Study B-601 November 14, 1995

Memorandum 95-71

Business Judgment Rule: Staff Draft

BACKGROUND

At the September 1995 meeting the Commission reviewed Professor Eisenberg's background study on the business judgment rule and decided to pursue the concept of codification of the rule. The Commission directed the staff to prepare a draft for consideration that includes the following major features:

(1) The basic standard for codification should be that found in the ALI Principles of Corporate Governance.

(2) The draft should cover officers as well as directors, provided the officer's action is within the scope of authority.

(3) The draft should be limited to corporations and not extended to other entities, whether for profit or nonprofit, at this time.

(4) The staff should investigate devices for limiting groundless lawsuits.

The staff draft is attached as Exhibit pp. 1-5. This memorandum discusses issues in connection with the draft.

DUTY OF CARE v. BUSINESS JUDGMENT RULE

The ALI Principles of Corporate Governance define the duty of care of a director to the corporation, and provide protection to the director from liability to the corporation for good faith business judgments. It is not clear, however, whether this is intended to distinguish a duty to the corporation from a duty to shareholders, since a shareholder may sue in the right of the corporation (derivative action) or in the shareholder's own behalf (direct or class action).

It is probable that direct shareholder actions are based largely on alleged violations of federal securities laws rather than on state corporate fiduciary laws. However, violations of state corporate fiduciary laws are most likely also alleged in the complaint.

The California statutes in a number of instances refer to the duty of directors to the corporation *and shareholders,* suggesting that the interests of shareholders may be distinct from the interests of the corporation. The basic fiduciary duty of directors stated in Corporations Code Section 309, for example, requires a director to act "in a manner such director believes to be in the best interests of the corporation and its shareholders". The reference to shareholders was added to the statute by 1987 legislation.

The ALI commentary does not distinguish between a duty to the corporation and a duty to shareholders. The commentary points out that the duty of care standards "involve duties owed directly to the corporation", and emphasizes that the draft is not intended to create new third-party rights (e.g., for tort claimants or governmental agencies) against directors or officers. The duty of care standards "apply only to relationships among directors, officers, shareholders, and their corporations."

Because an argument can be made that under California law the duty of care of directors and officers is owed separately to the corporation and to its shareholders, out of an abundance of caution we have phrased the draft of the business judgment rule to cover both.

FORMULATION OF BUSINESS JUDGMENT RULE

Reasonable Belief v. Rational Belief

The ALI Principles of Corporate Governance require that, in order for a disinterested director or officer to be protected from liability for a good faith business judgment, the director or officer (1) must be informed to the extent the director or officer "reasonably believes" is appropriate, and in addition (2) must "rationally believe" that the decision is in the best interests of the corporation. The Commission was concerned about the interplay of the standards of reasonability and rationality, and requested the staff to give further consideration to this.

The ALI commentary explains the relation of these standards thus:

> This [rational belief] standard 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 the 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 [the business judgment rule] if the director or officer believes it to be in the best interest of the corporation and that belief is rational.

The commentary further notes that the term has both an objective and 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. The standard is intended to afford directors and officers wide latitude when making business decisions and is consistent with the large majority of business judgment cases and with sound public policy.

The ALI points out that this language is based on Delaware law. While other tests, such as "reasonable" and "good faith" have been used by the courts, the "reasonable" test is too strict and the "good faith" test is too liberal. Sound public policy demands a standard that gives directors and officers sufficient latitude, without insulating decisions that go beyond the realm of reason. "The need for clarity, certainty, and effective legal counseling also point to the advantage of clearly setting forth the 'rationally believes' standard."

The staff believes the ALI formulation of the standard is appropriate, particularly as amplified by the ALI commentary to the provision. Moreover, part of the impetus for this study is to put California law on an equal footing with Delaware law in this area, which the ALI formulation would do. By using the ALI formulation, and by referring to the ALI commentary, we can clarify California law on this matter and give interested persons a well- and thoroughly-articulated exposition of the governing law and policy. The staff draft of the business judgment rule includes a Comment that refers to the ALI commentary.

There may be instances where a special standard of review is necessary because of the unique nature of the decision, such as a board decision to seek dismissal of a derivative action. This is the subject of a separate Commission inquiry. See Memorandum 95-72 (demand and excuse in shareholder derivative actions).

Satisfaction of Duty of Care v. Immunity from Liability

The ALI Principles of Corporate Governance formulation of the business judgment rule states that a director or officer "fulfills the duty of care of the director or officer to the corporation" if specified conditions are satisfied. The Commission asked the staff to consider whether a more direct formulation — e.g., the director or officer is not liable for a good faith business judgment if the specified conditions are satisfied — would be preferable.

