Study B-601 June 17, 1996

Memorandum 96-52

Business Judgment Rule: Revised Draft

BACKGROUND

At the May 1996 meeting the Commission considered comments of the State Bar committees on Corporations and Nonprofit Organizations to the effect that codification of the business judgment rule would be inadvisable. Because a quorum was not present at the meeting, the Commission decided to defer decision on this matter, and to memorialize for later review the oral remarks of Prof. Mel Eisenberg (the Commission's consultant on this study) and Steve Blake (of the Corporations Committee). Their remarks are summarized below.

The Commission also requested the staff to prepare a revised draft of the business judgment rule for consideration in connection with the later review. The draft would incorporate ideas of the State Bar committees to the extent both Prof. Eisenberg and the staff find those ideas acceptable. The revised draft is attached to this memorandum.

CHANGES IN REVISED DRAFT

The revised draft of the business judgment rule includes a number of significant changes suggested by the bar committees that greatly limit and define the scope of the draft. In particular:

> (1) The codification covers only directors and not officers. Officers would continue to be governed by case law.
>
> (2) The codification covers only personal liability of directors and not issues involved in enjoining or setting aside board action. Those issues would continue to be governed by case law.
>
> (3) The possible implication that the business judgment rule supersedes the duty of care in Corporations Code Section 309 is eliminated by eliminating the amendment of Section 309 and redrafting to make clear that the business judgment rule is a standard of review and not a standard of care.

(4) The definition of an "interested" director is made exclusive rather than inclusive and at its broadest point is limited to pecuniary interests of which the director knows or is aware.

(5) The special rules on actions that have the foreseeable effect of blocking an unsolicited tender offer are eliminated.

(6) Areas of possible ambiguity are elaborated in the Comments, including the meaning of "business judgment", the relationship of presumption and burden of proof considerations, and the meaning of "controlling influence".

SUMMARY OF ORAL REMARKS AT MAY MEETING

The oral remarks made at the May meeting by Steve Blake on behalf of the Corporations Committee and by Prof. Mel Eisenberg, the Commission's consultant, are summarized here. It should be noted, however, that their remarks may have less relevance to the draft as the staff has revised it. In fact, the changes in the draft are so substantial and conform to such a great degree with the suggestions of the bar committees, that it is possible those committees would have a different attitude towards the concept of codification.

Remarks of Steve Blake on Behalf of Corporations Committee

The Corporations Committee believes there is no demonstrated need to undertake a codification of the business judgment rule, particularly when any codification will be exposed to the vagaries of the legislative process, with potentially unfortunate results. Judges and others have been dealing with the common law in this area with sound results, and it is familiar to those having to use it; codification risks an inadvertent change in the standard and greater confusion and uncertainty than now exists.

The bar committees consist of many lawyers from around the state from a variety of backgrounds, and both committees believe codification is inadvisable. Lawyers on all sides of the issue from all types of practices have managed to read, understand, and apply the common law satisfactorily.

Codification of the law in this area would have the undesirable effect of rigidifying and limiting the dynamic growth and change that goes on all the time in the business sector. Moreover, business persons, business lawyers, and plaintiffs' lawyers are an ingenious lot, and any codification in this area is liable to result in unexpected interpretations and consequences.

Codification of the business judgment rule would not significantly affect the business climate here. The fact that codification has never been tried before would mean that California would serve as a proving ground, which could be detrimental to the business climate. If the Commission is intent on improving the business climate, there are many other issues of greater importance than this.

Remarks of Prof. Mel Eisenberg, Commission Consultant

Prof. Eisenberg observed that there is in fact confusion among many persons dealing in this area about what the law is. The question is not how a lawyer should advise clients — the standard of care governs this — but what the rules are when litigation occurs. While codification of the business judgment rule is not the most earthshaking project, it nonetheless would be a useful clarification of the law. Prof. Eisenberg also noted that, in evaluating his comments, the Commission should be aware that he is not a "proponent" of codification, as suggested in the Corporations Committee letter. He believes common law development is desirable as a general principle, but that it has not worked very well in this area.

Prof. Eisenberg disagreed with the concept that it is inappropriate to codify the business judgment rule. The statement of the business judgment rule in the ALI Principles of Corporate Governance was not a matter of significant debate, and in fact there was broad consensus on it. It has not been previously suggested by any of the many corporation law experts involved in the ALI formulation that there is any ambiguity in it. Although the bar committees have asserted that ambiguities may be created, they have not identified any; and nothing could be more ambiguous than the existing inconsistent case law on the matter.

