Study B-601 April 15, 1997

Memorandum 97-17

Business Judgment Rule: Comments on Discussion Draft

Attached to this memorandum is a copy of the Commission's discussion draft to codify the business judgment rule. 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 circulated the proposal for comment in November 1996, with a mid-March response request. The comments we have received to date are listed below. We will supplement this memorandum with any other comments received before the Commission meeting.

		Exhibit pp.
1.	Peter K. Shack, Deputy Attorney General	1-3
2.	Reed R. Kathrein, Milberg, Weiss, et al.	4-12
3.	David H. Schwartz, San Francisco	13-19
4.	R. Bradbury Clark, Los Angeles	20-34

The submission of Mr. Kathrein includes nine Exhibits, referenced in his letter but too voluminous for extensive reproduction and distribution. The general thrust of the Exhibits is to support the concept that greater accountability of corporate directors and officers is necessary. Copies of the Exhibits are being distributed to Commission members, consultants, and active participants in this study. Copies of the Exhibits are also available for inspection in the Commission's office and at the Commission meeting where this memorandum is considered.

GENERAL REACTION

The general reaction to the discussion draft was negative. Each commenter had a different focus, but all share a common theme. We summarize their general concerns here; their specific points are addressed later in the memorandum.

Peter Shack, Deputy Attorney General, states that the proposal weakens the “reasonable inquiry” standard of care of existing California law. This concerns the Department of Justice’s Charitable Trust Division, because courts in considering issues involving charitable corporations or assets may look to business corporation law.

Reed Kathrein, of Milberg, Weiss, et al., objects to the direction of the proposal, which he states is too protective of directors and impairs accountability. He takes the position that the law on director liability should be allowed to evolve by judicial decision — “Would it not be better to allow the courts — the courts who actually receive the evidence; who have the ability to weigh the evidence; and who have the ability to test its credibility — to fine-tune the law to society’s needs? Would it not be better to avoid sweeping in untested changes — new words like ‘rational’ and new and inflexible definitions of who is ‘independent’ — and avoid years of litigating these concepts to develop their meaning and to avoid harsh and unforeseen consequences?” Exhibit p. 7.

David Schwartz, of San Francisco, is concerned that the business judgment rule is inappropriately applied to corporate decisions that favor the interests of directors or management over the interests of shareholders. He does not believe the draft statute deals adequately with this problem, and therefore concludes that “the rule is best left to be advanced and defined on a case-by-case basis through judicial decisions.” Exhibit p. 18.

Brad Clark, of Los Angeles, believes the discussion draft is a vast improvement over earlier drafts, but “I still believe the BJR should not be codified in California.” Exhibit p. 20. His reasons, previously expressed to the Commission, include (1) existing California case law establishing the business judgment rule is not causing problems in practice, (2) any effort to codify the law will cause greater problems by limiting judicial flexibility in an area where flexibility is necessary and by creating new ambiguities and uncertainties where none exist now, (3) the issues are too complex to lend themselves to ready codification, and (4) corporation law experts who have previously considered the matter have declined to attempt codification, and no other jurisdiction has done it.

The common theme of these comments is that, while existing case law may not be perfect, it is better to allow the law to evolve by judicial decision than to rigidify it and possibly cause problems by codification. **The Commission needs to decide whether on balance codification is desirable.**

In order to minimize issues, we limited the business judgment rule codification to ordinary business decisions by directors of business corporations. Several of the comments we received address the scope and application of the draft.

Nonprofit Corporations

As the discussion draft notes, the standard of care that should be applicable to a director of a nonprofit corporation may differ from the standard that should be applicable to the director of a business corporation. The Commission has not made a study of the circumstances of nonprofit corporations, and therefore has limited the proposed codification of the business judgment rule to business corporations.

Mr. Shack, of the Attorney General's office, believes that it is not sufficient to limit the draft to business corporations: nonprofit corporations should be explicitly excluded. He proposes addition of a provision along the following lines:

> This article does not apply to either of the following:
>
> (a) A director of a nonprofit public benefit corporation organized under Part 2 (commencing with Section 5110) of Division 2.
>
> (b) A director of a nonprofit mutual benefit corporation organized under Part 3 (commencing with Section 7110) of Division 2, to the extent that the director's business judgment affects assets held in charitable trust by the nonprofit mutual benefit corporation.

The staff has no problem with this in theory, except that it would create a negative implication that the business judgment rule *does* apply to other types of nonprofit corporations and to decisions affecting other types of assets. This could be combated by a Comment to the effect that the codification relates only to business corporations, and does not affect the statutory or common law as to the terms or application of the business judgment rule to any other type of entity or action.

On the other hand, Brad Clark has come to believe that the courts should be able to analogize the business judgment rule for nonprofit corporations that are essentially businesses or have significant business activities. "In those cases it might be well for courts to consider the rules of Sections 320-321 by analogy to the extent decisions by their directors are driven by business considerations that are essentially the same as in business corporations, but with due regard to differences in corporate purposes, managers' duties, members' interests and the like." Exhibit p. 22. He would augment the Comment along these lines.

The staff believes as a matter of principle we should not suggest in any way that the codification might be applied to nonprofit corporations. We have not studied the matter. If the courts want to analogize, they will. But it will be enough of a struggle just to enact a law that applies it only to business corporations.

Foreign Corporations

California law seeks to apply key corporate governance provisions to foreign corporations that have a substantial presence in California. Corp. Code § 2115. An example of this would be a corporation that is essentially a California corporation but that has reincorporated in Delaware to take advantage of its more liberal corporate governance laws.

Brad Clark notes that Section 2115 seeks to apply the basic duty of care (Corp. Code § 309) to foreign corporation directors. He suggests that by the same token the business judgment rule should be made part of Section 2115. "Otherwise it may be unclear whether directors of those foreign corporations (whose duties Section 2115 says Section 309 governs) would have the benefit of the codified BJR and if not, what rules would apply." **This suggestion makes sense to the staff.**

Protection of Interested Director

The protection of the business judgment rule does not apply to an interested director. Brad Clark notes that even though the business judgment rule does not protect an interested director, there may be other doctrines that protect the interested director from liability, and these should be reflected in the draft. Specifically:

(1) An interested director may not be liable for the decision because the director abstains from participating in it. This fact is reflected in the Comments, but Mr. Clark suggests it would be helpful to include a more explicit recognition of the result of abstention in the statute itself. The staff does not oppose this concept in principle, but it may prove difficult to draft a satisfactory statute prescribing the effects of abstention. **Given the difficulty we have had so far just**

drafting a clear statement of the business judgment rule, the staff is reluctant to take on this side issue.

(2) Mr. Clark would add Comment language that an interested director who participates in a decision may not be liable where "satisfaction of the business judgment rule or the requirements of Section 309 by other directors acting in the matter may make the interested director's interest moot." Exhibit p. 29. **The staff has no problem with this sort of Comment language as suggested by Mr. Clark**, since it merely alerts the reader to possible relevant legal doctrines and does not attempt to prescribe those doctrines.

Transactions in Control and Responses to Derivative Actions

A significant issue the Commission struggled with in developing the discussion draft was the application of the business judgment rule to corporate decisions outside the normal course of business — in particular, decisions of directors to block a hostile tender offer or to dismiss a derivative action. The ALI Principles of Corporate Governance treat these types of decisions specially.

We were unable to find a generally acceptable approach to these types of decisions. As a consequence, the draft statute is silent on the application of the business judgment rule to them. The Comment to Section 320 notes that courts in other jurisdictions have limited the application of the business judgment rule in these types of cases, and states that, "Nothing in Section 320 would prevent California courts from developing standards to determine whether and under what circumstances Section 320 is applicable to such cases."

Mr. Schwartz does not believe this treatment is adequate. "Contrary to the Commission's statement, the proposed statutory language could easily be found to *preclude* judicially defined exceptions to the business judgment rule." Exhibit p. 14. He argues that Commission Comments are evidence of legislative intent only where the statutory language is ambiguous, and as presently drafted the codification is unambiguous in its application to all corporate decisions. He notes that the business judgment rule does not apply where an director is interested, but this does not help with a decision to block a hostile tender offer or dismiss a derivative action due the narrow meaning of "interested" under the draft.

He concludes that codification is defective because it does not provide an express basis for the courts to limit application of the business judgment rule where a decision involves corporate control or another matter in which a director may have an interest that conflicts with the interests of shareholders. He would leave the matter to case law development.

The staff believes that this argument has some force. We note that our decision to treat this issue in the Comment rather than in the statute is driven by political necessity resulting from our inability to find any kind of politically acceptable statute language.