The ALI Comment notes that a breach of the duty of care of a director or officer to the corporation 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. The duty of care provisions deal 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 or a transaction in control, will involve the business judgment rule, "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 the business judgment rule.

If it is intended that the business judgment rule determine whether the standard of care of a director or officer has been satisfied for all purposes, then the ALI formulation appears correct. However, an argument can be made that the effect of the business judgment rule should be limited to personal liability of a director or officer for violation of the standard of care. A primary justification for the rule is that the protection it provides for honest business judgments is necessary to encourage good people to serve as directors and to make socially-desirable decisions involving risk.

But this is not the only justification for the business judgment rule, and the ALI Introductory Note points out that:

> 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 or private-sector business decisionmaking.

This rationale would also support allowing a transaction to proceed if the decision has been made by a disinterested director or officer in good faith with appropriate information and a rational belief it is in the best interests of the corporation.

The staff concludes the ALI formulation — a person who satisfies the conditions of the business judgment rule "fulfills the duty" of care — is proper. We have drafted the provision accordingly.

We do note, however, that the ALI Principles would not apply the business judgment rule in certain types of proceedings for injunctive relief — where the decision involves an interested director, and where the decision has the foreseeable effect of blocking an unsolicited tender offer. The interested director situation is not a concern to us, since the business judgment rule would be inapplicable by its own terms. **The tender offer problem should be addressed**, though, since corporate takeovers put greatest pressure on the business judgment rule. The staff will prepare a separate analysis of this matter.

APPLICATION TO OFFICERS

The Commission has decided that the business judgment rule should apply to officers as well as directors.

The underlying standard of care of officers is not clear. The California statutes only prescribe the standard of care of directors, and the case law on officers is scant. There is some indication in the literature that officers are held to a higher standard of care than directors, and this would make some sense since the officers are necessarily closer to the operation of the company than the directors. See 1 Ballantine & Sterling, California Corporation Laws § 102.02 (4th ed. 1993). The Legislative Committee Comment to the 1975 enactment of Corporations Code Section 309 states:

> The standard of care does not include officers. The Committee on Corporate Laws concluded that:

> ... it was not appropriate in connection with a revision of Section 35 to deal with those officers who were not also directors of the corporation. Although a non-director officer may have a duty of care similar to that of a director as set forth in Section 35, his ability to rely on factual information, reports or statements may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation [Committee on Corporate Laws, Changes in the Model Business Corporation Act, 29 Bus. Lawyer 953 (1974)].

The ALI Principles of Corporate Governance would apply the same standard of care to officers as to directors — "A director or officer has a duty to the corporation to perform the director's or officer's functions ... with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." § 4.01(a). The commentary to this provision explains the reasons for it:

> 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. [Citation.] When it comes to the application of these formulations, of course, full-time officers will 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.

It would be possible to amend Corporations Code Section 309 to make the standard of care that is applicable to directors also applicable to officers. The theory of the ALI Principles of Corporate Governance is that the standard of care is a flexible general standard — the prudent person standard — and therefore the same standard can be applied with different results to persons in the positions of officers and directors. An ordinarily prudent person in the position of a full-time officer would generally be expected to be more familiar with the affairs of a corporation than an ordinarily prudent person in the position of an outside director.

One might well ask whether it makes a difference what the duty of care of an officer is, if the duty can be satisfied by compliance with the requirements of the business judgment rule. The answer is that for many purposes, the business judgment rule will override the duty of care. But the duty of care of an officer could become significant in circumstances where the requirements of the business judgment rule are not satisfied — the action complained of does not involve a business judgment, the officer is interested in the transaction or not reasonably informed, or the officer does not rationally believe that the transaction will benefit the corporation.

As an academic matter, the staff sees some benefit to codifying the duty of care of officers. As a political matter, the staff is concerned that the more we try to bite off in this area, the more difficult it will be to get anything enacted. This is particularly true since there is some indication in the statutes that officers may be held more accountable than directors. **On balance, the staff is inclined not to try to codify the duty of care of corporate officers, although this is a close call.**

LIMITING LIABILITY OF DIRECTORS

While the business judgment rule applies automatically to protect directors and officers from liability, the Corporations Code provides additional mechanisms by which a corporation may provide greater protection for its directors and officers.

