Study B-601 January 22, 1998

First Supplement to Memorandum 98-2

Status of Bills: Business Judgment Rule

Memorandum 98-2 notes that the business judgment rule recommendation was revised at the Commission's December meeting, subject to ratification. In this connection we have received a letter from Brad Clark suggesting revision of two of the affected Comments. See attached Exhibit.

Comment on Application of Business Judgment Rule to Transactions in Control and Derivative Actions

The statute draft and Comment to proposed Section 321 would codify case law allowing the court to depart from the business judgment rule where the decision is being challenged as an unreasonable response to a hostile tender offer or as an improper dismissal of a derivative action. Mr. Clark suggests the following alternative wording for the Comment:

> Subdivision (c) qualifies the definition of an "interested" director under this section. 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, courts have limited application of the rule 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). ~~The determination of whether a director is "interested" for these purposes under subdivision (c) encompasses a wide range of considerations. See, e.g., ALI Principles of Corporate Governance §§ 1.23(c) ("interested" as applied to director named as defendant in derivative action), 7.10(b) (effect of retention of significant improper benefit) (1992).~~ Application of the business judgment rule in these circumstances may require special attention by the court and in some cases shifting to the corporation or other defendants some obligation to show independence, good faith, and reasonable investigation on the part of those who made the business decision.

Professor Eisenberg does not believe the suggested wording precisely captures the full impact of the cases. He suggests as a variant on Mr. Clark's draft:

> Subdivision (c) qualifies the definition of an "interested" director under this section. 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~~, and have instead applied a standard of review that is intermediate between the business judgment rule on the one hand, and a strict fairness review on the other, in those cases. In particular, courts have limited application of the rule 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). The determination of whether a director is "interested" for these purposes under subdivision (c) encompasses a wide range of considerations. See, e.g., ALI Principles of Corporate Governance §§ 1.23(c) ("interested" as applied to director named as defendant in derivative action), 7.10(b) (effect of retention of significant improper benefit) (1992).

Whatever formulation of this Comment is adopted in Section 321, a similar but more general formulation should also be included in the Comment to Section 320, with a cross-reference to Section 321 and its Comment.

Application of Business Judgment Rule to Nonprofit and Other Entities

Mr. Clark suggests Comment language along the following lines:

> Because Sections 320-321 are added to the General Corporation Law, they apply directly only to corporations subject to it. However, the facts that they codify judicial decisions applying the same business judgment rule to entities other than business corporations and that the standards of duty of directors set forth in the statutes governing those entities are essentially identical to Section 309 should be taken into account in cases involving those other entities.

For purposes of comparison, the staff's draft in response to Commission decisions at the December meeting provides:

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 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 or that, to the extent their managers are subject to the same duty of care as a director of a business corporation, they may not be judged by the same rules. Cf. Lee v. Interinsurance Exchange, 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (1996).

Respectfully submitted,

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Executive Secretary

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Attention: Nathaniel Sterling, Esq.
Executive Secretary

Ladies and Gentlemen:

I am writing you about the current proposal to codify the Business Judgment Rule ("BJR") and in particular the portion of the minutes of the Commission's meeting held December 12, 1997, relating to that proposal. I have two comments on that material as set forth below.

Proposed Commission Comment on Section 322(c)

Proposed Section 322(c) provides that nothing in the section (which defines when a director is "interested" in a transaction) limits the authority of the court to determine whether and to what extent a director is "interested" in the subject of a business judgment in two instances: (1) where the challenge to the business judgment seeks injunctive or other relief, other than damages, for conduct alleged to be an unreasonable response to an unsolicited tender offer; and (2) where the conduct challenged is a board or committee request for dismissal of a derivative action as not in the best interests of the corporation.

The Commission comment on this proposed subsection indicates that courts of other jurisdictions that have applied the BJR have limited its application "in certain kinds of cases that fall between the traditional duty of care cases and traditional duty of loyalty cases," and that, in particular, courts have limited application of the rule 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.

