Study B-601 April 26, 1996

Memorandum 96-31

Business Judgment Rule: Issues on Draft of Tentative Recommendation

BACKGROUND

At the last Commission meeting the Commission briefly considered the comments of the State Bar Corporations Committee, the State Bar Nonprofit Organizations Committee, and Professor Hugh Friedman of University of San Diego Law School, to the effect that codification of the business judgment rule is inadvisable. See letters attached to the First and Second Supplements to Memorandum 96-24. (Note: The interest of the Nonprofit Organizations Committee is indirect. Although the project is limited to business corporations, their concern is that business corporation concepts may be imported into the nonprofit area.) The Commission decided to consider this matter further at a future meeting when more time is available and when Professor Eisenberg is able to attend.

The letters of the bar committees comment extensively on this project, and reflect considerable thought and attention to it. The letters express both general concerns about the project to codify the business judgment rule and specific problems with the language of the draft tentative recommendation. This memorandum summarizes the general concerns of the bar committees. Attached to this memorandum is a copy of the draft tentative recommendation, with an analysis of their specific problems in ☞ **Staff Notes** following each section of the draft.

GENERAL CONCERNS

Complexity of Task

The bar committees point out that the complexity of the task of codification of the business judgment rule has persuaded eminent authorities not to attempt it, including the drafters of the Model Business Corporation Act and the corporate drafting committees of various state corporation laws. Even the ALI Principles of

Corporate Governance state that the business judgment rule might better be implemented by judicial decision than by codification.

The staff believes that the fact that corporation law experts previously have hesitated to attempt codification is instructive. Whether the Commission should attempt it, though, should depend more on our assessment of the extent to which existing California law is in need of reform. As to this issue, see the next point.

Codification Not Necessary

The Corporations Committee states that with relatively few exceptions, the California cases have reached correct results in applying the business judgment rule to the facts presented them. Any confusion in articulated standards is a reflection of the inherently subjective nature of the judicial inquiry; codification will not add certainty to this subjective determination.

The Nonprofit Organizations Committee likewise believes that, with one exception, the California courts seem to have understood the business judgment rule and have come to just conclusions. Any confusion in case law expressions of the rule has not produced bad results so far as they are aware.

The staff believes it is significant that lawyers who represent the very persons the business judgment rule protects believe there are no substantial problems with existing law. Of course, lawyers are adept at working with the common law and its ambiguities; codification of a clear statement of the rule may not be as important to them as it may be to others, or as important to corporation law specialists as it is to nonspecialists.

Codification Will Create New Uncertainties

The Corporations Committee believes that codification "cannot result in a clarification of the business judgment rule in California." They are concerned that codification necessarily uses terms and concepts that are subjective, which will require judicial interpretation and produce additional uncertainty rather than clarification. There is also the danger that the codification will inadvertently omit or change a key element of the business judgment rule.

The staff notes that our effort here is to codify existing law, rather than create new law. To the extent we are able to codify the rule in the very language used by the courts, we will not be injecting any uncertainty into the law that is not already present. Careful review of the draft by interested and affected persons,

such as we have before us from the bar committees, should help to eradicate potential problem areas in the draft.

Codification Will Restrict Flexibility

The bar committees feel the business judgment rule needs to remain flexible enough to fit varying fact situations and to apply to new circumstances. Codification could unduly restrict the needed flexibility.

The staff suggests that flexibility can be achieved in the draft by employing appropriate standards for application by the court. This is accomplished to some extent in the current draft by using concepts such as "good faith" and "reasonably informed". In common law jurisdictions the business judgment rule may continue to evolve over the coming years to eliminate old elements or add new elements. In California, if the rule is codified, the evolution would be within the control of the Legislature, rather than the courts, unless the next point proves correct.

Codification Pointless Because Courts Will Ignore It

The Nonprofit Organizations Committee believes that even if a clear, certain, and unambiguous codification can be achieved, it won't reduce litigation or change its outcome. That is because "our courts will still do what they would have done and want to do."

STAFF ASSESSMENT

To the staff it is plain from a review of the cases and treatises that the content of the California business judgment rule is unclear and confused, and that a clear statement of it would be beneficial.

The staff agrees with the State Bar commentators that there is a risk that codification will create ambiguities not now present in the law. Certainly the committees have identified a number of issues that ought to be addressed if we proceed. See ☞ **Staff Notes** following sections in the attached draft. The staff agrees that, if we proceed, we should devote all the time and attention necessary to develop and refine the draft in a way that satisfactorily addresses the identified problems, and we should seek broad input on it. This is the way we try to operate always.

Drafting to cure identified problems will require a departure from the wording of the ALI Principles of Corporate Governance. This is unfortunate,

since we believe that the ALI Principles will be heavily relied on by the courts over the years. Moreover, our departure from the ALI Principles will lose the valuable ALI commentary that can serve as a gloss for the draft. However, from the outset we intended to use the ALI Principles as a starting point, not as an end in itself.

Will codification unduly rigidify the law? The staff thinks the concepts involved in the business judgment rule are relatively flexible and leave room for appropriate application of the law to different circumstances. Although these concepts require judicial interpretation, they are merely a codification of common law concepts that require the same judicial interpretation.

The staff is heavily influenced, however, by the considered judgment of the corporation law experts on the bar committees that, despite the inadequacies of existing law, there are no real problems in practice. This contradicts information we had at the outset of this study from the business litigation perspective. But the Corporations Committee assures us that its membership is broad and representative, and includes litigators as well as corporate lawyers.