The staff believes it is worth another try to find statute language that preserves the common law on the standard of care required for non-routine business decisions. **Perhaps elevating the Comment language to the statute along the following lines might work:**

> **§ 322 Application of article to transactions in control and responses to derivative actions**
>
> 322. This article is not intended to preclude the courts from developing standards to determine whether and under what circumstances this article applies in situations that fall between traditional duty of care and duty of loyalty cases, including but not limited to a transaction incident to a contest for control (such as a defensive action to a takeover bid), and a board or committee determination that a derivative action is not in the best interests of the corporation.
>
> **Comment.** Section 322 qualifies the application of the business judgment rule. Courts of other jurisdictions that apply the business judgment rule in duty of care cases have limited the application of that rule in certain kinds of cases that fall between traditional duty of care cases and traditional duty of loyalty cases; in particular, in cases involving transactions incident to contests for control, such as defensive actions to takeover bids, and in cases involving the effect of a board or committee determination that a derivative action against a corporate director or officer is not in the best interests of the corporation. See, e.g., Unocal v. Mesa Petroleum Corp., 493 A.2d 946 (Del. 1985); Zapata Corp. v. Maldonado, 420 A.2d 799 (Del. 1981). Nothing in this article would prevent California courts from developing standards to determine whether and under what circumstances Section 320 is applicable to such cases. Cf. Lee v. Interinsurance Exchange, 57 Cal. Rptr. 2d 798 (1996).

Effect of Corporations Code Section 204(a)(10)

Corporations Code Section 204(a)(10) permits the articles of incorporation to include a provision that eliminates or limits the personal liability of a director for monetary damages in a derivative action. The Commission discussed whether this section eclipses the business judgment rule, and concluded that it does not —

not all corporate articles include the authorized provision and, for those that do, its coverage parallels but is not coextensive with the business judgment rule. The discussion draft notes in commentary that the business judgment rule does not "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)."

Reed Kathrein argues that Section 204(a)(10) is now the de facto business judgment rule in California, and the question before the Commission should be whether it goes too far and gives directors too much protection. "If any revision is to be made to Section 309, on the other hand, it should be the elimination of the ability of the Board to do away with their own monetary liability, and Section 204(a)(10) should be eliminated in its entirety." Exhibit p. 12.

This suggestion of course goes far beyond the Commission's narrow intent in this area, which is simply to make a clear statement of existing law, not to revise the state's basic policy of the level of protection to be given to corporate directors. To seriously consider Mr. Kathrein's suggestion would propel the Commission into a far-ranging consideration of fundamental corporate governance issues. **The staff believes this would be inadvisable.**

TERMS OF THE CODIFICATION

Application of the business judgment rule is conditioned on satisfaction of three conditions — the director must (1) be disinterested, (2) be reasonably informed, and (3) rationally believe that the action is in the best interests of the corporation and its shareholders. We received comment on each of these conditions.

Disinterested Director

In order to receive business judgment rule protection, a director may not be interested in the decision. The definition of an "interested" director in Section 321 of the draft was the subject of a number of comments.

(1) Personal and other relationships

The major complaint is that the definition is too narrow and would protect directors who lack independence. The following criticisms are leveled at it by Mr. Kathrein (Exhibit pp. 10-11), some of which are also reflected in the comments of Mr. Schwartz (Exhibit pp. 15-18) and Mr. Clark (Exhibit pp. 28-29, 33-34):

(1) It fails to include directors who have cross-directorships with each other.

(2) If fails to include directors who are mere surrogates by virtue of their influencing relationships with other directors and with management (e.g., longstanding friendships).

(3) It fails to include directors who are too busy to pay attention and therefore must rely on management.

Mr. Schwartz summarizes his concern:

> The definition of "interested" in proposed section 321 is seriously flawed because it does not take into account either the natural unwillingness of persons, including corporate directors, to give up positions of power and influence once they are granted, and because it fails to acknowledge the existence of "structural bias" which may exist, particularly with respect to directors who sit by virtue of pre-existing personal or social relationships and not primarily due to an outside institutional affiliation or specialized expertise or experience.
> Exhibit p. 17

Mr. Clark likewise suggests that references to "pecuniary" interests are too narrow, and should be broadened to include financial or personal interests in a transaction. "Clearly, however, a director would seem to be 'interested' as a result of interests that are not just pecuniary." Exhibit p. 33.

The definition of an "interested" director is drawn from the ALI Principles of Corporate Governance. **The Commission should consider whether the definition should be expanded to include personal or other interests.** For example, Section 321(b)(3) might refer to "a person with respect to whom the director has a business or financial [<u>or personal</u>] [<u>or other</u>] relationship ... but if and only if the 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."

One problem with such a formulation is that it would make it nearly impossible for a director ever to know when the director is "interested" within the meaning of business judgment rule. What sort of "personal relationship" would reasonably be expected to affect the director's judgment. If the director socializes with the CEO at dinner or cocktails before or after a board meeting, is this disqualifying?

The discussion draft tries to get at this problem from a different direction. The business judgment rule is not intended to apply to types of business decisions where “structural bias” may be significant — such as actions to block hostile tender offers or dismiss derivative actions. Perhaps clarification of the limitations of the business judgment rule as suggested in the discussion above of “Transactions in Control and Responses to Derivative Actions” is the best resolution of this issue.

(2) Familial relationships

Brad Clark would delete the reference to “aunt, uncle, nephew, niece” from the definition of “associate” in Section 321(b)(1). He argues that this casts too broad a net. Exhibit p. 34. Rather than hold the director automatically accountable for these “often remote” relationships, he would instead broaden the reference in subdivision (b)(3) to personal or other relationships that would reasonably be expected to affect the director’s judgment. **See discussion immediately above.**

(3) Presumptions of financial interest

Mr. Kathrein is concerned that the definition of “interested” director includes presumptions of financial interest that are too inflexible. Specifically, Section 321(a)(3) presumes that a director’s judgment is not adversely affected if the director owns less than 10% of the stock of any class of equity interest in the company. He notes that even a 1% interest, in a large public company, may be huge and may influence a director’s judgment. Exhibit p. 12.

We have tried to address this concern in the draft by making clear that the presumption is rebuttable, and noting in the Comment that “an interest less than 10% might reasonably be expected to affect the director’s judgment, for example, if the interest is in a large, publicly held business and the value of the ownership interest is substantial for that director.”

Mr. Kathrein argues, however, that the presumptions effectively take discretion from the judge or jury, and that the general standard of Section 321(a)(3) is satisfactory — the director is interested if a business or financial 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.

The staff is inclined to agree with Mr. Kathrein on this point. The presumptions are somewhat arbitrary, although they are drawn from other provisions of the corporate securities laws. We are not sure how helpful the presumptions will be to a director in any event, since they are rebuttable and it is reasonably certain that a plaintiff will mount an effective effort to rebut them whenever they get in the way. A simpler statement of the basic statutory standard would probably be more useful to directors.

Reasonable Inquiry

Mr. Shack of the Attorney General's office states their concern that the standard stated in the business judgment rule draft would weaken existing due diligence requirements. He notes that existing statutory standard of care requires the care, "including reasonable inquiry", that an ordinarily prudent person in a like position would use under similar circumstances. The business judgment rule draft requires that the director be:

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

Notwithstanding the concern of the Attorney General's office, the staff believes the draft business judgment rule's requirement that the direct be "informed" is equivalent to, but more concrete and direct, than the general duty of "reasonable inquiry". Moreover, it codifies existing California law on the business judgment rule, and parallels the ALI Principles of Corporate Governance. See, e.g., Lee v. Interinsurance Exchange, 57 Cal. Rptr. 2d 798 (1996); Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989); ALI Principles of Corporate Governance § 4.01(c)(2). **The staff believes the provision is satisfactory as drafted.**

Rational Belief

Reed Kathrein objects to the rationality standard of the business judgment rule. He argues that:

(1) The rationality standard would excuse nefarious corporate behavior that is rational even if harmful to the public.

(2) The rationality standard is not well defined in comparison to other legal standards such as "reasonable" and "negligent".

(3) The rationality standard undermines the general duty of care stated in Corporations Code Section 309 that a director must use the care that an ordinarily prudent person in a like position would use under similar circumstances.

(4) The rationality standard gives undue deference to corporate decisionmakers, even though it has been demonstrated that corporate malfeasance is rife.

This position attacks the heart of the business judgment rule, in effect arguing that the standard of review developed by the courts is poor social policy and should not be codified in statute. Mr. Kathrein has provided us with extensive information to document this position.

Professor Eisenberg has in his background studies for the Commission laid out the policy considerations that favor the business judgment rule, as developed by the courts. The Commission has agreed with these policy considerations, and preserved them in the discussion draft. **If the Commission is convinced by Mr. Kathrein's presentation, then this project should not be an effort to codify the business judgment rule, but rather to overrule it.**

TECHNICAL DETAILS

Drafting Clarifications and Improvements

Brad Clark suggests a number of helpful drafting clarifications and improvements. These are set out in strikeout and underscore at Exhibit pp. 23-30, and are explained at Exhibit pp. 31-34. The staff will review these with our consultant, Professor Eisenberg, and incorporate those on which there is a consensus, subject to substantive changes made at the Commission meeting.

Role of Commentary

Brad Clark notes that the Commission's commentary on the codification will be important to interpret it, and requests assurance that the commentary will be preserved and be made a part of any legislative history.

