

First Supplement to Memorandum 97-17

Business Judgment Rule: Comments of State Bar Subcommittee

Attached to this memorandum are comments from a subcommittee of the State Bar Corporations Committee on the proposed codification of the business judgment rule. In brief, the State Bar subcommittee believes:

(1) The proposed codification is sound and should be adopted. Existing California law is not clear, and a clear business judgment rule is important for development and growth of California business and employment.

(2) The improvements suggested by Brad Clark that are discussed in Memorandum 97-17 are generally appropriate. In particular:

- The codification of the rule should apply to foreign corporations that are subject to California corporation law pursuant to Corporations Code Section 2115.
- The law should be clear that even though a particular director may not qualify for protection under the business judgment rule (due to conflict of interest), the director should not be held liable if the corporate decision was properly made by other disinterested directors.

(3) The definition of an “interested director” should not be expanded to include personal (as opposed to financial) interests. This would cause uncertainty in the application of the rule.

(4) Business decisions are complex and their consequences uncertain. Rational business decisions by corporate directors ought not to be second-guessed by the judicial system for “reasonableness”. Clear articulation and application of the business judgment rule is needed for responsible and effective business decisionmaking by boards of directors. “Clarification and codification of the Rule will promote the interests of shareholders in creative and vigorous leadership by assuring directors that they will not be subject to personal liability for imperfect decisions in which they do not have a personal financial stake.”

These views are elaborated in the attached letter.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

Law Revision Commission
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THE STATE BAR OF CALIFORNIA**

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655 FRANKLIN STREET
SAN FRANCISCO, CA 94102
(415) 561-8870

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REPLY TO: (916) 441-0131

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

Re: Codification of the Business Judgment Rule

Ladies and Gentlemen:

I am writing this letter on behalf of the subcommittee ("Subcommittee") of the Corporations Committee of the Business Law Section of the State Bar of California that has considered various versions of a proposed codification of the Business Judgment Rule ("Rule") prepared by your staff. During 1996, the Subcommittee has provided written comments on various discussion drafts of the Rule and related commentary, held discussions with the Commission's Executive Director, and appeared and spoken at Commission hearings at which the Rule was discussed. In the fall of last year, members of the Subcommittee attended a meeting in Berkeley with Mr. Nathaniel Sterling, the Commission's Executive Director, and its consultant on the Rule, Professor Melvin Eisenberg. Mr. Reid R. Kathrein, a private practitioner who had also provided comments to the staff and the Commission, was also in attendance at that meeting. The 1996 activities of your staff and the Subcommittee and the Berkeley meeting culminated in the November 1996 discussion draft of the Rule and Commentary (the "Pending Proposal") that has been circulated for comment. The purpose of this letter is to express the Subcommittee's views on the Pending Proposal.

The Subcommittee supports the Pending Proposal and we urge its adoption by the Commission. We reach this conclusion even though the Subcommittee originally expressed substantial reservations about the wisdom of codifying the

business judgment rule. The reasons for our position appear in the remainder of this letter.

The primary reason for our support of the Pending Proposal is our belief that existing case law in California, taken as an entirety, does not articulate a consistent and clearly stated view of the business judgement rule. In the experience of members of the Subcommittee, this creates uncertainty in the board rooms of California corporations, both large and small, about the circumstances under which directors' business decisions, made in good faith, can be second guessed and can subject the decision makers to legitimate claims involving their personal liability. The Subcommittee believes that this uncertainty is not conducive to considered risk taking, which the Subcommittee, as well as numerous commentators, believes to be essential to the development and growth of California business and employment.

The Subcommittee would not, and does not, support a rule of absolute immunity for decision making by directors. The members of the Subcommittee believe that the laws strikes an appropriate balance between the clear business need to accord judicial deference to corporate business decisions and the need to hold directors accountable for the decisions they make. We believe the Pending Proposal codifies this balance.

The Subcommittee members have carefully considered the comments and suggestions made by Bradbury Clark in his March 26 letter to the Commission. On the whole, we subscribe to Mr. Clark's suggestions for changes to the Pending Proposal as well as the rational supporting his position. We underscore the following points made by Mr. Clark:

(i) Section 2115 of the California Corporations Code should be amended to apply Sections 320 and 321 to foreign corporations that become subject to Section 309.

(ii) Directors interested in a transaction should not be subject to potential liability under Section 309 if the action taken by the disinterested directors with respect to the transaction would satisfy the requirements of Section 320 and such action is sufficient to constitute action by

the board of directors. Stated differently, a director should only be responsible for conduct that is the proximate cause of the claimed damages suffered by the corporation. The court in Gaillard V. Natomas Co. seems to have overlooked this principle.

