Study B-601 August 29, 1996

Memorandum 96-62

Business Judgment Rule: Revised Draft

Attached to this memorandum is a draft codification of the business judgment rule, revised in accordance with Commission decisions at the July meeting. Also attached as Exhibit pp. 1-11 is a letter from the State Bar Corporations Committee suggesting several further revisions of the draft.

The staff notes the following issues. Our objective is to make any necessary changes to enable us to circulate a discussion draft for comment.

TASK FORCE ON SECURITIES LITIGATION

The Commission asked the staff to report back on the activities of the securities litigation task force established by Senator Lockyer. The task force is quiescent at present, but will become active in the near future. We have added the task force to our mailing list to receive drafts, and **we will stay in communication** with them in case common issues arise.

ABA COMMITTEE ON CORPORATE LAWS

The State Bar Committee reports they are in contact with the ABA Committee on Corporate Laws, which has its own project on codification of the business judgment rule. **The State Bar Committee will keep us advised** of any information it receives from the ABA Committee on its project. Exhibit p. 7.

SETTING ASIDE OR ENJOINING CORPORATE ACTION

Background

Earlier versions of our business judgment rule draft would have applied the business judgment rule in a proceeding to set aside or enjoin corporate action as well as in a proceeding to subject a director to liability. The earlier versions did this by providing that the director "fulfills the duty of care to the corporation and

its shareholders" by complying with the requirements of the business judgment rule. The Comment noted:

> 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.

This is based on the approach of the ALI Principles, the commentary to which states:

> *e. Application of § 4.01 to enjoining or setting aside an action or transaction.* Part IV addresses factual situations in which a finding that a breach of the duty of care has occurred could lead to the imposition of various kinds of remedies. Among these remedies could be an injunction preventing the consummation of a transaction or equitable relief setting aside a transaction. Section 4.01 deals with standards of care for purposes of determining whether these remedies are potentially available against directors and officers, just as it deals with standards of care for purposes of determining whether monetary damages may be imposed.
>
> Normally an effort to enjoin a pending transaction, or to set aside a consummated transaction, not involving a conflict of interest such as an interested director's transaction (Part V) or a transaction in control (Part VI), will involve Subsection (c) [the business judgment rule], since any corporate transaction of importance is likely to have taken place as a consequence of an exercise of business judgment. The substantive issue would be whether the corporate decisionmaker has met the standards of § 4.01(c). However, a different substantive standard for injunctive relief would be applicable in certain cases involving conflicts of interest or transactions in control (see, e.g., §§ 5.02 and 6.02).

Professor Eisenberg reports that an early version of the ALI statement of the business judgment rule sought to do this directly, rather than indirectly, but was dropped because of the unanimous consensus that there were too many difficulties.

State Bar Proposal

The State Bar Corporations Committee offers a variant draft to apply the business judgment rule to both validity and liability issues. Exhibit pp. 1-4. In form slightly modified by the staff, it provides:

§ 320. Business judgment rule

320. (a) A director who makes a business judgment in good faith is presumed to have satisfied 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) The presumption established by this section is a presumption affecting the burden of proof.

(c) The burden of proof on a person challenging the conduct of a director as a breach of Section 309 or the validity of the corporate action includes the burden of rebutting the presumption of this section by proving failure of the director to satisfy subdivision (a) and, if and only if, that burden is sustained, of showing the director's failure to satisfy the requirements of Section 309, 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.

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

The staff is not opposed this sort of formulation, provided the following issues are also satisfactorily addressed as part of it:

(1) It is not sufficient to make the business judgment rule a presumption; it is also a substantive rule.

(2) The business judgment rule should not be drafted in such a way that, while protecting directors from personal liability, it would have the effect of automatically validating an illegal transaction, a self-interested transaction, or a transaction that blocks a hostile takeover attempt.

These matters are discussed immediately below. After reviewing these issues, and possible cures for them, **we may well conclude that the current Commission draft is preferable** to the State Bar alternative.

PRESUMPTION v. SUBSTANTIVE RULE

The business judgment rule is both a presumption and a substantive rule. It both (1) imposes the burden of proof on a person challenging an action of the directors to show that the duty of care has been violated, and (2) provides a substantive rule that if certain conditions are fulfilled, the duty of care is satisfied, not merely presumed satisfied. The State Bar formulation of the business judgment rule preserves the burden of proof aspect of it but not the substantive rule aspect.

If we are to work from the State Bar formulation, we need to preserve the substantive aspect of it. Otherwise, a director who fulfills the conditions of the business judgment rule would only be presumed to have satisfied the duty of care; that presumption would be rebuttable, and the issue of satisfaction of duty of care subject to further litigation.

If we are to phrase the business judgment rule exclusively in presumption and burden terms as proposed in the State Bar formulation, **we need to make the business judgment presumption conclusive**.

