Study B-601 April 5, 1996

First Supplement to Memorandum 96-24

Business Judgment Rule: Comments of State Bar Committees

Attached to this memorandum are comments on the draft codification of the business judgment rule from R. Bradbury Clark on half of the State Bar Nonprofit Organizations Committee (Exhibit pp. 1-18) and Diane Holt Frankle on behalf of the State Bar Corporations Committee (Exhibit pp. 19-31). Their letters include comments addressed both to the concept of codification of the business judgment rule and to details of the draft codification.

In the interest of getting their letters out sufficiently in advance of the meeting that Commissioners and other interested persons will have an opportunity to read them, we will not here analyze their comments addressed to the details of the draft codification. This we will do at the meeting.

Of greater importance is that both letters express serious concern about or opposition to the concept of codification of the business judgment rule. They believe that the existing California case law establishing the business judgment rule is not causing problems in practice, and that any effort to codify the law will cause greater problems by limiting judicial flexibility in an area where flexibility is necessary and by creating new ambiguities and uncertainties where none exist now. They believe the issues are too complex to lend themselves to ready codification, and that if the Commission is intent on proceeding, it should do so only after far more extensive consultation and input from affected persons than it has so far received.

The perspective of these experts that the existing case law on the business judgment rule is not causing problems in practice in California is significant, since the premise of this project to codify the business judgment rule is that existing law is confused, resulting in a California legal environment that is hostile to business. Their perception that any confusion in the law is not serious, and that legislative intervention is likely to generate problems, questions the premise of the study.

We do not know the composition of these State Bar committees, and whether the committee members represent a broad or narrow spectrum of clients. We do

know that it is not just the corporate bar that is apprehensive about this study. The plaintiffs' bar has not been overly enthusiastic about it, and the Attorney General's office has expressed concern about the potential indirect impact of the project on charitable corporations (this is also the perspective from which Mr. Clark writes).

Of course, the Commission usually tries to get the necessary broad input by circulating and publicizing a tentative recommendation on the subject. Realistically, however, the input received by the Commission in response to a tentative recommendation is usually fairly limited. We probably have many of the most interested parties already before us.

The staff believes we must weigh seriously the advice of these committees that, whatever modest problems may be found in existing law, correcting them does not warrant the disruption that the correction would cause. While broader input on this issue would be nice, the question is whether realistically we will get broader input and whether the expenditure of resources (both the Commission's and those of persons following this project) is worth it. In this connection, both committees feel that if the Commission proceeds, far more work needs to be done, and many more persons consulted, before we will be in a position to issue a reasonable tentative recommendation.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

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April 3, 1996

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

Attention: Nathaniel Sterling, Executive Secretary

Re: Proposed Codification of the Business Judgment Rule

Ladies and Gentlemen:

Enclosed with this letter is a memorandum of comments on the Staff Draft of Tentative Recommendation, Business Judgment Rule dated April 1996 ("Tentative Recommendation"), as attached to Staff Memorandum 96-24 dated March 15, 1996. This memorandum is submitted on behalf of the Nonprofit Organizations Committee of the Business Law Section of the California Bar, which has requested me to prepare comments on the Tentative Recommendation. I should advise you that all members of the Committee have not had an opportunity to review my memorandum and it does not necessarily express their views or all of their views on this matter. I am also submitting this memorandum on my own behalf as a corporate lawyer and as the editor of Ballantine & Sterling, California Corporation Laws, which deals, among other things, with duties of directors and officers and the business judgment rule.

I recognize that nonprofit corporations are not the subject of the Tentative Recommendation. The Nonprofit Organizations Committee is concerned with the proposal, however, because directors of California nonprofit corporations are subject to formulations of duty similar in many respects to that in Corporations Code § 309 and they and their officers make many decisions on behalf of their corporations. Their decisions are driven by quite different considerations in almost all cases than decisions for business corporations. The business judgment rule, as it has been developed in the cases does not properly apply to them to the extent their decisions are not driven by business

considerations but by their charitable, mutual benefit or religious purposes. However, if the business judgment rule is codified in the General Corporation Law, a court may apply it by analogy to nonprofit organizations and therefore they have an interest that any codification does its job as well as possible.

You will note that one of the comments in the introductory portion of the enclosed memorandum suggests that the Commission not issue materials on the Business Judgment Rule at this time as a tentative recommendation but rather that if it issues them, it do so only for discussion and comment. The reasons for this suggestion are more specifically set forth in the memorandum. I urge you to give serious consideration to adopting that approach.

On behalf of the Nonprofit Organizations Committee and personally I appreciate the opportunity to submit these comments and hope that they will be helpful to the Commission in its own judgments about the Tentative Recommendation.

Sincerely yours,

R. Bradbury Clark

R. Bradbury Clark

RBC:bas
Enclosure

M E M O R A N D U M

TO: California Law Revision Commission

SUBJECT: Staff Draft dated April 1996 of Tentative Recommendation Respecting the Business Judgment Rule ("Tentative Recommendation")

DATE: April 3, 1996

FROM: R. Bradbury Clark

1. Introductory

This memorandum contains comments and suggestions on the proposed legislation set forth in the Tentative Recommendation mentioned above. As indicated in my letter transmitting this memorandum to the California Law Revision Commission (the "Commission"), this memorandum is submitted on behalf of the Nonprofit Organizations Committee of the Business Law Section of the California Bar, which has requested me to prepare comments on the Tentative Recommendation. That letter explains the interest of the Nonprofit Organizations Committee in this matter.

After the following three paragraphs, Section 2 of this memorandum discusses whether the business judgment rule (the "BJR") should be codified. Section 3 then makes a number of specific comments and suggestions on all of the proposed legislation except proposed new Section 323.

I ask the reader of this memorandum to bear in mind that the Tentative Recommendation was released on March 15, 1996, that I did not receive it until March 26, 1996 and that I understand that the Commission may consider issuing it as a tentative recommendation at the Commission's April 12 meeting. I mention this not as a complaint (I accept full responsibility for not having obtained a copy of the Tentative Recommendation promptly upon its receipt) but as an explanation for the fact that the following comments have been somewhat hastily prepared so as to be available to the Commission at that meeting and could stand a good deal more refinement. My situation is not unique, however. Many persons who would be exceedingly interested in this proposal are entirely unaware of it. Those who are aware of it have had a similarly short time to consider the most recent draft, changes in which deal with some, but by no means all, of the problems contained in earlier drafts. In particular, in

trying to focus on specific suggestions, I have spent relatively little time on whether the codification should be made at all.

The point of the previous paragraph is that I would strongly recommend that if the Commission decides to proceed with consideration of this codification, it should not adopt any tentative recommendation at this time but rather make any changes prompted by suggestions with which the Commission agrees and then issue the proposal only for study and comment. I suggest this because once the Commission makes a "tentative recommendation", it often is thought that the die is largely cast and that it is not a good use of time to study or comment on the proposal. I know from prior experience with the Commission that that is not the intent of the Commission but that can be the result of premature exposure of a statutory recommendation. Such a result would be unfortunate because the subject is very difficult, very subtle and very important.

I have had an opportunity to read a draft of the thoughtful comments of Diane Holt Frankle on the Tentative Recommendation, made on behalf of the Corporations Committee of the Bar's Business Law Section. For what my views are worth, I think her comments are all well taken.

2. Should the BJR be Codified?

The Most Qualified Commentaries say "NO". The ALI's Principles of Corporate Governance ("ALI Principles"), so heavily relied on by the Tentative Recommendation and the major source of proposed Section 320, recommends against codification in its comment on implementation of its formulation of the BJR. This despite the presence as Chief Reporter of that work of Professor Eisenberg, a proponent of statutory codification. Comment (b) on p. 141 states Section 4.01(a)(1)-(d), which includes the BJR, "might be better implemented by judicial decision than by legislative codification."