The Commission Comments are part of the legislative history. They are before the Legislature and the legislative committees when the legislation is being considered, and we provide copies of them to the law publishers for inclusion in their annotated codes. The courts have determined that Commission Comments are persuasive indicators of legislative intent. **This will not be a problem.**

Respectfully submitted,

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March 13, 1997

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Re: Business Judgment Rule - Comments

Dear Commissioners:

The Attorney General submits these comments on the Commission's discussion draft proposal to codify the business judgment rule.

As you know the Attorney General has broad enforcement responsibilities over nonprofit public benefit corporations, and over nonprofit mutual benefit corporations that hold assets in charitable trust.[1]

> "The primary responsibility for supervising charitable trusts in California, for insuring compliance with trusts and articles of incorporation, and for protection of assets held by charitable trusts and public benefit corporations, resides in the Attorney General. The Attorney General has broad powers under common law and California statutory law to carry out these charitable trust enforcement responsibilities." (Gov. Code § 12598(a).)

Notwithstanding that the proposed codification of the business judgment rule only deals with business corporations,[2] this office

[1] Unless otherwise stated, for purposes of these comments "public benefit corporation" includes nonprofit mutual benefit corporations to the extent that they hold assets in charitable trust.

[2] In the background section of the discussion draft, the Commission states that "[t]his 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 a partnerships and nonprofit corporations."

is concerned that the standards enunciated in proposed Corporations Code section 320 could result in judicial application of the rule as codified to public benefit corporations.

Specifically, we are most concerned that the "reasonable inquiry" standard reflected in Corporations Code sections 309 and 5231 is weakened by the proposal. In our experience many of these cases turn on due diligence, whether the directors made reasonable inquiry prior to making their decisions. The proposal changes this language, replacing it with language requiring a level of inquiry "to the extent the director believes is appropriate, and that belief is reasonable, under the circumstances." (Proposed Corp. Code § 320(a)(3), emphasis added.) A court may well conclude that this language weakens the current reasonable inquiry standard, which is part of the prudent person rule.

We suggest that the language of Corporations Code sections 309 and 5231 be retained in any codification of the business judgment rule that would be applicable to business corporations. Specifically, we suggest that the text of proposed Corporations Code section 320(a)(3) read as follows:

> "The director has exercised that due care as an ordinarily prudent person in a like position would use under similar circumstances, including reasonable inquiry, in informing him/herself with respect to the subject of the business judgment."

In addition, the Charitable Trust Section would strongly recommend that the Attorney General oppose this proposal if it is introduced as legislation unless the following language is added:

> **§ 320 (c) Nothing in this article shall apply to directors of nonprofit public benefit corporations organized under Part 2 of Division 2, or to directors of nonprofit mutual benefit corporations organized**

under Part 3 of Division 2 insofar as the directors' business judgment affects assets held in charitable trust by the nonprofit mutual benefit corporation.

Sincerely,

DANIEL E. LUNGREN
Attorney General

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PKS:lc

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March 14, 1997

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Re: Business Judgment Rule
<u>Discussion Draft, November 1996</u>

Dear Commissioners:

We want to commend the Commission on the time and effort it has spent studying "the standard under Section 309 of the Corporations Code for protection of a director from liability for a good faith business judgment." We especially want to thank the Commission for soliciting our participation in the process, allowing us an opportunity to state our view, and for incorporating some of our ideas and suggestions. Nevertheless, we are concerned that the proposed revision set out in the November 1996 Discussion Draft is premature. The courts just now are refining their interpretation of the Business Judgment Rule and the law should be given time to evolve; what's more, no California precedent is crying to be overturned. More important, we take exception with the apparent objective of holding directors less accountable for their actions; we cannot agree with elimination of director liability for breach of the duty of care by "unreasonable" conduct, so long as the breach is "rational"; and we object to language expanding the definition of an "independent" director to include situations where, in the face of irrefutable proof of a lack of independence, a court would be compelled to hold otherwise.

As the Commission is aware, we have been counsel for plaintiffs in numerous shareholder derivative actions initiated in both California state and federal courts. We have represented aggrieved shareholders and their affected corporations in more than 40 shareholder derivative actions in California state and federal courts over the last 10 years. Currently, we are handling several such suits, including suits against Apple Computer, Inc. and Walt Disney Co.

The Commission will remember that we wrote on December 4, 1995 and expressed our concern that

> codifying the Business Judgment Rule -- an inherently flexible standard which addresses a myriad of situations -- is an extremely volatile and complicated subject requiring a great deal of study and policy decisions. However, there is no justification for engaging in a "race to the bottom" by attempting to codify the Business Judgment Rule in California to conform it to the pro-business and anti-shareholder version in place in Delaware.
>
> As the staff correctly notes, the issue of the scope of the Business Judgment Rule and the demand requirement in shareholder derivative actions is an issue of extreme sensitivity involving numerous public policy issues. If the Commission should find any interest in pursuing this matter, it should do so only after there has been a more exhaustive analysis of the real-world experiences of shareholder derivative litigation throughout California. We urge the Commission to proceed cautiously in this sensitive area"

These concerns still apply.

Revision of a statutory scheme should not occur absent evidence that the scheme is not working or is being interpreted in a manner not consistent with expressed public policy. Significantly, the legislation authorizing the Law Revision Commission to study Section 309 does not express a legislative objective or public policy against which Section 309 is to be measured. In fact, the events which have transpired since the 1993 directive -- witness the gross mismanagement of Apple Computer, Inc., the excessive compensation packages of Walt Disney Co. executives, the public outcry of the California Public Employee's Retirement System against corporate abuse and the weakening of federal protection for securities fraud committed by directors -- all justify greater scrutiny of corporate directors, not lesser. Indeed today, income gaps between corporate executives and the general population are becoming dangerously wider. Corporate control over the major media outlets (newspapers, television, radio and even the Internet) is threatening to stifle the voice of the common citizenry. See Robert A.G. Monks, The American Corporation at the End of the Twentieth Century, at 1, 3 and 14 (1996) (Exhibit A). Even worse, the political process is now dominated by corporate-sponsored donations. Id. Certainly, with this concentration of power in the corporation, lesser scrutiny of corporate directors is not prudent.

Corporations, as we now have, did not exist 200 years ago when our founding fathers drew up our Constitution. Thus, our Constitution does not address how to deal with this new super citizen. See Robert A.G. Monks, Corporate Governance in the Twenty-First Century, a Preliminary Outline at 4-6 (1996) (Exhibit B). At the turn of the century, when this super citizen was gaining in concentration, the legislature passed antitrust laws. In the middle of the century, when this super citizen soaked up citizens' cash, the legislature passed securities fraud laws. Now, when this super citizen has even more power, more influence, and more control over the dissemination of ideas, the legislature should not grant such power brokers and their directors carte blanche to take any rational action despite its reasonableness or moral implications.

The Discussion Draft assumes revision is necessary because of a purported "confusion" with the Business Judgment Rule's application. Confusion, however, in California's formulation of the Business Judgment Rule is not a proper basis for giving more power to directors and less to the shareholders. Confusion in California's formulation does not require the adoption of the American Law Institute's scheme which, while internally consistent and well drafted, does not reflect an accepted political objective of California citizens.

We also believe that confusion does not truly exist; unless one does not believe in allowing courts to develop the common law. Only recently have the courts begun addressing many of the issues surrounding Section 309 and the Business Judgment Rule. For example, the Discussion Draft cites extensively to Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 96 Daily Journal D.A.R. 13278 (October 31, 1996). Only recently (in 1987) was Section 309 amended to provide blanket protection for directors' activities. See Sections 309(c) and 204(a)(10). Moreover, the California Supreme Court has not yet even had the opportunity to address the Business Judgment Rule or Section 309.

To tinker with Section 309 now would stop its evolution and begin the process anew. Throwing out the bathwater without proof that it is poisoned ignores the ability of our California judges to mold the law to reflect our society's needs. As recognized by Justice Oliver Wendell Holmes, our court system is resourceful, and flexible:

> Every important principle which is developed by litigation is in fact and at bottom the result of more or less definitely understood views of public policy; most generally, to be sure, under our practice and traditions, the unconscious result of instinctive preferences and inarticulate convictions, but none the less traceable to views of public policy in the last analysis. And as the law is administered by able and experienced men, who know too much to sacrifice good sense to a syllogism, it will be found that, when ancient rules maintain themselves . . . new reasons more fitted to the time have been found for them, and that they gradually receive a new content, and at last a new form, from the grounds to which they have been transplanted.

Oliver Wendell Holmes, The Common Law 32 (Harvard Press Ed. 1963) (1881).