> 320. (a) A director who makes a business judgment in good faith is conclusively presumed to have satisfied 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) ~~The presumption established by this section is a presumption affecting the burden of proof.~~
>
> ~~(c) The burden of proof on a~~ A person challenging the conduct of a director as a breach of Section 309 or the validity of the corporate action ~~includes~~ has the burden of ~~rebutting the presumption of this section by~~ proving failure of the director to satisfy subdivision (a) and, if and only if, that burden is sustained, of showing the director's failure to satisfy the requirements of Section 309, 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.
>
> ~~(d)~~ (c) This section shall be known and may be cited as the business judgment rule.

ILLEGAL TRANSACTIONS

If the formulation of the business judgment rule is to explicitly address issues relating to proof of both director liability and validity of corporate action, it should also address areas where a director may be free of liability but public policy demands that the corporate action be subject to challenge. The three areas we have identified so far that give cause for concern are illegal acts, self-interested acts, and acts that block tender offers.

It is possible for directors to approve a transaction that satisfies all the requirements of the business judgment rule yet still be illegal. For example, the directors may make a decision to set prices based on discussions with industry leaders in the good-faith, disinterested, and reasonably informed belief that the action is in the best interests of the corporation and shareholders. But the scheme may subsequently be determined to be illegal price-fixing. Just because the directors are immune from personal liability under the business judgment rule does not mean the corporate action should automatically be "valid" and not enjoinable.

If we are to explicitly validate transactions that satisfy the business judgment rule, **we should have a provision something like**:

> **§ 324. Illegal acts**
>
> 324. 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 is illegal, but directors who authorize that action are not subject to liability for damages if their conduct meets the standard of the business judgment rule.

SELF-INTERESTED TRANSACTIONS

Under the State Bar formulation, a person seeking to challenge the validity of a corporate action has the burden of proving failure to satisfy the duty of care of a director.

In the case of a challenge to a transaction involving an interested director, however, Corporations Code Section 310 expressly imposes on the person asserting the validity of the transaction the burden of proving that the transaction was just and reasonable as to the corporation at the time the decision was made.

The broad statement of the burden of proof as to validity in the State Bar formulation should not be read to override the specific requirements of

Corporations Code Section 310. **We need to add something along the following lines**:

> (b) ~~A~~ Except as otherwise provided by statute, a person challenging the conduct of a director as a breach of Section 309 or the validity of the corporate action has the burden of proving failure of the director to satisfy subdivision (a) and, if and only if, that burden is sustained, of showing the director's failure to satisfy the requirements of Section 309, 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.** The introductory portion of subdivision (b) recognizes the existence of statutes providing special rules as to burdens of proof. See, e.g., Section 310(a) (contract or transaction in which director has material financial interest)

ACTION THAT BLOCKS UNSOLICITED TENDER OFFER

If the business judgment rule is to apply in determining the validity of a corporate action, then we need also to reexamine its application to a decision by the directors that will block an unsolicited tender offer for control of the corporation.

The State Bar Committee takes the position that existing California law does not apply a higher standard than the business judgment rule to corporate takeover decisions. They see no need for special rules to address this situation. Exhibit p. 5.

Existing Law

Existing California law on this point is not clear. The lack of clarity parallels the prevailing situation in the law generally, including Delaware. Decisions there hold that when directors take action to block an unsolicited tender offer, they assume the burden of showing that they had reasonable grounds to believe that a danger to corporate policy and effectiveness exists, and their action is reasonable in relation to the threat posed. See, e.g., Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985), and cases following. The cases state that if the directors satisfy this burden, then the business judgment rule applies — this is more properly characterized as an "intermediate" review standard or an "enhanced" business judgment standard than as the "business judgment rule".

Policy of ALI Principles

Under the ALI Principles of Corporate Governance, the business judgment rule may apply to protect a director from liability for taking action to block a hostile tender offer. But proceedings to enjoin or set aside the corporate action are judged on the basis of whether the corporate action is a reasonable response to the tender offer. The business judgment rule may not be used to prevent corporate action that is unreasonable from being enjoined or set aside.

The policy supporting the higher standard in these circumstances is that 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. The business judgment would still protect a disinterested director from personal liability if the response was *rational*. A *reasonableness* test for liability could unduly discourage directors from taking blocking action even if in the best interests of the corporation and shareholders. Separation of validity 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.

Standard, or Lack of It

The last draft considered by the Commission on this matter did not get into the question of what the standard should be for enjoining or setting aside board action to block an unsolicited tender offer. The draft simply provided that the business judgment rule is applicable to determine liability of directors for such an action but not to determine whether the action should be enjoined or set aside. The latter issue was left to case law development.