The ALI Principles do not oppose codification; they simply prefer common law implementation, as an accommodation for the ABA Model Act group, which opposed codification. Prof. Eisenberg indicated that the ABA Model Act group, which opposed codification of the business judgment rule in the past, may now in fact be undertaking a codification project. In any case, California law in general is better than Model Act law and should not be constrained by it.

Prof. Eisenberg found some aspects of the Corporations Committee letter either inconsistent or incorrect, including their suggestion that the uncertainty in existing law is the result of the inherently subjective nature of this area of law and that the existing cases are satisfactory (see, e.g., the *Gaillard* case). On one hand the committee suggests that codification would not change much, and on

the other the committee is concerned about changes that would be caused by codification. The committee thinks that the existing business judgment rule is clear to business persons, but in fact it is not now codified and the cases state inconsistent versions of it.

With respect to specifics in the letters of the bar committees, Prof. Eisenberg found either desirable or acceptable many of their suggestions, including (1) there should be better articulation between the standard of care and the business judgment rule, (2) it should be made more clear in the draft that the business judgment rule is a standard of review and not a standard of care, (3) the definition of "interested" should be exclusive rather than inclusive and should be narrower, and (4) officers should not be dealt with in the present recommendation (it can be revisited at a future date). He disagreed with the concept that Section 309 should be referred to as a duty of loyalty statute.

WHERE DO WE GO FROM HERE?

If the Commission decides not to pursue the effort to codify the business judgment rule, we need give the matter no further consideration except as it impacts the derivative action project.

If the Commission decides to pursue the codification effort, we should take seriously the bar committees' suggestion that we not rush it, but allow plenty of time for input by affected parties before we proceed to the tentative recommendation stage. The staff does not see a particular need to rush this project.

An added benefit of a go slow approach would be the opportunity to monitor what the ABA Model Business Corporation Act people are doing in this area. Although the Model Business Corporation Act does not include a codification of the business judgment rule, Prof. Eisenberg indicates they are now working on one. Perhaps this is spurred by the ALI Principles, or even by the Commission's work in the area. We may be able to get something useful from them.

Whichever way we go on this, the staff appreciates the outstanding input we have received and continue to receive from the bar committees. They have

devoted substantial resources to a careful review of this project; their involvement and commitment is gratifying.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

#B-601

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

Staff Draft

Discussion Draft

Business Judgment Rule

July 1996

This discussion draft 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 draft as it is to advise the Commission that you believe revisions should be made in the draft.

COMMENTS ON THIS DISCUSSION DRAFT SHOULD BE RECEIVED BY THE COMMISSION NOT LATER THAN **October 30, 1996.**

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

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BUSINESS JUDGMENT RULE

Summary of Discussion Draft

This discussion draft proposes to codify the business judgment rule in terms drawn from the ALI Principles of Corporate Governance. Under this formulation, a director is not personally liable to the corporation or its shareholders for a good faith business judgment if the director is disinterested, is reasonably informed, and rationally believes that the action is in the best interests of the corporation and its shareholders.

BUSINESS JUDGMENT RULE

BACKGROUND

The Legislature in 1993 authorized the 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 motivation 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 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 entities, such as partnerships and nonprofit corporations.[4]

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, reflected in the statutory formulation of the standard found in Corporations Code Section 309(a). That statute 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

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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 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 Ass'n, 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).

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.

Given the fact that other fiduciaries are held to a standard of prudence and due care, is the special protection of the business judgment rule necessary or proper?[5] The trend in the law generally is to recognize that some risk is inherent in sound decisionmaking, and to make allowance for that fact.[6] Risk is a necessary element of proper business decision making, to an even greater degree than investment decisions of fiduciaries.[7]

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5. See Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. 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." Prob. Code § 16047(b). See also *Uniform Prudent Investor Act*, 25 Cal. L. Revision Comm'n Reports 543 (1995).

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

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 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 statement of the standard of careful conduct in Corporations Code Section 309(a) codifies 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 statement 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 also considered the question whether the existence of other devices in the law for protecting directors against personal liability may diminish the importance of a clear statement of the business judgment rule. These devices include insurance and indemnification for directors,[13] as well as protection from liability under the articles.[14] These devices are not universal among California corporations, nor do they eliminate the benefit of a sound expression of the governing law.

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

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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 & R. Finkle, Marsh's California Corporation Law § 11.3 (3d ed. 1990).

