a) reflects both general law and California case law.

I will call the standard of conduct in Cal. Corp. Code § 309(a), RMBCA § 8.30(a) and Principles of Corporate Governance § 4.01(a) "the standard of careful conduct." This standard has both objective and subjective elements. The portions of the standard that requires the care that "an *ordinarily prudent person* in a like position would use under similar circumstances" is an objective standard. The portions of the standard that require "good faith," and actions that the director "believes to be in the best interests of the corporation and its shareholders," are subjective standards, although, as will be discussed below, they may have at least a minimal objective component as well.

This Subsection (a) is subject to the provisions of Subsection (c) (the business judgement rule) where applicable.

(1) The duty in Subsection (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.

(2) In performing any of his or her functions (including oversight functions), a director or officer is entitled to rely on materials and persons in accordance with §§ 4.02 and 4.03 (reliance on directors, officers, employees, experts, other persons, and committees of the board).

The application of the standard of careful conduct to the functions of directors results in several distinct duties:

(i) Directors must reasonably monitor or oversee the conduct of the corporation's business to evaluate whether the business is being properly managed, by regularly evaluating the corporation's principal senior executives and ensuring that appropriate information systems are in place. This is known as the duty to monitor.

(ii) Directors must follow up reasonably on information acquired through monitoring systems, or otherwise, that should raise cause for concern. This is known as the duty of inquiry.

(iii) Directors must make reasonable decisions on matters that the board is obliged or chooses to act upon.

(iv) Finally, directors must employ a reasonable decision-making process to make decisions.

Officers have comparable duties, although for most officers decision-making is likely to be more important than monitoring.

On its face, the standard of careful conduct is fairly demanding. This is particularly true of the element of prudence or reasonability. For example, in *San Leandro Canning Co., Inc. v. Perillo*, 84 Cal. App. 627, 633, 258 P. 666, 669 (1927), the court said that: "[The directors] were bound to exercise that *degree of care which men of common prudence take in their own concerns*" (Emphasis added.) In *Burt v. Irvine Co.* 237 Cal. App.2d 828, 852, 47 Cal. Rptr. 392, 407-08 (1965), the court said that: "'The rule exempting officers of corporations from

liability for mere mistakes and errors of judgment does not apply where the loss is the result of failure to exercise proper care, skill and diligence. "Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. *They cannot excuse imprudence on the ground of their ignorance or inexperience, or the honesty of their intentions; and, if they commit an error of judgment through mere recklessness, or want of ordinary prudence and skill, the corporation may hold them responsible for the consequences.*" (Emphasis added.)

III. THE BUSINESS-JUDGMENT RULE

Despite the apparently demanding quality of the standard of careful conduct, in practice the standard of review of disinterested conduct by directors or officers is often significantly less stringent, especially when the *substance or quality* of a decision — that is, the reasonableness of the decision, as opposed to the reasonableness of the decision-making process that has been used — is called into question. In such cases, a much less demanding standard of review may apply, under the business-judgment rule. The business-judgment rule consists of four conditions and a special standard of review that is applicable, if the four conditions are satisfied, in suits that are based on the substance or quality of a decision a director or officer has made. The four conditions are as follows:

First, a judgment must have been made. So, for example, a director's failure to make due inquiry, or any other simple failure to take action, does not qualify for protection of the rule. (However, a deliberately made decision to not take a certain action would normally satisfy this condition.)

Second, the director or officer must have informed himself with respect to the decision to the extent he *reasonably* believes appropriate under the circumstances — that is, he must have employed a *reasonable* decision-making process.

Third, the decision must have been made in subjective good faith — a condition that is not satisfied if, among other things, the director or officer knew that the decision violates the law.

Fourth, the director or officer may not have a financial interest in the subject matter of the decision. For example, the business-judgment rule is inapplicable to a director's decision to approve the corporation's purchase of his own property.

If these four conditions are met, then the substance or quality of the director's or officer's decision will be reviewed, not under the standard of careful conduct to determine whether the decision was prudent or reasonable, but only under a much more limited standard.

There is some difference of opinion as to how that limited standard should be formulated. A few courts have stated that the standard is whether the director or officer acted in good faith. It is often unclear, however, whether good faith, as used in this context, is purely subjective or also has an objective element.