Also absent from the Discussion Draft is any evidence that the California Business Judgment Rule has not served our society well or evidence that justifies change. Absent is evidence that corporations have been wrongfully scrutinized or directors inappropriately challenged; absent is evidence that the proposed changes will serve an accepted political objective; and absent is evidence that the proposed changes will not lead to abuse or societal harm. Would it not be better to allow the courts -- the courts who actually receive the evidence; who have the ability to weigh the evidence; and who have the ability to test its credibility -- to fine-tune the law to society's needs? Would it not be better to avoid sweeping in untested changes -- new words like "rational" and new and inflexible definitions of who is "independent" -- and avoid years of litigating these concepts to develop their meaning and to avoid harsh and unforeseen consequences?

We also have specific problems with the particulars of the Discussion Draft.

First, we take exception with proposed Section 320's standard which protects directors if their action is "rational" but not "reasonable." Is it not "rational" to act in a manner to protect one's job or to save a corporate culture? See discussion of Paramount v. Time, 571 A.2d 1140 (Del. Sup. 1990), in Robert A.G. Monks, Power and Accountability at 11-12 and 18 (Exhibit C). Why should a corporate director -- who makes the "unreasonable" and immoral business decision to allow hazardous material to be flown on his company's planes without appropriate safeguards; to allow alcoholic captains to sail his company's oil tankers; or to permit unreasonably dangerous parts to be installed in consumer products -- not be held accountable to the corporation or its shareholders because these decisions were rational when weighed against the likelihood of getting caught? Why should the corporate director who "unreasonably" agrees to compensate corporate officers tens of millions of dollars, because of friendship or passivity, not be held accountable to the corporation and its shareholders? Why should the corporate director who makes unreasonable high risk gambles with corporate assets, not be accountable to the corporation? Why should a corporate director not be held accountable to the corporation for actions which he even believes are unreasonable?

The term "rational" has other problems. Unlike terms such as reasonable, negligent, grossly negligent, reckless or intentional, there is no body of law developed to interpret the term "rational." Moreover, the term does not even have a clear, commonly understood meaning. Thus, dictionaries define "rational" as both a variant of "logical" or "reasonable." To our knowledge, there exists very little case law on how one is to apply a standard of care based on "logic" rather than "reasonableness." Without such a body of law, only more confusion will be generated.

Undoubtedly, replacing the duty of care for affirmative board decisions to require only a "rational" or logical basis will greatly decrease a director's accountability from the present standard of conduct. Section 309 is the present standard of accountability -- a standard which requires both passive and active conduct to be performed:

1. in good faith;

2. in a manner such that the director believes to be in the best interests of the corporation and its shareholders; and

> 3. with such care, including a reasonable inquiry, **as an ordinarily prudent person in a like position would use under similar circumstances.**

The statute is unequivocally clear that all actions of the director are to be performed with "care" -- and its measure is "such care . . . as an ordinary, prudent person in a like position would use under similar circumstances."

Proposed Section 320 completely eliminates Section 309's duty of care, for affirmative acts, by creating a so-called "standard of review" which drops any requirement of "care" or its measure. To say that the "standard of care" continues to exist when a court is not allowed to look at it would be intellectually dishonest.

The disenfranchisement of shareholders from their corporation through the legalization of corporate malfeasance is only a recent phenomenon, as recounted by Robert A.G. Monks in Power and Accountability. In his book, Monks discusses the development of the Business Judgment Rule (see pages 8-9) (Exhibit C). In short, he states that the Business Judgment Rule (as with Section 309) gives "directors a rebuttable presumption of correctness" (id. at 9), if the directors show "'good faith and reasonable investigation'" (id. at 10), that they were "'informed'" (id.), and that their action was "'reasonable'" (id.). He then notes how cases, beginning in the late 1980's began eroding the standard of care by not requiring an objectively reasonable inquiry into the facts and objectively reasonable actions. Rather, the Delaware courts deferred to what the directors wanted rather than what was reasonable to the shareholders. Id. at 11-19.

Monks recognized that at the same time the Delaware courts were loosening their grip over directors, the "duty of care" died completely in some states as the result of state legislatures passing laws giving limited liability and indemnification to directors. Id. at 19. Indeed, California killed off the duty of care for directors when in 1987 the legislature amended Section 309(c) to allow California corporations to eliminate or limit a director's liability for monetary damages unless the director's acts fell within the narrow set of acts enumerated in California Corporations Code Section 204(a)(10). Thus, for all practical purposes Section 204(a)(10) is the true Business Judgment Rule in California. This Section authorizes provisions in the articles of incorporation:

> eliminating or limiting the personal liability of a director for monetary damages in an action brought by or in the right of the corporation for breach of a director's duties to the corporation and its shareholders, as set forth in Section 309, provided, however, that (A) such a provision may not eliminate or limit the liability of directors (i) for acts or omissions that involve intentional misconduct or a knowing and culpable violation of law, (ii) for acts or omissions that a director believes to be contrary to the best interests of the corporation or its shareholders or that involve the absence of good faith on the part of the director, (iii) for any transaction from which a director derived an improper personal benefit, (iv) for acts or omissions that show a reckless disregard for the director's duty to the corporation or its shareholders in circumstances in which the director was aware, or should have been aware, in the ordinary course of performing a director's duties, of a risk of serious injury to the corporation or its shareholders, (v) for acts or omissions that constitute an unexcused pattern of inattention that amounts to an abdication of the director's duty to the corporation or its shareholders, (vi) under Section 310, or (vii) under Section 316, (B) no such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when the provision becomes effective, and (C) no such provision shall eliminate or limit the liability of an officer for any act or omission as an officer, notwithstanding that the officer is also a director or that his or her actions, if negligent or improper, have been ratified by the directors.

Given this broad protection, we submit that the real issue to be addressed by the Commission is whether or not Sections 204 and 309 go too far and give directors too much protection.

We also take exception with proposed Section 321's narrow definition of "interested director" -- a director who is not given the benefit of the Business Judgment Rule because of interest in the subject matter or lack of independence. Disturbingly, proposed Section 321 does not include directors who have cross-directorships with each other; directors who are mere surrogates by virtue of their influencing relationships (i.e., longstanding friendships) with other directors; and directors who are too busy to pay attention and therefore must rely on management. Such corporate abuses abound and would only be encouraged by adoption of proposed Section 321. We have attached the following as examples:

- Articles depicting the utter lack of independence of Walt Disney Co.'s Board which -- consisting of Michael Eisner's architect, children's school teacher, etc., -- approved compensation packages greater than the gross national product of some countries. (Exhibit D.)

- Articles depicting the passivity of Archer-Daniel-Midland Co.'s Board which consisted of overpaid friends and insiders; and allowed its chairman, Dwayne Andreas, to run the company with no scrutiny. (Exhibit E.)

- Articles depicting A.C. "Mike" Markkula Jr.'s control over Apple Computer, Inc.'s Board and the company's dismal record after turning down mergers and appointing a friend of Markkula's as Chief Executive Officer. (Exhibit F.)

- Articles on the California Public Employee's Retirement System lambasting certain corporations, including Apple Computer, Inc., for having too many outside directors who sit on too many Boards, "thereby diminishing their ability to help the company." (Exhibit G.)

- Webpages from the Council of Institutional Investors identifying "Turkey" directors who sit on too many boards, including Carol Bartz of Autodesk in San Rafael, California. The page also lists presumptions <u>against</u> "independence" which should be considered in any revision to Section 309. (Exhibit H.)

- A November 25, 1996 BusinessWeek article on "The Best and Worst Boards." <u>See</u> especially page 86 on judging board independence. This article recognizes, unlike the Discussion Draft, that independence may be "co-opted by family ties, business links, and longstanding friendships." (Exhibit I.)

The Discussion Draft's attempt to narrowly define interested directors, by not including such factors indicating a lack of independence, is not supported. To the contrary, the above examples demonstrate that approval would be bad policy.

Finally, we continue to take exception with the presumptions of "independence" set out in Section 321(3)(A),(B) and (C). We believe the last sentence in Section 321(3) and subsections (A), (B) and (C) should be deleted in their entirety. Whether intended or not, these presumptions create guideposts for a judge or jury to follow, thus taking away their discretion -- yet, the draft contains no evidence, whether scientific or anecdotal, to support these guideposts of "independence." Surely, a director who has less than a 10% interest in a class of stock could have real interest in a transaction affecting the stock even if he has less than 1% ownership. The test should be the effect of the transaction on the director -- 1% may mean tens of millions of dollars to a director -- and not the director's share of the transaction. We can see no justification for these presumptions other than to grant further protection to directors acting in their own self-interest. On the other hand, Section 321(3) works without these presumptions. Without these presumptions of "independence," the court or jury will be able to weigh the actual evidence to determine whether a particular "relationship . . . would reasonably be expected to affect the director's judgment."

In conclusion, we again express our thanks for the opportunity to participate and be heard. We believe, however, that the Business Judgment Rule and the impact of recently revised Section 309 and Section 204(a)(10) should be allowed to be developed by the courts. If any revision is to be made to Section 309, on the other hand, it should be the elimination of the ability of the Board to do away with their own monetary liability, and Section 204(a)(10) should be eliminated in its entirety.

