Study B-601 September 29, 1997

Memorandum 97-67

Business Judgment Rule: Revised Draft

Attached to this memorandum is a draft of the business judgment rule recommendation, revised in accordance with Commission decisions at the July 1997 Commission meeting. The Commission should note the following significant changes in this draft from the last draft:

(1) References to "material economic interest" have been substituted for references to "material pecuniary interest" in Section 321. The rebuttable presumptions, particularly those that presumed interestedness or lack of it based on percentage share ownership, are omitted from the section.

(2) New Section 322 has been added to make clear that the courts (i) may elect to apply the business judgment rule where other types of relief than monetary damages are being sought, and (ii) may elect not to apply the business judgment rule where the business decision challenged implicates the directors' duty of loyalty (e.g. a decision to block a derivative action or a hostile tender offer).

(3) An amendment to Section 2115 has been added to apply the business judgment rule to a foreign corporation in a situation where the Section 309 duty of care would also apply to the corporation.

The Commission may be interested in the following remark by E. Norman Veasey (Chief Justice of Delaware) in *The Defining Tension in Corporate Governance in America*, 52 The Business Lawyer 393, 394 (1997) [footnotes omitted]:

> The business judgment rule can be stated simply: in making a business decision, the directors are presumed to have acted independently, on an informed basis, in good faith, and in the honest belief that the decision is in the best interests of the corporation. A business decision will normally be sustained unless the presumption is rebutted in either of two ways: (i) the process, independence, or good faith of the directors is compromised; or (ii) the decision cannot be attributed to a rational business purpose.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

#B-601

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

STAFF DRAFT RECOMMENDATION

Business Judgment Rule

October 1997

California Law Revision Commission
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Business Judgment Rule

Summary of Recommendation

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

This recommendation applies only to directors of business corporations. The Law Revision Commission has not studied the circumstances of directors of nonprofit corporations and makes no recommendation on the application of the business judgment rule to them.

Business Judgment Rule

BACKGROUND

The Legislature in 1993 authorized the Law Revision Commission to study whether "the standard under Section 309 of the Corporations Code for protection of a director from liability for a good faith business judgment, and related matters, should be revised."[1] The motivation for this study is that California law in the area is confused. The uncertainty of California law, compared with the well-articulated Delaware law on this subject, may be a factor in the decision of some California corporations to reincorporate in Delaware. The business judgment rule of Delaware and other jurisdictions may offer useful guidance for codification and clarification of the law in California.[2]

The Commission retained Professor Melvin A. Eisenberg of the University of California, Berkeley, School of Law to prepare a background study on the matter.[3] The present recommendation is the product of the Commission's deliberations at a series of public meetings held during 1995–1997.

STANDARD OF CARE AND BUSINESS JUDGMENT RULE

Standard of Care of Directors

Corporate directors are held to a standard of careful conduct. The standard of careful conduct has evolved from basic fiduciary concepts, reflected in the statutory formulation of the standard found in Corporations Code Section 309(a). That statute requires a director to act in good faith in a manner the director believes to be in the best interests of the corporation and shareholders, and "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."

Standard of Judicial Review

In applying the standard of careful conduct to a business judgment made by a director, the courts have used a lower standard of review, provided the director made the decision in good faith, did not have an economic interest in the decision, and used a reasonable decisionmaking process. The lower standard of review applied in these circumstances is called the "business judgment rule."

There are various formulations of the business judgment rule. One standard that has been applied is subjective — whether the director has acted in good faith. A

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1. 1993 Cal. Stat. res. ch. 31.

2. *Annual Report for 1992*, 22 Cal. L. Revision Comm'n Reports 831, 845 (1992).

3. See Eisenberg, *Background Study for the California Law Revision Commission on Whether the Business-Judgment Rule Should Be Codified* (May 1995). The background study is available electronically at the following URL: http://www.clrc.ca.gov/. It is also reprinted as an Appendix to this report.

more common standard is objective — whether the decision of the director is rational, as distinct from prudent.