Similarly the Model Business Corporation Act ("MBCA") adopted by the American Bar Association's Committee on Corporate Laws does not include a codification of the BJR. Its official comment explains that a 1983 draft included one but that adverse comments received led to its deletion: "it was decided that the issues dealt with in this section [8.30, to which the draft BJR had been added] were too complex and that they should be left to continuing judicial interpretation and development" (Model Business Corporation Act Annotated, Third Ed., Vol. 2 ("MBCA Anno."), p. 8-173). So § 8.30 was left much as it had been and without the BJR. This conclusion by a group of the most experienced corporate lawyers in this country, who understand the need to protect corporations and their shareholders as well as directors, merits respect.

What Do Other States Do? Thirty-five states generally follow the MBCA lead, without including the BJR (See MBCA Anno., pp. 8-175-176). The Tentative Recommendation says that no state has codified the BJR (p. 3). Given that many state corporation laws, like California's, have been carefully and thoughtfully drafted and are carefully reviewed for updating by experienced practitioners and others interested, this omission is no accident. Application of the BJR can be subtle, demands flexibility to fit widely variant facts and needs room for growth and development. Delaware, which probably has the most developed BJR (it certainly has the most cases), has addressed this need well judicially, without a statute. The complexity of application can be seen in the discussion of the BJR in Delaware contained in one excellent treatise: Folk on the Delaware General Corporation Law (1996 Ed.) needs 103 pages to discuss the BJR and its ramifications as embodied in Delaware cases. Although it is impossible to tell, it seems doubtful that less litigation would have ensued or the outcome of these cases different if Delaware had the Tentative Recommendation's BJR in place. Quite likely there would have been more litigation because of the uncertainties in and problems with the proposed legislation, some of which are mentioned below.

There is room for leadership in corporate law, but apparently the best leaders have chosen not to codify the BJR. Leadership by California needs to avoid the wrong direction.

Is Codification of the BJR Necessary to Correct Abuse or Misunderstanding? Compared to Delaware, California has only a handful of decisions. With the possible exception of the Gaillard case cited in the Tentative Recommendation, California courts seem to have understood the BJR well enough and to come to just conclusions. These facts would seem to negate any need for correction or revision by statute. As to the Gaillard decision, Harold Marsh aptly describes its shortcomings (See 2 Marsh & Finkle, Marsh's California Corporation Law, (3d Ed., pp. 794-799).

The confusion about the content of the BJR seen by the Commission Staff has not produced bad results so far as I am aware. Even the Gaillard case seems to turn not on a misperception of the content of the BJR but of how to apply it and Corp. Code Section 309 to what the court (correctly) saw as improper behavior by both interested and disinterested directors and by officers. Some confusion may result from perceptions of the BJR as an actual statement of directors' duties rather than as a threshold for judicial review as to compliance with, now, Corp. Code Section 309. Some confusion may occur in applying the BJR in actual cases, without confusion as to what the BJR is. Neither of these confusions will be prevented by the proposed BJR, as mentioned below.

Is the BJR Capable of Useful Codification? The ABA Committee on Corporate Laws, no slouches at corporate law

drafting, did not think so. If the BJR is codified in a way that carries forward its currently developed content (including not only that to be found in California cases, but also in Delaware cases and as described in the best secondary sources) and is clear, certain and unambiguous so that litigation can focus on the substance of directors' (and officers') behavior and not on statutory nuances, it probably won't reduce litigation or change its outcome from that under the judicial BJR because our courts will still do what they would have done and want to do. If so, the case for codification isn't made.

One reason given for not codifying the BJR is the need for it to remain flexible enough to fit the already potentially endlessly varying fact situations of director (and officer) conduct and to permit application to new fact situations and new expectations about directors' and officers' duties. This concern figures in the decisions not to codify the BJR, some of which are mentioned above, and has merit.

Summary. The foregoing considerations lead me to suggest that the BJR not be codified at all now. They and the comments below suggest that the current proposal should not be recommended by the Commission without further exposure, return to the drafting room and a fresh start.

3. Specific Comments on the Proposed BJR Legislation

The BJR should not be codified now. If it is, however, the Tentative Recommendation should be revised in at least the respects set forth below. Time has not permitted a really exhaustive catalogue of needed change. The problems identified have often been handled properly in the judicial application of the BJR and many of the problems reinforce the ALI Principles' conclusion that definition and application of the BJR is best left to the courts.

The following comments will be keyed to the Code section involved and will set forth what changes should be made and why. Many of the comments on Section 309(d) also would apply to Section 312.5 (if it is retained) and should be so understood.

Section 309(d).

Effect of Section 320 on Section 309. As drafted, Section 309(d) may replace Section 309 with Section 320, although this is unclear and apparently unintended (see below). From the standpoint of directors, Section 309 should provide the standard of care and loyalty to be applied by and to them. The less rigorous standard of the BJR should not be a substitute except as a determinant of judicial review, as set forth below. Thus, on

one hand, if the BJR provides that the duty of care is "fulfilled" if its requirements are met, that would seem to substitute for and dilute the requirements of Section 309(a). But, on another hand, if all BJR requirements are not met, Section 309(d) could be construed to mean that even if the director has met Section 309 requirements, his or her duty of care has not been fulfilled and liability could result. Neither result is acceptable. Reliance on a Commission comment to avoid this result (see last paragraph on p. 12 of the Tentative Recommendation) should be unnecessary and is dangerous in view of the rather plain meaning of the words in Section 320, and that a court may not feel bound by the comment. Accordingly, subdivision (d) should either be deleted or Section 320 should make clear that it provides only standards which, if met, preclude court review of directors' conduct, and which, if not met, permit judicial review of whether Section 309's standards have been met.

Further, if a person does perform the duties of a director as set forth in Section 309 (a) and (b), that person should have no liability for breach of the duty of care even if the BJR standards are not met. Of course, the BJR standards (other than that relating to "interest") usually will be met if the present standards of Section 309 are also met.

Section 321(c), added to the latest draft, may be an attempt to deal with Section 320's potential to supersede Section 309, but 321(c) does not clearly do so and has its own problems commented on below. The best solution is to delete subdivision (d) and deal with the effect of Section 320 on business judgments in it, with at most a cross reference in Section 309 to Section 320.

Only Section 309(a) Should Be Referred To In (d) If Retained. If retained, (d) should refer only to (a) unless it is made entirely clear that the BJR is only a threshold for judicial review. Section 309(b) should not be subject to the BJR without that clarification:

> (1) Even a director who does not meet the BJR's standards should be entitled to rely in accordance with Section 309(b) as long as the director "acts in good faith, after reasonable inquiry where the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted," as required by the closing proviso of (b)). That proviso, which in the present statute applies to all of the preceding provisions of (b), provides the protection as to reliance needed by each of the corporation, its shareholders and its directors. Sometimes, several or perhaps even a majority, of a corporation's directors may not meet the BJR's standards because they are "interested" even though they meet its other requirements. If they meet Section 309(b)'s

requirements for reliance, they would also almost necessarily meet those other requirements of the BJR. If some or a majority of directors are "interested" in a proposed transaction, it will still be important to the corporation that an appropriate business judgment be made as to that transaction (which could be not to do it). In that case the Board may have no choice but to delegate that decision to a disinterested committee or to disinterested directors who can meet the BJR's and Section 309's standards. There is no reason why all other directors, including the interested directors, should not be able to rely, in accordance with § 309(b), upon the recommendation or decision of that committee and thereby fulfil their duty, subject, of course, to other protective sections of the law such as Sections 310 or 315. Use of the "disinterested directors" as permitted decisionmakers, where some directors are "interested," is a concept ALI Principles recognizes as necessary to permit corporate business to be carried on (See § 1.15 and Part V; see also Corp. Code Section 310, which recognizes this concept). The BJR, if codified must allow for this use of disinterested directors and protect other directors from liability when their interest is recognized and they abstain from the relevant decisionmaking. Their abstention or delegation to a committee should be encouraged to permit a disinterested decision, not be penalized or cause them to be singled out for liability. Even if there are no interested directors, boards more and more delegate matters and decisions to committees. Where a director believes a committee merits confidence and the proviso of (b) is satisfied that should be the test of fulfillment of duty as to a matter delegated to the committee (See ALI Principles, page 141, comment (c)).