Notwithstanding our general endorsement of Mr. Clark's position on the Pending Proposal, we take issue with one aspect of his suggestions. Mr. Clark would modify the Section 321(a) definition of "interested" director by expanding the concept of "pecuniary interest" to "financial or personal" interest (emphasis added). We believe the Commission would be ill advised to incorporate the concept of a non-financial personal stake in the definition of "interested." This addition would create a substantial level of uncertainty in the availability of the business judgement rule since it could allow courts to negate the applicability of the rule by merely finding that the directors or their associates had a non-financial personal interest in the decision. Although Section 321(a) also requires that it be shown that the interest would affect the director's judgement adversely to the corporation and its shareholders, this is a subtlety that may be easy for judges and juries to overlook or, perhaps worse, infer from the circumstances rather than from direct evidence. Moreover, in the absence of any definition or other guidance about the meaning of the term "personal" in this context, it is unclear how a director would prove the absence, or rebut a claimant's contention of the existence, of such an interest.

We have also given careful consideration to the March 14 letter from Mr. Kathrein to the Commission, as well as the compendium of interesting (albeit largely unpersuasive) supplemental information accompanying his letter. Mr. Kathrein's letter, rather than focusing on the propriety of codifying the Rule, is largely an attack on the Rule itself. We are unpersuaded by the reasons Mr. Kathrein advances for opposition to the Rule, notwithstanding his invocation of the words of Oliver Wendell Holmes and his claims of widespread abuse in the setting compensation of corporate officers. These words and claims do not directly address the issue whether a business judgement rule, which is needed for effective and responsible decision making by boards of directors of California corporations, should be codified. The Subcommittee lacks information that would be

pertinent to evaluate Mr. Kathrein's allegations about imprudent decisions made by a number of companies described in Mr. Kathrein's materials including those involving Apple Computer Corporation and The Walt Disney Company. Nevertheless, the Subcommittee's members question whether the Commission should give serious weight to these unproven claims in light of the fact that Mr. Kathrein's law firm is currently litigating derivative actions based upon these very issues against Apple and Disney. The personal, direct and immediate financial stake possessed by Mr. Kathrein and his law firm in the outcome of these cases should not influence the development of California's policy on the codification of the business judgment rule.

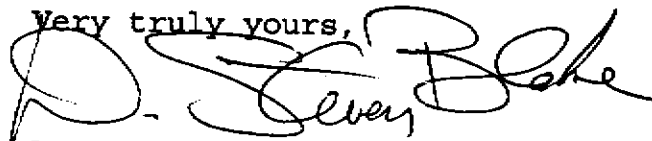
Mr. Kathrein's letter indicates a fundamental misunderstanding of the Rule, which is itself a strong argument for codification of the Rule. The Rule is intended to shield directors who make business decisions without a personal financial stake in the outcome from having those decisions later second guessed as "unreasonable." Rational decisions by such directors, whether or not later found to be "reasonable," ought not to be revisited by courts or juries who are less qualified than directors to make these decisions. While the Subcommittee understands that Mr. Kathrein's firm does not like this body of law, courts in every state have recognized that without the Rule directors could not discharge their duties to the shareholders.

Ultimately, the Subcommittee has reached its decision to endorse the Pending Proposal because it believes that a clear articulation and application of the Rule are conducive to promoting responsible and effective business decision making by boards of directors. The Subcommittee also believes that clarity in this area is important in light of the efforts of some to obfuscate - and limit - the Rule. Effective decision making can only be achieved by enabling California corporations to attract the best people to serve as directors and to protect the business decisions that meet the criteria established by the Rule. Most business decisions made by directors are complex and involve a complicated balancing of competing considerations that have different and in some cases uncertain weights and consequences.

In light of both the complexity of and need for effective corporate decision making, the Subcommittee's members believe that it hardly benefits shareholders to have their directors act timidly by seeking risk-free or low risk decisions out of excessive concern for their personal exposure. Clarification and codification of the Rule will promote the interests of shareholders in creative and vigorous leadership by assuring directors that they will not be subject to personal liability for imperfect decisions in which they do not have a personal financial stake.

While we conclude the Pending Proposal is not perfect, we urge that it be adopted by the Commission. We are prepared to state these views at any hearing held by the Commission at which the Pending Proposal will be considered.

Very truly yours,

A handwritten signature in dark ink, appearing to read "D. Steven Blake". The signature is fluid and cursive, with the first name "D." and last name "Blake" being more distinct than the middle name "Steven".

D. Steven Blake,
Co-Chair, Corporations Committee
for the Subcommittee

cc: Alan J. Barton, Esq.
Evelyn Lewis, Esq.
Timothy Hoxie, Esq.
Diane Frankel, Esq.
R. Bradbury Clark, Esq.