The simplest way to deal with the matter would be to leave it to continued case law development, as in the Commission's last draft of it:

> **§ 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.

If, however, the Commission is inclined to try to develop a statutory standard for enjoining or setting aside this type of corporate action, the logical place to start is the ALI Principles of Corporate Governance. The ALI Principles adopt a modified form of Delaware's *Unocal* test. **A statute based on the ALI Principles would look something like this**:

> **§ 323. Action that has foreseeable effect of blocking unsolicited tender offer**
>
> 323. (a) The board may take an action that has the foreseeable effect of blocking an unsolicited tender offer, if the action is a reasonable response to the offer.
>
> (b) In considering whether its action is a reasonable response to the offer, the board may do any of the following:
>
> (1) Take into account all factors relevant to the best interests of the corporation and shareholders, including, among other things, questions of legality and whether the offer, if successful, would threaten the corporation's essential economic prospects.
>
> (2) In addition to the analysis under paragraph (1), have regard for interests or groups (other than shareholders) with respect to which the corporation has a legitimate concern if to do so would not significantly disfavor the long-term interests of shareholders.
>
> (c) A person who challenges an action of the board on the ground that it fails to satisfy subdivision (a) has the burden of proof that the board's action is an unreasonable response to the offer.
>
> (d) An action that does not satisfy subdivision (a) may be enjoined or set aside, but directors who authorize the action are not subject to liability for damages if their conduct satisfies the business judgment rule (Section 320).
>
> **Comment.** Section 323 is drawn from ALI Principles of Corporate Governance § 6.02(d) (1992).
>
> 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.

"Foreseeable Effect" of Blocking Tender Offer

One problem with the ALI provision is the potential uncertainty about what type of corporate actions might be considered to have "the foreseeable effect of blocking an unsolicited tender offer". The draft on its face relates only to corporate action in response to an existing tender offer, since it speaks in terms of "a reasonable response to *the* offer." Subdivision (a) (emphasis added).

The ALI commentary notes the authority of directors both to engage in pre-planning actions to respond to future unsolicited tender offers and to respond to existing offers. The commentary suggests that even if a poison pill or other device is in place, it might be incumbent on the directors, as a reasonable response to a tender offer, to disarm the anti-takeover device, if that is within their power. If they have created a device, without shareholder approval, that they are powerless to disengage in response to a specific future offer, that could, depending upon the facts and circumstances, "constitute an unreasonable restriction on the shareholders' right to transfer their shares." ALI Principles § 6.02, Comment c (10).

INTERESTED DIRECTOR DEFINITION

The business judgment rule does not apply to an interested director. In the current draft we seek to give some content to the meaning of the term "interested". See Section 322.

Simplification of Draft

The following draft combines **simplifications of the definition** suggested by the State Bar Committee with simplifications proposed by the staff. See Exhibit pp. 9-11. This draft does not change the substance of the provision.

§ 322. Interested director

322. (a) For the purpose of the business judgment rule, a director is "interested" in a transaction or conduct that is the subject of a business judgment only 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~~,~~ or 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)~~ (3) The director is subject to a controlling influence by ~~another~~ a party to the transaction or conduct (other than the corporation) or by 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 familial, business, financial, or similar relationship ~~that~~ other than a person described in paragraph (1) or (2), but if and only if the familial, business, financial or similar relationship 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~~:

(c) For the purpose of determining whether a director's relationship with a business organization would reasonably be expected to affect the director's judgment with respect to a transaction or conduct in a manner adverse to the corporation or its shareholders, the following presumptions affecting the burden of proof apply:

(1) ~~A business organization is not an associate of a director~~ The director's judgment is presumed not to be adversely affected solely because the director is a director or principal manager of the business organization.

(2) ~~A business organization in which a~~ The director's judgment is presumed not to be adversely affected if the 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~~.

(3) ~~A business organization in which a~~ The director's judgment is presumed to be adversely affected if the 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~~.

Familial Relationships

The State Bar Committee suggests that the statutory reference to "familial" relationships be eliminated in favor of a potentially larger but more specific listing of immediate family relationships. They note that the federal securities laws offer models. Exhibit p. 5.

Rule 16a-1 under the Securities Exchange Act of 1934 contains a definition of immediate family that is slightly broader than the ALI definition of associate, in that it includes grandparents and makes clear that adoptive relationships also are covered. It provides that, "The term 'immediate family' shall mean any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and shall include adoptive relationships."

The staff does not have a problem with eliminating the reference to a familial relationship in reliance on the specific listing of immediate family members in the federal securities law definition. Once you get further away than these immediate relationships (e.g., nieces and nephews, cousins, etc.) you probably don't gain much in trying to ensure a disinterested decision. Does it make any sense to distinguish a remote relative from a best friend?