Very truly yours,

Reed R. Kathrein

RRK/pj
Enclosures
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OF COUNSEL
Ernest L. Graves, ret.

March 14, 1997

California Law Revision Commission

Re: **Comment on Draft Proposal to Codify the Business Judgment Rule in California**

Dear Members of the Commission:

I am a lawyer practicing in San Francisco. During the course of my 22 years in practice I have handled several shareholder derivative actions. For the past two and one-half years I have been representing shareholders in a derivative action against some former and present directors and officers of a company charging that the directors breached their fiduciary duties in expending corporate funds to buy off a major shareholder who sought to challenge existing management's control of the company. The litigation has involved extensive exploration of the application of the business judgment rule to actions taken in response to threats to corporate control, the duty of loyalty, and the extent to which the business judgment rule may be used as a shield to defeat litigation challenging corporate action taken in a threat to control situation.

In my opinion the Commission's proposed draft does not adequately address the application of the business judgment rule to those situations where directors must respond to a shareholder or third party who proposes to take an action which might result in the directors being removed from their positions or otherwise threatens the continued control of the corporation by existing management.

In its comment to proposed Corporations Code Section 320, the Commission states:

> Section 320 codifies the business judgment rule. Courts of other jurisdictions that apply the business judgment rule in duty of care cases have limited the application of that rule in certain kinds of cases that fall between traditional duty of care cases and traditional duty of loyalty cases; in particular, in cases involving transactions incident to contests for control, such as defensive actions to takeover bids, and in cases involving the effect of a board or committee determination that a derivative action against a corporate director or officer is not in the best interests of the corporation. See, e.g., Unocal v. Mesa Petroleum Corp., 493 A.2d 946 (Del. 1985); Zapata Corp. v. Maldonado, 420 A.2d 799 (Del. 1981). Nothing in Section

320 would prevent California courts from developing standards to determine whether and under what circumstances Section 320 is applicable to such cases. Cf. Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13284 (October 31, 1996).

Once codified, the business judgment rule as proposed would not necessarily leave California courts free to fashion exceptions along the lines set forth in the *Unocal* and *Zapata* decisions. Contrary to the Commission's statement, the proposed statutory language could easily be found to *preclude* judicially defined exceptions to the business judgment rule.

The proposed statutory language contains no express or implied limitation on the application of the business judgment rule to particular types of decisions. Most significantly, the proposed language fails to distinguish between normal business operations and investment decisions, on the one hand, and those types of decisions which by their inherent nature pose a risk that the interests of management and directors may be divergent from, or directly contrary to, the interests of shareholders. The latter types of decisions would include decisions involving an immediate or potential change in the management control of the corporation and/or the composition of the board, decisions pertaining to executive compensation, decisions resulting in disparate treatment of different shareholders or classes of shareholders, and decisions on the corporate response to derivative complaints alleging claims for the benefit of the corporation.[1]

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[1] Some of these exceptions are *already* recognized by California Courts. See *Lee v. Lee v. Interinsurance Exchange*, (1986) 50 Cal.App.4th 694, at 715:

> The business judgment rule sets up a presumption that directors' decisions are made in good faith and are based upon sound and informed business judgment. (*Barnes, supra*, 16 Cal.App.4th at p. 378, 20 Cal.Rptr.2d 87; *Katz v. Chevron Corp., supra*, 22 Cal.App.4th at pp. 1366- 1367, 27 Cal.Rptr.2d 681.) An exception to this presumption exists in circumstances which inherently raise an inference of conflict of interest. (*Katz v. Chevron Corp., supra*, 22 Cal.App.4th at p. 1367, 27 Cal.Rptr.2d 681.) Such circumstances include those in which directors, particularly inside directors, take defensive action against a take-over by another entity, which may be advantageous to the corporation, but threatening to existing corporate officers. (*Ibid.*) Similarly, a conflict of interest is inferrable where the directors of a corporation which is being taken over approve generous termination agreements--"golden parachutes"--for existing inside directors. (*Gaillard v Natomas Co., supra*, 208 Cal.App.3d at pp. 1268-1271, 256 Cal.Rptr. 702.) In situations of this kind, directors may reasonably be allocated the burden of showing good faith and reasonable investigation. (*Katz v. Chevron Corp., supra*, 22 Cal.App.4th at p. 1367, 27 Cal.Rptr.2d 681; cf. *Gaillard v. Natomas Co., supra*, 208 Cal.App.3d at p. 1271, 256 Cal.Rptr. 702 [under circumstances raising an inference that corporate interests were not served, trier of fact could find that directors should have independently reviewed the terms of challenged "golden

Commission comments to the effect that a particular construction should or should not be applied are not binding on the California courts and will not necessarily be considered unless the court first finds the language to be ambiguous and in need of extrinsic aids to construction.[2] In important respects the proposed language for sections 320 and 321 could easily be found to be unambiguous, leaving the courts no room to carve out exceptions.

The most serious issue in this regard is the proposed definition of "interested" in proposed Section 321, which sets forth the *exclusive* grounds on which a director may be deemed "interested." Because proposed Section 321 does not include any non-pecuniary definition of "interested" and expressly excludes from the definition the normal compensation and perquisites that are afforded to directors, the proposed codification effectively insulates director's decisions from scrutiny even where common sense would indicate the directors were "interested" in the outcome or otherwise unable to exercise an independent judgment on the merits of a transaction with respect to the company's shareholders.[3]

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parachutes"].) But in most cases, the presumption created by the business judgment rule can be rebutted only by affirmative allegations of facts which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts. (*Eldridge v. Tymshare, Inc., supra*, 186 Cal.App.3d at p. 776-777, 230 Cal.Rptr. 5.) Interference with the discretion of directors is not warranted in doubtful cases. (*Beehan v. Lido Isle Community Assn.* (1977) 70 Cal.App.3d 858, 865, 137 Cal.Rptr. 528.)

[2] See e.g., *People v. San Nicolas* (1986) 185 Cal.App.3d 403, 406-407: Comments of the Law Revision Commission do not have the effect of law and are not binding on the courts. They are merely sources by which legislative intent may be discerned when interpreting the meaning of a statute. (58 Cal.Jur.3d, Statutes, S 161, pp. 563-564; see *Davis v. Cordova Recreation & Park Dist.* (1972) 24 Cal.App.3d 789, 796, 101 Cal.Rptr. 358.) "Legislative intent[, however,] is best determined by the language of the statute." (*Plumbing etc. Employers Council v. Quillin* (1976) 64 Cal.App.3d 215, 224, 134 Cal.Rptr. 332, citing *Hutchins v. Waters* (1975) 51 Cal.App.3d 69, 73, 123 Cal.Rptr. 819.) " 'If the words of the statute are clear, the court should not add to or alter them to accomplish a purpose that does not appear on the face of the statute or from its legislative history.' [Citations.]" *(California Teachers Assn. v. San Diego Community College Dist.* (1981) 28 Cal.3d 692, 698, 170 Cal.Rptr. 817, 621 P.2d 856; *Friends of Mammoth v. Board of Supervisors* (1972) 8 Cal.3d 247, 284, 104 Cal.Rptr. 761, 502 P.2d 1049.)

[3] This problem also applies to the Commission's statement that the codification would not be controlling with respect to a Board's vote to move to dismiss a shareholder derivative action, assuming a majority of those voting to dismiss could not be deemed "interested" within the exclusive criteria of proposed Section 321.

For example, assume that a board of directors, a majority of whom have negligible stock holdings in the corporation, is faced with a threat from an outside owner of 10% of the voting stock of the company who seeks by proxy contest to remove the existing directors and management. The outside shareholder contends that current management is bloated and resistant to cutting costs, and that a majority of the existing board are personal friends of the CEO who owe their position on the board to the CEO and consequently are unwilling to take action to remove the CEO or require him to make the necessary changes. The outside shareholder contends that his proposed management changes will cause the stock price to increase significantly. The directors vote to use corporate funds to purchase the challenger's stock at a premium above market and/or with the payment of a substantial sum to compensate the shareholder for his "expenses." The company must borrow money in order to make the payment to the outside shareholder, resulting in a significant decrease in shareholder equity and a shortage of operating funds.

Under the proposed codification of the business judgment rule, a shareholder derivative plaintiff who sought to challenge the decision to have the corporation purchase the outside shareholder's stock at a premium would have his case dismissed at the pleading stage unless the plaintiff could allege that one or more of the provisions of Section 320(a) did not apply. Under the proposed codification, a board which went through the motions of a "due diligence" review would be virtually immune from having its judgment reviewed (let alone rejected) even if the evidence before the directors demonstrated undisputedly that the outside shareholder's assessment was correct.

First, the plaintiff would be unable to demonstrate that any director was "interested" in the corporation's purchase of the outside shareholder's stock. Proposed section 321 expressly sets forth the *exclusive* definitions of "interested" for purposes of Section 320. The plaintiff would not be able to demonstrate that any director was "interested" in the transaction or conduct (§ 320(a)(2)) because no director would necessarily meet any of the criteria for being "interested" set forth in proposed Section 321:

-- The directors would not be "parties" (§ 321(a)(1)) to the stock purchase except in the sense that they voted for it, a definition of "party" which clearly is not intended by the Commission and which, if adopted, would eliminate the business judgment rule in its entirety.