(2) The first sentence of Section 309(c) needs to apply or not dependent on whether the requirements of Section 309(a) or (b) or both are met. If neither (a) nor (b) is satisfied, (c) will have no effect, and if either is met, (c) should be given effect, irrespective of the BJR. Thus this sentence need not be referred to in (d).

(3) The second sentence of Section 309(c) should not be referred to in (d). Doing so in effect guts the protection for directors intended to be available through Corp. Code § 204(a)(10). The intention not to gut that provision is evidenced by the Commission Staff's comment on Section 320 appearing in the top paragraph of page 13 of the Tentative Recommendation. However, Section 309(d) should be drafted (or eliminated) so that its language does not gut 204(a)(1) and my suggestion would do that.

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Section 312.5.

General. This proposed section creates a number of problems. When the General Corporation Law ("GCL") was being considered in the '70s, the Joint State Bar and Assembly Legislative Committee considered in detail whether to include a standard for officers' duty of care. After that careful consideration, the Committee decided that officers' duties vary so widely (depending, e.g., upon the nature and business of their employer, its size and complexity, the nature of their duties, the extent of their discretion and the specification of or agreement on their required duties and skills in corporate articles, bylaws or employment agreements) that a statutory standard was undesirable. This conclusion remains sound and is reinforced by the problems with proposed Section 312.5, a few of which are set forth below.

Section 312.5(a): Prudent Person Standard. Requiring an officer to use "the care, including reasonable inquiry, that an ordinarily prudent person in a like position would use under similar circumstances" would more often than not be unhelpful and inappropriate. It is my experience that an officer usually is not chosen because he or she is an "ordinarily prudent person". At the upper level of executive management, officers normally need much more than ordinary prudence and are typically chosen for, and are expected to use, a much higher level of judgment based on their insights, experience or expertise. Conversely, an officer near the bottom of a corporate hierarchy normally carries out assigned and supervised duties, often in accordance with detailed standard operating procedures, so that "prudence" would not be an important factor in his or her selection and usually would not enter into that officer's decisions even if they involve some level of judgment. Thus, "ordinary prudence" would not be very germane in these cases. If the phrases "in a like position" or "under similar circumstances" are designed to address this gulf between expected skill levels, they don't do so unless somehow the phrases refer to the exact job in the exact situation, with all of the bells and whistles of officer selection, contract considerations, supervision, corporate rules, procedures, etc. The ALI Principles do suggest this rather expansive meaning (see p. 151-152), but whether a court would feel bound by something in ALI Principles is not all clear. If that is their meaning, the phrases add nothing useful. In another place ALI Principles actually reinforces this concern by describing "ordinary prudent person" as "intended to convey the image of a generalist who has the *capacity* [Emphasis added] to perform a given corporate assignment," with no special expertise in any field, "with very limited exceptions: e.g., controller or general counsel" (ALI Principles § 4.01, comment (e), p. 148). The prudent person requirement rarely will fit officers in the real corporate world.

Section 312.5(a): Officers' "Beliefs". Although there seems no doubt that an officer should perform his or her duties in "good faith" (see below), the extent to which the officer must form, as to duties lawfully assigned or prescribed by the board or superiors (and as to judgments made in carrying out those duties), a belief that his or her actions are "in the best interests of the corporation and its shareholders" seems dubious. An officer might often doubt (or have no specific view as to) the wisdom of a particular assigned course of conduct.

Sometimes officers' duties are not delineated with any specificity in bylaws, employment contracts or corporate job descriptions and sometimes they are spelled out in detail. In neither case does the statutory provision as to belief fit. Where the officer's duties are carefully laid out, leaving little or no discretion, there seems to be no basis for application of any standards other than good faith, honesty and performance of the assigned duties. Conversely, where duties are not spelled out but are the subject of instructions from superiors on a general or task by task basis, the (as drafted) overriding standard of § 312.5(a) seems confusing since it suggests that the officer must second guess superiors or instructions or refuse to act whenever the officer either has not formed a belief about the best interests of the corporation and its shareholders or questions the matter.

An officer should be able to perform assigned duties (and make related judgments) honestly and in good faith without fear of liability and should not risk a statutorily imposed failure to perform duties by simply carrying out assigned duties and making necessary ancillary business judgments in doing so.

Section 312.5(a): Reasonable Inquiry. For an officer to be at risk if he or she does not make "reasonable" inquiry (or has to decide whether to make inquiry) before making a business judgment appurtenant to carrying out his or her duties will often be unfair. Again, it might seem that the phrases "in a like position" and "under similar circumstances" (if the ALI Principles' view of them is given effect) would foreclose the requirement of reasonable inquiry when an officer is carrying out lawful instructions or proceeding in accordance with standard procedures. That seems a vague and (from an officer's point of view) highly uncertain use of these phrases. Injecting that uncertainty into a statute seems only to muddy the waters and to raise risks of wasteful litigation (not to mention managerial confusion) to resolve this and other ambiguities and uncertainties.

Section 312.5(a): Good Faith. This term is not defined in the GCL or ALI Principles. The California Uniform Commercial Code defines it as "honesty in fact" (§ 1201(19)). It is not clear that the term doesn't have that meaning in the GCL, but no one really knows. As applied to officers, the term presents serious questions. Is "good faith" presumptively absent

if an officer is "interested" or has some conflict of interest that the wide net of "interested" didn't pick up? Perhaps, but not necessarily: officers frequently have an interest in or conflicts of interest about corporate matters that are dealt with by disclosure and appropriate supervision or compromise, allowing the officer to perform his or her duties without questions of breach. Superior officers, the board or both, with their duties of management and control and with required disclosure, can and do regularly deal with officers "interests" or conflicts without subjecting the officer to the ambiguous and potentially too inflexible statutory standard of § 312.5 and without impairing the officer's value to the corporation.

Section 312.5(b). Several things about this subdivision need change. First, the final clause of Section 309(b), (beginning "so long as, in any such case, . . ." should be added to Section 312.5(b) if it is retained. Clearly, to the extent an officer is entitled to rely as provided by subdivision (b), reliance must be subject to that final clause. Beyond that, however, as already suggested, more often than not in performing his or her duties, an officer will be relying on instructions, procedures and information that may not emanate from any of the listed sources, such as the board itself or a board committee. Thus, the permitted sources of officers' reliance are too narrow. Also, if instructions come from the board or another officer of the corporation, the acting officer's belief (or absence of belief) in the reliability and competence of the board, a superior or even a coordinate officer should not be a matter placing the acting officer at risk of violating his or her statutory duties.

Section 312.5(d). If 312.5 is retained, subdivision (d) should be modified in the same way suggested as to Section 309(d), or deleted, for reasons similar to those set forth as to that Section.

Need to Relate Section 312.5 to Other Standards. As intimated above, if Section 312.5 is retained in any form, it should be revised not only as described above but also to provide that its standards, especially as to the duty of care, are expressly subject to any modifying provisions in articles, bylaws, employment contracts or corporate procedures. See ALI Principles, p. 146.

