Study B-601 December 7, 1995

Second Supplement to Memorandum 95-71

Business Judgment Rule: Comments of Attorney General

Attached as Exhibit pp. 1-3 is a letter from Carole Ritts Kornblum, Assistant Attorney General, commenting on the proposed codification of the business judgment rule. The Attorney General is concerned because of its involvement with supervision of charitable trusts, and "it is likely given legislative history in California" that statutes involving liability of directors and officers of for-profit corporations will subsequently be recommended for charitable nonprofit corporations as well.

Ms. Kornblum states that it is the view of the Attorney General's Charitable Trusts Section staff that the proposed codification "would significantly weaken the fiduciary standards applied to officers and directors in order to solve a non-existent problem." Exhibit p. 1.

The letter goes on to elaborate how the business judgment rule interacts with fiduciary duties and standards of care. However, the letter fails to demonstrate, in the staff's opinion, any particular harm that would result from codifying the rule. The letter merely makes the conclusory statement, without giving specifics, that the proposal "seems to create several possible problems, both in creating new standards that are not legally defined and in creating potential uncertainties regarding the duties of officers and directors." Exhibit p. 2.

It was actually our hope that a precise codification of the business judgment rule would clarify uncertainties and define legal standards that are presently unclear and undefined in existing California case law statements of the rule. **We will ask the Attorney General's office to elaborate its concerns.**

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

DANIEL E. LUNGREN
Attorney General

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DEPARTMENT OF JUSTICE

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December 6, 1995

Mr. Nathaniel Sterling
California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto CA 94303

RE: Business Judgment Rule (Study B-601) - December 8, 1995 Meeting of California Law Revision Commission

Dear Mr. Sterling:

We wish to provide written comments to you concerning the proposed codification of the "business judgment rule" as proposed by Professor Eisenberg. While this proposal would initially apply only to for-profit corporations, it is likely given legislative history in California that it will subsequently be recommended for charitable nonprofit corporations as well.

In sum, it is the view of the Attorney General's Charitable Trusts Section staff that Professor Eisenberg's approach would significantly weaken the fiduciary standards applied to officers and directors in order to solve a non-existent problem. It is our view that the "business judgment" rule and the duties of "due care" and "loyalty" successfully co-exist in the law, at least insofar as they apply to charitable corporations.

At the outset, it should be noted that there is no potential conflict whatsoever between the duty of loyalty and the business judgment rule, as the latter does not apply to self-dealing transactions. (This is expressly noted by Professor Eisenberg.) As such, self-dealing transactions involving directors of public benefit corporations are governed exclusively by Corporations Code section 5233 and common law fiduciary rules.

With respect to the duty of due care, it is, in practice, largely a process rule. It commonly tests the decision-making process in terms of due diligence, reasonable inquiry, and reasonable efforts to monitor and review corporate affairs. Liability under this rule is not predicated on a failure to make a "good" business decision (for a director has no such legal obligation), but rather on a failure to conduct the level of inquiry to justify the making of a decision or to engage in

corporation oversight consistent with directors' fiduciary obligations. This is essentially a negligence standard.

Once this "process" standard is met, directors are generally immune from liability providing the decision they make is within their discretion and is not entirely irrational. This is what the courts have generally denominated the "business judgment" rule. It does not conflict with the "due care" rule, but rather complements it. This has, moreover, been articulated by the California courts. (See Burt v. Irvine Co., 237 Cal.App.2d 828 at 852).

> "'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 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."' (3 Fetcher Cyc. Corp. (1965) § 1041, p. 628, quoting original work of Fletcher as recited in Wangrow v. Wangrow (1924) 211 App.Div. 552, 556 [296 N.Y.S. 132, 136].)
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> "A reconciliation of these two concepts is found in Casey v. Woodruff, supra, wherein it is stated: 'The question is frequently asked, how does the operation of the so-called "business judgment rule" tie in with the concept of negligence? There is no conflict between the two. 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. A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. 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. [Citations.]' (49 N.Y.S. 2d at p. 643.)"

As noted by Brad Clark, the proposed new statute seems to create several possible problems, both in creating new standards that are not legally defined and in creating potential uncertainties regarding the duties of officers and directors.

We appreciate the opportunity to share our concerns with the Commission.

Sincerely,

DANIEL E. LUNGREN
Attorney General

CAROLE RITTS KORNBLUM
Assistant Attorney General

CRK:cb

cc: Jim Schwartz
F. McCauley Small, Jr.