As several Commission members noted at the last Commission meeting, codification serves the interests others besides lawyers. A clear statement in the law of the business judgment rule and the protection it affords can help create an atmosphere that is hospitable to business, apart from whether lawyers manage to achieve appropriate results under the common law.

Should the Commission decide to proceed with the effort to codify the business judgment rule despite the judgment of the corporation law experts that this is inadvisable, the staff does believe that the specific problems they raise can be satisfactorily addressed. The staff wonders, however, whether it is worth the effort, given the other important topics on the Commission's very full agenda and the antipathy of the corporate bar toward this one.

IF WE PROCEED

The Nonprofit Organizations Committee is concerned that, if we proceed, there are many people who have an interest in this subject and would want to comment, but who are not yet aware of the project. The committee suggests that issuance of a tentative recommendation by the Commission would stifle comment because, once the Commission issues 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."

Of course, this is the opposite of the Commission's intention in issuing a tentative recommendation. We do not know how widespread the problem identified by the committee may be, but if it is at all prevalent, the Commission needs to rethink its basic operating procedures.

In any case, the staff certainly has no objection to issuing a "discussion draft" or some such document as suggested by the committee, instead of a tentative recommendation, should the Commission decide to go forward with this project.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

#B-601

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

Staff Draft

TENTATIVE RECOMMENDATION

Business Judgment Rule

April 1996

This tentative recommendation is being distributed so that interested persons will be advised of the Commission's tentative conclusions and can make their views known to the Commission. Any comments sent to the Commission will be a part of the public record and will be considered at a public meeting when the Commission determines the provisions it will include in legislation the Commission plans to recommend to the Legislature. It is just as important to advise the Commission that you approve the tentative recommendation as it is to advise the Commission that you believe revisions should be made in the tentative recommendation.

COMMENTS ON THIS TENTATIVE RECOMMENDATION SHOULD BE RECEIVED BY THE COMMISSION NOT LATER THAN **July 31, 1996.**

The Commission often substantially revises tentative recommendations as a result of the comments it receives. Hence, this tentative recommendation is not necessarily the recommendation the Commission will submit to the Legislature.

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BUSINESS JUDGMENT RULE

Summary of Tentative Recommendation

This recommendation proposes to codify the business judgment rule in terms drawn from the ALI Principles of Corporate Governance. Under this formulation, a good faith business judgment of a director fulfills the director's duty of care to the corporation and its shareholders if the director is disinterested, is reasonably informed, and has a rational belief that the action is in the best interests of the corporation. The same principles would apply to a good faith business judgment of a corporate officer. The business judgment rule would not apply in a proceeding to enjoin or set aside board action that has the effect of blocking an unsolicited tender offer.

TENTATIVE RECOMMENDATION

relating to

BUSINESS JUDGMENT RULE

BACKGROUND

The Legislature in 1993 authorized the California Law Revision Commission to study whether "the standard under Section 309 of the Corporations Code for protection of a director from liability for a good faith business judgment, and related matters, should be revised."[1] The motivating consideration for this study is that California law in the area is confused, which has been a factor in the decision of a number of California corporations to reincorporate in Delaware. The business judgment rule of Delaware and other jurisdictions should be examined to determine whether they may offer useful guidance for codification and clarification of the law in California.[2]

The Commission retained Professor Melvin A. Eisenberg of the University of California, Berkeley, School of Law to prepare a background study on the matter.[3] The present recommendation is the product of the Commission's deliberations at a series of public meetings held during 1995 and 1996.

This recommendation deals with standards of care and application of the business judgment rule only in the context of business corporations. It does not deal with those issues as applied to other business and non-business entities, such as partnerships and nonprofit corporations.[4]

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1. 1993 Cal. Stat. res. ch. 31.

2. *Annual Report for 1992*, 22 Cal. L. Revision Comm'n Reports 831, 845 (1992).

3. See Eisenberg, *Background Study for the California Law Revision Commission on Whether the Business-Judgment Rule Should Be Codified* (May 1995). Copies of the 21-page Background Study are available for purchase from the Law Revision Commission for $8.50 plus tax.

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

STANDARD OF CARE AND BUSINESS JUDGMENT RULE

Standard of Care of Directors

Corporate directors are held to a standard of careful conduct. The standard of careful conduct has evolved from basic fiduciary concepts. This can be seen in the statutory formulation of the standard found in Corporations Code Section 309(a), which requires a director to act in good faith in a manner the director believes to be in the best interests of the corporation and shareholders, and "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."

Standard of Judicial Review

In applying the standard of careful conduct to a business judgment made by a director, the courts have used a lower standard of review, provided the director made the decision in good faith, did not have a financial interest in the decision, and used a reasonable decision-making process in arriving at it. The lower standard of review applied in these circumstances is called the "business judgment rule".

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

Rationale of Business Judgment Rule

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

Is the special protection of the business judgment rule necessary or proper, given the fact that other fiduciaries are held to a standard of prudence and due care?[5] The trend in the law generally is to recognize that some risk is inherent in sound decision making, and to make allowance for that.[6] Risk is a necessary element of

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5. See Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 So. Cal. L. Rev. 287 (1992). Professor Gevurtz concludes that corporate directors are not unique in the types of decisions they make, and should not receive special treatment.