Rationale of Business Judgment Rule

The reason for the business judgment rule is that business decisions inherently involve risk. It would be unfair to penalize a director for a risky decision made in what the director rationally and in good faith believes to be in the corporation's interest, just because the risk materializes. This would make the director in effect an insurer of the corporation's acts, and would tend undesirably to promote risk-averse decisionmaking by directors.

But given the fact that other fiduciaries are held to a standard of prudence and due care, is the special protection of the business judgment rule necessary or proper?[4] The trend in the law generally is to recognize that some risk is inherent in sound decisionmaking, and to make allowance for that fact.[5] Risk is a necessary element of proper business decisionmaking, to an even greater degree than investment decisions of fiduciaries.[6]

CALIFORNIA LAW AND THE NEED FOR CLARIFICATION

California's formulation of the business judgment rule is confused. Some cases have articulated a reasonability standard,[7] others a good faith standard,[8] and still others have combined the two concepts or treated them as interchangeable.[9]

Statements may be found in case law that California's statement of the standard of careful conduct in Corporations Code Section 309(a) codifies the business judgment rule.[10] But that section actually codifies the standard of careful conduct, with which the business judgment rule is inconsistent. In fact, it could be argued that the statement of the standard of care in Section 309 negates the business

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4. See Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. Cal. L. Rev. 287 (1992). Professor Gevurtz concludes that corporate directors are not unique in the types of decisions they make, and should not receive special treatment.

5. For example, in determining whether a trustee has used reasonable care, the trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but "as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust." Prob. Code § 16047(b). See also *Uniform Prudent Investor Act*, 25 Cal. L. Revision Comm'n Reports 543 (1995).

6. See, e.g., Protecting Corporate Officers and Directors from Liability (Cal. Cont. Ed. Bar 1994).

7. See, e.g., Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Fornaseri v. Cosmosart Realty Corp., 96 Cal. App. 549, 274 P. 597 (1929); Briano v. Rubio, 54 Cal. Rptr. 2d 408, 415 (1996).

8. 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).

9. See, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989).

10. See, e.g., *id*. at 1264; Barnes v. State Farm Mutual Auto. Ins. Co., 16 Cal. App. 4th 365, 379 n.12, 20 Cal. Rptr. 87 (1993); Briano v. Rubio, 54 Cal. Rptr. 2d 408, 415 (1996).

judgment rule by its failure to create a business judgment exception to the statutory standard.[11]

The Commission has also considered the question whether the existence of other devices in the law for protecting directors against personal liability may diminish the importance of a clear statement of the business judgment rule. These devices include insurance and indemnification for directors,[12] as well as protection from liability under the articles.[13] These devices are not universal among California corporations, nor do they eliminate the benefit of a sound expression of the governing law.

The Commission has concluded that, given the justifications and importance of the business judgment rule, and the uncertainty of its status and formulation in California, it is desirable to codify the rule.

PRINCIPLES OF CODIFICATION

Models for Codification

The business judgment rule is a creature of the common law. No state has yet codified the rule.

It is generally thought that the California and Delaware business judgment rules are basically similar, although the California law is subject to some confusion. One attraction of Delaware law for many corporations is the substantial body of law that has developed in Delaware, offering useful guidance to corporate directors.[14] This would argue for codification in California based on Delaware law.

The Commission believes that a better model is the Principles of Corporate Governance (1992) of the American Law Institute (ALI). This compilation of principles represents a fair statement of the general law in a way that is not inconsistent with either Delaware law or existing California law, and would resolve any concern about discrepancies between California and Delaware law on this matter. A significant added benefit to codification of the business judgment rule in the form of the ALI Principles of Corporate Governance is that, besides

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11. See discussion in 1 H. Marsh & R. Finkle, Marsh's California Corporation Law § 11.3 (3d ed. 1990).

