

Study B-601

November 1, 1996

Memorandum 96-80**Business Judgment Rule: Revised Draft**

Attached to this memorandum is a revised draft of the business judgment rule codification. The staff recommends that the Commission circulate this draft for public comment as a “discussion draft”, with whatever changes appear necessary at the meeting. (There appears to be a perception in the corporate law community that once the Commission issues a “tentative recommendation” it has pretty much finalized its thinking on the matter.)

This draft was revised after a meeting between the staff, Professor Eisenberg, representatives of the State Bar Corporation Committee, and Reed Kathrein of Milberg, Weiss. The significant revisions make clear that the codification is limited to liability issues, but does not preclude common law application of business judgment rule principles to validity issues in appropriate cases. See discussion at page 9, lines 16-32. The staff has deleted from the section the short title [“This section shall be known and may be cited as the business judgment rule.”], in light of the limited scope of the codification.

The staff would characterize the other changes in the revised draft as fine-tuning, although the other participants in the discussions might disagree with this assessment.

Respectfully submitted,

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Executive Secretary

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

Staff Draft

Discussion Draft

Business Judgment Rule

October 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 xxxxx.

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

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BUSINESS JUDGMENT RULE

Summary of Discussion Draft

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

The Commission solicits views both as to whether or not the Business Judgment Rule should be codified and as to the details of the proposed codification.

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

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). The background study is available electronically at the following URL: <http://www.clrc.ca.gov/> A photocopy version of the 21-page Background Study is 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).

believes to be in the best interests of the corporation and shareholders, and “with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.”

Standard of Judicial Review

In applying the standard of careful conduct to a business judgment made by a director, the courts have used a lower standard of review, provided the director made the decision in good faith, did not have a financial interest in the decision, and used a reasonable decisionmaking process. 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 distinct from 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.

But 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 decisionmaking, 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 the statement of the standard of care in Section 309 negates 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 yet 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., *id.* at 1264; *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 ALI Principles of Corporate Governance clearly lays out the elements of the business judgment rule. 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.
- (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

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).

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 basic standards in the codification of the rule.

The Commission recommends two qualifications of these standards:

(1) Paragraphs (2) and (3) refer to a "familial" relationship to the director. Because of the potentially open-ended nature of this concept, the codification narrows the concept to named close relationships, including the director's spouse, children, parents, siblings, and other near relatives, including step, in-law, and adoptive relations.

(2) 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

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 & S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* 38-39 (4th ed. 1993).

necessary degree of director and officer accountability.”²⁰ An example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained.

The rationality standard allows a wider range of discretion than a reasonableness standard would impose; it gives the director a safe harbor from liability for a business judgment that might not be reasonable, so long as it is not so removed from the realm of reason when made that liability should be incurred.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

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

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).

PROCEEDINGS TO ENJOIN OR SET ASIDE ACTION OF BOARD

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

Whether the business judgment rule should apply 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.

1 PROPOSED LEGISLATION

2 An act to add an article heading immediately preceding Section 300 of, and to
3 add Article 2 (commencing with Section 320) to Chapter 3 of Division 1 of Title 1
4 of, the Corporations Code, relating to the business judgment rule.

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

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

8 Article 1. General Provisions

9 **Comment.** Sections 300 to 318 are grouped as an article to facilitate creation of a separate
10 article elaborating the business judgment rule. See Article 2 (commencing with Section 320). The
11 business judgment rule is codified in Section 320, contrary language in some cases
12 notwithstanding. See, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1264, 256 Cal. Rptr.
13 702 (1989) (Section 309 “codifies California’s business-judgment rule”); Barnes v. State Farm
14 Mutual Auto Ins. Co., 16 Cal. App. 4th 365, 20 Cal. Rptr 2d 87 (1993).

15 **Corp. Code §§ 320-321 (added). Business judgment rule**

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

18 Article 2. Business Judgment Rule

19 **§ 320. Business judgment rule**

20 320. (a) A director who makes a business judgment is deemed to have satisfied
21 Section 309 if all of the following conditions are satisfied:

22 (1) The director acts in good faith.

23 (2) The director is not interested (Section 321) in the subject of the business
24 judgment.

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

28 (4) The director believes that the business judgment is in the best interests of the
29 corporation and its shareholders, and that belief is rational.