6. For example, in determining whether a trustee has used reasonable care, the trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but "as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." California. Prob. Code § 16047(b). See also *Uniform Prudent Investor Act*, 25 Cal. L. Revision Comm'n Reports 543 (1995).

proper business decision making, to an even greater degree than investment decisions of fiduciaries.[7]

CALIFORNIA LAW AND THE NEED FOR CLARIFICATION

California's formulation of the business judgment rule is confused. Some cases have articulated a reasonability standard,[8] others have articulated a good faith standard,[9] and still others have combined the two concepts or treated them as interchangeable.[10]

Statements may be found in case law that California's codification of the standard of careful conduct in Corporations Code Section 309(a) is a codification of the business judgment rule,[11] but that section actually codifies the standard of careful conduct, with which the business judgment rule is inconsistent. In fact, it could be argued that codification of the standard of care in Section 309 overturns the business judgment rule by its failure to create a business judgment exception to the statutory standard.[12]

The Commission has concluded that, given the justifications and importance of the business judgment rule, and the uncertainty of its status and formulation in California, it is desirable to codify the rule.

PRINCIPLES OF CODIFICATION

Models for Codification

The business judgment rule is a creature of the common law. No state has codified the rule.

It is generally thought that the California and Delaware business judgment rules are basically similar, although the California law is subject to some confusion. One attraction of Delaware law for many corporations is the substantial body of law that has developed in Delaware, offering useful guidance to corporate directors.[13] This would argue for codification in California based on Delaware law.

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7. Cf. Protecting Corporate Officers and Directors from Liability (CEB Prog. Hndbk. 1994).

8. 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).

9. 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).

10. See, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989).

11. See, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1264, 256 Cal. Rptr. 702 (1989); Barnes v. State Farm Mutual Auto. Ins. Co., 16 Cal. App. 4th 365, 379 n.12, 20 Cal. Rptr. 87 (1993).

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

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

> Both California and Delaware cases apply the business judgment rule to protect good faith diligent business decisions of directors where there is no conflict of interest, even where, in hindsight, the

The Law Revision Commission believes that a better model is the Principles of Corporate Governance (1992) of the American Law Institute (ALI). This compilation of principles represents a fair statement of the general law in a way that is not inconsistent with either Delaware law or existing California law, and would resolve any concern about discrepancies between California and Delaware law on this matter. A significant added benefit to codification of the business judgment rule in the form of the ALI Principles of Corporate Governance is that, besides clarifying California law, it will pick up an instant body of interpretation in the form of official commentary and reporter's notes. Moreover, the ALI Principles are likely to become a dominant factor in shaping the law in the future.

Elements of Business Judgment Rule

The formulation of the business judgment rule in the ALI Principles of Corporate Governance lays out the elements of the rule clearly. Under this formulation, a director who makes a good faith business judgment fulfills the duty of care if the director:

(1) is not interested in the subject of the business judgment;

(2) is informed with respect to the subject of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the corporation.[14]

Disinterested Director

The business judgment rule only applies where the director "is not interested in the subject of the business judgment." Under the ALI draft, a director is "interested" in a transaction or conduct in any of the following circumstances:[15]

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

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

(3) The director, an associate of the director, or a person with whom the director has a business, financial, or familial relationship, has a material pecuniary interest in the transaction or conduct (other than usual and customary directors' fees and

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decision was wrong. The business judgment rule does not protect against grossly negligent decisions, although this is a factual determination. *See Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985); *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965). There is far more case law in Delaware on this issue, and California courts may, and do, consider these Delaware cases as persuasive authority under appropriate circumstances.

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

14. American Law Institute, *Principles of Corporate Governance* §4.01(c) (1992).

15. American Law Institute, *Principles of Corporate Governance* §1.23 (1992).

benefits) and that interest and (if present) that relationship would reasonably be expected to affect the director's judgment in a manner adverse to the corporation.

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

This draft provides clear and useful standards that enable some certainty in determining whether the business judgment rule will be applied in particular circumstances. The Commission believes it should be made a part of the codification of the rule.

Rationality Standard

Under the ALI Principles of Corporate Governance, the business judgment rule protects a good faith exercise of business judgment by a disinterested and reasonably informed director if the director "rationally believes that the business judgment is in the best interests of the corporation."[16] Although courts have announced various formulations of the business judgment rule, the rationality standard is the most prevalent.[17]

The rationality 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."[18] An example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained.

The rationality standard allows a wider range of discretion than a reasonableness standard would impose; it gives the 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.[19]

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16. American Law Institute, *Principles of Corporate Governance* §4.01(c)(3) (1992).

17. See, e.g., Edward Brodsky and M. Patricia Adamski, Law of Corporate Officers and Directors: Rights, Duties, & Liabilities § 2.11 (1984); Dennis Block, Nancy Barton, and Stephen Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors 38-39 (4th ed. 1993).

18. Eisenberg, *Background Study for the California Law Revision Commission on Whether the Business-Judgment Rule Should Be Codified* 11 (May 1995).

19. American Law Institute, *Principles of Corporate Governance*, Comment to §4.01(c)(3) (1992):

This [rational belief] standard is intended to provide directors and officers with a wide ambit of discretion. It is recognized that the word "rational," which is widely used by the courts, has a close etymological tie to the word "reasonable" and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable," and to give a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonable" but are not so removed from the realm of reason when made that liability should be incurred. Stated another way,

The rationality standard represents a middle ground among the various standards that have been articulated in the California cases.[20] It has the added benefits that it is consistent with the mainstream of case law in other states, including Delaware law. And it picks up the useful explanatory material set out in the ALI Principles of Corporate Governance.