Immunity from Personal Liability for Monetary Damages

Corporations Code Section 204(a)(10), enacted in 1987, allows a corporation to protect its directors, but not its officers, from liability to the corporation for monetary damages:

> 204. The articles of incorporation may set forth:
> (a) Any or all of the following provisions, which shall not be effective unless expressly provided in the articles:
> ...
> (10) Provisions eliminating or limiting the personal liability of a director for monetary damages in an action brought by or in the right of the corporation for breach of a director's duties to the corporation and its shareholders, as set forth in Section 309, provided, however, that
> (A) such a provision may not eliminate or limit the liability of directors

> (i) for acts or omissions that involve intentional misconduct or a knowing and culpable violation of law,
>
> (ii) for acts or omissions that a director believes to be contrary to the best interests of the corporation or its shareholders or that involve the absence of good faith on the part of the director,
>
> (iii) for any transaction form which a director derived an improper personal benefit,
>
> (iv) for acts or omissions that show a reckless disregard for the director's duty to the corporation or its shareholders in circumstances in which the director was aware, or should have been aware, in the ordinary course of performing a director's duties, of a risk of serious injury to the corporation or its shareholders,
>
> (v) for acts or omissions that constitute an unexcused pattern of inattention that amounts to an abdication of the director's duty to the corporation or its shareholders,
>
> (vi) under Section 310, or
>
> (vii) under Section 316,
>
> (B) no such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when the provision becomes effective, and
>
> (C) no such provision shall eliminate or limit the liability of an officer for any act or omission as an officer, notwithstanding that the officer is also a director or that his or her actions, if negligent or improper, have been ratified by the directors.
>
> ...

This provision in effect allows a corporation to immunize its directors from liability on the same general terms as the business judgment rule. The immunity provision diminishes the importance of the business judgment rule, since it is likely that most corporations will include such an immunity provision in their articles. The statutes make this easy to do by allowing articles to pick up the immunity provision by means of a simple provision that, "The liability of the directors of the corporation for monetary damages shall be eliminated to the fullest extent permissible under California law." Corp. Code § 204.5.

However, there are differences from the business judgment rule that make it impossible to state with any assurance that the two provisions would provide the same degree of protection to a director in any individual case. For example, the immunity provision applies to any act or omission of a director, whereas the business judgment rule is limited to business judgments. The immunity provision applies only to monetary damages, whereas the business judgment rule provides an absolute protection. The immunity provision applies only in an

action by the corporation or in a derivative action, whereas the business judgment rule applies in direct shareholder actions as well.

Even in the areas of overlap of the two provisions, there are serious questions of whether the protection provided is the same. For example, the immunity provision does not apply where "intentional misconduct" is involved, while the business judgment rule only applies to "good faith" decisions. Are these two concepts identical? Similar questions may be asked about every other parallel provision of the two protective provisions — the immunity provision's requirement that the director not have derived an "improper personal benefit" from the transaction, as opposed to the requirement of the business judgment rule that the director not be "interested in the subject of the business judgment" — and so on down the line.

Would codification of the business judgment rule unduly complicate the law, at least as to corporations that have included an immunity provision in their articles? The close similarities, but arguable differences, between the two protective provisions could result in having to deal with both defenses in a liability case, with fine distinctions and arguments turning on the divergent phrasing of the two provisions. But this could happen even if the business judgment rule is not codified, since the business judgment rule is a common law doctrine. A case can be made that if a corporation adopts an immunity provision of the type authorized by Section 204, the immunity provision and not the business judgment rule should govern the relationship between the corporation and its directors. The business judgment rule would then be a default rule, applicable when there is no applicable immunity provision in the corporation's articles.

One consequence of this approach would be that if a corporation provides in its articles an immunity provision that is narrower than the statute allows, or adopts a provision denying any immunity, the lesser protection provided in the articles would govern issues of liability to the corporation to the exclusion of the business judgment rule. Of course this is an academic question, since the universal interest of business corporations is to encourage good people to serve as directors by protecting them from liability for their honest business decisions, not to deter them from serving by subjecting them to greater liability than the law generally would impose.

The staff has added to the draft of the business judgment rule a provision that the rule does not apply in a case where an immunity provision in the corporation's articles is applicable. See Section 319(c).

Indemnification

The California statutes permit the corporation to indemnify directors and officers against liability in a case where the director or officer acted in good faith and in a manner the director or officer reasonably believed to be in the best interests of the corporation. Corp. Code § 317(b). This provision does not apply in an action by or in the right of the corporation, however. In such a case indemnification is allowed for litigation expense (including attorney's fees), unless the director or officer is found liable or settles the case without court approval. Corp. Code § 317(c).