13. Corp. Code § 317.

14. Corp. Code § 204(a)(10).

law that has developed in Delaware, offering useful guidance to corporate directors.[15] This would argue for codification in California based on Delaware law.

The 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.[16]

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:[17]

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

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15. 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 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).

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

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

(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 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 by a person who has a material pecuniary interest in the transaction or conduct, and the 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.

The Commission recommends one qualification of these standards. Under paragraph (3), neither the director nor an associate or other person with whom the director has a relationship may have a material pecuniary interest in the transaction that could adversely affect the director's judgment. But a director may be unaware of the existence of such a material pecuniary interest. The director should not be considered interested for purposes of the business judgment rule unless the director knows or should be aware of the existence of the material pecuniary interest.

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."[18] Although courts have announced various formulations of the business judgment rule, the rationality standard is the most prevalent.[19]

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."[20] An example of a

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

19. See, e.g., E. Brodsky & M. Adamski, Law of Corporate Officers and Directors: Rights, Duties, & Liabilities § 2.11 (1984); D. Block, N. Barton, and S. Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors 38-39 (4th ed. 1993).

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

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.[21]

The rationality standard represents a middle ground among the various standards that have been articulated in the California cases.[22] 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.[23] 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 person alleging a violation. This would codify existing law.[24]

PROCEEDINGS TO ENJOIN OR SET ASIDE ACTION OF BOARD

The business judgment rule is applicable to determine whether the directors' standard of care has been satisfied for purposes of determining liability of the directors. It may also be applicable for determining whether the course of action they have decided on can be enjoined or set aside.[25] Application of the business

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21. 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 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.

22. See discussion in text at nn. 8-10, *supra*.

23. Evid. Code §§ 500, 521.

24. 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).

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

judgment rule to a determination whether to enjoin or set aside board action is not a simple matter, however, and varies with the type of board action at issue.[26] The Commission would leave application of the business judgment rule in proceedings to enjoin or set aside board action to common law development.

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.[27] This matter will be addressed in a separate recommendation by the Commission.

CODIFICATION INAPPLICABLE 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 Commission recommends that the codification of the business judgment rule should be limited to directors, and that its possible application to officers be made the subject of a separate study. Codification of the business judgment rule for directors should not affect the common law protection of officers.[28]

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26. See, e.g., ALI Principles of Corporate Governance § 6.02(d) (1992) (action that has foreseeable effect of blocking unsolicited tender offer).

27. 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).

28. American Law Institute, *Principles of Corporate Governance* , Comment to § 4.01 (1992). But see Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989), suggesting that business judgment rule protection may not apply to officers.

PROPOSED LEGISLATION

An act to add an article heading immediately preceding Section 300 of, 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 business judgment rule.

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

Comment. Sections 300 to 318 are grouped as an article to facilitate creation of a separate article elaborating the business judgment rule. See Article 2 (commencing with Section 320). The business judgment rule is codified in Section 320, 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).

Corp. Code §§ 320-322 (added). Business judgment rule

SEC. 2. 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 who makes a business judgment in good faith is not personally liable for breach of Section 309 if all of the following conditions are satisfied:

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

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

(3) The director 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. Nothing in this section affects the standard applied in a judicial proceeding for breach of the duty of care of an officer or the standard applied in a judicial proceeding to enjoin or set aside an action of the board.

Comment. Section 320 codifies the business judgment rule as it applies to personal liability of a director of a corporation. Other provisions of this article elaborate the meaning and 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 (ALI), 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.

This section applies to conduct of directors; business judgment rule protection for officers, if any, is governed by the common law. Compare Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1265, 256 Cal. Rptr. 702 (1989) (judicial deference afforded under the business judgment rule should not apply to officers) with ALI Principles of Corporate Governance, Comment to § 4.01 (business judgment rule applicable to officers).

Common law, and not this section, governs application of business judgment rule principles in a judicial proceeding to enjoin or set aside an action of the board. See, e.g., Heckman v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

The business judgment rule provides a "safe harbor" for determining a director's liability for breach of the director's duty of care under Section 309, but it does not provide the exclusive means for this determination. An interested director, for example, is not entitled to protection of the business judgment rule but the director's actions may nonetheless satisfy the duty of care under Section 309 that an ordinarily prudent person in a like position would use under similar circumstances.

In a judicial proceeding, a director is presumed to have satisfied Section 309, and a person challenging the conduct of the director has the burden of showing the director's failure to satisfy the requirements of Section 309 or this section. See Section 321 (presumption and burden of proof).