Presumption and Burden of Proof

The business judgment rule is sometimes described as a presumption in favor of the regularity of acts of the directors. But the business judgment rule is really a defense to an allegation that the duty of care has been violated. The burden of proof is on the person challenging the acts of the directors in any event.[21] These principles should be made clear in the codification of the business judgment rule. A director is presumed to have satisfied both the duty of care and the requirements of the business judgment rule, the burden of proof of these matters being on the plaintiff. This would codify existing law.[22]

ACTION THAT BLOCKS UNSOLICITED TENDER OFFER

The business judgment rule is applicable to determine whether the standard of care of directors has been satisfied, not only for determining liability of the directors, but also for determining whether the course of action they have decided on can be enjoined or set aside. A decision by the directors that will block an unsolicited tender offer for control of the corporation tests the limits of the business judgment rule.

A shareholder normally has the right to sell shares free of restrictions to any person who seeks to purchase the stock. An action by the board that interferes with that right by blocking a tender offer exceeds the usual board function of conducting the corporation's business, and requires special justification.

Under the ALI Principles of Corporate Governance, an action taken by the board to block a tender offer cannot be judged by the business judgment rule. The board may take an action that has the foreseeable effect of blocking an unsolicited tender offer only if the action is a reasonable response to the offer.[23] The business judgment rule may not be used to prevent an action that is unreasonable from being enjoined or set aside.

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the judgment of a director or officer will pass muster under [the business judgment rule] if the director or officer believes it to be in the best interest of the corporation and that belief is rational.

20. See discussion at footnotes 8-10, supra.

21. Evid. Code §§ 500, 521.

22. See, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); 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).

23. American Law Institute, *Principles of Corporate Governance* §6.02 (1992).

However, under the ALI Principles of Corporate Governance, the business judgment may protect a disinterested director from personal liability if the response was rational.[24] A reasonableness test for liability could unduly discourage directors from taking blocking action even if in the best interests of the corporation and shareholders. The separation of injunctive issues from liability issues enables the courts to avoid the dilemma of either being overly harsh in the remedies they impose for what they believe to be an unjustifiable defensive maneuver, or else overly lenient in permitting a transaction to stand in order to avoid imposing substantial liability on the directors.

The policy of the ALI Principles of Corporate Governance that the business judgment rule is inapplicable in proceedings to enjoin or set aside board action blocking an unsolicited tender offer is sound. Codification of the business judgment rule should exclude its application in these circumstances; this would codify existing California law.[25] The business judgment rule would continue to govern personal liability of the directors, however.

DERIVATIVE ACTIONS

Application of the business judgment rule to an action of directors to block or dismiss a derivative action as not in the best interests of the corporation is problematic.[26] This matter will be addressed in a separate recommendation by the Law Revision Commission.

APPLICATION TO OFFICERS

Most of the development of the law relating to business judgments has occurred in connection with directors, particularly in derivative action litigation. There is relatively little law concerning corporate officers. The Law Revision Commission recommends clarification of (1) the duty of care of officers and (2) the application of the business judgment rule to officers acting within the scope of their authority.

Duty of Care

There is little authority on the duty of care of officers. It appears to be 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.[27]

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24. American Law Institute, *Principles of Corporate Governance* §6.02(d) (1992).

25. See, e.g., Heckman v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

26. See Eisenberg, *The Requirement of Making a Demand on the Board Before Bringing a Derivative Action* and *The Standard of Review of a Board or Committee Determination that a Derivative Action Is Not in the Corporation's Best Interests* (Oct. 1995).

27. American Law Institute, *Principles of Corporate Governance*, Comment to §4.01 (1992).

While the duty of care of directors is codified in California, the duty of care of officers is not.[28] There is some indication in the literature that officers might be held to a higher standard of care than directors.[29] However, legal scholars agree that the standard of care applied to directors is flexible and can be applied equally well to officers.[30]

A director must act "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."[31] The same may be said of an officer. An ordinarily prudent person in the position of a full-time officer would generally be expected to be more familiar with the affairs of a corporation than an ordinarily prudent person in the position of an outside director. 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 under similar circumstances.

For purposes of clarity, the duty of care of an officer should be codified. An officer should be subject to the same duty of care as a director — the care, including reasonable inquiry, that an ordinarily prudent person in a like position would use under similar circumstances.

Application of Business Judgment Rule

The common law generally applies business judgment rule protection to officers as well as directors.[32] 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. These policies apply as well to decisions of officers as to decisions of directors.

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28. 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).

29. See 1 Ballantine & Sterling, California Corporation Laws § 102.02 (4th ed. 1993). The Legislative Committee Comment to the 1975 enactment of Corporations Code Section 309 states:

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

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

30. "Sound public policy points in the direction of holding officers to the same duty of care and business judgment standards as directors, as does the little case authority that exists on the applicability of the business judgment standard to officers, and the views of most commentators support this position." American Law Institute, *Principles of Corporate Governance*, Comment to §4.01 (1992).

31. Corp. Code § 309(a).

32. American Law Institute, *Principles of Corporate Governance* , Comment to §4.01 (1992).

One California case appears to deny business judgment rule protection to officers. Gaillard v. Natomas Co.[33] holds 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 since the officer-directors were acting as officers rather than directors.[34] The court here reaches the right result, but for the wrong reason — the business judgment rule in fact applies to officers, but the *Gaillard* officers should not receive its protection because they were interested in the transaction.[35]

To correct the confusion in California law, application of the business judgment rule to officers should be made clear by statute. 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 be interested when directors are not, and therefore may not receive business judgment rule protection for the same decision. Likewise, the requirement of the business judgment rule may protect a reasonably informed 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.

33. 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989).

34. "The judicial deference afforded under the business judgment rule therefore should not apply." 208 Cal. App. 3d at 1265.

35. 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.

PROPOSED LEGISLATION

An act to amend Section 309 of, to add an article heading immediately preceding Section 300 of, to add Section 312.5 to, and to add Article 2 (commencing with Section 320) to Chapter 3 of Division 1 of Title 1 of, the Corporations Code, relating to the duty of care of directors and officers of corporations.