The corporation may expand its ability to indemnify directors and officers by an appropriate provision in its articles. Corporations Code Section 204(a)(11) permits the corporation to include in its articles a provision authorizing indemnification of directors and officers "in excess of that expressly permitted by Section 317 for those agents of the corporation for breach of duty to the corporation and its stockholders", subject to the same limitations as a directorial immunity provision in the articles (Section 204(a)(10).

The staff does not see a direct or indirect interaction of the indemnity provisions with the business judgment rule. Indemnification occurs after the fact, and does not affect the standards by which the director's or officer's liability is to be judged.

DEVICES FOR LIMITING GROUNDLESS LAWSUITS

The Commission requested the staff to investigate statutory devices for limiting groundless lawsuits.

Existing Devices

A number of devices for limiting groundless lawsuits against corporate directors and officers already exist.

The principle device, of course, is the **business judgment rule** itself. The effect of the business judgment rule is to provide a protective standard of court review that helps weed out the marginal cases. One reason the Commission is engaged in the present study of the business judgment rule is the concern that

the rule is not as clearly articulated in California as it might be, particularly in light of the extensive Delaware exposition of the law. Codification of a clear formulation of the rule may be significant in helping to deter groundless lawsuits.

Another device is a **presumption** in favor of the regularity of acts of the directors and officers. Sometimes the business judgment rule is described as a presumption, but it is really a defense to allegations of a violation of the duty of care. The ALI Principles of Corporate Governance incorporate a presumption that the directors and officers have satisfied both their duties of care and the requisites of the business judgment rule. It does this by making clear that the burden of proof on both these matters is on the plaintiff. We have incorporated this feature in our draft. See Section 319(b).

In a derivative action against a director or officer, Corporations Code Section 800 allows the defendant to demand a **bond** covering the defendant's reasonable expenses, including attorneys' fees, incurred in the action. The amount of the bond is limited to $50,000.

Current Legislative Activity

The main complaint of corporate defendants is that when the value of the company's stock suffers a substantial drop, plaintiffs immediately bring a securities class action alleging misconduct of the directors or officers. Even if the lawsuit is not meritorious, the cost of defending such a suit is so great that it is more cost effective to settle than to litigate.

These types of securities class actions are maintained under the federal securities laws. Congress is responding to this concern with legislation currently pending to curtail these types of lawsuits by means of a number of devices, including **"loser pays" provisions**. At the time of the writing of this memorandum, both Senate and House had adopted reforms by veto-proof margins and the measures were being considered in conference committee.

Assuming federal legislation adequately addresses the main abuse problem — securities class actions — is there any need for further activity at the state level to deter unmeritorious lawsuits? It is certainly conceivable that federal reforms could shift the major litigation activity to the state level.

During the past year, **state tort litigation reform** has been part of the Governor's legislative program, including devices intended to limit unmeritorious lawsuits. These proposals have not made it through the

Legislature. We understand that signatures are currently being collected for initiative measures for the same purpose, but have no information on this effort.

Other Possibilities

Other possible devices for limiting groundless lawsuits have been suggested.

The derivative action **bond for litigation expenses**, for example, could be increased and extended to other forms of action for breach of duty of care litigation.

Professional negligence actions require a 90-day **advance notice of intent to sue**. This type of provision has the effect shortening the applicable statute of limitations. This does not appear to be a significant factor in many types of corporate duty litigation, where the complaint alleging director or officer misconduct is filed within days of a drop in share price.

Legislation designed to deter SLAPP lawsuits (strategic lawsuits against public participation) takes a dual approach: the lawsuit is subject to a s**pecial motion to strike unless the plaintiff establishes a probability that the plaintiff will prevail; discovery is stayed** until the motion is resolved. This type of approach would probably work fairly well in the corporate litigation context.

Recommendation

The draft of the business judgment rule would make a clear statement of the protection afforded directors and officers, and would clearly state the burden of proof on plaintiffs. The staff believes this is a deterrent to unmeritorious lawsuits.

The major problems in securities class action litigation are being addressed at the federal level, and there is legislative and initiative activity at the state level. The matter is highly political and contentious. **The staff recommends against the Commission going beyond the current draft of the business judgment rule until the dust has settled and we see whether there continues to be a problem with unmeritorious litigation.**

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

Exhibit

BUSINESS JUDGMENT RULE

Corp. Code § 309 (no change). Director's duties of loyalty and care

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) 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.

(c) 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.

Note. No change is recommended in Section 309. It is set out here for the convenience of the reader.