12. Corp. Code § 317.

13. Corp. Code § 204(a)(10).

14. The Delaware Law Study Group of the State Bar Business Law Section's Corporations Committee provides this comparison:

> Both California and Delaware cases apply the business judgment rule to protect good faith diligent business decisions of directors where there is no conflict of interest, even where, in hindsight, the decision was wrong. The business judgment rule does not protect against grossly negligent decisions, although this is a factual determination. *See Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985); *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965). There is far more case law in Delaware on this issue, and California courts may, and do, consider these Delaware cases as persuasive authority under appropriate circumstances.

How Section 2115 Affects Your Delaware Clients: A Comparison of Delaware and California Law Applicable to Quasi-California Corporations, 15 Business Law News 28-29 (Summer 1993).

clarifying California law, it will pick up a whole body of interpretation in the form of official commentary and reporter's notes. Moreover, the ALI Principles are likely to become a dominant factor in shaping the law in the future.

Elements of Business Judgment Rule

The elements of the business judgment rule are laid out clearly in the ALI Principles of Corporate Governance. A director who makes a good faith business judgment fulfills the duty of care if the director:

> (1) is not interested in the subject of the business judgment;
>
> (2) is informed with respect to the subject of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances; and
>
> (3) rationally believes that the business judgment is in the best interests of the corporation.[15]

Disinterested Director

The business judgment rule only applies where the director "is not interested in the subject of the business judgment." Under the ALI Principles, a director is "interested" in a transaction or conduct in any of the following circumstances:[16]

> (1) The director or an associate of the director is a party to the transaction or conduct.
>
> (2) The director has a business, financial, or familial relationship with a party to the transaction or conduct, and that relationship would reasonably be expected to affect the director's judgment with respect to the transaction or conduct in a manner adverse to the corporation.
>
> (3) The director, an associate of the director, or a person with whom the director has a business, financial, or familial relationship, has a material pecuniary interest in the transaction or conduct (other than usual and customary directors' fees and benefits) and that interest and (if present) that relationship would reasonably be expected to affect the director's judgment in a manner adverse to the corporation.
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> (4) The director is subject to a controlling influence by a party to the transaction or conduct or by a person who has a material pecuniary interest in the transaction or conduct, and the controlling influence could reasonably be expected to affect the director's judgment with respect to the transaction or conduct in a manner adverse to the corporation.

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

The Commission recommends several clarifications of these standards, including:

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15. American Law Institute, Principles of Corporate Governance §4.01(c) (1992).
16. American Law Institute, Principles of Corporate Governance §1.23 (1992).

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

(2) Under the standards, neither the director nor an associate or other person with whom the director has a relationship may have a material pecuniary interest in the transaction that could adversely affect the director's judgment. But a director may be unaware of the existence of such an interest. The director should not be considered interested for purposes of the business judgment rule unless the director knows or should be aware of the existence of the interest.

Rationality Standard

Under the ALI Principles of Corporate Governance, the business judgment rule protects a good faith exercise of business judgment by a disinterested and reasonably informed director if the director "rationally believes that the business judgment is in the best interests of the corporation."[17] Although courts have announced various formulations of the business judgment rule, the rationality standard is the most prevalent.[18]

The rationality standard is relatively easy to satisfy — conduct that may be imprudent or unreasonable is not necessarily irrational. "Unlike a subjective-good-faith standard, a rationality standard preserves a minimum and necessary degree of director and officer accountability."[19] An example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained.

The rationality standard allows a wider range of discretion than a reasonableness standard would impose; it gives the director a safe harbor from liability for a business judgment that might not be reasonable, so long as it is not so removed from the realm of reason when made that liability should be incurred.[20]

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17. American Law Institute, Principles of Corporate Governance §4.01(c)(3) (1992).

18. See, e.g., E. Brodsky & M. Adamski, Law of Corporate Officers and Directors: Rights, Duties, & Liabilities § 2.11 (1984); D. Block, N. Barton & S. Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors 38-39 (4th ed. 1993).