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

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

Article 1. General Provisions

Corp. Code § 309 (amended). Director's duty of care

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

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

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

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

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

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

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

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

Comment. Section 309 is amended to reflect codification of the business judgment rule. The business judgment rule is codified in Section 320 (not in Section 309), contrary language in some cases notwithstanding. See, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1264, 256 Cal.

Rptr. 702 (1989) (Section 309 "codifies California's business-judgment rule"); Barnes v. State Farm Mutual Auto Ins. Co., 16 Cal. App. 4th 365, 20 Cal. Rptr 2d 87 (1993).

The business judgment rule is applicable to determine fulfillment of the duty of care under this section when a good faith business judgment is involved. See Section 320 (business judgment rule). While the business judgment rule provides a "safe harbor" for determining fulfillment of the duty of care, it is not the exclusive basis for such a determination, and conduct of a director that does not meet the standard of the business judgment rule may nonetheless satisfy the requirements of Section 309. See Section 321(c) (proof of fulfillment of duty of care).

☞ **Staff Note.**

Leadline. The leadline of this section refers to the director's duty of care. The Corporations Committee would refer also to the "duty of loyalty". The Commission removed the reference to duty of loyalty from the leadline because the duty of loyalty is dealt with more in Section 310. However, the staff agrees with the committee's analysis that the section deals with both care and loyalty to some extent. **We have no problem adding the reference to duty of loyalty**, although we do note that the leadlines used by us or anyone else to characterize the section are not part of the law and do not affect its meaning. Cf. Corp. Code § 6.

Subdivision (d). Both the Corporations Committee and the Nonprofit Organizations Committee object to subdivision (d) because it may be construed to replace the standard of care stated in Section 309 with the business judgment rule, when in fact the business judgment rule doesn't replace the section but is simply one means of satisfying its requirements. **The staff has no problem revising or eliminating this provision** if it will be construed in a way that creates problems; its only purpose is to provide a cross-reference to the business judgment rule to alert a reader of the code to its existence.

Corp. Code § 312.5 (added). Officer's duty of care

SEC. 3. Section 312.5 is added to the Corporations Code, to read:

312.5. (a) An officer shall perform the duties of an officer in good faith, in a manner the officer believes to be in the best interests of the corporation and its shareholders and with the care, including reasonable inquiry, that an ordinarily prudent person in a like position would use under similar circumstances.

(b) In performing the duties of an officer, an officer is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:

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

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

(c) A person who performs the duties of an officer in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as an officer.

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

Comment. Section 312.5 codifies the duty of care of an officer. See ALI Principles of Corporate Governance § 4.01 & Commentary (1992). This section does not seek to address conflicts that may arise in the context of an insolvent corporation.

The duty of care of an officer parallels the duty of care of a director. See Section 309(a). However, what is required of an officer may differ from what is required of a director, and what is required of an officer may vary considerably depending upon the position the officer holds with

the corporation. Cf. 1 H. Marsh & R. Finkle, Marsh's California Corporation Law § 11.3 (3d ed. 1990). The duty of care is a flexible standard, and its application depends on the circumstances of the person to whom it is applied; the test of fulfillment of the duty is whether the officer has acted with the care that a reasonably prudent person in a similar position would use.

The business judgment rule is applicable to determine fulfillment of the duty of care under Section 312.5 when a good faith business judgment is involved. See Section 320 (business judgment rule). Application of the business judgment rule to officers overrules the statement in Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1265, 256 Cal. Rptr. 702 (1989), that the judicial deference afforded under the business judgment rule should not apply to officers. While the business judgment rule provides a "safe harbor" for determining fulfillment of the duty of care, it is not the exclusive basis for such a determination, and conduct of an officer that does not meet the standard of the business judgment rule may nonetheless satisfy the requirements of Section 312.5. See Section 321(c) (proof of fulfillment of duty of care).

☞ **Staff Note.** The Nonprofit Organizations Committee opposes codification of the standard of care of officers, noting the following problems:

Subdivision (a). The requirement that an officer act in "good faith" is problematic as applied to officers because it is undefined and because officers can and do carry out their assigned duties effectively despite conflicts.

The requirement that an officer believe the actions to be "in the best interests of the corporation and its shareholders" is inappropriate for a person whose function may be to effectively implement policy set by the board.

The requirement that an officer make "reasonable inquiry" before carrying out assigned duties is inappropriate.

Upper level executive management should be held to a higher standard than an "ordinarily prudent person" because those officers are chosen for their greater than ordinary abilities. Lower level officers perform ministerial functions for which prudence is an inappropriate standard. These problems are not solved by using problematic terms such as "in a like position" or "under similar circumstances".

Subdivision (b). The statute should allow the officer to rely on a broader range of information than provided in the draft, including the board and board committees, but should be limited by the proviso that the officer "acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted."

Subdivision (d). See discussion of proposed Section 309(d).

Modification by other provisions. The standard of care fails to indicate that it is subject to modification in the articles, bylaws, employment contracts, and corporate procedures.

Staff Reaction. Codification of the duty of care of officers is not the object of the current study. It comes up only because the business judgment rule protects officers as well as directors, but the duty of care of officers is not defined by statute. The staff believes it is useful but not necessary to codify the duty of care of officers. Since there does not appear to be a consensus on how to define the duty, the staff would not pursue this matter. It is incidental and should not be allowed to divert us from the main objective.

