

Memorandum 96-12

Business Judgment Rule: Draft Statute

Attached to this memorandum as Exhibit pp. 1-9 is a staff draft of the business judgment rule, implementing Commission decisions made at prior meetings. This memorandum discusses a few key issues presented by the draft.

RATIONALITY STANDARD

The ALI Principles of Corporate Governance formulation of the business judgment rule, which is codified in the draft, protects a good faith exercise of business judgment by a disinterested and reasonably informed director or officer if the director or officer “**rationaly believes** that the business judgment is in the best interests of the corporation and its shareholders.” Corp. Code § 320(a)(3). The Comment explains that the rationality test allows a wider range of discretion than a **reasonableness** standard would impose; it gives the officer or director a safe harbor from liability for a business judgment that might not be reasonable, so long as it is not so removed from the realm of reason when made that liability should be incurred.

The Commission has been concerned about the rationality standard, and its possible confusion with reasonableness. We have also heard from the State Bar Corporations Committee, concerned that the rationality standard is problematic. We have seen similar critiques of it in the literature.

The function of the business judgment rule is to protect an honest exercise of business judgment, but not to completely immunize the decisionmaker in a case where the judgment exercised is so poor that it cannot be condoned. Some balance is necessary. After all, besides encouraging risk-taking, the rule should also encourage sound decisionmaking. If there were no limitations at all, the quality of decisionmaking would suffer.

Professor Eisenberg’s background study notes that a few courts have stated the test is whether the director or officer has acted in **good faith**. However, it is unclear whether this test includes an objective element. There is an interplay

between the good faith of the decisionmaker and the quality of the decision, since the poor quality of a decision may evidence a lack of good faith.

Most courts have employed a standard that involves some objective review of the quality of the decision, however limited.

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.

Background Study at 10

Professor Eisenberg indicates that the prevalent formulation of the standard of review is rationality — the standard outlined in the ALI Principles of Corporate Governance. This standard is relatively easy to satisfy — conduct that may be imprudent or unreasonable is not necessarily totally 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.” Background Study at 11. An example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained.

Existing California case law formulations of the business judgment rule lack clarity. Some cases have articulated a reasonability standard (see, e.g., *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); *Fornaseri v. Cosmosart Realty Corp.*, 96 Cal. App. 549, 274 P. 597 (1929)), others have articulated a good faith standard (see, e.g., *Marble v. Latchford Glass Co.*, 205 Cal. App. 2d 171, 22 Cal. Rptr. 789 (1962); *Eldridge v. Tymshare, Inc.*, 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986)), and still others have combined the two concepts or treated them as interchangeable (see, e.g., *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989)). Rationality would represent a middle ground between the reasonability and good faith standards found in the cases.

Other standards that have been used by courts include **arbitrary**, **reckless**, **gross abuse of discretion**, and **gross negligence**. Delaware has been known to employ all of these terms, as well as rationality, and in fact it is not clear what the differences are between the standards or whether they are interchangeable.

The staff is satisfied that the rationality standard used in the ALI Principles of Corporate Governance represents sound policy and roughly captures the effect of the various court expressions of the standard of review under the business judgment rule. It represents a middle ground between the standards articulated in the California cases, and it will pick up the useful commentary set out in the ALI Principles.

If substantial resistance to use of the rationality standard remains, the staff believes an alternate standard could be used without real harm. The basic idea is to protect business judgments generally, while still giving courts a handle to award injunctive relief or impose liability in an egregious case. For this purpose, any of the Delaware-type standards will do.

APPLICATION TO OFFICERS

At the December 1995 meeting the Commission requested a staff analysis of the standard of care of officers, and the application of the business judgment rule to them. For more detail supporting the following analysis, see Exhibit pp. 10-14.

Duty of Care

There is very little authority on the duty of care of officers. The Commentary to the ALI Principles of Corporate Governance § 4.01 (1992) states that “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.”