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

20. American Law Institute, Principles of Corporate Governance, § 4.01(c)(3) Comment (1992):

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

The rationality standard represents a middle ground among the various standards that have been articulated in the California cases[21] and would codify the most recent California case law formulation.[22] It has the added benefits that it is consistent with the mainstream of case law in other states, including Delaware law. And it picks up the useful explanatory material set out in the ALI Principles of Corporate Governance.

Presumption and Burden of Proof

The business judgment rule is sometimes described as a presumption in favor of the regularity of acts of the directors.[23] But the business judgment rule is really a defense to an allegation that the duty of care has been violated. The burden of proof is on the person challenging the acts of the directors in any event.[24] These principles should be made clear in the codification of the business judgment rule. A director is presumed to have satisfied both the duty of care and the requirements of the business judgment rule, the burden of proof of these matters being on the person alleging a violation. This would codify existing law.[25]

TRANSACTIONS IN CONTROL AND DERIVATIVE ACTIONS

Courts of other jurisdictions that have applied the business judgment rule 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.[26] Whether the business judgment rule should apply to an action of directors to block or dismiss a derivative action as not in the best interests of the corporation is problematic.[27] The proposed legislation makes clear that California courts may develop standards to determine whether

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21. See discussion in text at nn. 8-10, *supra*.

22. See Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 711, 57 Cal. Rptr. 2d 798, 808 (1996)).

23. See, e.g., Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 709-15, 57 Cal. Rptr. 2d 798, 807-11 (1996); Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 261 Cal. Rptr. 868 (1989).

24. Evid. Code §§ 500, 521.

25. See, e.g., Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (1996); 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).

26. See, e.g., Unocal v. Mesa Petroleum Corp., 493 A.2d 946 (Del. 1985); Zapata Corp. v. Maldonado, 420 A.2d 799 (Del. 1981).

27. See Eisenberg, *The Requirement of Making a Demand on the Board Before Bringing a Derivative Action* and *The Standard of Review of a Board or Committee Determination that a Derivative Action Is Not in the Corporation's Best Interests* (Oct. 1995).

and under what circumstances the business judgment rule should apply to these cases.[28]

PROCEEDINGS TO ENJOIN OR SET ASIDE ACTION OF BOARD

The business judgment rule is applicable to determine whether the directors' standard of care has been satisfied for purposes of determining liability of the directors. It may also be applicable for determining whether the course of action they have decided on can be enjoined or set aside.[29] Application of the business judgment rule to a determination whether to enjoin or set aside board action is not a simple matter, however, and varies with the type of board action at issue.[30] The Commission would leave application of the business judgment rule in proceedings to enjoin or set aside board action to common law development.

CODIFICATION INAPPLICABLE TO OFFICERS

Most of the development of the law relating to business judgments has occurred in connection with directors, particularly in derivative action litigation. There is relatively little law concerning corporate officers. The Commission recommends that the codification of the business judgment rule should be limited to directors, and that its possible application to officers be made the subject of a separate study. Codification of the business judgment rule for directors should not affect the common law protection of officers.[31]

CODIFICATION APPLICABLE TO CERTAIN FOREIGN CORPORATIONS

The standard of conduct of a director codified in Section 309 by its terms applies to domestic California corporations. By virtue of Section 2115 it also applies to certain foreign corporations doing business in California. Because the business judgment rule provides the standard of judicial review of an action alleged to be in violation of Section 309, the business judgment rule should likewise apply to a foreign corporation subjected to Section 309 by Section 2115. The recommended legislation includes this concept as part of its codification of the business judgment rule.

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28. *Cf.* Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (1996).

29. See. e.g., Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (1996); Heckman v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

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

31. American Law Institute, Principles of Corporate Governance, Comment to § 4.01 (1992). But see Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989), suggesting that business judgment rule protection may not apply to officers.

Codification Inapplicable to Nonprofit Corporations and OTHER ENTITIES

The recommended legislation deals with standards of care and application of the business judgment rule only in the context of business corporations. It does not deal with those issues as applied to other entities, such as partnerships and nonprofit corporations.[32] In particular, the Commission has not studied the circumstances of directors of nonprofit corporations and makes no recommendation on the application of the business judgment rule to directors of nonprofit corporations.[33]

32. *Cf.* Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (1996) (application of common law business judgment rule to reciprocal insurer).