General Principles

The business judgment rule does not protect a director from liability if the director is interested in the subject of the business judgment. Although there is a fair amount of law dealing with the *validity* of corporate actions involving an interested director, the law on the personal *liability* of an interested director is not well developed. The Model Business Corporation Act, for example, notes that an interested director may be held personally liable in some circumstances; liability could occur when the court leaves the transaction itself in place as well as when the court rescinds the transaction. The Act, however, leaves these personal liability issues "entirely to the judgment of the court." Model Business Corporation Act Annotated § 8.61 at 8-421 (3d ed. 1994).

As the ALI Principles of Corporate Governance point out, "Relatively few cases have imposed personal liability for damages." ALI Principles § 4.01 (introductory note *b*). The measure of damages for liability of an interested director also appears to be fairly limited. Typically, the offending director may be required to disgorge any improper profits received as a result of the interested transaction, or to respond in damages for injury suffered by the corporation as a result of the transaction.

Duty of Loyalty Issues

A director is subject to basic duties of care and loyalty to the corporation and its shareholders. Most of the law on personal liability of interested directors involves violation of the duty of loyalty. To some extent an interested director may avoid liability by disclosing the conflict, not participating in the decisionmaking process, abstaining from voting, or a combination of these, depending on the type of decision at issue.

Corporations Code Section 310 provides that a transaction involving an interested director may be valid if the conflict is disclosed by the interested director and approved by a sufficient majority of the board without counting the vote of the interested director; for this purpose, the interested director is counted in determining the presence of a quorum. However, directors who approve improper shareholder distributions or improper loans or guarantees to directors or officers, "shall be jointly and severally liable"; a director who is present at a

meeting at which the improper action is taken and who abstains from voting "shall be considered to have approved the action." Corp. Code § 316.

Duty of Care Issues

Whether a violation of the duty of care by an interested director, as opposed to the duty of loyalty, invokes any special considerations is problematic. The duty of care is set out in Corporations Code Section 309, which requires, in addition to the care that an ordinarily prudent person in like circumstances would use, that the director act "in good faith, in a manner such director believes to be in the best interests of the corporation".

An interested director cannot rely on the business judgment rule to avoid liability for violation of the duty of care. The corporate articles cannot immunize a director from liability for a violation of the duty of care "from which a director derived an improper personal benefit". Corp. Code § 204(a)(10)(A)(iii). The corporation cannot indemnify a director for liability if the director failed to act in good faith and in a manner the director reasonably believed to be in the best interests of the corporation. Corp. Code § 317. While it is conceivable that an interested director can make a decision in good faith, in a manner the director believes to be in the best interests of the corporation, such a decision should be cause for scrutiny.

The mere fact that an interested director has participated in a decision that violates the duty of care is not necessarily grounds for director liability. Corporate decisions are made by a board or committee and not by individual directors. Cf. Corp. Code § 307(a)(8) (act of a majority of directors present at meeting at which quorum is present is act of board). The question really is, was the action of the interested director a legal cause of damage to the corporation? "A director who fails to perform an oversight obligation, for example, may have caused no damage to the corporation because the failure was rendered harmless by the care of other directors." ALI Principles § 4.01 (introductory note *a*).

Application of Business Judgment Rule to Interested Director

Brad Clark has suggested that where an interested director discloses the interest or abstains from voting or both, the director should be entitled to business judgment rule protection if a majority of the directors who do vote on the matter satisfy its requirements. "Since one or more directors of corporations will inevitably at times be interested in business judgments made by the board,

they should not be placed in a separate, more liable class of directors if they make appropriate disclosures and abstain from voting or their vote is not necessary to the outcome of the decision." Otherwise, their safe harbor would be to leave the board, not a desirable result in most cases.

But does an interested director need business judgment rule protection? Doesn't an interested director's abstention per se eliminate any potential liability for violation of the director's duty of care to the corporation and its shareholders? The State Bar Committee takes the position that the business judgment rule need not cover abstaining directors — by definition a director who abstains is not making a business judgment, so there is no ground for liability. See Exhibit p. 6.

Surprisingly we have found scant material in the legal literature addressing the issue. Hamilton, The Law of Corporations (in a Nutshell) § 10.9 (4th ed. 1996), remarks that, "Filing of a dissent not only eliminates liability, but also obviates later problems of proof and may have a psychological effect upon the other directors ..." But a dissent is different from an abstention.

There is Delaware case law to the effect that abstention by a director does not immunize the director from liability for a corporate action, absent special circumstances. Dalton v. American Investment Co., 6 Del. J. Corp. L. 402 (1981). Abstention on the basis of conflict of interest is such a special circumstance that would immunize the director from liability. In re Tri-Star Pictures, Inc., Litigation, 20 Del. J. Corp. L. 854 (1995); Propp v. Sadacca, 175 A. 2d 33 (1961).