30 (b) A person challenging the conduct of a director as a breach of Section 309 has
31 the burden of proving failure of the director to satisfy the requirements of
32 subdivision (a) and, if that burden is sustained, of proving the director’s failure to
33 satisfy the requirements of Section 309, and in a damage action under Section 309,
34 the burden of proving that the breach was the proximate cause of damage suffered
35 by the corporation or its shareholders.

36 **Comment.** Section 320 expresses the business judgment rule in terms drawn from American
37 Law Institute (ALI), Principles of Corporate Governance: Analysis and Recommendations
38 (1992). The Introductory Note and Comments to that treatise provide extensive discussion of the

1 meaning and interpretation of the business judgment rule as codified in this section; those
2 materials should be consulted in connection with questions of construction and intent of this
3 section.

4 This section codifies the business judgment rule for business corporations. The codification
5 does not affect common law application of the business judgment rule, if any, to other entities,
6 such as partnerships and nonprofit corporations.

7 This section is a qualification of Section 309, which prescribes the duty of care of directors.
8 Therefore, this section by its terms applies only to conduct of directors.

9 This section specifies nonexclusive conditions under which Section 309 is deemed to be
10 satisfied. Section 309(a) and (b) codifies the duty of care by stating the manner in which a
11 director must perform the duties of a director. Section 309(c) addresses the liability of a director
12 for failure to perform the duties under Section 309(a) and (b). Therefore, Section 320 would apply
13 to liability actions against directors under Section 309 based on the duty of care, as well as to
14 actions against directors seeking other remedies based on alleged violations of the duty of care
15 under Section 309(a) and (b).

16 Strictly speaking, Section 320 would not apply in an action in which remedies are sought
17 against the corporation to enjoin or set aside a business transaction with a third party, as opposed
18 to an action against individual directors. However, since any such transaction of importance is
19 likely to have taken place as a consequence of the exercise of directors' business judgment, the
20 substantive issue in such an action would normally be whether the directors exercised their
21 business judgment in a manner that satisfies Section 320. Nothing in Section 320 is intended to
22 validate a corporate action that is not authorized in accordance with law.

23 Section 320 codifies the business judgment rule. Courts of other jurisdictions that apply the
24 business judgment rule in duty of care cases have limited the application of that rule in certain
25 kinds of cases that fall between traditional duty of care cases and traditional duty of loyalty cases;
26 in particular, in cases involving transactions incident to contests for control, such as defensive
27 actions to takeover bids, and in cases involving the effect of a board or committee determination
28 that a derivative action against a corporate director or officer is not in the best interests of the
29 corporation. See, e.g., *Unocal v. Mesa Petroleum Corp.*, 493 A.2d 946 (Del. 1985); *Zapata Corp.*
30 *v. Maldonado*, 420 A.2d 799 (Del. 1981). Nothing in Section 320 would prevent California courts
31 from developing standards to determine whether and under what circumstances Section 320 is
32 applicable to such cases.

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

39 In a judicial proceeding, a person challenging the conduct of the director has the burden of
40 showing the director's failure to satisfy the requirements of this section and, if that burden is
41 sustained, of showing the director's failure to satisfy the requirements of Section 309. Subdivision
42 (b).

43 The business judgment rule applies only to satisfaction of a director's duty of care to the
44 corporation and its shareholders under Section 309. It does not apply to the director's duty of
45 care, if any, to third persons. Nor does it limit any protection otherwise available for a director,
46 including a provision in the articles eliminating or limiting the liability of a director for monetary
47 damages for breach of the duty of care of the director to the corporation and its shareholders as
48 authorized by Section 204(a)(10). See Section 309(c).

49 The introductory portion of subdivision (a) makes clear that this section protects only business
50 judgments of directors. To qualify as a "business judgment" within the meaning of this provision,
51 a decision must have been consciously made and judgment must, in fact, have been exercised. It
52 is important to recognize that a business decision may involve a judgment either to act or to
53 abstain from action. Many decisions will involve a number of subsidiary issues. The prerequisite
54 that there be an exercise of judgment does not require directors to focus collectively on each

1 subsidiary issue. It simply requires that, in general, the directors become informed about and
2 consciously reach a decision with regard to the overall issue.