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

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

Article 2. Business Judgment Rule

§ 320. Business judgment rule

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

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

(2) The director or officer is informed with respect to the subject of the business judgment to the extent the director or officer believes is appropriate under the circumstances, and that belief is reasonable.

(3) The director or officer believes that the business judgment is in the best interests of the corporation and its shareholders, and that belief is rational.

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

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

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

The business judgment rule applies to conduct of both directors and officers. The standard of care of directors is prescribed in Section 309; the standard of care of officers is prescribed in Section 312.5. Protection of an officer's conduct under this section is limited to conduct within the scope of the officer's authority. The duties of an officer are prescribed in the bylaws or determined by the board. Section 312(a).

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

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

The business judgment rule provides a "safe harbor" for determining a director's or officer's satisfaction of the duty of care to the corporation and shareholders, but it does not provide the exclusive means for this determination. An interested director or officer, for example, is not entitled to protection of the business judgment rule but the director's or officer's actions may nonetheless satisfy the duty of care that an ordinarily prudent person in a like position would use under similar circumstances. See Section 321(c) (proof of fulfillment of duty of care).

The business judgment rule applies only to satisfaction of a director's or officer's duty of care to the corporation and its shareholders. It does not apply to the duty of care, if any, to third persons. Nor does it limit any protection otherwise available for a director or officer, including a provision in the articles eliminating or limiting the liability of a director for monetary damages for

breach of the duty of care of the director to the corporation and its shareholders as authorized by Section 204(a)(10). See Section 309(c).

The introductory portion of subdivision (a) codifies the principle of existing law that the business judgment rule applies only to a good faith business judgment. See, e.g., Barnes v. State Farm Mutual Auto Ins. Co., 16 Cal. App. 4th 365, 20 Cal. Rptr 2d 87 (1993); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); Marsili v. Pacific Gas and Electric Co., 57 Cal. App. 3d 313, 124 Cal. Rptr. 313 (1975); 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).

Subdivision (a)(1) codifies the principle of existing law that the business judgment rule applies only to a disinterested decision. See, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989). For the meaning of "interested" as used in subdivision (a)(1), see Section 322 (interested director or officer).

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

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)). Subdivision (a)(3) applies a rationality standard that represents a middle ground among the various standards articulated by the California cases.

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

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

☞ **Staff Note.**

Application to officers. The Corporations Committee believes there is less justification for codifying business judgment rule protection for officers than for directors. They note that officers are in a different position than directors, being typically more adequately compensated, more experienced, and more personally interested. They suggest that the balancing of policies here is better accomplished by the courts on a fact-specific basis than by an inflexible statutory formula.

The Nonprofit Organizations Committee believes that if the rule is codified for officers it should apply only to discretionary judgments, should not be limited to acts "within the scope of the officer's authority", and should apply to an interested officer if the interest is disclosed.

The staff believes it is possible to codify the business judgment rule for officers without codifying the duty of care of officers, although this is not ideal. If we were to omit officers from the codification of the business judgment rule there would be an implication that no protection exists, although this could be refuted by Comment language or statute language preserving the common law business judgment rule for officers. The staff would prefer statute language, since at least one California case appears to deny business judgment rule protection to officers, and this should be overruled. Of course, courts applying the common law business judgment rule to officers would obviously take their cue from the codified version applicable to directors. **On balance, the staff favors codification for officers if codification is to be done for directors; we can craft special standards for officers if necessary.**

"Business judgment". The protection of the business judgment rule extends only to a "business judgment". The bar committees believe that term is not clear, despite its use in the cases. They are concerned it may provide a basis for a court to deny business judgment rule protection to a particular decision of a director. **The staff has no problem with making an effort to define this term, if that would be useful.**

"Fulfills the duty of care". The bar committees are concerned that the language of the draft, to the effect that a person who satisfies the requirements of the business judgment rule fulfills the person's duty of care to the corporation and shareholders, could be read to itself create a special duty of care that supersedes the general duty of care. Their cure is to replace this language with a direct statement that a person who satisfies the business judgment rule requirements is not "liable". The Commission considered such an approach early on and concluded that the business judgment rule goes beyond liability to protect the business judgment itself from being enjoined or set aside, and therefore the ALI formulation is preferable. **The staff has no problem, however, with dumping the fulfillment language in favor of some other formulation, provided the formulation protects the validity of the decision as well as the pocket book of the director.**

Interested director. The Corporations Committee would not codify the requirement that the director not be interested in the transaction because of difficulties in defining "interested". They are also concerned that participation by an interested director in a board decision may shift the burden to directors to prove that the transaction is fair. **The staff believes that the condition for application of the business judgment rule that the participating directors be disinterested is fundamental; we would not delete it.** As to issues in defining "interested", see the Staff Note under Section 322.

"Rational belief". The standard of review under the draft business judgment rule is that the director must believe the decision is in the best interests of the corporation and its shareholders, and the belief must be rational. The Corporations Committee is concerned that the rationality standard will cause confusion because it is susceptible to different interpretations. Moreover, the committee believes there is no consensus on the appropriate standard, whether reasonableness, good faith, or rationality. The committee is also concerned about legislative backlash against a highly protective standard, and feels it's safer in the hands of the judiciary.

The Commission, too, has been concerned about "rationality" as a standard, although our research has convinced us that is in fact the common law formulation in Delaware and elsewhere. **The staff believes it would be a perfectly satisfactory alternative to apply some other protective standard**, such as "gross abuse of discretion" or even "shocks the conscience of the court". The point is that there should be a highly protective standard of review, but the court must retain authority to correct an egregious case. A promising approach drawn from some of the cases would be to provide a "good faith" standard, and make clear that a decision that defies rational explanation is evidence of lack of good faith.