Example: Section 312.5, applied to a CEO. It is instructive to apply proposed Section 312.5(a) to a typical chief executive officer, whose position might be thought to come closest to that of a director. Clearly a CEO should perform his or her duties in good faith (subject to my prior comment as to its scope). A CEO making discretionary decisions probably ought to believe that they are in the best interests of the corporation and its shareholders. Even at that level, however, where the CEO is carrying out assigned duties or board decisions (including any implementing judgments), requiring him or her to believe that

carrying out those duties or decisions is in the best interests of the corporation and its shareholders (as opposed to carrying out the task as well as possible) creates an impossible dilemma. Determining when a decision is discretionary or effectively dictated by the need to handle an assignment will often be impossible for the CEO, let alone a reviewing court. If the CEO cannot or does not form the required belief, must he or she refuse to carry out lawfully delegated duties? If the CEO carries out the duties without forming that belief, has Section 312.5(a) been violated? If the CEO believes a proposed course of action approved by the board is not in the corporation's/ shareholders' best interests, the CEO's decisions mandated by Section 312.5 should be designed to kill it. How can the CEO do that in "good faith" or in carrying out duties?

Beyond that, "ordinary prudence" (see above) is normally a vastly insufficient standard for a CEO of anything but the simplest business entity. Even there, that generalist standard should apply only if that is what the board bargained for or expected. Here again, if "ordinarily prudent person" means a person having whatever high (or low) level of skill, prudence, experience, etc., and having the skills bargained for by the corporate employer, that someone applying retrospective judgment finds to be required, the term loses any usefulness.

Moving on, the right of a chief executive officer to rely as specified in Section 312.5(b) will fluctuate wildly. In a highly complex, large business, to do his or her job the CEO inevitably must rely on others, but still may have a duty of supervision, personal knowledge and question-raising far beyond acting in "good faith" and only making inquiry "when the need therefor is indicated by the circumstances." Conversely, in a small organization reliance by the CEO on others often may be inappropriate most of the time because the shareholders and directors may expect more, i.e., that the CEO will personally acquire a sufficient basis for judgments and not rely on others. The statement in ALI Principles (pp. 134-5) that officers "have no obligation to look behind [information and other data] on which they are relying unless suspicious circumstances or other unusual facts would make it unreasonable not to make further inquiry" is simply wrong in many situations.

Section 320.

Ambiguity of Section's Effect. The language of Section 320(a) as presently drafted rather clearly would add a second standard of director and officer duty that is substantially different from that of Section 309 and, if retained, Section 312.5. The earlier section(s) cover all duties, not just "business judgments", although the extent to which directors' duties actually extend in important respects beyond making "business judgments" seems quite small. As noted above, when its

provisions are satisfied, the "plain language" of Section 320 seems to supersede the earlier section(s) at least as to "business judgments", dependent on what being "subject to" Section 320 means to those sections. When those provisions are not satisfied, Section 320 may also supersede the earlier ones and create liability without regard to compliance with the earlier sections. See the comments on Section 309(d) above.

"Business Judgment" Unclear. Although "business judgment" at first sight seems an easily understood term and has been used in the cases, it needs a second look before it is codified in Section 320. ALI Principles doesn't define the term, although the Introductory Note to Part IV seems to equate it to "business decisions". Probably a decision by directors to act or not act involves a business decision, but the extent to which officers' actions involve "business judgments" is, as already suggested, not at all clear. Sometimes they will and sometimes they won't and sometimes there will be a mixture of judgment and simple performance of duty. Further thought is necessary as to whether and how the term can and should be clarified, given its importance to a codified BJR.

BJR Should Only be a Standard for Judicial Review. As noted above, the usual application of the BJR is by a court to determine whether judicial review and possible substitution of a judge for the board is appropriate. Professor Eisenberg's May 1995 Background Study makes this point (p. 1), but its implementation in Section 320 has been lost. The basis for this limited application is well recognized: the directors are to manage the corporation, not judges (or even dissatisfied shareholders); directors need room within their strict standard (§ 309) to make judgments involving risks and to make mistakes at times, room protecting them from liability in situations within the BJR; and courts normally do not have the background to make (or second guess) managerial decisions, especially from their remoteness in time, circumstance and place. That application has made good sense for many years (see, e.g., Block, Barton and Radin, The Business Judgment Rule (Fourth Ed. 1993, Supp. 1995), Ch. 1.). Section 320(a) should be recast to provide for that application. Perhaps that could be done as simply as deleting "fulfills" and substituting "shall not be adjudicated personally liable for breach of". This necessary change should be accompanied by deletion of Sections 309(d) and 312.5(d).

Focus on the board not individual directors. The "interest" of a director or his or her's established failure to meet other standards of the BJR may justify court review of directors' action. Section 320, however, should not prevent that review from focusing on the board's management and whether directors acting as a board met the standards of Section 309. For example, as already mentioned, an "interested" director should be able to disclose the interest and allow other directors or a disinterested committee to make the business decisions without liability if the board's decision meets required

standards. Again, if in discussion of a business decision, a director questions its wisdom or does not personally agree with it, but the board decides to proceed, is the director at risk? In modern businesses, "interests" of directors (and officers) are bound to arise and directors and officers sometimes will question decisions of the board or supervising officers. They must be able to do this without risk if the business decision is made properly by the board or an officer and without taint from "interest" or conflict. Otherwise, an affected director or officer should resign before the decision, a result usually undesirable. The point: Section 320, if added, must not be worded to cast doubt on this managerial requirement.

Use of "fulfills duty of care". Recasting Section 320(a) as suggested should eliminate the ambiguity of the words "fulfills the duty of care." If, as a guide to propriety of judicial review, the BJR requirements are met, of course, the director (or officer) would not be adjudicated personally liable for breach of duty as a result of a business judgment because the court would not review that judgment. However, if the standards are not met, do these words mean that the director (or officer) has not fulfilled the duty? They could easily be so construed notwithstanding the Tentative Draft comment referred to above and Section 321(c). The words should be changed as suggested if enactment of Section 320 is to be proposed.

If the BJR is codified and applies to officers, there is another important reason to make the change suggested above and also to modify § 312.5 as suggested to allow for officers' duties to be controlled by the actual employment arrangement. The reason is that as between the corporation and an officer, "fulfillment" of duty should be governed by the agreed or understood employment arrangement (especially if more demanding than Sections 312.5 or 320), and neither section should permit a claim that the actual arrangement is overridden by the statute. As drafted, both Section 312.5 and 320 appear to create inflexible and overriding standards (whether only one applies or both somehow do) that cannot be changed by agreement.

Effect of "Interest". The fact that an officer is "interested" in a transaction should not put the officer at risk under the BJR if adequate disclosure is made because, unlike directors who are not directly supervised by any superior body, even top corporate officers are under the supervision and control of the Board or other officers, whose duties should include neutralizing the effect of officers' disclosed or known personal interests in transactions. This is highly important because officers will often be "interested" in the business judgments which they are making or carrying out, so that mere existence of "interest" should not be a determinant in evaluating their conduct. If Section 320(a)(i) is retained, it should refer to undisclosed interests at least as to officers and, for reasons mentioned above, also as to directors.