3 Subdivision (a)(1) codifies the principle of existing law that the business judgment rule applies
4 only to a good faith action of a director. See, e.g., *Barnes v. State Farm Mutual Auto Ins. Co.*, 16
5 Cal. App. 4th 365, 20 Cal. Rptr 2d 87 (1993); *Eldridge v. Tymshare, Inc.*, 186 Cal. App. 3d 767,
6 230 Cal. Rptr. 815 (1986); *Marsili v. Pacific Gas and Electric Co.*, 57 Cal. App. 3d 313, 124 Cal.
7 Rptr. 313 (1975); *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); *Fornaseri v.*
8 *Cosmosart Realty Corp.*, 96 Cal. App. 549, 274 P. 597 (1929).

9 Subdivision (a)(2) codifies the principle of existing law that the business judgment rule applies
10 only to a disinterested decision. See, e.g., *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 256
11 Cal. Rptr. 702 (1989). For the meaning of “interested” as used in subdivision (a)(2), see Section
12 321 (interested director). It should be noted that an interested director who abstains from
13 participation in a corporate decision due to the conflict of interest would not ordinarily be held to
14 have violated the standard of care of Section 309, absent a specific statutory provision such as
15 Section 316(b) (director who abstains from specified board action is deemed to have approved
16 action). Cf. *Propp v. Sadacca*, 175 A. 2d 33 (1961).

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

20 Existing California case law formulations of the business judgment rule lack clarity. Some
21 cases have articulated a reasonability standard (see, e.g., *Burt v. Irvine Co.*, 237 Cal. App. 2d 828,
22 47 Cal. Rptr. 392 (1965); *Fornaseri v. Cosmosart Realty Corp.*, 96 Cal. App. 549, 274 P. 597
23 (1929)), others have articulated a good faith standard (see, e.g., *Marble v. Latchford Glass Co.*,
24 205 Cal. App. 2d 171, 22 Cal. Rptr. 789 (1962); *Eldridge v. Tymshare, Inc.*, 186 Cal. App. 3d
25 767, 230 Cal. Rptr. 815 (1986)), and still others have combined the two concepts or treated them
26 as interchangeable (see, e.g., *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702
27 (1989)). Subdivision (a)(4) applies a rationality standard that represents a middle ground among
28 the various standards articulated by the California cases.

29 The rationality standard of subdivision (a)(4) is drawn from ALI Principles of Corporate
30 Governance § 4.01(c) (1992). The ALI Comment to § 4.01 notes that:

31 This standard is intended to provide directors and officers with a wide ambit of
32 discretion. It is recognized that the word “rational,” which is widely used by the courts,
33 has a close etymological tie to the word “reasonable” and that, at times, the words have
34 been used almost interchangeably. But a sharp distinction is being drawn between the
35 words here. The phrase “rationally believes” is intended to permit a significantly wider
36 range of discretion than the term “reasonable,” and to give a director or officer a safe
37 harbor from liability for business judgments that might arguably fall outside the term
38 “reasonable” but are not so removed from the realm of reason when made that liability
39 should be incurred. Stated another way, the judgment of a director or officer will pass
40 muster under § 4.01(c)(3) if the director or officer believes it to be in the best interest of
41 the corporation and that belief is rational.

42 Subdivision (b) is drawn from American Law Institute Principles of Corporate Governance §
43 4.01(d) (1992). It codifies the burdens of proof in existing law on a person challenging the
44 conduct of a director as a breach of Section 309. See, e.g., *Will v. Engebretson & Co.*, 213 Cal.
45 App. 3d 1033, 261 Cal. Rptr. 868 (1989); *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250, 256
46 Cal. Rptr. 702 (1989); *Eldridge v. Tymshare, Inc.*, 186 Cal. App. 3d 767, 230 Cal. Rptr. 815
47 (1986); *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); *Fornaseri v.*
48 *Cosmosart Realty Corp.*, 96 Cal. App. 549, 274 P. 597 (1929). The burden of proof is proof by a
49 preponderance of the evidence. Evid. Code § 115.

1 **§ 321. Interested director**

2 321. (a) For the purpose of Section 320, a director is “interested” in a transaction
3 or conduct that is the subject of a business judgment only if any of the following
4 conditions is satisfied:

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

7 (2) The director or an associate of the director has a material pecuniary interest
8 in the transaction or conduct (other than usual and customary directors’ fees and
9 benefits), of which the director knows or should be aware, that would reasonably
10 be expected to affect the director’s judgment in a manner adverse to the
11 corporation or its shareholders.