While the duty of care of directors is codified in California, the duty of care of officers is not. See Corp. Code § 309. The committee that drafted the Corporations Code thought it was inappropriate to treat officers with directors, since the duty of care of an officer “is probably greater than that of a director” and the duty “would vary considerably depending upon the position which the officer held with the corporation”. 1 H. Marsh & R. Finkle, Marsh’s California Corporation Law § 11.3 (3d ed. 1990).

Most commentators argue that the standard of care applied to directors is flexible and can be applied equally well to officers. A director must act “with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.” Corp. Code § 309(a). It could be equally well said that an officer should act with the care, including reasonable inquiry, that an ordinarily prudent person in a similar position would use in

similar circumstances. The degree of care that would be expected of a full-time officer-employee may be greater than the degree of care that would be expected of a part-time director. But in either case, the test of fulfillment of the duty of care is whether the person has acted with the care that a reasonably prudent person in a like position would use.

Application of Business Judgment Rule

The critical point is not the duty of care of the officer, but the application of the business judgment rule to the conduct of the officer. The common law generally applies business judgment rule protection to officers as well as directors.

Professor Eisenberg indicates that the major functions of the business judgment rule are to protect corporate decisionmakers from unfair imposition of liability and to help ensure that corporate decisionmaking does not become unduly risk averse. Background Study at 12-15. These policies apply as well to decisions of officers as to decisions of directors.

However, at least one California case appears to deny business judgment rule protection to officers. *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989), held that the decision of officer-directors to secure golden parachute agreements for their own benefit, even though ratified by outside directors, is not entitled to business judgment rule protection. The officer-directors were not “performing the duties of directors” in this instance but were acting as officer employees of the corporation. “The judicial deference afforded under the business judgment rule therefore should not apply.” 208 Cal. App. 3d at 1265.

The court reaches this conclusion because it equates Corporations Code Section 309 with the business judgment rule, and Section 309 applies only to directors; the court therefore reasons that the business judgment rule applies only to directors. This analysis is incorrect. Section 309 does not codify the business judgment rule; it codifies the duty of care of directors, upon which the business judgment rule acts as a limitation. The result in the case — the officers in *Gaillard* were denied business judgment rule protection — is sound, but not for the reasons stated by the court. The business judgment rule *does* apply to officers, but the *Gaillard* officers should not receive its protection because they were interested in the transaction. The court in effect recognizes this when it concludes that denial of business judgment rule protection to the officers “is in accord with

the premise of the business judgment rule that courts should defer to the business judgment of *disinterested* directors who presumably are acting in the best interests of the corporation.” 208 Cal. App. 3d at 1265-6.

This illustrates the point that, due to the different circumstances of officers and directors, the business judgment rule may apply to them differently, just as the standard of care may apply to them differently. Officers may more frequently be interested than directors, thereby disqualifying them from business judgment protection. Likewise, it is possible that the requirement of the business judgment rule that the director or officer be reasonably informed will be satisfied by a director but not by an equally well-informed officer if the officer’s position in the corporation is such that greater familiarity with the facts can reasonably be expected.

Staff Recommendation

The staff’s conclusion is that the ALI Principles of Corporate Governance properly provide the same standard of care for officers and directors and properly apply the business judgment rule to decisions of both officers and directors. The staff believes it would be worthwhile to provide a clear statement of the law on these matters in the California statutes. We have added to the draft a codification of the standard of care of officers. See Corp. Code § 312. We would add to the business judgment rule Comment an explanation of how, while the rule is the same for officers and directors, it may be applied differently in light of their different circumstances. See Comment to Corp. Code § 320.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

Exhibit

1 BUSINESS JUDGMENT RULE

2 **Corp. Code §§ 300-318 (article heading). General provisions**

3 SECTION 1. An article heading is added to Chapter 3 (immediately preceding
4 Section 300) of Division 1 of Title 1 of the Corporations Code, to read:

5 Article 1. General Provisions

6 **Corp. Code § 309 (amended). Director's duties of loyalty and care**

7 SEC. 2. Section 309 of the Corporations Code is amended to read:

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

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

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

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

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

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

6 (d) This section is subject to the business judgment rule (Section 320).