Corp. Code § 319 (added). Business judgment rule

319. (a) A director, or an officer acting within the scope of the officer's authority, who makes a business judgment in good faith fulfills the duty of care of the director or officer to the corporation and its shareholders 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 and its shareholders.

(b) A person challenging the conduct of a director or officer as a breach of the duty of care of the director or officer to the corporation or its shareholders 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), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation or its shareholders.

(c) To the extent the articles of a corporation include a provision eliminating or limiting the liability of a director for monetary damages for breach of the duty of care of the director to the corporation and its shareholders as authorized by paragraph (10) of subdivision (a) of Section 204, that liability of the director is governed by the articles of the corporation and not by subdivision (a).

(d) As used in this section a director or officer is "interested" in the subject of a business judgment in any of the following circumstances:

(1) The director or officer, or an associate of the director or officer, is a party to the subject of a business judgment.

(2) The director or officer has a business, financial, or familial relationship with another party to the subject of a business judgment, and that relationship would reasonably be expected to affect the director's or officer's judgment with respect to the subject of a business judgment in a manner adverse to the corporation or its shareholders.

(3) The director or officer, an associate of the director or officer, or a person with whom the director or officer has a business, financial, or familial relationship, has a material pecuniary interest in the subject of a business judgment (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 or officer's judgment in a manner adverse to the corporation and its shareholders.

(4) The director or officer is subject to a controlling influence by another party to the subject of a business judgment or a person who has a material pecuniary interest in the subject of a business judgment, and that controlling influence could reasonably be expected to affect the director or officer's judgment with respect to the subject of a business judgment in a manner adverse to the corporation and its shareholders.

(e) As used in this section, "associate" means any of the following persons:

(1) The spouse (or a parent or sibling of the spouse) of a director or officer, or a child, grandchild, sibling, or parent (or the spouse of any of them) of a director or officer, or an individual having the same home as a director or officer, or a trust or estate of which an individual specified in this paragraph is a substantial beneficiary.

(2) A trust, estate, incompetent, conservatee, or minor of which a director or officer is a fiduciary.

(3) A person with respect to whom a director or officer has a business, financial, or similar relationship that would reasonably be expected to affect the director's or officer's judgment with respect to the subject of the business judgment in a manner adverse to the corporation and its shareholders.

(4) Notwithstanding paragraph (3), a business organization is not an associate of a director or officer solely because the director or officer is a director or principal manager of the business organization. A business organization in which a director or officer is the beneficial owner or record holder of not more than 10 percent of any class of equity interest is not presumed to be an associate of the director or officer by reason of the holding, unless the value of the interest to the director or officer would reasonably be expected to affect the director's or officer's judgment with respect to the subject of the business judgment in a manner adverse to the corporation and its shareholders. A business organization in which a director or officer is the beneficial or record holder (other than in a custodial capacity) of more than 10 percent of any class of equity interest is presumed to be an associate of the director or officer by reason of the holding, unless the value of the interest to the director or officer would not reasonably be expected to affect the director's or officer's judgment with respect to the

transaction or conduct in question in a manner adverse to the corporation and its shareholders.

Comment. Section 319 codifies the business judgment rule in terms drawn from ALI Principles of Corporate Governance. The ALI Introductory Note and Comments provide extensive discussion of the meaning and interpretation of these provisions, and these materials should be consulted in connection with questions of construction and intent of this section. See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994).

The business judgment rule applies to conduct of both directors and officers. The standard of care of directors is prescribed in Section 309; the standard of care of officers is not codified. Protection of an officer's conduct under this section is limited to conduct within the scope of the officer's authority. The duties of an officer are prescribed in the bylaws or determined by the board. Section 312(a).

The business judgment rule applies only to satisfaction of a director's or officer's duty of care to the corporation and its shareholders. It does not apply to the duty of care, if any, to third persons.

Subdivision (a) is drawn from ALI Principles of Corporate Governance § 4.01(c). The ALI Comment to § 4.01 notes that:

> 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 of [sic] officer does not rationally believe that the business judgment is in the best interests of the corporation. This standard 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 the 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 interest of the corporation and that belief is rational.

Subdivision (b) is drawn from ALI Principles of Corporate Governance § 4.01(d).

Subdivision (c) makes the business judgment rule inapplicable to determine the personal liability of a director where a corporation has adopted a provision in its articles immunizing the director from liability. In such a case the articles serve

a similar function to the business judgment rule, but subject to somewhat different standards. See Section 204(a)(10).

Subdivision (d) is drawn from ALI Principles of Corporate Governance § 1.23.

Subdivision (e) is drawn from ALI Principles of Corporate Governance § 1.03.