12 (3) The director is subject to a controlling influence by a party to the transaction
13 or conduct (other than the corporation) or by a person who has a material
14 pecuniary interest in the transaction or conduct, and that controlling influence
15 could reasonably be expected to affect the director’s judgment with respect to the
16 transaction or conduct in a manner adverse to the corporation or its shareholders.

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

18 (1) The spouse of the director; a child, grandchild, parent, sibling, uncle, aunt,
19 nephew, niece, step-child, stepparent, or step-sibling of the director, including
20 adoptive relationships, and the spouse of such a person; a mother-in-law, father-in-
21 law, brother-in-law, or sister-in-law of the director; a person, other than a domestic
22 employee, having the same home as the director; and a trust or estate of which the
23 director or a person designated in this paragraph is a substantial beneficiary.

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

26 (3) A person with respect to whom the director has a business or financial
27 relationship other than a person described in paragraph (1) or (2), but if and only if
28 the relationship would reasonably be expected to affect the director’s judgment
29 with respect to the transaction or conduct in question in a manner adverse to the
30 corporation or its shareholders.

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

36 (1) The director’s judgment is not presumed to be adversely affected solely
37 because the director is a director or principal manager of the business organization.

38 (2) The director’s judgment is not presumed to be adversely affected if the
39 director is the beneficial owner or record holder of not more than 10 percent of any
40 class of equity interest.

41 (3) The director’s judgment is presumed to be adversely affected if the director
42 is the beneficial or record holder (other than in a custodial capacity) of more than
43 10 percent of any class of equity interest.

1 **Comment.** Subdivision (a) of Section 321 is drawn from American Law Institute (ALI)
2 Principles of Corporate Governance § 1.23 (1992). *See also* Model Business Corporation Act §
3 8.31, Comment 5 (“a director should normally be viewed as interested in a transaction if he or the
4 immediate members of his family have a financial interest in the transaction or a relationship with
5 the other parties to the transaction such that the relationship might reasonably be expected to
6 affect his judgment in the particular matter in a manner adverse to the corporation.”) Subdivision
7 (a) is an exclusive listing of circumstances that may cause a director to be “interested” for
8 purposes of application of the business judgment rule.

9 The consequence of a director being interested in a particular action is that the director will not
10 receive business judgment rule protection for that action. However, this does not imply that the
11 director is liable under Section 309, since, despite the fact that the director is interested, the
12 director’s actions may nonetheless satisfy the duty of care (but not necessarily the duty of loyalty)
13 that an ordinarily prudent person in a like position would use under similar circumstances.

14 Unlike ALI Principles of Corporate Governance § 1.23 (1992), subdivision (a)(2) is limited to
15 pecuniary interests “of which the director knows or should be aware”.

16 Under subdivision (a)(3), controlling influence is most likely to occur in the case of a board that
17 is dominated by a controlling shareholder. It is not intended that a person would be treated as
18 subject to a controlling influence, and therefore interested, solely because of a long-time
19 friendship or other social relationship, or solely because of a long-time business association
20 through service on the same board of directors or other relationship not involving direct pecuniary
21 dealing. However, where senior executives of two corporations sit on each other’s board of
22 directors, and each senior executive is in a position to review the other’s compensation, or other
23 transactions or conduct in which the other senior executive is pecuniarily interested, a court could
24 consider that fact in determining whether in the circumstances of a particular case each of the
25 senior executives is interested when reviewing each other’s conflict of interest transactions or
26 conduct.

27 Subdivision (b)(1) is drawn from ALI Principles of Corporate Governance § 1.03 (1992) and
28 from Rule 16a-1 under the Securities Exchange Act of 1934 (“The term ‘immediate family’ shall
29 mean any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-
30 law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and shall include
31 adoptive relationships.”) Subdivision (b)(1) omits reference to son-in-law and daughter-in-law
32 since those relationships are otherwise covered by reference to the spouse of a child. Subdivision
33 (b)(1) includes reference to brother-in-law and sister-in-law, even though those relationships are
34 otherwise covered by reference to the spouse of a sibling, since those relationships may also
35 include the sibling of a spouse.