Officers: Generally. Making performance of duties by an officer subject to the BJR is quite independent of whether an officer's standard of care should be codified, although, if a standard of care is not codified, it may be difficult to adapt a single Section 320 appropriately to officers. However, if Section 312.5 is retained and if officers are to be subject to the BJR, it should apply only to discretionary judgments. Admittedly, limiting the BJR to discretionary judgments creates complications, but an officer should not be protected against failure to perform his or her duties merely because the BJR's standards are met if the officer is not actually complying with his or her duties as specified in the relevant employment arrangement. Conversely, an officer should not have liability or be subject to judicial review for carrying out his or her duties because of failure to satisfy the BJR as to nondiscretionary actions (and ancillary business judgments). It could be argued that non-discretionary actions do not involve business judgments, but at least in upper levels of management even carrying out assigned duties often involves making decisions and judgments.

Officers: "Acting Within Scope . . ." It seems unwise to add to the ALI Principles' formulation of the BJR a limitation that an officer must act "within the scope of the officer's authority" in order to be protected by the Rule. Notwithstanding Corp. Code Section 312(a) and the comment in the Tentative Recommendation (see third paragraph of comment on p. 12), officers' duties are often not prescribed either by a board or bylaws in the detail necessary for determination of scope of authority. Very commonly officers' duties are specified in general terms that are made specific by supervision, understood procedures, custom and accepted practices, are informal and do not lend themselves to easy objective proof. Adding this limitation seems only to inject an element of uncertainty, which to the extent officers focus on Section 320 can only be unsettling, and seems to invite claims (litigation) unrelated to whether the three articulated requirements of the BJR are met. This clause should be deleted.

Section 321

Section 321(a) and (b): Applicability. It is not clear to me (a nonlitigator) whether Section 321(a) as presently worded would only apply in a judicial proceeding. If it could apply beyond that, it should be modified. For example, as between a corporation and its directors or officers except perhaps in litigation to hold them personally liable, there seems no need for a presumption either way. Perhaps the last sentence of (a) indicates that my uncertainty is not well founded. Section 321(b) seems to be more clearly limited to litigation. I would suggest both subdivisions be modified to limit their applicability to judicial proceedings if that is the Commission's intent.

Section 321(b): Use of "Inapplicability". The use of this word seems wrong unless Section 320 does supersede Sections 309/312.5 if Section 320's requirement are or are not met. If what is intended is to provide that the challenger must prove that the requirements of Section 309/312.5 were not satisfied it would be better to replace "inapplicability of" with "failure to satisfy".

Ambiguity of Section 321(c). Section 320 does not actually (and should not) provide a "means" for determining fulfillment of duty; it provides standards and "basis" might be a better word. However, the BJR presently is, and whether or not codified should be, only a determinant for judicial review. Drafted as such a determinant, Section 320 would not need the disclaimer in Section 321(c) and it could be deleted.

If retained, the final clause of Section 321(c) (beginning "and other conduct...") is highly inadequate. What does "other conduct" mean? Does it mean conduct that does not meet the BJR but does meet Section 309/312.5? Dependent on the effect of not meeting the BJR on the applicability of Section 309/312.5, does "other conduct" allow for a standard other than Section 309/312.5? In context (except for the impact of "interest" on satisfying the BJR) "other conduct" seems to contemplate conduct at a level that is required by the BJR and therefore possibly below the standards of Section 309/312.5. If retained, this clause needs further thought and revision.

Section 322

Section 322(a): Use of "include, but not limited to,". This phrase is not in ALI Principle's definition of "interested" (See § 1.23), from which Section 322 is otherwise largely copied. It is not in ALI Principles for good though unstated reasons: the definition casts too wide a net as it is (see below). Directors and officers will be at enough risk to keep all enumerated elements in mind when a judgment is made without the specter of even wider, unspecified reach of the term. Given that directors and, even more so, officers will be "interested" at times and given the seriousness of losing the benefit of the BJR, it can be expected that any uncertainty in this definition will chill action or encumber it by a perceived need to create a protective record for later use in court to prove compliance with Section 309/312.5 (assuming changes in them and Section 320 to make clear that satisfaction of the earlier sections constitutes compliance with the statutory duties) in any case that hindsight could say involved an "interest" not specified in the definition. The phrase should be deleted and the ALI version (modified as suggested below) used if Section 322 is enacted.

Section 322(b): the Definition Itself. The definition itself seems much to broad, especially so in the following respects:

(1) the use and definition of "associate" is too broad for daily awareness by those making business decisions. The definition appears to be derived from SEC concepts, which tend to be focussed on disclosure requirements in specific and limited circumstances and times. So focussed, specific inquiries can be made at relevant discreet times as to the existence and significance of a wide group of "associates".

(2) Applicability to "Relatives". Especially where a person has a large family with siblings and children, their spouses and relatives, grandchildren and their spouses, daily awareness -- needed because a business judgment can be required at any time -- of all these people and their possible role in a transaction is impractical in all but the simplest family circles. The idea that a person will necessarily know whether any of the "associates" in the entire family group is a beneficiary of a trust or estate is similarly inaccurate. It is true that a person probably will know whether some of the group, e.g., a spouse, is involved. Experience tells us, however, that a person more often than not will not know, and may not have an ongoing relationship with all members of the group that will enable finding out, whether some one or more of its members is a party to the transaction or has a material pecuniary interest in it. The definition of "associate" should be cut back to a reasonable level for the daily BJR context or be tied to the person's knowledge of the associate's relationship to the transaction.

(3) Applicability to Business Associates. Inclusion in "associate" of "any person" as to whom a director/officer has a "business, financial or similar relationship" is also too broad even with the modifier (beginning "that would reasonably ...") and the exclusions. First the typical director/officer usually has a large set of such persons and may have no reason to be aware of or even be able to find out about relationships of all of them to the business judgment. Here again, the director/officer's knowledge or awareness should be required before the participation of any member of this potentially large group in a transaction strips the officer/director of the protection of the BJR. The modifier doesn't help significantly; it doesn't say whose expectation is involved and leaves the matter to retrospective and potentially subjective hindsight.

(3) "Controlling Interest". In Section 322(a)(4), "controlling interest" is not defined and should be if the concept is retained. ALI Principles does not

define the term either but does define "control" in somewhat the same terms as GCL § 160. Neither, however, really deals with control of a director/officer. This is another example of an idea that should be left to the courts. If the concept is retained, it should be defined at least to exclude whatever "controlling interest" the board or a superior officer has over an officer, so that it cannot be claimed that such an interest caused the officer to make a judgment in carrying out his or her duties that someone (perhaps even the officer if he or she doubts the wisdom of the transaction) feels could be "expected" to affect the corporation or its shareholders adversely.

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April 4, 1996

Mr. Nathaniel Sterling
Executive Secretary
California Law Revisions Commission
4000 Middlefield Road
Palo Alto, CA 94303-4739

Re: Codification of the Business Judgment Rule

Dear Nat:

As you know, the Corporations Committee of the Business Law Section of the State Bar of California (the "Committee") has followed with interest the study by the California Law Revision Commission (the "CLRC") of the possible codification of the business judgment rule. The CLRC has reviewed Professor Eisenberg's Background Study, entitled "Whether the Business-Judgment Rule Should Be Codified" (May 1995) and the ALI Principles of Corporation Governance (1992) formulation of the business judgment rule. The Corporations Committee has reviewed this material as well as several staff memoranda, including Memorandum 96-24 (March 15, 1996) tentatively recommending the codification of the business judgment rule.

The judicial development of the business judgment rule, both in California and elsewhere, has provided directors with assurance from the courts that, if directors meet a defined standard of conduct in reaching their decisions, these decisions in the exercise of their business judgment will not be "second-guessed" by the courts. The Corporations Committee believes that the business judgment rule is vital to the effective governance of corporations, because it provides a strong incentive to directors to fulfill their duties, while assuring them that they will not have to serve as guarantors by facing liability for honest mistakes made in the good faith exercise of those duties.

