Study B-601 November 13, 1996

Second Supplement to Memorandum 96-80

Business Judgment Rule: Comments on Draft

Attached as Exhibit pp. 1-2 is a letter from Reed Kathrein with comments on the revised draft of the business judgment rule. We have also received an oral comment from the State Bar Corporations Committee. This memorandum reviews their comments briefly.

"Business Judgment" Defined

Mr. Kathrein suggests that the Comment make clear that the business judgment rule applies to conscious decisions of directors. The Comment already does this, although it is somewhat buried. See p. 9, line 49 ff. The staff suggests that this material be moved earlier in the Comment so it will be more apparent.

"Rational" Business Judgment

Mr. Kathrein is troubled by the "rational" belief standard of the business judgment rule, and suggests it be elaborated in the Comment. The Commission has also been concerned about this standard. It is elaborated somewhat in the Comment at p. 10, lines 31-41, but Mr. Kathrein suggests additional explanatory language, such as "gross negligence" or "recklessness".

The staff thinks his suggested language is too restrictive — the intent is to avoid an inquiry by the courts into the merits of a business decision, except in an extreme case. Although the courts have used many different words to get at this concept, "rationality" is the most common. In *Interinsurance Exchange* (see 1st Supp. Memo 96-80) for example, the court indicates that directors have broad discretion and courts will not interfere with a decision "if the decision made by the directors can be attributed to a rational business purpose." Perhaps language such as this in the Comment would be helpful.

Validity Issues

The Comment notes that the business judgment rule codification addresses liability of directors, not validity of corporate actions. Mr. Kathrein suggests a clarification of this discussion in the Comment at page 9, lines 21-22: "Nothing in

Section 320 is intended to validate a corporate action that is not ~~authorized~~ otherwise in accordance with law." This appears appropriate to the staff.

"Interested Director" Defined

Both the State Bar Corporations Committee and Mr. Kathrein have concerns with Section 321(c) (page 11, lines 31-43). That provision creates a presumption that the director is "interested" if the director's relationship with a business organization involved in a transaction exceeds a 10% ownership interest.

The State Bar Committee's issue is a technical one — if the director's interest is less than 10%, the director's judgment is "~~not~~ presumed not to be adversely affected".

Mr. Kathrein thinks the interested director presumption should be triggered at the 5% rather than 10% ownership level. He indicates that 5% is the threshold for SEC reporting requirements (Rule 13d-1 of Securities Exchange Act of 1934) — a 5% stake in almost any publicly held corporation "is huge and material."

Mr. Kathrein also finds the interrelation of the presumption with the other provisions of the section confusing. The staff agrees it is quite complex. It is intended that the presumption apply to determine two different issues —

> (1) whether a person is an "associate" of the director within the meaning of (a)(1) and (2)
>
> (2) whether the director is subject to a "controlling influence" within the meaning of (a)(3)

We would spell this out in the Comment.

Respectfully submitted,

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Re: Business Judgment Rule

Dear Nat:

I am sorry I did not get back to you by October 31st, as requested. Unfortunately, a lot of "things" have been happening lately. While my partners have not had an opportunity to review the revised business judgment draft, I have the following comments:

1. The comments section to section 320 should define business judgment as we all understand it -- a safe harbor for conscious decisions -- so as to clearly distinguish it from Section 309's, general duty of care which will then only apply to failures to pay attention or act. We could do this by adding the following language at the end of line 3 on page 2:

> The business judgment rule is triggered whenever directors make a conscious business decision to take or reject board action on a specific proposal. Directors actually must exercise their judgment before the business judgment rule applies.

2. I continue to have difficulty with my partners explaining what the word "rational" means. When I discussed this term during the last meeting with staff, everyone seemed to agree that it is proper to equate it with action which is not grossly

negligent. I believe some clarification of this would be appropriate after line 43 on page 3 along the following lines:

> "Put another way, the term 'rational' means conscious action which is logically justified for purposes of accomplishing a legitimate business goal and is not grossly negligent or so removed from the realm of reason as to be reckless."

3. The comment sentence on page 2, lines 21 and 23 appears to be somewhat circular. Perhaps the word "authorized" on line 22 is supposed to be "otherwise"?

4. I continue to have difficulty with Section 321's definition of "interested director." On close examination, the language of Section 321(c) does not properly mesh with Section 321(a) or (b). As currently drafted, Section 321(c) actually appears to carve out another condition which, if satisfied, means a director is "interested" . In the June 4th and August 28th draft, it modified Section 321(b)(3). While the revisions were supposed to "simplify" the draft, I think it misses the mark. We need to discuss exactly what the Commission has in mind.

More importantly, we continue to believe that a ten percent threshold for reversing the burden of proof is too high. Five percent is the threshold for S.E.C. reporting requirements, and indeed, seems more likely an indication of materiality. See, Rule 13d-1 under the Securities Exchange Act of 1934. A 10% stake in most any publicly held corporation is huge. Even a 5% stake is huge and material.

I look forward to discussing these concepts with you further. Please feel free to contact me.

Very truly yours,

Reed R. Kathrein

cc: Al Barton
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