The Delaware law appears to comport with logic. If the director does not participate in the decision due to a conflict of interest, it does not appear proper to subject the director to duty of care liability. (Note that if a *disinterested* director does not participate, there may be liability for failure to carry out the duties of a director. The Corporate Directors Guidebook states that "courts often have not sustained damage awards against directors for breach of this duty but instead have indicated they will impose liability for breach of the duty of care only in cases of obvious or prolonged failure to participate diligently and to exercise oversight or supervision. However, recent decisions of the Delaware Supreme Court have re-emphasized the need for directors to take an active, rather than a passive, role in meeting the duty of care if liability is to be avoided." ABA, Business Law Section, Corporate Directors Guidebook XIV (1994).)

In light of the general lack of clarity in this area, it may be worth adding to the statute a provision along the following lines:

§ 325. Nonparticipation by interested director

325. Except as otherwise provided by statute, a director who does not participate in a business judgment because the director is interested (Section 322) in the subject of the business judgment and who discloses that interest to the board is conclusively presumed to have satisfied Section 309.

Comment. Section 325 enables an interested director to receive the effect of the business judgment rule by disclosing the interest and not participating in the board action. In order to be deemed not to have participated within the meaning of this section, the director must not only have abstained from the board action but also must have declined to participate in board discussion of the matter. Section 325 is subject to contrary statutory provisions. See, e.g., Section 316(b) (director who abstains from specified board actions is deemed to have approved actions).

Effect of Definition of "Interested" Director

The State Bar Committee is concerned that the definition of "interested director" in Section 322 is so broad that it will encourage abstention in many borderline cases for fear that the director may incur liability. Moreover, frequent abstentions may also subject a director to liability on both duty of care (failure to act) and duty of loyalty (admission of "interest") grounds. See Exhibit pp. 6-7.

The staff thinks these concerns are overwrought. The business judgment rule right now is not available to interested directors, and "interest" is undefined — it is left to the subjective judgment of the courts. Are counsel right now advising mass abstentions, given the fact that a disqualifying "interest" is potentially unlimited? At least the definition in Section 322 provides some guidance as to the circumstances in which a director may be considered interested, whereas existing law provides none.

To some extent, the State Bar concerns may be allayed by eliminating reference to undefined "familial" relations from the definition of "interest" as suggested by the State Bar Committee. **A not wholly satisfactory alternative, in the staff's opinion, would be simply to eliminate the definition of "interest" and leave the matter to case law development.**

In this connection, it is worth noting that the Model Business Corporation Act's conflict of interest provisions do not define "interest", but their commentary notes that "a director should normally be viewed as interested in a transaction if he or the immediate members of his family have a financial interest in the transaction or a relationship with the other parties to the transaction such

that the relationship might reasonably be expected to affect his judgment in the particular matter in a manner adverse to the corporation." MBCA § 8.31, Comment 5. This sounds a lot like the general language of our draft Section 322, minus the specific detail included in our draft.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

GRAY CARY WARE
▲ FREIDENRICH
A PROFESSIONAL CORPORATION

ATTORNEYS AT LAW
400 HAMILTON AVENUE
PALO ALTO, CA 94301-1825
TEL (415) 328-6561
FAX (415) 327-3699

DIANE HOLT FRANKLE
DIRECT DIAL: (415) 833-2026
INTERNET: DFRANKLE@GCWF.COM

OUR FILE NO.
1269999-661205

August 16, 1996

VIA CALIFORNIA OVERNIGHT

Mr. Nathaniel Sterling
Executive Secretary
California Law Revision Commission
4000 Middlefield Road
Palo Alto, CA 94302-4739

Re: Codification of the Business Judgment Rule (Study B-601)

Dear Nat:

As we indicated at the California Law Revision Commission ("CLRC") hearing on July 11, 1996, the task force established by the Corporations Committee of the State Bar of California's Business Law Section (the "Committee") has reviewed the staff's current draft and staff memorandum dated June 17, 1996 (96-52) regarding the project on the codification of the business judgment rule ("BJR"), as well as Brad Clark's letter to the CLRC dated July 8, 1996. Initially, we want to express our appreciation to the staff for its kind attention and responsiveness to our comments set forth in our letter dated April 4, 1996. The task force believes that the current draft proposal for codification addresses many of our preliminary concerns and is a significant step forward from the previous draft.

The Committee continues to have significant reservations concerning the codification of the business judgment rule in California because of the uncertainty and interpretive questions which will be introduced by such a change in the statutory framework. Nevertheless, the Committee acknowledges that the judicial formulation of the BJR in California is relatively undeveloped in case law. Accordingly, a statutory formulation of the BJR may assist the courts over time in reaching correct results regarding validity of corporate action and liability.