Accordingly, the Committee believes that reform in this area should only be undertaken if the result provides additional certainty to directors and officers as to what standard of conduct is required and when liability will be imposed. If a "reform" proposal raises more issues than the current case law provides, we

respectfully suggest that the reform does not further the public policies underlying the reform effort. After careful review of the current codification proposal, the Committee has concluded that the proposed codification would introduce considerable new uncertainty into the law in this area, while not resolving any significant issues currently pending, and would therefore not further the public policy favoring reform. Accordingly, the Committee opposes codification at this time.

I. Summary of Committee's Position

The Committee's view on the CLRC's proposal are set forth in detail below in this letter. As noted above, in general, the Committee is opposed to the concept of codifying the business judgment rule. The following is a brief summary of the reasons for the Committee's position:

1. The Committee believes that codification cannot result in a clarification of the business judgment rule in California. The Committee believes that any attempt to codify the rule can only result in a restatement of the rule in terms that are comparable to judicial formulations. These formulations contains terms that are inherently subjective and do not lend themselves to precise application. Moreover, the complexity of the rule and its application will inevitably lead to a formulation that is conceptually incomplete and therefore inadequate for judicial application without substantive judicial modification. The Committee believes that this process is unlikely to produce the clarification that the CLRC seeks to achieve.

2. The Committee submits that the different judicial formulations of the business judgment rule do not mean that there is uncertainty in California law over the legal principle involved. Instead, the cases suggest that the courts are of necessity applying subjective standards (e.g., good faith and reasonableness) to very complicated business decisions that often involve a range of reasonable options. This process may produce different formulations of the standard of review but not necessarily unjustifiable results. The Committee believes that it is essential that the standard of review be sufficiently flexible to enable courts to deal with difficult situations. Codification of the standard is inconsistent with the need for flexibility to enable California law to evolve as circumstances warrant.

3. The Committee believes that the CLRC's proposal would introduce considerable uncertainty into current law and would not necessarily resolve the uncertainties posed by the California cases. The Committee does not believe that codification would advance the policy objectives that favor reform.

4. The CLRC proposal is conceptually flawed in its attempt to make satisfaction of the standard of care required of directors (Section 309 in its current form) and officers (proposed Section 312.5) dependent on satisfying the conditions to the application of the business judgment rule, which is a standard of judicial review. In the standard of review, if there is a determination that the elements of the business judgment rule have been met, a presumption is created that will prevent the court from looking into whether the director's conduct meets the requirements of Section 309. Thus, in concept, the standard of care and the standard of judicial review should operate independently.

5. In addition to the Committee's conceptual objections to the CLRC's proposal, the Committee believes that the proposal contains a number of technical deficiencies, which are described below. Nevertheless, even if these deficiencies could be remedied, for the reasons stated above, the Committee is opposed to codification of the business judgment rule.

II. Codification of the Business Judgment Rule is not Warranted At This Time

A. *Introduction.*

Doubts that codification will bring increased clarity stem from the fact that the subject matter of the codification involves the intersection and overlay of two flexible, subjective standards, rather than fixed, bright-line rules. The two standards involved are the standard of negligence to be applied to the conduct of directors and the standard of judicial review of the conduct. The business judgment rule, which is standard of review, was spawned in response to difficulties in applying the standards like those set forth in Section 309 to business decisions, which are complex, and typically are formed in an atmosphere where risk must be taken and more than one answer may be right at the time of the decision. Business decisions are multi-faceted and often involve the exercise of judgment involving a range of reasonable options. In such circumstances, it is important to encourage directors to make a decision which the directors believe is in the corporation's and shareholders' best interests, even if later the decision is proved to be wrong.

Essentially, the business judgment rule operates to restrain courts from second-guessing the business judgment of a director unless facts are presented which raise a significant likelihood that the director might fail the applicable standard of care or duty of loyalty or good faith on closer examination. In determining whether a business decision is sufficiently suspect to warrant expanded review, the courts examine the quality of the decision-making process and any factors which indicate

that the director may have breached the duty of loyalty, and may give some threshold review of the quality of the decision. In giving the latter review of the quality of the decision, the case law admittedly uses different phraseology to articulate the standard for the threshold review. The standards are inherently subjective and fact-specific, designed to be flexible measures suitable for ad hoc application because the standards address fact specific circumstances.

B. *There Is Inadequate Evidence of Confusion in Current Law As Justification For Codification.*

In evaluating the wisdom of codification, one must ask whether the uncertainty in existing law which codification seeks to cure is a reflection of the inherent uncertainty of subjective, flexible standards, or a reflection of confusion regarding the applicable standard. If the former, codification is not warranted, because attempts to codify subjective criteria for a particular standard simply restate judicial formulations and may prevent later refinements needed by different circumstances. The Committee believes that any present uncertainty in the law seems more likely to be a result of the inherently subjective nature of the judicial determination, rather than due to confusion about the standard for determination. With relatively few exceptions, our California cases have reached correct results in applying the business judgment rule to the facts presented them.

The CLRC Background Study points out that some California cases characterize the business judgment rule as a reasonability standard, others as a good faith standard, and others as a combination of the two. What is not made clear in the CLRC study is whether the use of the different terms by the courts is also yielding different results. If the courts view these terms as synonyms, or components of a single standard (which may be given different emphasis in different cases), then the different terms simply reflect the subjective, flexible standard being applied by the courts to determine if expanded review is warranted. Instead, the different phraseology is yielding different results, then it is arguable that courts are confused as to which standard should be applied. If such were the case, codification would be helpful, assuming for the moment, that definitive standards would be captured in the codification. However, based on the material presented in the CLRC study, it appears that the different terms are simply different articulations of the same standard. If so, codification will not give rise to greater certainty of outcome, because the only uncertainty is that inherent in the application of a flexible, subjective standard to varying facts.

C. *The Rule is not Susceptible to Easy Codification.*

To the knowledge of the Corporations Committee, no state has yet adopted the ALI Principles of Corporate Governance formulation of the business judgment rule. The Committee believes that this is due to the complexity of the task. The CLRC may be aware that, as reported in G. Varallo & D. Dreisbach, "The Board of Directors," 63 Corp. Prac. Series at A-29 (B.N.A., 1993), the American Bar Association Committee on Corporate Laws, the drafter of the Model Business Corporation Act, set out to codify the business judgment rule in its overhaul of the Model Act during the 1980s. The project was eventually abandoned, apparently in light of concerns that no codification of the rule can accommodate all the circumstances a board might possibly address. Id.; *See* E. Norman Veasey & Julie M. S. Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project -- A Strange Porridge,* 63 Tex. L. Rev. 1483, 1496 (1985).

The American Law Institute did earlier propose the codification of the rule. Section 4.01(c) of *the Principles of Corporation Governance: Analysis and Recommendations,* (May 1985). This formulation has been the subject of extensive criticism and debate. *See, e.g.,* Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation; Delaware Law and the Current ALI Proposals Compared,* 44 Bus, Law 503 (1989); Roswell B. Perkins, *The ALI Corporate Governance Project in Midstream,* 41 Bus, Law, 1195 (1986); Veasey & Seitz, supra, at 1483.

Many of the Committee's members actively counsel clients seeking to understand their duties as directors and officers of California corporations and would value further clarity in this area. Nevertheless, it is the view of the Committee that it would be extremely difficult to produce a codification of the business judgment rule which did not create more interpretive questions than it resolved. We are concerned that even if the specific concerns addressed in this letter are resolved, codification will likely create additional uncertainty, rather than the desired clarity of reform. As examples of the difficulty inherent in codification, we take note of the changes introduced in the March 15 staff materials in response to very significant issues; the possible inadvertent exclusivity of the proposed business judgment rule, and omission of officers' right to rely on experts. In short, the issues addressed in any codification of the business judgment rule are of vital importance to directors and officers, the difficulties inherent in the task are monumental and errors could result in increased liability for officers and directors. In view of these factors and the potential uncertainties created by codification, the Committee believes that codification is not appropriate.