The business judgment rule applies only to satisfaction of a director's duty of care to the corporation and its shareholders under Section 309. It does not apply to the director's duty of care, if any, to third persons. Nor does it limit any protection otherwise available for a director, 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).

To qualify as a "business judgment" within the meaning of this provision, a decision must have been consciously made and judgment must, in fact, have been exercised. It is important to recognize that a business decision may involve a judgment either to act or to abstain from action. Many decisions will involve a number of subsidiary issues. The prerequisite that there be an exercise of judgment does not require directors to focus collectively on each subsidiary issue. It simply requires that, in general, the directors become informed about and consciously reach a decision with regard to the overall issue.

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).

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:

> 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.**

"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 elaborated the meaning of this term in the Comment.

Personal liability. After consultation with Professor Eisenberg, we have adopted a formulation of the business judgment rule in this draft that is limited to personal liability of the director, as suggested by the bar committees. This formulation does not address issues involving enjoining or setting aside a board decision, which is left to the common law. Professor Eisenberg indicates that a sound statutory formulation of issues involving the validity of the decision itself is quite difficult; leaving this matter out of the codification will simplify the project and limit the number of issues in controversy.

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.

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 negligence or "gross abuse of discretion", although these may in fact be less protective than "rationality". The point is that there should be a highly protective standard of review, but the court must retain authority to correct an egregious case.

Application to officers. We have limited the codification to directors, in the interest of simplification. Officers would be left to application of common law principles as they are now.

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 added language to the Comment noting the application of Section 321 (presumption and burden of proof) to Section 320 (business judgment rule).

§ 321. Presumption and burden of proof

321. In a judicial proceeding for breach of Section 309:

(a) A director is presumed to have satisfied Section 309. 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 as a breach of Section 309 includes the burden of proving the failure to satisfy the requirements of Section 309 or the business judgment rule, 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.

Comment. Section 321 is drawn from American Law Institute Principles of Corporate Governance § 4.01(d) (1992). It codifies 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.

☞ **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) 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.

§ 322. Interested director

322. (a) For the purpose of the business judgment rule, a director is "interested" in transaction or conduct that is the subject of a business judgment if any of the following conditions is satisfied:

(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 another 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 or its shareholders.

(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 benefits), of which the director knows or should be aware, 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 or its shareholders.

(4) The director 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 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 a child, grandchild, sibling, or parent (or the spouse of any of them) of a director, or an individual having the same home as a director, 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 is a fiduciary.

(3) A person with respect to whom a director has a business, financial, or similar relationship that would reasonably be expected to affect the director'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 solely because the director is a director or principal manager of the business organization.

(B) A business organization in which a director 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 by reason of the holding, unless the value of the interest to the director would reasonably be expected to affect the director'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 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 by reason of the holding, unless the value of the interest to the director would not reasonably be expected to affect the director'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 American Law Institute (ALI) Principles of Corporate Governance § 1.23 (1992). Subdivision (a) is an exclusive listing of circumstances that may cause a director to be "interested" for purposes of application of the business judgment rule.

The consequence of a director being interested in a particular action is that the director will not receive business judgment rule protection for that action. However, this does not imply that the director is liable under Section 309, since, despite the fact that the director is interested, the

director's actions may nonetheless satisfy the duty of care that an ordinarily prudent person in a like position would use under similar circumstances. And in fact, the director is presumed to have satisfied the duty of care under Section 309. See Section 321 (presumption and burden of proof).

Unlike ALI Principles of Corporate Governance § 1.23 (1992), subdivision (a)(3) is limited to pecuniary interests "of which the director knows or should be aware".

Under subdivision (a)(4), controlling influence is most likely to occur in the case of a board that is dominated by a controlling shareholder. It is not intended that a person would be treated as subject to a controlling influence, and therefore interested, solely because of a long-time friendship or other social relationship, or solely because of a long-time business association through service on the same board of directors or other relationship not involving direct pecuniary dealing. However, where senior executives of two corporations sit on each other's board of directors, and each senior executive is in a position to review the other's compensation, or other transactions or conduct in which the other senior executive is pecuniarily interested, a court could consider that fact in determining whether in the circumstances of a particular case each of the senior executives is interested when reviewing each other's conflict of interest transactions or conduct.

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 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.

The Nonprofit Organizations Committee is concerned that these provisions are too broad for daily awareness by those making business decisions; they appear 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. We have addressed this issue in the draft by limiting subdivision (a)(3) to pecuniary interests of which the director knows or should be aware.

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. The staff has added language to the Comment elaborating the meaning of this term.