Relation to burden of proof. The Corporations Committee believes the burden of proof provisions (Section 321) are integral to the business judgment rule and should be incorporated in it or linked to it. **The staff has no problem adding a direct cross-**

reference between the two, if that appears appropriate after all the redrafting is done.

§ 321. Proof of fulfillment of duty of care

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

(b) The burden of proof on a person challenging the conduct of a director or officer as a breach of the duty of care of the director or officer to the corporation or its shareholders includes the burden of proving the inapplicability of the provisions as to the fulfillment of duty under Section 309 or 312.5 or the business judgment rule (Section 320), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation or its shareholders.

(c) The business judgment rule (Section 320) does not provide the exclusive means for determining whether a director or officer has fulfilled the duty of care of the director or officer to the corporation and its shareholders, and other conduct of the director or officer may fulfill the duty even though that conduct does not meet the standard of the business judgment rule.

Comment. Subdivisions (a) and (b) of Section 321 are drawn from ALI Principles of Corporate Governance § 4.01(d) (1992). They codify the presumption in existing law in favor of the validity of business judgments of corporate directors. See, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); 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). The burden of proof is proof by a preponderance of the evidence. Evid. Code § 115.

Subdivision (c) makes clear that the business judgment rule does not provide the exclusive means for determining whether a director's or officer's duty of care to the corporation and shareholders has been satisfied. An interested director or officer, for example, is not entitled to protection of the business judgment rule (see Section 320(a)(1), but the director's or officer's actions may nonetheless satisfy the duty of care that an ordinarily prudent person in a like position would use under similar circumstances. See Sections 309 (duty of care of directors) and 312.5 (duty of care of officers).

☞ **Staff Note**. The Corporations Committee states that the presumption provisions of this section will create significant uncertainty and invite litigation by its failure to provide an evidentiary standard or specify a consequence to overcoming the presumption. The staff does not understand this point. Subdivision (a)(1) makes clear that the presumption is one affecting the burden of proof; by statute, that is proof by a preponderance of the evidence. The effect of the burden of proof is also laid out by statute — it imposes on the party against whom it operates the burden of proof as to the nonexistence of the presumed fact; proof sufficient to overcome the presumption is proof sufficient to establish the nonexistence of the presumed fact. Moreover, the Corporations Committee states on the one hand that "these issues have not been completely resolved in California jurisprudence and present serious policy issues", and on the other hand that "the case law has been doing an adequate job generally in resolving these issues." **Without more specifics, the staff is unable to address these concerns.**

Subdivision (a). The Nonprofit Organizations Committee believes it should be made clear that the presumption of satisfaction of duty only applies in litigation, indicating

there is no need for a presumption other than for purposes of litigation. **The staff agrees that is the intent of this provision and it should be made clear if it is not already.**

Subdivision (b). The plaintiff has the burden of proving the inapplicability of the requirements of the duty of care or the business judgment rule. The Nonprofit Organizations Committee would replace "inapplicability of" with "failure to satisfy". **The staff agrees the suggested language is preferable and would adopt it.**

Subdivision (c). The Nonprofit Organizations Committee thinks subdivision (c) would be unnecessary if the business judgment rule were properly drafted to make clear it does not provide the exclusive means of satisfying the duty of care. This position makes sense, although it may be useful to reinforce the concept in subdivision (c) in any case. The committee also has some drafting concerns with the provision. **The staff suggests we hold off on these suggestions until we see whether any redraft of the business judgment rule in fact makes subdivision (c) unnecessary.**

§ 322. Interested director or officer

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

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

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

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

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

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

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

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

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

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

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

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

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

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

☞ **Staff Note**. The Corporations Committee believes that the determination of what is a disabling interest is peculiarly fact driven and requires judicial flexibility, citing as an example a 1993 Delaware decision that not every personal interest is sufficiently material to deprive a director of business judgment rule protection. The staff does not find this example particularly persuasive, since the materiality concept is already embedded in the text of Section 322. The tension here is between flexibility and certainty. There may be some benefit to knowing that specific circumstances are disqualifying, and a director or officer in those circumstances can act accordingly. **On balance, the staff thinks it's worth making the effort to provide some content to the "interested" concept.**

Subdivision (a). The bar committees are concerned that this definition of "interested" is not a safe harbor because, broad as it is, it is inclusive rather than exclusive . **The staff agrees with this concern**, although we note that the Commission moved away from its original safe harbor version at the request of a Corporations Committee representative attending one of the first Commission meetings on this matter.

Subdivision (a)(4). The draft would deny business judgment rule protection to a person subject to "controlling influence" by an interested person. The Nonprofit Organizations Committee states that this concept should be defined if it is to be retained, and at a minimum should exclude the controlling influence over an officer by the board or a superior officer. **The staff thinks this suggestion is appropriate.**

Subdivision (b). The Nonprofit Organizations Committee is concerned that the definition of "associate" is too broad for daily awareness by those making business

decisions; it appears to be drawn from SEC disclosure requirements, which focus on specific and limited circumstances and times, rather than on the circumstances of routine corporate decisionmaking. **The staff has no problem with considering refinements of the definition, including the following:**

Subdivision (b)(1). The Nonprofit Organizations Committee suggests the definition of an interested relative of an officer or director be cut back to a manageable level for the daily decisionmaking context, or be tied to the director's or officer's actual knowledge of the relative's relationship to the transaction.

Subdivision (b)(3). The Nonprofit Organizations Committee suggests the definition of an interested business associate of an officer or director be tied to the director's or officer's actual knowledge of the business associate's relationship to the transaction.