One of the few places where a definition of good faith is codified is the Uniform Commercial Code, but even the Code lacks clarity on this point. The Code's General Provisions (Part I) provide that good faith means "honesty in fact in the conduct or transaction concerned."² Although that definition seems to be subjective, it may not be. A person may be deemed to act honestly if he acts according to his own best lights, or a person may be deemed to act honestly only if he acts according to his own best lights and without transgressing the basic moral standards set by society. Furthermore, under the Code's Sales provisions (Part II) a merchant's duty of good faith includes an explicitly objective element — "the observance of reasonable commercial standards of fair dealing in the trade."³ Similarly, Judge Friendly held, in another context, that "Absent some basis in reason, action could hardly be in good faith even apart from ulterior motive."⁴

Correspondingly, most courts have not limited the standard of review under the business-judgment rule to subjective good faith, but instead have employed a standard that involves some objective review of the quality of the decision, however limited. As William Quillen, formerly a leading Delaware judge, has stated: "[T]here can be no question that for years the courts

²U.C.C. § 1-201(19).

³U.C.C. § 2-103(1)(b).

⁴Sam Wong & Son, Inc. v. New York Mercantile Exchange, 735 F.2d 653, 678 n.32 (2d Cir. 1994).

have in fact reviewed directors' business decisions to some extent from a quality of judgment point of view. Businessmen do not like it, but courts do it and are likely to continue to do it because directors are fiduciaries."⁵ Even courts that seem to use the term "good faith" in a relatively subjective way nevertheless almost always review the quality of decisions, under the guise of a rule that the irrationality of a decision shows bad faith.⁶

Courts have adopted an objective standard in applying the business-judgment rule because a purely subjective good faith standard would depart too far from the general principles of law that apply to actors who have a duty of care, and serious problems would arise if even an irrational business decision was protected solely because it was made in subjective good faith.

Accordingly, the prevalent formulation of the standard of review, under the business-judgment rule, is that if the four conditions to that rule have been satisfied the decision must be rational.⁷ This rationality standard of review is much easier to

⁵William T. Quillen, *Trans Union, Business Judgment, and Neutral Principles*, 10 Del. J. Corp. L. 465, 492 (1985).

⁶See *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, 91,715 (Del. Ch. Jan. 31, 1989).

⁷See, e.g., American Law Institute, *Principles of Corporate Governance* § 4.01(c); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir.1982) (courts will not disturb a business judgment if "any rational business purpose can be attributed" to a director's decision); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) ("any rational business purpose" test); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del.1971)

satisfy than the standard of careful conduct, which demands prudence or reasonability. In everyday life, for example, it is common to characterize a person's conduct as imprudent or unreasonable, but very uncommon to characterize a person's conduct as irrational. Unlike a subjective-good-faith standard, a rationality standard preserves a minimum and necessary degree of director and officer accountability, and allows courts to enjoin directors and officers from taking actions that would waste the corporation's assets.

An obvious example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained. For example, in *Selheimer v. Manganese Corp. of America*,⁸ managers poured a corporation's funds into the development of a single plant even though they knew the plant could not be operated profitably because of various factors, including lack of a railroad siding and proper storage areas. The court imposed liability, because the managers' conduct "defie[d] explanation; in fact, the defendants have failed to give any satisfactory explanation or advance any justification for [the] expenditures."

("rational business purpose" test); Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 119-21 (1979). See also *Meyers v. Moody*, 693 F.2d 1196, 1211 (5th Cir. 1982); *McDonnell v. American Leduc Petroleum, Ltd.*, 491 F.2d 380, 384 (2d Cir. 1974) (under California law a business judgment must be reasonable).

⁸224 A.2d 634 (Pa. 1966)

Why should the standard of review applicable to the quality of decisions by corporate directors and officers be only rationality, when the standard of conduct is reasonability or prudence? The answer to this question involves considerations of both fairness and policy. To begin with, the application of a reasonableness standard of review to the quality of disinterested decisions by directors and officers could result in the unfair imposition of liability. In paradigm negligence cases involving relatively simple decisions, like automobile accidents, there is often little difference between decisions that turn out badly and bad decisions. In such cases, typically only one reasonable decision could have been made under a given set of circumstances, and decisions that turn out badly therefore almost inevitably turn out to have been bad decisions. In contrast, in the case of business decisions it may often be difficult for factfinders to distinguish between bad decisions and proper decisions that turn out badly. Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks, so that typically a range of decisions is reasonable. A decision-maker faced with uncertainty must make a judgment concerning the relevant probability distribution and must act on that judgment. If the decision-maker makes a reasonable assessment of the probability distribution, and the outcome falls on the unlucky tail, the decision-maker has not made a bad decision, because some outcomes will inevitably fall on the unlucky tail of any normal probability distribution.

For example, an executive faced with a promising but expensive and untried new technology may have to choose between investing in the technology or forgoing such an investment. Each alternative involves certain negative risks. If the executive chooses one alternative and the associated negative risk materializes, the decision is "wrong" in the very restricted sense that if the executive had it to do all over again he would make a different decision, but it is not for that reason a bad decision. Under a reasonableness standard of review, however, factfinders might too often erroneously treat decisions that turned out badly as bad decisions, and unfairly hold directors and officers liable for such decisions.