33. The considerations that favor protecting directors of nonprofit corporations from liability may differ from the considerations involved in business corporations. Risk-taking and business decision-making may be less important in the nonprofit corporation context. However, because of the liability exposure of nonprofit corporation directors, who are often volunteers, added protection may be necessary to encourage participation on the board. There is a patchwork of recently-enacted legislation providing various types of liability protection for nonprofit corporation directors, responding to the holding in Frances T. v. Village Green Owners Ass'n, 42 Cal. 3d 490, 723 P. 2d 573, 229 Cal. Rptr. 456 (1986), refusing to apply the business judgment rule to protect nonprofit corporation directors from tort liability. A description of the existing provisions may be found in Sproul, *Director and Officer Liability in the Nonprofit Context*, 15 Business Law News 7 (Spring 1993).

PROPOSED LEGISLATION

An act to amend Section 2115 of, to add an article heading immediately preceding Section 300 of, and to add Article 2 (commencing with Section 320) to Chapter 3 of Division 1 of Title 1 of, the Corporations Code, relating to the business judgment rule.

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

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

Article 1. General Provisions

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

Corp. Code §§ 320-321 (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

320. (a) A director of a corporation 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 (1) that the director failed to satisfy the requirements of subdivision (a), and (2) if that burden is sustained, that the director failed to satisfy the requirements of Section 309, and (3) 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. The business judgment rule stated 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 developed by judicial decisions; those materials should be consulted in connection with questions of construction and intent of this section and the other provisions of this article to the extent the provisions are based on the ALI formulation.

Section 320 codifies the business judgment rule for business corporations that are subject to Section 309. *Cf.* Sections 102 (application of division), 162 ("corporation" defined). 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 entities are not included in Section 320 does not imply that a common law business judgment rule does not apply to them.

Section 320 relates to Section 309, which prescribes duties of directors. Therefore, Section 320 applies only to conduct of directors. To qualify as a director's "business judgment" within the meaning of Section 320, a decision must have been made and judgment must, in fact, have been exercised. It is important to recognize that a business decision may involve a judgment to act or to abstain from acting.

Section 320 effectively creates a conclusive presumption that a director has satisfied the requirements of Section 309 if the conditions of subdivision (a) are satisfied. Section 309(a) states the manner in which a director must perform the duties of a director. Section 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) has no liability based on alleged failure to discharge obligations as a director. Therefore, Section 320 would apply to liability actions against directors based on alleged violations of Section 309, as well as to actions against directors seeking other remedies based on alleged violations of Section 309.

While the business judgment rule applies in an action for damages against a director, it may also be relevant in a suit for injunctive or other relief against the corporation. See Section 322(a) & Comment (application of article to injunctive and other relief). 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 for other cause, but if the corporate action is otherwise in accordance with law, Section 320 should be relevant to the efficacy of directors' approval.

Section 320 does not prevent California courts from developing standards to determine whether and under what circumstances Section 320 is applicable in 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 Section 322(b) & Comment (application of article to transactions in control and responses to derivative actions).

The business judgment rule provides a "safe harbor" for determining a director's liability for breach of the director's 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 action may nonetheless satisfy the duty of care under Section 309 (but not necessarily the duty of loyalty) that an ordinarily prudent person in a like position would use under similar circumstances.

The business judgment rule applies only to satisfaction of a director's duties to the corporation and its shareholders under Section 309. It does not apply to the director's 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 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 necessarily require directors to focus collectively on each subsidiary issue.

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, 50 Cal. App. 4th 694, 709-15, 57 Cal. Rptr. 2d 798, 807-11 (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, 50 Cal. App. 4th 694, 709-15, 57 Cal. Rptr. 2d 798, 807-11 (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 director's conflict of 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 requires an informed decision. See, e.g., Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 711, 57 Cal. Rptr. 2d 798, 808 (1996); Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989). This is comparable to the requirement of Section 309(a) that a director make reasonable inquiry in performing the duties of a director.