-- Nor would any director have a "material pecuniary interest in the transaction or conduct" (§ 321(a)(2)) because "usual and customary directors' fees and benefits" are expressly excluded from the definition of a "material pecuniary interest."

-- Finally, it is unlikely that any director would be deemed to be " subject to a controlling influence by a party to the transaction or conduct" (§ 321(a)(3)). The Proposed Section 321 does not contain any definition of "controlling influence,"

> but the Commission's own comment indicates that "Under subdivision (a)(3), . . . *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.*" (Emphasis supplied)

The definition of "interested" in proposed section 321 is seriously flawed because it does not take into account either the natural unwillingness of persons, including corporate directors, to give up positions of power and influence once they are granted, and because it fails to acknowledge the existence of "structural bias"[4] which may exist, particularly with respect to directors who sit by virtue of pre-existing personal or social relationships and not primarily due to an outside institutional affiliation or specialized expertise or experience.

As previously noted, the ability to challenge a board decision based upon proposed Section 320(a)(3) might well be deemed satisfied if the directors review the relevant information and do not make any glaring omissions with respect to pertinent information and opinions. Hence, in the example cited, if the board receives and review whatever information the outside shareholder presents and obtains meaningful consultation from appropriate experts such as lawyers, accountants, investment bankers, etc., the decision would not be subject to attack on the basis of Section 320(a)(3) regardless of the merits.

A shareholder challenging the action would therefore be left attempting to prove either that the decision failed to meet the criteria under subdivision (a)(4) or (a)(1). Subdivision (a)(4) appears to require two distinct criteria: a subjective belief by the director that the decision is in the best interests of the corporation and its shareholders, and an objective test that the belief is rational. However, once a "rational" explanation for the decision were articulated, it is unlikely that courts would permit an exploration of the "subjective" states of the directors to demonstrate that the articulated rationale was merely a pretext and was not what the directors actually believed.[5] Indeed, in the context of a normal business operating or investment decision, it would

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4 California courts have acknowledged that "structural bias" should be considered in reviewing board decisions under the business judgment rule. See, e.g., *Will v. Engebretson & Co.*, 213 Cal. App. 3d 1033, 1043.

5 In the example given, assume the directors articulate a rationale that purchase of the outside shareholder's stock was necessary because despite the considerable evidence the shareholder presented that existing management was inhibiting profitability, a change in management control would be too disruptive to employee and mid-managerial morale and would damage the corporation's reputation for management stability. The articulated reasons are both rational and rationally related to the best interests of the corporation, and presumably under the proposed codification the courts would not be permitted to review the effect on the decision

defeat the salutary purposes of the business judgment rule to permit court inquiry into the subjective beliefs of the directors absent a showing that directors were "interested" or overt indications that the directors had failed to act in good faith.

However, because the language of the proposed codification does not offer any basis for limiting its application where the nature of the decision itself creates a potential for divided loyalty, there is no obvious basis on which a court could fashion a limitation or qualification to the rule in those situations where the interests of management may be at odds with the best interests of the corporation.

The derivative plaintiff faces a similar barrier in proving the absence of the first criteria under Section 320(a) -- the existence of good faith. The absence of good faith is seldom proven by resort to direct evidence. Rather it is typically revealed by circumstantial evidence tending to show that the action taken was calculated to promote the interests of the defendant in a manner which violated the defendant's duty to the plaintiff. In the context of the proposed statutory rule, it is unlikely that a court would find that circumstantial evidence that a director was making a decision for reasons which did not relate to the definitions of "interest" under proposed Section 321 would be relevant to prove that the director did not act in good faith. Hence, evidence that a director voted for the stock purchase in order to preserve his position on the board would not tend to show an absence of good faith because it would not tend to show the existence of an disqualifying interest under proposed section 321.

CONCLUSION

The proposed codification does not expressly provide a basis for the courts to limit the application of the rule where decisions involve issues or corporate control or other matters on which directors may have interests which conflict with those of the stockholders. Codification of the rule risks either that the rule is applied without qualification to all corporate decisions including those decisions which courts in this state and in other states have found should not be given the business judgment rule protection, or that the codification contains an exception which would threaten to swallow the entire rule and eliminate its salutary effects with respect to the normal business decisions which require the taking of risk but in which there is presumably no conflict between the directors as directors and the shareholders whose interests they are representing.

I would submit that the rule is best left to be advanced and defined on a case-by-case basis through judicial decisions.

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making process of group loyalty amongst the CEO and directors, or the director's own interests in preserving their position. Nor does anything in the proposed language give the courts a basis for finding that the legislature wars leaving it to court discretion whether a *Unocal* type of review would be more appropriate than strict adherence to the codified rule.

Very truly yours,

David H. Schwartz

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March 21, 1997

California Law Revision Commission
4000 Middlefield Road, Suite D-2
Palo Alto, California 94303-4739

Attention: Nathaniel Sterling, Executive Secretary

Re: <u>Codification of Business Judgment Rule</u>

Ladies and Gentlemen:

This letter provides comments on the November 1996 Discussion Draft -- Business Judgment Rule ("BJR") in a way that I hope is efficient and helpful.

I am enclosing two versions of the part of the Discussion Draft that sets forth proposed Sections 320 and 321 and the Commission's Comments on them. This part consists of pages 8 through 12 of the Draft. One version is the original text of the Draft marked to show exactly what changes I am suggesting. The other version is a clean copy of the same part of the Draft as my suggestions would change it. The marked version has 21 numbers at various places in its left margin. These numbers key to the same numbers in a memorandum I am enclosing explaining the changes suggested at those places. I hope this presentation will make it easier for you to consider these suggestions. There are some suggested changes not discussed in the memorandum because they are self-explanatory.

In addition to the comments in the memorandum just mentioned, I have these additional thoughts:

1. Despite what may seem a large number of comments on proposed Sections 320 and 321, I think the current proposal is vastly improved over the one on which I commented last year. I also think it is an improvement over the BJR as embodied in ALI's Principles of Corporate Governance.

2. I still believe that the BJR should not be codified in California. I tried to state my reasons in my April 3, 1996 letter and now have little to add. Others

have also expressed their reasons for believing that the BJR should or should not be codified. I believe that at one time it was reported, as a point in favor of codification, that the American Bar Association's Committee on Corporate Laws was considering codifying the BJR in its Model Business Corporation Act. Based on a copy of a letter I have seen from James Lottstein, a member of that Committee, to Diane Frankle, I understand that it is not the Committee's intention to codify the BJR in that Act. I think this fact and the data you have on whether to codify should be considered afresh and fully as you try to answer that question.

3. The Commission's Comments on Sections 320 and 321 are extremely useful. They will be very helpful to those attempting to understand the ramifications and background of the new sections, if enacted. Without suggesting that the Comments should be shortened (I do not), I wonder to what extent the Commission can ensure that its Comments will accompany the text of the sections if and when they are embodied in various prints of the Corporations Code. I think this is important because, without the Comments, someone not thoroughly versed in corporate governance matters would have difficulty fully comprehending the codification. In a sense, that (i.e., the real necessity to have detailed comments on these sections to make them fully understandable) is one of the problems of codifying a complex topic that, like the BJR, needs careful adaptation to the specific facts of cases as they arise. In addition, these Comments should be made part of the legislative history of the Sections, if enacted, to enhance the Comments' authority in the interpretation of the Sections.

4. Since Corporations Code Section 2115 includes Corporations Code Section 309 among the sections that it makes applicable to certain foreign corporations, I think you should include in proposed legislation codifying the BJR an amendment to Section 2115 adding the new sections to it. Otherwise it may be unclear whether directors of those foreign corporations (whose duties Section 2115 says Section 309 governs) would have the benefit of the codified BJR and if not, what rules would apply.

5. I continue to think that the proposed codification of the BJR should not apply (or be applied) in the exact form set forth in Sections 320-321 to nonprofit corporations and other business entities. The Commission has made this point in its comment on lines 4-6 on page 9. My own

thinking, however, has undergone a modest change. A good many nonprofit corporations are essentially businesses or have significant business activities. Some have members whose status resembles, in some degree, that of shareholders. In those cases it might be well for courts to consider the rules of Sections 320-321 by analogy to the extent decisions by their directors are driven by business considerations that are essentially the same as in business corporations, but with due regard to differences in corporate purposes, managers' duties, members' interests and the like. If so, the Commission might consider augmenting its comment along the lines just mentioned. See also the suggested addition to lines 4-6 and the explanation of that suggestion in my memorandum.