Sections 320 and 321. Our primary concerns with the current staff draft center on Sections 320 and 321. In our April 1996 letter to the CLRC, we expressed concern with the formulation of the rule, which as then drafted provided that a director [or officer] who met the standard set forth in Section 320 "fulfills the duty of care." We

noted that the point of the business judgment rule was to establish a threshold of judicial review which cuts off inquiry without requiring the court to determine if all facts necessary to determine that the standard of conduct required by Section 309 had been met. Thus, as drafted, Section 320 appeared to suggest that the standard of conduct required to trigger the business judgment rule was the same as the standard of conduct required by Section 309, much as was done in the dicta of the Gaillard case. In attempting to suggest a "quick fix" for this drafting problem, we suggested two solutions. One was to change the term "fulfills the duty" to "will not be liable." The other was to combine Sections 320 and 321, thus providing that if a director met the standards set forth in Section 320, the director would be entitled to the presumption in Section 321.

As we indicated at the July 11, 1996 hearing, when we reviewed the staff's draft in response to our comments, we realized that the proposal to provide that the director "will not be liable" if he meets the standards in Section 320 created more problems than it solved. By limiting the codified business judgment rule solely to director liability, as is expressly provided in Section 320(d), the CLRC would permit, and perhaps invite, courts to develop two standards of review, one favorable review standard for liability and another, perhaps stricter, standard for the validity of the corporate action itself. This result would create far more potential for confusion and bad law than is resolved by the proposed codification. At the hearing various participants suggested that one potential fix for this possible differing review standard was additional commentary admonishing that the CLRC did not intend a different review standard. The Committee does not believe that this would be an effective cure for the problem. Courts could consider the express legislative intent to treat the two differently (see Section 320(d)), and at a minimum could imply legislative permission to do the same judicially. We believe that the main goal of codification is to bring additional clarity to the law and that not addressing validity in the proposed codification will at a minimum result in potential confusion for California courts called upon to review the validity of a corporate action.

We note that the common law business judgment rule has operated as a limitation on judicial inquiry to the action taken by directors, and thus also to their personal liability. The challenge to corporate action most often occurs first in an injunction action against the action itself, with a liability action following such determination. Corporations, of course, must be most concerned with the validity of an action on which their business is based. There is generally no public policy reason to apply a different standard to liability than to validity. In fact one of the key criticisms levelled by Harold Marsh against the Gaillard case is that the court seemed to contemplate differing treatment of director liability and the validity of the corporate action:

> This approach would seem to subvert the very purpose of the business judgment rule (whether or not it is bifurcated into a "rule" and a "doctrine"), which is to reserve to the directors the making of business decisions under certain required circumstances and to preclude courts from second-guessing the directors regarding these decisions. Upon what basis would the insiders be liable to return the payments if they were made pursuant to valid agreements?

1 H. Marsh & R. Finkle, California Corporation Law Section 11.3 (3rd Ed. 1990) at 797.

Although our first suggestion to fix the identified wording problem in the former draft inadvertently resulted in this potential differing standard for liability and validity of corporate action, our second proposed solution does not create such a problem and in fact cures some other significant drafting issues identified below. Accordingly, we renew our suggestion that Section 320 and Section 321 should be combined, so that a director will be presumed to have met the required standard of conduct if he meets the tests set forth in existing Section 320. As redrafted Section 320 would read as follows:

§ 320 Business Judgment Rule

(a) A director who makes a business judgment in good faith is presumed to have satisfied Section 309 if all of the following conditions are satisfied:

(1) The director is not interested (Section 321) 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.

> (c) The presumption established by this subdivision is a presumption affecting the burden of proof.
>
> (d) The burden of proof on a person challenging the conduct of a director as a breach of Section 309 or the validity of the corporate action includes the burden of rebutting the presumption of this section by proving failure to satisfy Section 320(a) and, if and only if, that burden is sustained, of showing the director's failure to satisfy the requirements of Section 309, 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.

We believe that this formulation is closer to the formulation in ALI Principles of Corporate Governance Section 4.01 than the Staff's current formulation. This proposed revision would be consistent with the judicial formulation of the business judgment rule which is in essence a presumption. The equal treatment of director liability and the validity of corporate action removes a possible concern that the codification might be seen as a new shield for director liability, rather than as a codification of an existing common law rule.

As mentioned above, this reformulation also removes another serious drafting problem otherwise present in existing Section 321. As currently drafted, Section 321 shifts the burden to a director if a plaintiff proves that a director fails to meet either the standard in Section 309 or the [lower] standard of the business judgment rule. Thus Section 321 as currently written appears to subject a director to the standard of Section 309 in every case, contrary to the apparent intent of Section 320. This drafting problem is also continued in the comment to the existing Section (p. 9, line 21) as noted in Paragraph 6 of Brad Clark's July 8, 1996 letter. This drafting problem is resolved if the presumption applies upon satisfaction of the standards of good faith, reasonable inquiry, disinterested status and rational belief that the action is in the best interest of the corporation and its shareholders.