The business-judgment rule protects directors and officers from such unfair liability, by providing directors and officers with a large zone of protection when their decisions are attacked. Other kinds of decision-makers who must make decisions on the basis of incomplete information and in the face of obvious risks can often shield themselves from liability for decisions by showing that they followed accepted protocols or practices.⁹ In contrast, directors and officers can seldom shield themselves in that way, because almost every business decision is unique. Furthermore, unlike most types of negligence cases, negligent decisions by directors or officers characteristically involve

⁹See, e.g., *Osborn v. Irwin Memorial Blood Bank*, 5 Cal. App. 4th 234, 278 n.13, 7 Cal. Rptr. 2d 101 (1992) ("'compliance with accepted [medical] practice is generally taken as conclusive evidence of due care'").

neither personal injury to a plaintiff nor catastrophic economic damages to an individual. The law may justifiably be less willing to take the risk of erroneously imposing liability in such cases.

Furthermore, the shareholders' own best interests may be served by conducting only a very limited review of the quality of directors' and officers' decisions. It is often in the interests of shareholders that directors or officers choose the riskier of two alternative decisions, because the expected value of a more risky decision may be greater than the expected value of the less risky decision. For example, suppose that Corporation C, a publicly held corporation, has \$100 million in assets. C's board must choose between Decision X and Decision Y. Decision X has a 75% likelihood of a \$2 million gain and a 25% likelihood of a \$1 million loss. Decision Y has a 90% chance of a \$1 million gain, a 10% chance of breaking even, and no chance of a loss. It is in the interest of C's shareholders that the board make Decision X, even though it is riskier, because the expected value of Decision X is \$1.25 million (75% of \$2 million, minus 25% of \$1 million) while the expected value of Decision Y is only \$900,000 (90% of \$1 million). If, however, the board was concerned about liability for breaching the duty of care, it might choose Decision Y, because as a practical matter it is almost impossible for a plaintiff to win a duty-of-care action on the theory that a board should have taken greater risks than it did. A standard of review that imposed liability on a director or officer for

unreasonable, as opposed to irrational, decisions might therefore have the perverse incentive effect of discouraging bold but desirable decisions. Putting this more generally, under a standard of review based on reasonability or prudence, directors might tend to be unduly risk-averse because if a desirable although highly risky decision had a positive outcome the corporation but not the directors would gain, while if it had a negative outcome the directors might be required to make up the corporate loss. The business-judgment rule helps to offset that tendency.

IV. CALIFORNIA CASE LAW

Undoubtedly as a result of the considerations discussed in Section III, the business-judgment rule is part of the common law of corporations, and various formulations of the rule have been accepted by the California courts. However, these formulations often lack clarity. Some cases have articulated a reasonability standard. For example, in *Fornaseri v. Cosmosart Realty & Building Corp.*, 96 Cal.App. 549, 557, 274 P. 597, 600 (1929), the court said: "In the absence of fraud, breach of trust or transactions which are *ultra vires*, the conduct of directors in the management of the affairs of a corporation is not subject to attack by minority stockholders in a suit at equity, where such acts are discretionary and are performed in good faith, *reasonably believing* them to be for the best interest of the corporation." (Emphasis added.) In *Burt v. Irvine Co.* 237 Cal.

App.2d 828, 852, 47 Cal.Rptr. 392, 407-08 (1965), the court said that: "'The rule exempting officers of corporations from liability for mere mistakes and errors of judgment does not apply where the loss is the result of failure to exercise proper care, skill and diligence. "Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. *They cannot excuse imprudence on the ground of their ignorance of inexperience, or the honesty of their intentions; and, if they commit an error of judgment through mere recklessness, or want of ordinary prudence and skill, the corporation may hold them responsible for the consequences.*"'. . . 'Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is *reasonably exercised* by them. . . .'" (Emphasis added.) In *Findley v. Garret*, 109 Cal.App.2d 166, 174 (1952), the court said that "Where a board of directors . . . acts in good faith within the scope of its discretionary power and *reasonably believes* . . . [its] action is good business judgment in the best interest of the corporation, a stockholder is not authorized to interfere with such discretion. . . ."