Existing California case law formulations of the business judgment rule 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, 50 Cal. App. 4th 694, 710, 57 Cal. Rptr. 2d 798, 808 (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 burden of proof in existing law, allocating it to a person challenging the conduct of a director as a breach of Section 309. See, e.g., Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (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 economic 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 controlling influence by a party to the transaction or conduct (other than the corporation) or by a person who has a material economic interest in the transaction or conduct of which the director knows or should be aware, and that controlling influence 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, 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 this paragraph is a substantial beneficiary.

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

(3) A person with respect to whom the director has a business or economic relationship 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.

Comment. Subdivision (a) of Section 321 is drawn from American Law Institute (ALI) Principles of Corporate Governance § 1.23 (1992). Subdivision (a) is an exclusive listing of circumstances that may cause a director to be "interested" for purposes of application of the business judgment rule.

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

Unlike ALI Principles of Corporate Governance § 1.23 (1992), subdivisions (a)(2) and (a)(3) are limited to 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 economic 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.

It should be noted that fraudulent action by a director, whether or not the director is subject to controlling influence or is otherwise interested within the meaning of this section, may be an independent basis for a legal challenge to the action.

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

Subdivision (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.

§ 322 Application of article to injunctive and other relief, and to transactions in control and derivative actions

322. This article is not intended to preclude the courts from developing standards to determine whether and to what extent Section 320 applies in a challenge to the conduct of a director as a breach of Section 309 in any of the following circumstances:

(a) Where the challenge seeks injunctive or other relief, other than damages.

(b) Where the conduct challenged falls between the duty of care and the duty of loyalty, 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.

Strictly speaking, Section 320 would not apply in an action in which remedies are sought 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 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 did so in a manner that satisfies Section 320. Subdivision (a) makes clear that the courts may determine to what extent the business judgment rule may be applied in these circumstances.

Courts of other jurisdictions that have applied the business judgment rule 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). Subdivision (b) makes clear that 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, 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (1996).

Corp. Code § 2115 (amended). Foreign corporations

SEC. 3. Section 2115 of the Corporations Code is amended to read:

2115. (a) A foreign corporation (other than a foreign association or foreign nonprofit corporation but including a foreign parent corporation even though it does not itself transact intrastate business) is subject to this section if the average of the property factor, the payroll factor and the sales factor (as defined in Sections 25129, 25132 and 25134 of the Revenue and Taxation Code) with respect to it is more than 50 percent during its latest full income year and if more than one-half of its outstanding voting securities are held of record by persons having addresses in this state. The property factor, payroll factor and sales factor shall be those used in computing the portion of its income allocable to this state in its franchise tax return or, with respect to corporations the allocation of whose income is governed by special formulas or which are not required to file separate or any tax returns, which would have been so used if they were governed by such three-factor formula. The determination of these factors with respect to any parent corporation shall be made on a consolidated basis, including in a unitary computation (after elimination of intercompany transactions) the property, payroll and sales of the parent and all of its subsidiaries in which it owns directly or indirectly more than 50 percent of the outstanding shares entitled to vote for the election of directors, but deducting a percentage of the property, payroll, and sales of any subsidiary equal to the percentage minority ownership, if any, in the subsidiary. For the purpose of this subdivision, any securities held to the knowledge of the issuer in the names of broker-dealers, nominees for broker-dealers, (including clearing corporations) or banks, associations, or other entities holding securities in a nominee name or otherwise on behalf of a beneficial owner (collectively "Nominee Holders"), shall not be considered outstanding. However, if the foreign corporation requests all Nominee Holders to certify, with respect to all beneficial owners for whom securities are held, the number of shares held for those beneficial owners having addresses (as shown on the records of the Nominee Holder) in this state and outside of this state, then all shares so certified shall be considered outstanding and held of record by persons having addresses either in this state or outside of this state as so certified, provided that the certification so provided shall be retained with the record of shareholders and made available for inspection and copying in the same manner as is provided in Section 1600 with respect to that record. A current list of beneficial owners of a foreign corporation’s securities provided to the corporation by one or more Nominee Holders or their agent pursuant to the requirements of Rule 14b-1(b)(3) or 14b-2(b)(3) as adopted on January 6, 1992, promulgated under the Securities Exchange Act of 1934, shall

constitute an acceptable certification with respect to beneficial owners for the purposes of this subdivision.