We note Professor Eisenberg's concern 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." [Staff Note to Section 320]. However, we are concerned that the lack of treatment of validity of the corporate action in the current draft of Section 320 creates potential confusion as to the appropriate standard, appears to place undue emphasis and concern on director liability versus validity, and is not in the interest of sound jurisprudence or public policy. Of course, the courts can under common law work to address the policy issues on a case by case basis, as has occurred in Delaware. We continue to prefer this common law development of the business judgment rule. If

codification is proposed, however, we believe it should address all aspects of directorial action. If the CLRC determines that there are public policy reasons to treat a particular type of corporate action differently, the standards for each should be clearly stated to achieve the stated goals of codification.

We note that Professor Eisenberg has identified the area of corporate takeovers as a possible area in which special rules of conduct or review may be appropriate. As we noted in our previous letter, California courts have not to date applied a higher standard for any type of corporate action, including actions relating to corporate contests for control. We understood that the CLRC codification project was intended to address confusion in the existing California jurisprudence, and not to introduce a new standard which has not yet been considered or adopted by California courts. We strongly suggest that a differing standard for certain corporate actions is not currently California law, and that if the CLRC intends to change rather than clarify California law, the standards should be clearly articulated and separate policy reasons clearly set forth for comment. In this regard, we were pleased to note that Section 323 was removed from the codification, because as we advised in our April 4 letter we found that provision confusing, both over- and under-inclusive, and lacking an appropriate requirement for causality, as well as being unsupported in the existing California case law. In summary, we believe that our proposed redraft of sections 320 and 321 is consistent with existing California law and no new standard for certain types of corporate action is necessary as part of codification.

Section 322. Turning to existing proposed Section 322, we attach a copy of such section with deletions and additions reflecting the changes we suggest in this Section. Our principal change is the addition of non-immediate family relationships to the definition of "associate" in subsection (b)(3) and the deletion of this reference in other subsections to eliminate the potential for confusion caused by repetitive reference to familial relationships. However, we note that paragraph 7 of Brad Clark's July 8th letter recommends complete deletion of a triggering nexus for any familial relationships except immediate family. We have continuing concerns about the broad scope of Section 322 (see below) and recommend strongly that the non-immediate family relationships and the "similar" relationships referenced in (b)(3) be eliminated in favor of a potentially larger but very specific listing of immediate family relationships which trigger "interest." If the CLRC adopts this approach, such listings are readily available (see Rule 144 and Section 16(a) under the federal securities laws). If this approach is not adopted, at a minimum, we would suggest the changes to Section 322 in our attached redraft.

In addition, as we noted at the hearing on July 11, 1996, we propose that the word "only" be added in the second line of Section 322(a) immediately following the word "judgment" to clarify that the provisions of Section 322 operate as a safe harbor.

R. Bradbury Clark's Comments. As a final point, we note that we have reviewed all of Brad Clark's comments in his July 8, 1996 letter and, to the extent we have not otherwise specifically referenced our thoughts on those comments in this letter, we advise that we concur with and join in the remainder of Brad Clark's comments in full, excepting only the comments in Paragraph 5 of his letter. In his paragraph 5, Brad Clark expresses concern that the statute does not expressly give business judgment rule protection to directors who abstain. We do not believe however, that any express protection is needed in this instance when the abstention is per the procedures of Section 310. If a director abstains from a vote because he is interested in the transaction within the meaning of Section 310, he will not have made a business judgment and there will be no action to which the business judgment rule (i.e., the presumption) can apply. Further, abstention by a director per Section 310 parameters would not expose the director to liability because Section 310 expressly sanctions and/or requires such abstention. If abstaining directors were expressly included in the coverage of Section 320, such inclusion might unintentionally be interpreted by the courts as protecting abstaining directors from other potential breaches of duty relating to conduct surrounding the abstention.

However, although we do not have the same concern as was raised in Brad Clark's comments on the applicability of the business judgment rule presumption to Section 310 abstention cases, his comments do raise consideration of a related issue. There may be a potential problem for directors who abstain because they are interested under proposed Section 322 when such "interest" is not sufficient to implicate the provisions of Section 310. This issue arises because Section 322 defines "interested directors" more broadly than situations addressed by Section 310. Section 310 only applies to traditional conflict of interest transactions where the director is either a party or has a material financial interest in a party to the transaction. Thus, a director could be "interested" within the meaning of the proposed Section 322, but not be sufficiently interested to necessitate compliance with Section 310 for purposes of determining the validity of the action.