7 **Comment.** Section 309 is amended to reflect codification of the business
8 judgment rule. The business judgment rule is codified in Section 320 (not in
9 Section 309), contrary language in existing cases notwithstanding. See, e.g.,
10 Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1264, 256 Cal. Rptr. 702 (1989)
11 (Section 309 "codifies California's business-judgment rule"); Barnes v. State Farm
12 Mutual Auto Ins. Co., 16 Cal. App. 4th 365, 20 Cal. Rptr 2d 87 (1993).

13 The business judgment rule is applicable to determine fulfillment of the duty
14 of care under this section when a good faith business judgment is involved. See
15 Section 320 (business judgment rule).

16 **Corp. Code § 312 (amended). Officer's duty of care**

17 SEC. 3. Section 312 of the Corporations Code is amended to read:

18 312. (a) A corporation shall have a chairman of the board or a president or
19 both, a secretary, a chief financial officer and such other officers with such titles
20 and duties as shall be stated in the bylaws or determined by the board and as
21 may be necessary to enable it to sign instruments and share certificates. The
22 president, or if there is no president the chairman of the board, is the general
23 manager and chief executive officer of the corporation, unless otherwise
24 provided in the articles or bylaws. Any number of offices may be held by the
25 same person unless the articles or bylaws provide otherwise.

26 (b) Except as otherwise provided by the articles or bylaws, officers shall be
27 chosen by the board and serve at the pleasure of the board, subject to the rights,
28 if any, of an officer under any contract of employment. Any officer may resign at
29 any time upon written notice to the corporation without prejudice to the rights, if
30 any, of the corporation under any contract to which the officer is a party.

31 (c) An officer shall perform the duties of an officer with the care that an
32 ordinarily prudent person in a like position would use under similar
33 circumstances. This subdivision is subject to the business judgment rule (Section
34 320).

1 **Comment.** Subdivision (c) is added to Section 312 to codify the duty of care of
2 an officer. See ALI Principles of Corporate Governance § 4.01 & Commentary
3 (1992).

4 The duty of care of an officer parallels the duty of care of a director. See
5 Section 309(a). However, the degree of care required of an officer may differ from
6 the degree of care required of a director and may vary considerably depending
7 upon the position the officer holds with the corporation. Cf. 1 H. Marsh & R.
8 Finkle, Marsh's California Corporation Law § 11.3 (3d ed. 1990). The duty of care
9 is a flexible standard, and its application depends on the circumstances of the
10 person to whom it is applied; the test of fulfillment of the duty is whether the
11 officer has acted with the care that a reasonably prudent person in a similar
12 position would use.

13 The business judgment rule is applicable to determine fulfillment of the duty
14 of care under subdivision (c) when a good faith business judgment is involved.
15 See Section 320 (business judgment rule).

16 **Corp. Code §§ 320-323 (added). Business judgment rule**

17 SEC. 4. Article 2 (commencing with Section 320) is added to Chapter 3 of
18 Division 1 of Title 1 of the Corporations Code, to read:

19 Article 2. Business Judgment Rule

20 **320. Business judgment rule**

21 320. (a) A director, or an officer acting within the scope of the officer's
22 authority, who makes a business judgment in good faith fulfills the duty of care
23 of the director or officer to the corporation and its shareholders if all of the
24 following conditions are satisfied:

25 (1) The director or officer is not interested (Section 322) in the subject of the
26 business judgment.

27 (2) The director or officer is informed with respect to the subject of the
28 business judgment to the extent the director or officer reasonably believes to be
29 appropriate under the circumstances.

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

32 (b) This section shall be known and may be cited as the business judgment
33 rule.