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

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

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

Directors have authority, recognized in existing judicial decisions, both to engage in pre-planning actions to respond to future unsolicited tender offers and to respond to existing offers. For purposes of liability, the directors' action will be judged under this section as of the time it is taken, rather than as of some future date or as a matter of hindsight.

Section 323 draws a significant distinction, not presently articulated in the cases (although the concept may underlie some decisions), between the proof necessary to enjoin improper defensive conduct and the proof necessary to impose personal liability for improper defensive conduct to which the business judgment rule (Section 320) applies. Under this section, directors who take action to block an unsolicited tender offer are protected from liability for damages, even if the court finds that their action should be enjoined or set aside, if they satisfied the standards of the business judgment rule. It would be inappropriate to apply the standard for enjoining actions by the board to block tender offers in a liability setting because such an application might unduly discourage directors from taking blocking action even when board action to block a tender offer may be in the best interests of the corporation and shareholders. Accordingly, in liability cases Section 323 adopts the standard of the business judgment rule.

By not applying the same standard of review in determining (i) whether to grant equitable relief and (ii) whether to impose personal liability on directors, Section 323 allows the courts to avoid the dilemma of either being overly harsh in the remedies they impose for what they believe to be an unjustifiable defensive maneuver, or else overly lenient in permitting a transaction to stand in order to avoid imposing substantial personal liability on the directors.

Directors would not be viewed as interested (Section 322), and therefore excluded from the protection of the business judgment rule, solely because of the prospective loss of usual and customary directors' fees and perquisites (whether or not constituting a significant portion of a particular director's income). The presence of an agreement to indemnify directors or continue insurance for directors' actions, does not constitute an interest that would disqualify a director from protection of the business judgment rule in a liability suit based on the board of directors' action to block a tender offer. The pecuniary interest of a director as a shareholder also should not cause the director to be viewed as interested, so long as the director is to be treated the same as other shareholders in the transaction.

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

However, if the number of disinterested directors who approve conduct designed to cause an unsolicited offer not to be made or to be withdrawn is legally sufficient to authorize action of the corporation, then in a liability action management or other interested directors who participate in the decision, join in the vote, or otherwise take action to implement the decision of the disinterested directors should be afforded the same protection of the business judgment rule as the disinterested directors.

☞ **Staff Note**. This section provides business judgment rule protection against personal liability of directors and officers who take action to block an unsolicited tender offer, but a lawsuit to enjoin or set aside the action would not be determined under business judgment rule standards. The Corporations Committee views this section as "the most troubling of the proposals" because (1) it would dramatically change existing law, (2) is incorrect as a matter of policy, and (3) creates significant ambiguity.

(1) Existing law. The cases cited by the committee do not support the committee's assertion that the draft statute changes existing California law; rather, the cases show that Section 323 codifies existing law, as stated in the Comment to the Section. See Heckman v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

The first case cited by the committee, Gaillard v. Natomas Co., 208 Cal. App. 3d 1250 (1989), was an action for damages against directors and officers for their adoption of golden parachute agreements. It did not involve an action to enjoin or set aside the golden parachute agreements. The court stated that the business judgment rule applies to the decision of disinterested directors, although the court then proceeded to apply instead the standard of care of Corporations Code Section 309 rather than the business judgment rule. (The confused opinion incorrectly equates the duty of care in Corporations Code Section 309 with the business judgment rule.) This is consistent with the last clause of Section 323, which provides business judgment rule protection against liability for damages (and does so more clearly than the case, which says it is applying the business judgment rule but then reverts to the general standard of care).

The second case cited by the committee, Jewell Companies, Inc. v. Payless Drug Stores, 741 F.2d 1599 (9th Cir. 1983), likewise supports Section 323. That case arose on a motion for summary judgment against a claim for damages arising out of a merger agreement approved by the board. The court invokes the business judgment rule, which also would apply under the last clause of Section 323 in these circumstances. It is noteworthy, again, that Section 323 actually provides better protection for directors than the case law, since the opinion, while referring to the business judgment rule, goes on to note that transactions in control such as this require "special scrutiny" and are reviewed under the business judgment rule and "the fairness test" of *Heckman v. Ahmanson*, supra.

From all this, **the staff concludes that Section 323, rather than reversing existing case law, in fact codifies and clarifies it in a beneficial way**.

(2) Policy. The Corporations Committee is "astonished" that there is no discussion of the policy supporting this draft. The policy supporting the draft is that an action by the board blocking a tender offer is an extraordinary act that interferes with the right of a shareholder to sell shares freely; this exceeds the usual board function of conducting the corporation's business and requires special justification. **The policy is elaborated at pages 6-7 of the draft tentative recommendation.**

The Corporations Committee refers to the Delaware case of Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), for the proposition that public policy demands application of the business judgment rule in a lawsuit to enjoin or set aside board action that blocks a hostile tender offer. However, **that case actually supports the draft in Section 323 by requiring a court inquiry into whether the board action is reasonable**, before it will grant business judgment protection against injunction.

The Corporations Committee notes that Section 323 provides no alternate standard of review where the business judgment rule is inapplicable because the lawsuit is one to enjoin or set aside board action. That matter is intentionally left to case law development. **The staff agrees that this gap should be addressed, either in the statute or Comment.**

(3) Ambiguity. The Corporations Committee points out ambiguities inherent in the concept of board action that will have the effect of blocking an unsolicited tender offer. The Commission has recognized that the concept is nebulous, and has sought to give some context to it in the Comment. The staff agrees that this approach is not completely satisfactory; **we should make an effort to tie the concepts down with somewhat more precision if we are to keep this section**.