It is likely that with the passage of Section 322, directors will be advised by counsel to abstain from voting whenever there is even a remote chance they might be considered interested under the subjective standards of Section 322. This presents the possibility of frustrating the corporate decision-making process if such abstentions become frequent. In addition, a question is raised as to whether these abstaining directors would be exposed to increased liability for failure to act, if their abstentions

are viewed as overly-cautious, self-protective reactions to Section 322's expanded definition of "interest"). Also, if a director abstained because he might be interested per the subjective Section 322 definition, will such abstention be tantamount to an admission of "interest," which could raise a prima facie case for breach of the duty of loyalty with regard to any prior actions by the director regarding the subject for which he is deemed interested? Certainly we would not agree that it would be appropriate to expand the "interested director" transactions required to be cleansed under Section 310 to include all situations in which a director might be interested under Section 322. Further, does the interested director under Section 322 who abstains have possible liability for abdicating his duty of care by failing to act because he is potentially interested? Accordingly, we recommend that the law governing liability for failures to act be investigated before a recommendation is made by the CLRC on the business judgment rule, to determine if increased exposure may be created by the new Sections and if so, conduct an investigation of whether another fix is warranted.

We would be happy to discuss these comments with the CLRC Staff in person or by telephone and to respond to any questions the CLRC may have either prior to or at the September 12, 1996 hearing.

Finally, we have advised the ABA Business Law Section's Committee on Corporate Laws, through the Committee's incoming Chair, Larry Scriggens, of this CLRC project, and invited the Committee's comments as well as information on their own project on codification. We understand that Professor Eisenberg is a member of the Committee and he suggested that I contact the Chair to gain information on the Committee's work on codification. We are awaiting a response from the Committee as to whether they may have comments on the CLRC project and on their resolution of similar issues. We will advise you of any response we receive.

Very truly yours,

Diane Holt Frankle

Diane Holt Frankle
Co-Chair of the Corporations
Committee of the State Bar of
California Business Law Section

cc: Robert Mattson, Executive Committee,
State Bar of California Business Law Section
Ann Yvonne Walker, Co-Chair of the Corporations Committee
of the State Bar of California Business Law Section

Alan Barton, Corporations Committee
Evelyn Lewis, Corporations Committee
D. Steven Blake, Corporations Committee
R. Bradbury Clark

a "good faith" standard, and make clear that a decision that defies rational explanation evidences lack of good faith.

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 a only

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.~~

(2) ~~(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.

(3) ~~(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 Instituted (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.

Insert 1

(other than the corporation)

Insert 2

other than those covered by paragraphs (1) and (2) of this subsection (b), but if and only if, such familial, business, financial or similar relationship

#B-601

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

Discussion Draft

Business Judgment Rule

August 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. The Commission also solicits your views as to whether or not the Business Judgment Rule should be codified.

COMMENTS ON THIS DISCUSSION DRAFT SHOULD BE RECEIVED BY THE COMMISSION NOT LATER THAN **November 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.

California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, CA 94303-4739
(415) 494-1335 FAX: (415) 494-1827

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. The uncertainty of the California law, compared with the well-articulated Delaware law on this subject, may be a factor in the decision of some 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

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]

---

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

---

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); Briano v. Rubio, 96 Daily Journal D.A.R. 7617, 7621 (June 28, 1996).

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); Briano v. Rubio, 96 Daily Journal D.A.R. 7617, 7621 (June 28, 1996).

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 Principles, 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.

---

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.

These principles provide clear and useful standards that enable some certainty in determining whether the business judgment rule will be applied in particular circumstances. The Commission would include these standards in 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

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.[23] 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.[24] 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.[25]

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

---

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. See, e.g., Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 261 Cal. Rptr. 868 (1989).

24. Evid. Code §§ 500, 521.

25. 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).

they have decided on can be enjoined or set aside.[26] Application of the business 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.[27] 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.[28] 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.[29]

---

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

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

28. 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).

29. 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 codifies the business judgment rule only as it applies to business corporations. The codification does not affect common law application of the business judgment rule, if any, to other entities, such as partnerships and nonprofit corporations.

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 this section and, if that burden is sustained, of showing the director's failure to satisfy the requirements of Section 309. 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.

§ 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) A person challenging the conduct of a director as a breach of Section 309 has the burden of proving all of the following:

(1) The failure of the director to satisfy the requirements of the business judgment rule.

(2) The failure of the director to satisfy the requirements of Section 309.

(3) In a damage action, 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., Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 261 Cal. Rptr. 868 (1989); 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.

§ 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:

(1) "Associate" means any of the following persons:

(A) 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.

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

(C) 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:

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

(ii) 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.

(iii) 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.

(2) "Party" to transaction or conduct means a party other than the corporation.

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)(1) is drawn from ALI Principles of Corporate Governance § 1.03 (1992).