34 **Comment.** Section 320 codifies the business judgment rule; other provisions
35 of this article elaborate the meaning and define the application of the business
36 judgment rule.

1 This section and other provisions of this article express the business judgment
2 rule in terms drawn from American Law Institute, Principles of Corporate
3 Governance: Analysis and Recommendations (1992). The Introductory Note and
4 Comments to that treatise provide extensive discussion of the meaning and
5 interpretation of the business judgment rule as codified in this article; those
6 materials should be consulted in connection with questions of construction and
7 intent of this article.

8 The business judgment rule applies to conduct of both directors and officers.
9 The standard of care of directors is prescribed in Section 309; the standard of care
10 of officers is prescribed in Section 312(c). Protection of an officer's conduct under
11 this section is limited to conduct within the scope of the officer's authority. The
12 duties of an officer are prescribed in the bylaws or determined by the board.
13 Section 312(a).

14 Application of the business judgment rule to officers overrules the statement
15 in *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 1265, 256 Cal. Rptr. 702 (1989),
16 that the judicial deference afforded under the business judgment rule should not
17 apply to officers. Although the business judgment rule governs good faith
18 business judgments of both directors and officers, it may apply to them
19 differently due to their different circumstances. For example, a well-informed
20 director may be protected by the business judgment rule but not an equally
21 informed officer, if the officer's position in the corporation is such that greater
22 familiarity with the facts would be reasonably believed to be appropriate under
23 the circumstances.

24 The business judgment rule applies both to a determination whether a
25 transaction or conduct of a director or officer is a basis for liability of the director
26 or officer and to a determination whether the transaction or conduct may be
27 enjoined or set aside.

28 The business judgment rule applies only to satisfaction of a director's or
29 officer's duty of care to the corporation and its shareholders. It does not apply to
30 the duty of care, if any, to third persons. Nor does it limit any protection
31 otherwise available for a director or officer, including a provision in the articles
32 eliminating or limiting the liability of a director for monetary damages for breach
33 of the duty of care of the director to the corporation and its shareholders as
34 authorized by Section 204(a)(10). See Section 309(c).

35 The introductory portion of subdivision (a) codifies the principle of existing
36 law that the business judgment rule applies only to a good faith business
37 judgment. See, e.g., *Barnes v. State Farm Mutual Auto Ins. Co.*, 16 Cal. App. 4th
38 365, 20 Cal. Rptr. 2d 87 (1993); *Eldridge v. Tymshare, Inc.*, 186 Cal. App. 3d 767,
39 230 Cal. Rptr. 815 (1986); *Marsili v. Pacific Gas and Electric Co.*, 57 Cal. App. 3d
40 313, 124 Cal. Rptr. 313 (1975); *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal.
41 Rptr. 392 (1965); *Fornaseri v. Cosmosart Realty Corp.*, 96 Cal. App. 549, 274 P. 597
42 (1929).

43 Subdivision (a)(1) codifies the principle of existing law that the business
44 judgment rule applies only to a decision of a disinterested director. See, e.g.,
45 *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989). For the

1 meaning of “interested” as used in subdivision (a)(1), see Section 322 (interested
2 director or officer).

3 Subdivision (a)(2) codifies the principle of existing law that the business
4 judgment rule applies only to an informed decision. See, e.g., *Gaillard v.*
5 *Natomas Co.*, 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989).

6 Existing California case law formulations of the business judgment rule lack
7 clarity. Some cases have articulated a reasonability standard (see, e.g., *Burt v.*
8 *Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); *Fornaseri v. Cosmosart*
9 *Realty Corp.*, 96 Cal. App. 549, 274 P. 597 (1929)), others have articulated a good
10 faith standard (see, e.g., *Marble v. Latchford Glass Co.*, 205 Cal. App. 2d 171, 22
11 Cal. Rptr. 789 (1962); *Eldridge v. Tymshare, Inc.*, 186 Cal. App. 3d 767, 230 Cal.
12 Rptr. 815 (1986)), and still others have combined the two concepts or treated
13 them as interchangeable (see, e.g., *Gaillard v. Natomas Co.*, 208 Cal. App. 3d
14 1250, 256 Cal. Rptr. 702 (1989)). Subdivision (a)(3) applies a rationality standard
15 that represents a middle ground among the various standards articulated by the
16 California cases.