Other cases have articulated a good-faith standard. For example, in *Marble v. Latchford Glass Co.*, 205 Cal.App.2d 171, 178, 22 Cal.Rptr. 789 (1962) the court said that it would "not substitute its judgment for a judgment of the board of directors made 'in good faith.'" Similarly, in *Eldridge v. Tymshare, Inc.*,

186 Cal.App. 3d 767, 776, 230 Cal.Rptr. 815 (1986) the court stated that the business judgment rule "sets up a presumption that directors' decisions are based on sound business judgment [and] . . . this presumption can be rebutted only by a factual showing of fraud, bad faith or gross overreaching."

Still other cases seem to treat good-faith and reasonability standards as if they were interchangeable. For example, in *Gaillard v. Natomas Co.*, 208 Cal. App.3d 1250, 1263, 256 Cal.Rptr. 702 (1989) the court said:

The common law "business-judgment rule" refers to a judicial policy of deference to the business judgment of corporate directors in exercising their broad discretion in making decisions. . . . Under [the business judgment] rule, a director is not liable for a mistake in business judgment which is made *in good faith* and in what he or she believes to be the best interests of corporation, where no conflict of interest exists. . . .

". . . Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is *reasonably exercised* by them. . . ."¹⁰

V. CAL. CORP. CODE §309

¹⁰In *Katz v. Chevron Corp.*, 22 Cal. App. 4th 1352 (1994), the court stated that "'A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose..'" *Id.* at 1366 (citation omitted, quoting from *Unocal v. Mesa Petroleum*, 493 A.2d 946, 954 (Del. 1984) (emphasis added) and that "director liability is predicated upon concepts of gross negligence.'" (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). This case involved Chevron, a Delaware corporation, and was presumably decided under Delaware law.

In Gaillard v. Natomas Co., supra, the court stated that Cal. Corp. Code §309 "codifies California's business-judgment rule." 208 Cal.App.3d at 1264. See also Barnes v. State Farm Mutual Auto Insurance Company, 16 Cal.App. 4th 365, 379 n.12, 20 Cal.Rptr. 2d 87 (1993). This is incorrect. Section 309 codifies the standard of careful conduct, with which the business-judgment rule is inconsistent.

Indeed, an argument could be made that Section 309 overturns the business-judgment rule, because the business-judgment rule is established by case law, while the standard of Section 309, which is inconsistent with the business-judgment rule, is statutory. The better position, however, is that although Section 309 does not codify the business-judgment rule, neither does it overturn the rule. Thus Harold Marsh, who was chair of the State Bar Committee that authored Section 309(a), states:

This subdivision is largely copied from a proposed revision of former Section 35 of the Model Business Corporation Act adopted by the Committee on Corporate Laws of the American Bar Association . . . It can be seen at a glance that it incorporates the two seemingly contradictory ideas which have been voiced by the courts, i.e., the idea of good faith and acting "in a manner such director believes to be in the best interests of the corporation", . . . and the idea of reasonable care, expressed as "such care as an ordinarily prudent person in a like position would use under similar circumstances"

While these are not expressed as alternatives or as being applicable in different situations, but as cumulative requirements of the director, the ABA committee which drafted this language apparently considered that it was not overruling the business judgment rule by this formulation. The Report of the ABA Committee on Corporate Laws with respect to this revised Section 35 of the Model Act stated that it

intended by this language to incorporate "the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business judgment." While it could be argued that the qualifying phrase, "these criteria being satisfied," means that the director must always satisfy the standard of reasonable care imposed and therefore is always liable for negligence, that would make this comment nonsensical. A director then *would be* liable for an honest mistake of business judgment, if it was made negligently. Since this distinguished committee of corporate lawyers presumably meant to say something by this comment, it can only be interpreted as an indication that they, at least, intended to preserve the business judgment rule.

In the light of this background, it is highly doubtful that the California courts will hold that this section was intended to abolish the business-judgment rule, although it would certainly be open to a court to interpret it in that fashion, if it simply focused on the literal words of the statute.

1 H. Marsh and R. Finkle, Marsh's California Corporation Law § 11.3 (3d ed 1990).

VI. CONCLUSION AND RECOMMENDATION

Given the justifications and importance of the business judgment rule, and the uncertainty of its status and formulation in California, it would be desirable to codify the rule legislatively. The simplest approach would be to amend Cal. Corp. Code § 309 by incorporating the formulation of the business-judgment rule in American Law Institute's Principles of Corporate Governance § 4.01(c). Revised § 309 would read as follows:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of

the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) 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.

~~(b)~~ (c) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented.

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence.

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(d) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care, including the

inapplicability of the provisions as to the fulfillment of duty under Subsection (a) or (b), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.

~~(e)~~ (e) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director. In addition, the liability of a director for monetary damages may be eliminated or limited in a corporation's articles to the extent provided in paragraph (10) of subdivision (a) of Section 204.

Melvin A. Eisenberg