6. In my earlier comments, I mentioned the dilemma an interested director faces as to participating in a business decision in which he or she is "interested". The Commission's comments deal with this in several places, pointing out on page 10, lines 17-21, that an interested director who abstains would ordinarily not be held to violate his or her duties and pointing out elsewhere that failure by an interested director to satisfy the BJR must be the cause of damage before the director is liable for damages. Some tentative thoughts about this are: (1) it would be more protective of an interested director whose behavior deserves protection if the statute itself (not just the Commission's comments) could include a more explicit recognition of the result of abstention; (2) it may need to be clearer that abstention is not the only solution and that satisfaction of the BJR by sufficient other directors who do act would protect an interested director as to the business judgment even if the "interested" director participates in the decision. I have tried to deal with the second point in my suggestions.

I greatly appreciate the consideration you gave to my earlier comments on the codification proposal. I also greatly appreciate the opportunity to submit these comments and hope that they will be helpful to the Commission in its decisions about the discussion draft.

Sincerely yours,

R. Bradbury Clark

R. Bradbury Clark

RBC:bas
Enclosures
LA1-738039.V1

Discussion Draft - November 1996

Pages 8-12 Marked to Show Changes Suggested by R. Bradbury Clark

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 §§ 320-321 (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

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

(1) The director acts in good faith.

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

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

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

(b) A person challenging the conduct of a director as a breach of Section 309 has the burden of proving ~~failure of~~(i) that the director failed to satisfy the requirements of
(2) subdivision (a), and~~;~~ (ii) if that burden is sustained, ~~of proving the director's failure~~ that the director failed to satisfy the requirements of Section 309, and ~~in a damage action under Section 309, the burden of proving that the breach~~(iii) in a damage action against the director based on the director's failure to satisfy the requirements of Section 309, that

the failure was the proximate cause of damage suffered by the corporation or its shareholders.

Comment. ~~Section 320 expresses the~~ The business judgment rule ~~in terms~~ set forth
(3) in Section 320 is largely 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 section~~ developed by
judicial decisions; those materials should be consulted in connection with questions of
(4) construction and intent of ~~this section.~~ Section 320 to the extent it embodies the ALI
materials.

Section 320 codifies the business judgment rule for business corporations subject to
(5) Section 309. The codification does not affect common law application of the business
judgment rule, if any, to other entities, such as partnerships and nonprofit corporations.
The fact that these other entities are not included in Section 320 does not imply that a
common law business judgment rule does not apply to them.

(6) Section 320 ~~is a qualification of~~ relates to Section 309, which prescribes ~~the duty of
care~~ duties of directors. Therefore, ~~this section by its terms~~ Section 320 applies only to
conduct of directors.

To qualify as a " director's business judgment ~~" of a director~~ within the meaning of ~~this section~~ Section 320, 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.~~ acting.

(7) ~~Section 320 specifies nonexclusive conditions under which Section 309 is deemed to
be~~ The language of Section 320 effectively creates a conclusive presumption that a
director has satisfied the requirements of Section 309 if the conditions of Section 320(a)
are satisfied. Section 309(a) ~~and (b) codifies the duty of care by stating~~ states the manner
in which a director must perform the duties of a director. Section ~~309(c) addresses the
liability of a director for failure to perform the duties under~~ 309(b) permits a director to
rely on others to the extent specified. Section 309(c) provides in part that a person who
performs the duties of a director in accordance with Section 309(a) and (b) shall have no
liability based upon alleged failure to discharge obligations as a director. Therefore,
Section 320 would apply to liability actions against directors under Section 309 based on
(8) ~~the duty of care~~ breach of their duties, as well as to actions against directors seeking
other remedies based on alleged violations of ~~the duty of care under~~ Section 309(a) and
(b).

Strictly speaking, Section 320 would not apply in an action in which remedies are sought ~~against the corporation~~ to enjoin or set aside a business transaction of a

corporation with a third party, as opposed to an action against individual directors. However, since any such transaction of importance ~~is likely to have taken place as a~~
(9) ~~consequence of the exercise of directors'~~ that is considered by the directors would require them to exercise business judgment, the substantive issue in such an action would normally be whether the directors ~~exercised their business judgment~~ did so in a manner that satisfies Section 320. Nothing in Section 320 is intended to validate a corporate action that is not otherwise in accordance with law, whether due to illegality, failure to follow proper procedure, or ~~other for other cause.~~ for other cause, but Section 320 should
(10) be relevant to the efficacy of directors' approval.

~~Section 320 codifies the business judgment rule.~~ Courts of other jurisdictions that
(11) ~~apply~~ have applied the business judgment rule ~~in duty of care cases~~ have limited ~~the~~ its application ~~of that rule~~ in certain kinds of cases that fall between traditional duty of care cases and traditional duty of loyalty cases; in particular, in cases involving transactions incident to contests for control, such as defensive actions to takeover bids, and in cases involving the effect of a board or committee determination that a derivative action against a corporate director or officer is not in the best interests of the corporation. *See, e.g.*, Unocal v. Mesa Petroleum Corp., 493 A.2d 946 (Del. 1985); Zapata Corp. v. Maldonado, 420 A.2d 799 (Del. 1981). Nothing in Section 320 would prevent California courts from developing standards to determine whether and under what circumstances Section 320 is applicable to such cases. *Cf.* Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13284 (October 31, 1996).

The business judgment rule provides a "safe harbor" for determining a director's
(12) liability for breach of the director's ~~duty of care~~ duties under Section 309, but it does not provide the exclusive means for this determination. An action of an interested director, for example, is not entitled to protection of the business judgment rule but the director's actions may nonetheless satisfy his or her duties under Section 309. Further, action by other directors that satisfies either the business judgment rule or ~~the duty of care under Section 309 (but not necessarily the duty of loyalty) that an ordinarily prudent person in a~~
(13) ~~like position would use under similar circumstances. In a judicial proceeding, 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. Subdivision (b).~~ may prevent a
(14) director's failure to meet the requirements of the business judgment rule or even those of Section 309 from being the proximate cause of damage, if any, suffered by the corporation or its shareholders as a result of directors' decisions.

The business judgment rule applies only to satisfaction of a director's ~~duty of care~~
(15) duties to the corporation and its shareholders under Section 309. It does not apply to the director's ~~duty of care~~ duties, 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~~ director's duties to the corporation and its shareholders as authorized by Section 204(a)(10). See Section 309(c).

The introductory portion of subdivision (a) makes clear that this section protects only business judgments of directors. 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
(16) overall issue. **[Reconsider the foregoing sentence.]**

Subdivision (a)(1) codifies the principle of existing law that the business judgment rule applies only to a good faith action of a director. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282-4 (October 31, 1996); Barnes v. State Farm Mutual Auto Ins. Co., 16 Cal. App. 4th 365, 20 Cal. Rptr 2d 87 (1993); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); Marsili v. Pacific Gas and Electric Co., 57 Cal. App. 3d 313, 124 Cal. Rptr. 313 (1975); Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Fornaseri v. Cosmosart Realty Corp., 96 Cal. App. 549, 274 P. 597 (1929).

Subdivision (a)(2) codifies the principle of existing law that the business judgment rule applies only to a disinterested decision. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282-4 (October 31, 1996); Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989). For the meaning of "interested" as used in subdivision (a)(2), see Section 321 (interested director). It should be noted that an interested director who abstains from participation in a corporate decision due to ~~the conflict of~~ his or her interest would not ordinarily be held to have violated the standard of care of Section 309, absent a specific statutory provision such as Section 316(b) (director who abstains from specified board action is deemed to have approved action). Cf. Propp. v. Sadacca, 175 A.2d 33 (1961).

Subdivision (a)(3) codifies the principle of existing law that the business judgment rule ~~applies only to~~ requires an informed decision. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13284 (October 31, 1996); 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~~
(17) do not provide clear precedential authority. 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)). Other cases 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)). Yet other cases 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)(4) applies a rationality standard that represents a middle ground among the various standards articulated by the California cases, and is consistent with the most recent articulation of the standard in California. See Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282 (October 31, 1996) (court will not interfere with decision that has "rational business purpose").

The rationality standard of subdivision (a)(4) 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.

Subdivision (b) is drawn from ALI Principles of Corporate Governance § 4.01(d) (1992). It codifies the ~~burdens~~ burden of proof in existing law, placing it on a person challenging the conduct of a director as a breach of Section 309. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282 (October 31, 1996); 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.

§ 321. Interested director

321. (a) For the purpose of Section 320, 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 or an associate of the director has a material ~~pecuniary~~
(18) financial or personal interest in the transaction or conduct (other than usual and customary directors' fees and benefits), of which the director knows or should be aware, that would reasonably be expected to affect the director's judgment in a manner adverse to the corporation or its shareholders.

(3) The director is subject to a controlling influence by a party to the transaction or conduct (other than the corporation) or by a person who has a material ~~pecuniary~~
(18) financial or personal interest in the transaction or conduct of which the director knows or should be aware, and that controlling influence ~~could~~ 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.