17 The rationality standard of subdivision (a)(3) is drawn from ALI Principles of
18 Corporate Governance § 4.01(c) (1992). The ALI Comment to § 4.01 notes that:

19 If a director or officer acts in good faith and in accordance with
20 § 4.01.(c)(1) and (2) with respect to a business judgment, the
21 standard in § 4.01(c)(3) will provide insulation from liability unless
22 the director [or] officer does not rationally believe that the business
23 judgment is in the best interests of the corporation. This standard is
24 intended to provide directors and officers with a wide ambit of
25 discretion. It is recognized that the word “rational,” which is
26 widely used by the courts, has a close etymological tie to the word
27 “reasonable” and that, at times, the words have been used almost
28 interchangeably. But a sharp distinction is being drawn between
29 the words here. The phrase “rationally believes” is intended to
30 permit a significantly wider range of discretion than the term
31 “reasonable,” and to give a director or officer a safe harbor from
32 liability for business judgments that might arguably fall outside the
33 term “reasonable” but are not so removed from the realm of reason
34 when made that liability should be incurred. Stated another way,
35 the judgment of a director or officer will pass muster under §
36 4.01(c)(3) if the director or officer believes it to be in the best interest
37 of the corporation and that belief is rational.

38 **321. Presumptions and burdens of proof**

39 321. (a) A director, or an officer acting within the scope of the officer’s
40 authority, is presumed to have fulfilled the duty of care of the director or officer
41 to the corporation and its shareholders. The presumption established by this
42 subdivision is a presumption affecting the burden of proof.

1 (b) The burden of proof on a person challenging the conduct of a director or
2 officer as a breach of the duty of care of the director or officer to the corporation
3 or its shareholders includes the burden of proving the inapplicability of the
4 provisions as to the fulfillment of duty under Section 309 or 312 or the business
5 judgment rule (Section 320), and, in a damage action, the burden of proving that
6 the breach was the legal cause of damage suffered by the corporation or its
7 shareholders.

8 **Comment.** Section 321 is drawn from ALI Principles of Corporate
9 Governance § 4.01(d) (1992). It codifies the presumption in existing law in favor
10 of the validity of business judgments of corporate directors. See, e.g., Gaillard v.
11 Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989); Eldridge v.
12 Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); Burt v. Irvine Co.,
13 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Fornaseri v. Cosmosart Realty
14 Corp., 96 Cal. App. 549, 274 P. 597 (1929).

15 The burden of proof under this section is proof by a preponderance of the
16 evidence. Evid. Code § 115.

17 **322. Interested director or officer**

18 322. (a) For the purpose of the business judgment rule (Section 320), a director
19 or officer is “interested” in transaction or conduct that is the subject of a business
20 judgment in circumstances that include, but are not limited to, any of the
21 following:

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

24 (2) The director or officer has a business, financial, or familial relationship
25 with another party to the transaction or conduct, and that relationship would
26 reasonably be expected to affect the director’s or officer’s judgment with respect
27 to the transaction or conduct in a manner adverse to the corporation or its
28 shareholders.

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

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

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

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

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

14 (3) A person with respect to whom a director or officer has a business,
15 financial, or similar relationship that would reasonably be expected to affect the
16 director's or officer's judgment with respect to the transaction or conduct in
17 question in a manner adverse to the corporation or its shareholders. This
18 paragraph is subject to the following limitations:

19 (A) A business organization is not an associate of a director or officer solely
20 because the director or officer is a director or principal manager of the business
21 organization.