(b) The following chapters and sections of this division shall apply to a foreign corporation subject to this section (to the exclusion of the law of the jurisdiction in which it is incorporated):

Chapter 1 (general provisions and definitions), to the extent applicable to the following provisions;

Section 301 (annual election of directors);

Section 303 (removal of directors without cause);

Section 304 (removal of directors by court proceedings);

Section 305, subdivision (c) (filing of director vacancies where less than a majority in office elected by shareholders);

Section 309 (directors' standard of care);

Section 316 (excluding paragraph (3) of subdivision (a) and paragraph (3) of subdivision (f)) (liability of directors for unlawful distributions);

Section 317 (indemnification of directors, officers and others);

Sections 320 to 322, inclusive (business judgment rule);

Sections 500 to 505, inclusive (limitations on corporate distributions in cash or property);

Section 506 (liability of shareholder who receives unlawful distribution);

Section 600, subdivisions (b) and (c) (requirement for annual shareholders' meeting and remedy if same not timely held);

Section 708, subdivisions (a), (b) and (c) (shareholder's right to cumulate votes at any election of directors);

Section 710 (supermajority vote requirement);

Section 1001, subdivision (d) (limitations on sale of assets);

Section 1101 (provisions following subdivision (e)) (limitations on mergers);

Chapter 12 (commencing with Section 1200) (reorganizations);

Chapter 13 (commencing with Section 1300) (dissenters' rights);

Sections 1500 and 1501 (records and reports);

Section 1508 (action by Attorney General);

Chapter 16 (commencing with Section 1600) (rights of inspection).

(c) Subdivision (a) shall become applicable to any foreign corporation only upon the first day of the first income year of the corporation commencing on or after the 30th day after the filing by it of the report pursuant to Section 2108 showing that the tests referred to in subdivision (a) have been met or on or after the entry of a final order by a court of competent jurisdiction declaring that such tests have been met.

(d) Subdivision (a) shall cease to be applicable at the end of any income year during which a report pursuant to Section 2108 shall have been filed showing that at least one of the tests referred to in subdivision (a) is not met or a final order shall have been entered by a court of competent jurisdiction declaring that one of such tests is not met, provided that such filing or order shall be ineffective if a

contrary report or order shall be made or entered before the end of such income year.

(e) This section does not apply to any corporation (1) with outstanding securities listed on the New York Stock Exchange or the American Stock Exchange, or (2) with outstanding securities designated as qualified for trading as a national market security on the National Association of Securities Dealers Automatic Quotation System (or any successor national market system) if such corporation has at least 800 holders of its equity securities as of the record date of its most recent annual meeting of shareholders, or (3) if all of its voting shares (other than directors' qualifying shares) are owned directly or indirectly by a corporation or corporations not subject to this section. For purposes of determining the number of holders of a corporation's equity securities under clause (2) of this subdivision, there shall be included, in addition to the number of recordholders reflected on the corporation's stock records, the number of holders of the equity securities held in the name of any Nominee Holder which furnishes the corporation with a certification pursuant to subdivision (a) provided that the corporation retains the certification with the record of shareholders and makes it available for inspection and copying in the same manner as is provided in Section 1600 with respect to that record.

Comment. Section 2115 is amended to include the business judgment rule (Sections 320–322) among the provisions applicable to foreign corporations under this section. The business judgment rule relates to the standard of care of directors under Section 309; that section also is applicable to foreign corporations under Section 2115. Subdivision (b).