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

(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 adoptive relationships, and the spouse of such a person; a mother-in-law, father-in-law, brother-in-law, or sister-in-law of the director; a person, other than a domestic employee, having the same home as the director; and a trust or estate of which the director or a person designated in the paragraph is a substantial beneficiary.

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

(20) (3) A person with respect to whom the director has a business or ~~financial~~ other relationship ~~other than~~ except a person described in paragraph (1) or (2), but if and only if the 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. For the ~~purpose~~ purposes of this paragraph, as to a person that is a
(21) business organization, the following presumptions affecting the burden of proof apply:

(A) 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.

(B) 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 of the business organization.

(C) 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 of the business organization.

Comment. Subdivision (a) of Section 321 is drawn from American Law Institute (ALI) Principles of Corporate Governance § 1.23 (1992). See also Model Business Corporation Act § 8.31, Comment 5 ("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.") 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
(22) ~~director~~ director's action 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, (1) the director's actions may nonetheless satisfy the ~~duty of care (but not necessarily the duty of loyalty) that an ordinarily prudent person in a like position would use under similar circumstances.~~ duties specified in Section 309 or (2) the satisfaction of the business judgment rule or the requirements of Section 309 by other directors acting in the matter may make the interested director's interest moot.

Unlike ALI Principles of Corporate Governance § 1.23 (1992), ~~subdivision~~ subdivisions (a)(2) ~~is~~ and ((a)(3) are limited to ~~pecuniary~~ interests "of which the director knows or should be aware".

Under subdivision (a)(3), 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~~ financial 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) is drawn from ALI Principles of Corporate Governance § 1.03 (1992).

Paragraph (b)(1) incorporates concepts of Rule 16a-1 under the Securities Exchange Act of 1934 ("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.") Subdivision (b)(1) omits reference to son-in-law and daughter-in-law since those relationships are otherwise covered by reference to the spouse of a child. Subdivision (b)(1) includes reference to brother-in-law and sister-in-law, even though those relationships are otherwise covered by reference to the spouse of a sibling, since those relationships may also include the sibling of a spouse.

The presumptions created by subdivision (b)(3) are rebuttable. Whether the 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 will depend on the circumstances. An interest greater than 10% might not reasonably be expected to affect the director's judgment, for example, if the interest is in a small, privately held business and the value of the ownership interest is insubstantial for that director. On the other hand, an interest less than 10% might reasonably be expected to affect the director's judgment, for example, if the interest is in a large, publicly held business and the value of the ownership interest is substantial for that director.

<u>M E M O R A N D U M</u>

March 21, 1997

Explanation of Suggested Changes to Proposed Corporations Code Sections 320-321 and Official Comments Thereon

This memorandum should be read in tandem with the marked copy of proposed Corporations Code Sections 320-321 and the Law Review Commission's comments thereon as set forth in the Discussion Draft dated November 1996 as to codification of the Business Judgment Rule ("BJR"). The marked copy contains in its left margin in various places the numbers 1 through 21. The comments in this memorandum are keyed to those numbers and explain the reasons for the changes suggested at or near the place where the number appears in the marked copy.

1. I am troubled by "deemed . . . ", but have not devised a satisfactory substitute. Perhaps another commentator has. The problem is that a director needs to attempt to meet the standard of Section 309, but should not suffer personal liability if he or she (or action by sufficient other directors on behalf of the board) satisfies the BJR or Section 309. Perhaps, however, "deemed . . . " is the best we can do and the Comments will convey what it means.

2. The language changes in Section 320(b) are not substantive but I think they make this subsection more readable.

3. These changes reflect the fact that the BJR set forth in Section 309 is quite different in various respects from the ALI version. Also, the ALI discussion of the BJR is not of the rule as it would be codified in Section 309 but as developed by judicial decisions.

4. The point here is that the ALI should provide guidance only to the extent Section 320 embodies ALI materials.

5. The first change here reflects the fact that corporations subject to Section 309 are not only California business corporations generally governed by the General Corporation Law but also foreign corporations made subject to Section 309 by Corporations Code Section 2115. See the comment in my letter dated March 21, 1997 that Section 2115 should be amended to add Sections 320 and 321, if enacted, so that a

foreign corporation subject to Section 309 will also clearly be entitled to California's codified BJR.

The second change makes clear that enactment of Sections 320 and 321 would not imply that an appropriate version of the BJR does not exist and continue to apply to other types of entities managed by boards of directors, trustees or managers who make business judgments. Of course, applying a BJR to them must be done with due regard to their differences from the business corporations whose directors are subject to Section 309.

6. Section 320 does not actually qualify Section 309, which remains the primary specification of directors' duties. Section 320, however, "relates" to Section 309 because Section 320 establishes a threshold for judicial review of directors' judgments and their satisfaction of Section 309 requirements.

7. Section 309(a) is the provision that codifies a director's duties by stating the manner in which a director must perform them. Section 309(b) does not establish requirements as such. Rather, it permits reliance on the terms it specifies. Using that permission is not a part of a director's duties even though relying on others is a practical necessity in larger corporations.

8. The reference to the duty of care has been stricken here because the result of satisfying Section 320 is not just that a director is treated for purposes of the BJR as having satisfied the duty of care but rather is treated as satisfying "the" (i.e., all) requirements of Section 309, which imposes duties beyond a duty of care. The same deletion has been made in other places in this material for the same reason.

9. The change here reflects the fact that not all important transactions rise to the level of director consideration. Decisions as to many important transactions are made by others, such as committees, officers or agents, through delegation.

10. The addition here is designed to make it clear that Section 320 is relevant to the efficacy of directors' approval of a transaction even though that approval alone may not be sufficient to validate it if other requirements such as stockholder approval, applicable law or the like are not satisfied.

11. The deletion of the first sentence here results from the fact that although Section 320 would establish a codified BJR for California, it doesn't actually codify, i.e. copy, any of the various business judgment rules that have been applied by the courts. In addition, the deleted sentence seems

surplus to the subject of this paragraph. The deletion of the reference to duty of care is explained above in Paragraph 8.

12. Reference to duty of care is deleted here for the reasons explained in Paragraph 8 above.

13. I have deleted the sentence beginning "In a judicial proceeding," because it only restates what is in Section 320 and does not add any explanation or illumination of it.

14. Addition of the sentence beginning "Further, action . . ." and continuing to the end of the paragraph (after deletion of the sentence referred to above in 13) is designed as a reminder that (a) directors do not make corporate decisions individually but as a group through collective action as a board or as a committee of the board, (b) board or committee action by other directors that satisfies their duties to the corporation and its shareholders may make failure by a particular director to do so irrelevant, and (c) therefore, failure by one director (or even more) to satisfy Section 320 or even Section 309 may cause no justiciable harm. It is easy to lose sight of this distinction between actions by a particular director and corporate action by the board or a committee, as the court in the Natomas case may have done.

15. The changes in this paragraph are for the reasons explained in Paragraph 8, above.

16. I made the suggestion here because it is not at all clear to me that directors must become informed only about an overall issue. It is true that they do not have an obligation, and more often than not do not have the time given the pace of modern corporate transactions, to consider every aspect of every decision. Clearly, however, they must explore the more important subsidiary or related issues before they can make a judgment about "an overall issue". I have not, however, had time to suggest an alternate formulation.

17. The point here is that many California cases, taken individually, set forth the court's view of the BJR very clearly. Some do not do so, however, and taken together the cases do not provide adequately helpful precedential authority.

18. The alternative suggestions for language here result from my feeling that the exposure draft's limitation of interest to a "pecuniary" interest is too narrow. I earlier had a problem with use of the word "familial" in this material and my suggestion has been taken. Clearly, however, a director would seem to be "interested" as a result of interests that are not just pecuniary. "Financial" is somewhat broader and would be better, but pairing "financial" and "personal" would seem to me

to be a better description of the kind of interests that should be worrisome.

19. "Aunt, uncle, nephew, niece" seems to cast too broad a net and that is probably why the SEC's rule 16a-1 does not include those relationships. If there were a relationship between a director and one of those persons that fell within (b)(3), the person would become an "associate"; that seems a better way to deal with these often remote relationships than automatically to pick them up in (b)(1).

20. In some ways clause (3) is a catchall. I would suggest that "business or other" does a better job than "business or financial" because the latter leaves out any number of possible relationships that would reasonably be expected to affect a director's judgment adversely to the corporation or its shareholders.

21. This sentence appears to be derived from ALI's Principles, Section 1.03(b), which deals with some of the circumstances in which a business organization with which a director has a relationship is or is not an associate of the director. As included in the Exposure Draft, however, the condensation of Section 1.03(b) seems incomplete unless the additions suggested are made.

22. The first suggestion in this paragraph may be somewhat abstruse but seems appropriate. There are two reasons for the second suggestion. First, the reference to the duty of care is deleted for the reason set forth in Paragraph 8 above. The second is a reminder that, even if an interested director acts on a particular matter, that action should not make the director liable if <u>either</u> the director has satisfied Section 309 or sufficient other directors acting for the board do satisfy either the BJR or Section 309.

R. Bradbury Clark