22 (B) A business organization in which a director or officer is the beneficial
23 owner or record holder of not more than 10 percent of any class of equity interest
24 is not presumed to be an associate of the director or officer by reason of the
25 holding, unless the value of the interest to the director or officer would
26 reasonably be expected to affect the director's or officer's judgment with respect
27 to the transaction [or conduct] in a manner adverse to the corporation or its
28 shareholders.

29 (C) A business organization in which a director or officer is the beneficial or
30 record holder (other than in a custodial capacity) of more than 10 percent of any
31 class of equity interest is presumed to be an associate of the director or officer by
32 reason of the holding, unless the value of the interest to the director or officer
33 would not reasonably be expected to affect the director's or officer's judgment
34 with respect to the transaction or conduct in a manner adverse to the corporation
35 or its shareholders.

1 **Comment.** Subdivision (a) of Section 322 is drawn from ALI Principles of
2 Corporate Governance § 1.23 (1992). Subdivision (a) is not an exclusive listing of
3 circumstances that may cause a director or officer to be “interested” for purposes
4 of application of the business judgment rule.

5 Subdivision (b) of Section 322 is drawn from ALI Principles of Corporate
6 Governance § 1.03 (1992).

7 **Staff Note.** *The ALI Principles of Corporate Governance § 1.23(c) (1992) provide*
8 *additional grounds for a determination whether a director is interested in a board decision*
9 *to reject, dismiss, or settle a derivative action. Under this provision, a director is*
10 *interested if:*

11 *The director is a defendant in the action, except that the fact a director*
12 *is named as a defendant does not make the director interested under this*
13 *section if the complaint against the director:*

14 *(A) is based only on the fact that the director approved of or acquiesced*
15 *in the transaction or conduct that is the subject of the action, and*

16 *(B) does not otherwise allege with particularity facts that, if true, raise*
17 *a significant prospect that the director would be adjudged liable to the*
18 *corporation or its shareholders.*

19 *Addition of this provision to the draft depends on what action the Commission takes with*
20 *respect to application of the business judgment rule to actions by the board to reject,*
21 *dismiss, or settle a derivative action.*

22 **323. Action that has foreseeable effect of blocking unsolicited tender offer**

23 323. The business judgment rule (Section 320) does not apply in a proceeding
24 to enjoin or set aside an action of the board of directors that has the foreseeable
25 effect of blocking an unsolicited tender offer, but directors who authorize that
26 action are not subject to liability for damages if their conduct meets the standard
27 of the business judgment rule.

28 **Comment.** Section 323 is drawn from ALI Principles of Corporate
29 Governance § 6.02(d) (1992). It codifies existing law that makes the business
30 judgment rule inapplicable in a proceeding for injunctive relief where the effect
31 of the board action is to block an unsolicited tender offer. See, e.g., *Heckman v.*
32 *Ahmanson*, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

33 A director is not “interested” within the meaning of the business judgment
34 rule if the director’s interest is limited. For example, usual and customary
35 directors’ fees and perquisites (whether or not constituting a significant portion
36 of a particular director’s income), or the existence of an agreement to indemnify
37 or continue insurance for a director’s actions, is not disqualifying. The pecuniary
38 interest of a director as a shareholder also should not cause the director to be
39 viewed as interested, so long as the director is to be treated the same as other
40 shareholders in the transaction.

1 On the other hand, if a director receives significant benefits from the
2 corporation other than usual and customary fees and perquisites, or is to receive
3 a substantial severance payment, or has other significant financial interests
4 beyond normal fees and perquisites, the director might be considered interested
5 for purposes of the business judgment rule. The prospective loss of a position as
6 a senior executive, for example, would be viewed as a disabling interest, and
7 therefore a senior executive would not be entitled to the protection of the
8 business judgment rule when taking action to oppose a tender offer that could
9 result in the loss of the executive position.

10 See also Section 322 (interested director or officer).