D. *Further Time is Required to Consider Carefully the Issues Raised by Codification of the Business Judgment Rule.*

If the CLRC continues to believe that the codification of the business judgment rule is appropriate, then the Committee urges the CLRC to seek further comment from practitioners, law professors and bar associations with an interest in this subject prior to issuing a recommendation for legislation. The Committee points to the previously mentioned project of the ABA Committee on Corporate Laws, where factors arguing for and against codification were weighed over a lengthy period. The Committee suggests that although Professor Eisenberg's thoughtful background memorandum recommended codification, his views in favor of codification are well known through his work as Chief Reporter for the ALI Principles of Corporate Governance which proposed codification. Many likeminded colleagues had full voice in the ABA study referenced above, but in the end their view in favor of codification did not prevail.

We believe that the CLRC should seek out and carefully consider the equally cogent, and we believe more persuasive, arguments against codification before making a tentative recommendation. The Committee itself has been soliciting comments from practitioners and law professors. Those contacted to date have been uniformly opposed to codification, because of the inherent confusion and inflexibility of a legislative standard, as well as the difficulties of addressing in legislation the myriad issues which are critical to a judicial review standard. Accordingly, the Committee suggests that caution in this area is warranted and further views should be solicited and considered by the CLRC prior to the CLRC making a tentative recommendation. In this regard, the Committee has been advised that R. Bradbury Clark of O'Melveny & Myers, Los Angeles, is providing a letter and memorandum to the CLRC, raising significant issues regarding the codification proposal. The Committee urges the CLRC to consider carefully Mr. Clark's views.

III. The Particular Codification Proposal Raises More Issues Than Are Solved By Codification.

Several provisions in the current draft proposal illustrate the issues arising in any attempt to codify the business judgment rule. Accordingly, in the remainder of this letter we review particular problem areas which we have identified in the draft proposal.

Section 309. We disagree with the deletion of the phrase "of loyalty" in the title of this section. We believe that the duty to act in good faith and in a manner

such director believes in the best interest of the corporation and its shareholders state, in partial terms at least, the duty of loyalty. Thus, while a director acting in his own interests is subject to the provisions of Section 310 of the Code regarding the shifting of the burden of proof, we believe that Section 309 does include a statement of the duty of loyalty.

Further, we do not believe that it is appropriate to make Section 309 "subject to" a new Section 320 as provided in new subsection 309(d). Section 309 states a standard of care, while Section 320 states a judicial review standard. As Professor Eisenberg explains in his Background Study, these are very different legislative provisions. If Section 309 is made "subject to" Section 320, we believe that a court may conclude that a director is liable under Section 309 if the director cannot satisfy the conduct required to entitle the director to the presumption of the business judgment rule set forth in Section 320, despite the comment to Section 320 which proclaims the standards embodied therein as non-exclusive. If Section 320 is retained in any form, we propose that Section 309 and Section 320 stand independently. See our discussion below concerning Sections 320 and 321.

Section 312.5. We believe that the duties of an officer are currently subject to general principles of agency, as would be true for employees. We note that the new section appropriately permits officers to rely on experts. We have the same objection to the provision making this section "subject to" Section 320 as expressed above with regard to Section 309(c).

Section 320. Coverage and Structural Problems. Section 320 currently provides that a director or officer who meets the standard set forth in that section "fulfills the duty of care." However, the entire point of the business judgment rule is to establish a threshold of judicial review which cuts off judicial inquiry into corporate decisions without requiring the court to determine all of the facts necessary to determine that the standard of conduct stated in Section 309 has been met. As currently drafted, Section 320 cuts off inquiry if the director or officer meets three tests: he acted in good faith, he was reasonably informed, and he rationally believed that the decision was in the best interests of the corporation and its shareholders. It is not simply confusing, but erroneous, to equate satisfaction of that standard, a judicial review standard, with the satisfaction of a standard of conduct set forth in Section 309 or Section 312.5. This wording would therefore lead to considerable judicial confusion as to which "standard of conduct" governs.

Similarly, Section 320 currently applies to a director's "judgment." This is an ambiguous phrase, and permits a court to grant the limited review to only those

actions or affirmative decisions not to act which the court subjectively determines are equated with "judgment." That is, if the judgment did not meet the quality test applied by that particular court, the review standard of Section 320 might be held inapplicable. We propose that the first sentence of Section 320 might be reworded to address both of these issues; as reworded, the Section would provide that the director or officer "will not be liable for his action or his affirmative decision not to act."

As importantly, we believe that the current Section 320 cannot be read without the presumption contained in Section 321. A judicial review standard should include the evidentiary presumption required. These two sections should be combined. In other words, instead of stating that satisfaction of Section 320 "fulfills the duty" of a director under Section 309, it would be more accurate to provide that satisfaction of these standards entitles a director to the presumption set forth in Section 321. The two sections should be linked directly. However, even if this issue is clarified, Section 320 are fraught with interpretive problems, as discussed below.

Rationality versus Reasonableness. The Committee is concerned that the use of a rationality standard may yield significant confusion in judicial interpretations of the required conduct for directors. As the staff notes, the rationality standard is intended to provide directors [and officers] with a wide ambit of discretion " . . . a significantly wider range of discretion than the term 'reasonable.'" The staff is asserting one interpretation of rationality as "minimum rationality." The Committee does not necessarily agree with the staff's assertion that this rationality standard is a "middle ground" between good faith and reasonableness, and suggests that rationality would likely be viewed as the easiest of those standards of conduct to satisfy.

The Committee itself is divided as to the appropriate standard to trigger judicial review, with persuasive arguments made in favor of rationality, reasonableness and good faith. There is considerable commentary with regard to the various standards of conduct, G. Keating, "Reasonableness and Rationality in Negligence Theory" 48 Stanford Law Review 311 (Jan. 1996), although it appears to be defensible to have a lower standard as a threshold for judicial review than the applicable standard of conduct. The Committee is nevertheless concerned that if this amendment becomes law, judges may feel too constrained. In response, courts may feel compelled to punish directors or officers for arguably rational conduct due to the perceived harm to the shareholders in a particular case. Another possible result is that courts faced with a reasonableness test for inquiry and a rationality test for business purpose, will simply raise the bar to impossible heights as far as the director's required duty of reasonable inquiry to avoid the need to find the decision

irrational. This type of judicial backlash will do nothing to add clarity for directors and officers.

The risk of more, rather than less confusion is a function of the lack of general consensus on the appropriate standard, as well as the confusion over the meaning of "rationality." (The differences of views on the appropriate standard were aired during the development of the ALI Principles, as summarized by L. Ribstein and P. Letsou, BUSINESS ASSOCIATIONS at 456 (3d ed. 1996)). These strong differences of view suggest that consensus may be lacking and that codification may not be appropriate at this time, when the courts are still struggling with the competing policy considerations. We note that Section 309 does not define the standard by which a director must meet his duty to act in the corporation's and shareholders' best interest. This leaves to the judges to make this determination in developing a judicial review standard. Our discussion above suggests that although the courts have not always used the same phrases, the results from the courts have been reasonably predictable. The Committee is concerned that a legislative rule, rather than the flexible, judicially developed rule now in place, could result in more uneven judicial interpretation and even more uncertainty for directors as to their required standard of conduct.

In addition, the Committee believes that the formulation of the standard under Section 320 points up public policy issues which the legislature would confront in considering the proposed amendments to the Code. The effect of the rationality standard, according to the staff, is to protect conduct which may be "imprudent or unreasonable" but still arguably "rational." We do not believe that members of the legislature will necessarily agree as a matter of public policy that the standard should be "rationality." If they do not agree, the resulting standard of judicial review may be stricter than that currently applied; the Committee believes that such a legislative response would be met with shock by California directors and officers.

Officers Subject to Business Judgment Rule. The Committee believes that officers, qua officers, should be able to avail themselves of the business judgment rule. However, this is best done judicially. The business judgment rule was developed originally to encourage directors, who often serve with relatively low levels of compensation compared to the responsibility they assume, to make difficult decisions on behalf of the corporation. It is important to note that the business judgment rule protects action (which includes affirmative decisions not to take actions), not inaction. Directors fearing loss of the protection of the rule could simply decline to approve any actions for fear of liability. That would be disastrous in many

cases. Corporations would in that case also have serious difficulty attracting talented directors to serve.

None of these problems are attendant to the service of officers, who are subject, as agents of the corporation, to the terms of their employment arrangements, would usually be liable for negligence or misconduct in performing their duties, and who typically are well compensated for their responsibilities of carrying out the directions of the directors. Typically, the officers are doing their daily work, and act under the direction and within policies set by the Board. Further, executive officers are likely more experienced, more expert and more interested personally in the outcome of their actions. Accordingly, this is an area where the development of case law is an appropriate way to balance the facts, and the need for a statutory review standard appears to be limited.

Interested Directors. The Committee agrees with the policy stated in current case law that directors who are "interested" should not be entitled to the presumption provided by the business judgment rule. However, the Committee does not believe that this point is required to be stated in the statute. The statutory definition of "interest" as set forth in the proposal is not exclusive and therefore does not provide any safe harbor. Unfortunately, the listed criteria demonstrating interest could, given particular facts, prove overbroad, thereby creating a per se disabling "interest" unnecessarily. The inquiry into what personal interests should prevent the application of the favorable benefits of the business judgment rule is peculiarly fact driven and requires judicial flexibility. As an example, the Committee notes the recent Delaware case, Cede & Co. v. Technicolor, Inc., 634 A. 2d 345 (Del. 1993), affirming a holding of Chancellor Allen of the Delaware Chancery Court that not every personal interest held by a director is material and removes the director from the application of the business judgment rule. The list of "interested transactions" proposed in Section 321 is static, however, and does not permit such judicial flexibility. This section could therefore create additional problems in the evolution of the standard of conduct for directors, as described below.

The difficulty of codification is thus demonstrated; the judicial review standard would not be met if a director is "interested" and yet it is difficult, if not impossible, to codify what are appropriately disabling interests. Further, since directors act as a board, not as individuals, the interest of one or more directors, if disclosed to the other directors, may be neutralized by the formation of a special committee or by the director's abstention. The "interest" may result in shifting the burden to directors to prove that the transaction is fair under Section 310.

Section 322. The judicial evolution of the presumption resulting from the business judgment rule has been complicated by the need to address the effect of plaintiff failing to meet the presumption, plaintiff's standard to overcome the presumption and the effect of overcoming the presumption. These issues have not been completely resolved in California jurisprudence and present serious policy issues. The formulation contained in Section 322 does not address several of these issues. Indeed, the way we read the current draft of Section 322, there is no consequence to overcoming the presumption, as well as no evidentiary standard for overcoming the presumption. This section therefore will create significant uncertainty and invite litigation. Such uncertainty is clearly not the desired goal of a reform effort. The Committee believes further that the issues raised by an evidentiary presumption are not susceptible to easy legislative drafting and the case law has been doing an adequate job generally in resolving these issues.

Section 323. The Committee views this section as the most troubling of the proposals for several reasons. This section would dramatically change current California case law, is incorrect as a matter of policy and in addition creates significant ambiguity. First, the Committee notes that in Gaillard v. Natomas Co., (256 Cal. Reptr. 702, 208 Cal. App. 3rd. 1250 (Cal. App. Dist. 1989), the court was willing to apply the business judgment rule to so-called change of control agreements which would have had the impact of discouraging takeovers. (In that case, the court found that the directors in question had not met their duty of reasonable inquiry, or in some cases were interested, and therefore did not apply the business judgment rule.) The position stated in the draft section also appears to run contrary to the holding in Jewell Companies, Inc. v. Payless Drug Stores, 741 F.2d 1555 (9th Cir. 1983), in which the federal court reviewed California case law and concluded that California law permitted a board of directors to agree to an exclusivity clause in a merger agreement, which again would seem to discourage a takeover. Nevertheless, the Committee notes with astonishment that there is no discussion of the policy reasons in favor of this dramatic change in the rules applicable in California in the staff memorandum, and the Committee opposes the change.

The Committee notes that courts throughout the United States have held that directors are entitled to conclude in the exercise of their business judgment that provisions designed to discourage takeovers are in the best interest of shareholders. The courts have acknowledged that management may have a disabling interest in entrenchment, but have concluded that if nonemployee directors, either through a committee or as a majority of a board, control the decision as to the adoption of such measures, the transaction may be judged under a business judgment rule. This issue has received the most attention in Delaware. There courts have developed a

so-called "intermediate" standard, which requires directors to conclude that such a measure is reasonably related to a threat reasonably perceived. Unocal v. Mesa Petroleum Co. 493 A.2d 946 (Del. 1985) (measure must be reasonable response to a threat to the corporation reasonably perceived). It is peculiarly the role of directors to consider which of various competing alternatives is in the corporation's and shareholders' best interest, and this type of high risk decision-making is exactly what the business judgment rule is meant to foster. The Committee urges the CLRC not to change California law on such an important issue, particularly where no reasons for the need for a change are articulated and no alternative standard is provided,

The Committee's objections to the Section go beyond the change of policy, however. As drafted, the provision does not specify the necessary causal relationship between board action and the possible result of "blocking" an unsolicited tender offer. Therefore we believe the statute would be extremely uncertain in its application. Such routine Board actions as approval of a loan, the acquisition of a business, or the issuance of stock or options could possibly discourage a tender offer, either currently or in the future, and therefore would under Section 323 be removed from the protection of the business judgment rule. Similarly, the provision does not make clear what standard applies to determine whether a tender offer is "blocked" (e.g., a rights plan will not prevent a tender offer, but may delay closing while negotiations advantageous to the shareholders take place). The Committee believes that the uncertainty created by the statute would cause directors to forego actions otherwise in the best interests of the corporation. The Committee submits that there is no need for this provision, because California law is not unclear in this regard, and this provision will be cause for corporations to reincorporate in jurisdictions where the law provides greater certainty.

Conclusion

The Committee respectfully submits that the codification of the business judgment rule, a judicial review standard, is unwarranted and will lead to more, rather than less, confusion in determining the liability of directors and officers. The Committee has concerns that if this codification proposal becomes law, it may accelerate the flight of California corporations to other jurisdictions.

Despite the Committee's views expressed against the proposal, the Committee *@*wishes to extend its appreciation for the CLRC work in this area. The Committee believes that the CLRC draft, which represents many months of hard and able work by the CLRC staff, demonstrates some of the difficulties inherent in any codification of the business judgment rule. The CLRC's study and codification efforts have been

commendable and the Committee applauds the focus the CLRC has given this area. The Committee believes that the process of review and reflection on the issues which the CLRC's efforts have prompted have made a valuable contribution to the discourse and understanding of the business judgment rule. The Committee looks forward to answering questions concerning these comments at the CLRC's meeting on April 12th.

Very truly yours,

Diane Holt Frankle

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