It seems to me that the idea that certain cases "fall between" duty of care cases and duty of loyalty cases is unfortunately ambiguous. On one hand it could suggest that neither duty applies to those cases, without indicating whether any other duty does so and if so what. Alternatively, it could mean no more than that both duties apply to an unspecified extent. The term usually refers, as in the figurative "fall between two stools", to an inability to choose between or to reconcile two alternative or conflicting courses of action. It does not seem to me that the cases, especially the two cited, involve inability (or difficulty) in reconciling the two duties, although the duties can overlap. In particular, both the duty of care and the BJR require action "in good faith", which may carry into them some overtones of required loyalty. Both the Unocal and Zapata cases cited in the comment seem on close reading to deal with the BJR as it applies to the duty of care and not to have problems of reconciling it with the duty of loyalty. See the brief descriptions of these cases below.

It is true that some courts have had difficulty dealing with the particular kinds of cases mentioned. I think the difficulty may be whether presumptive application of the BJR to these cases precludes further review of directors' actions when challenged in these and perhaps other types of situations unless the challenge overcomes the presumption. It also seems to me that in these cases, the proper course is not just to determine whether a director is "interested" but rather to determine whether both duties have been satisfied, including appropriate (see below) deference to the BJR as to the duty of care.

As already indicated, I believe the cases which may have limited applicability of the BJR in these situations have not really focused on satisfaction of both duties or on whether the conduct at issue "falls between" anything. For example, the Unocal case appears to me clearly to apply the BJR to the directors' conduct, but to "limit" its presumptive application by stating that there is an "omnipresent specter" that the board may be acting primarily in its own interest and that therefore there

is an "enhanced duty which calls for judicial examination at the threshold before protection of the [BJR] may be conferred" (493 A.2d at 954). Implementing this thought, the court stated that the directors must show that they had reasonable grounds for their beliefs (943 A.2d at 955), adding that they satisfy that burden by showing good faith and reasonable investigation. In its conclusion the court ruled that the board's action was entitled to be judged by the BJR (493 A.2d at 955); the "limit" on the BJR in this case was to shift a burden of proof to the directors as to their good faith and reasonable investigation.

The Zapata case (the applicable citation is 430 A.2d 779) puts more limits on application of the BJR but focuses mainly on the duty of care in dealing with whether the directors had satisfied their fiduciary duties. In so doing, it held the BJR applicable to directors' decisions as to dismissal of a derivative action and that a decision to do so will be respected unless wrongful (430 A.2d at 784). However, in an effort to balance "well-meaning derivative plaintiffs" and the managerial powers of boards and board committees, the court found it necessary to apply "caution beyond adherence" to the BJR. This caution involved two steps. First, the court put the burden on the corporation to show directoral independence, good faith and reasonable investigation rather than presuming them. If this step is satisfied, the court is then to apply "its own independent business judgment" to whether a corporate motion to dismiss the suit should be granted (430 A.2d at 787-789). Notwithstanding the court's detailed explication of the BJR this case seems to use the BJR only as a threshold which, if met requires the court to apply the second step and, if not met, to deny a motion to dismiss.

Both cases refer to directors' "fiduciary duties" without really saying whether they are referring to more than the duty of care. References in both cases to these duties as including "good faith" could be references to the duty of loyalty, but on balance seem only to refer to good faith as a component of due care.

Based on these two cases (most others of which I am aware fall into this pattern or give more effect to the BJR even in these special situations), I think the appropriate description, and one which might be more helpful to those seeking guidance from the Commission's comment, of how the BJR is to be applied to these types of cases would be that it is applicable but that its applicability may require special attention and in some cases shifting to the corporation or other defendants some obligation to show independence, good faith and reasonable investigation on the part of those who made the business decision. If this approach is adopted, I would suggest putting a

period after "certain kinds of cases," deleting the remainder of that sentence and adding a sentence after the citations along the lines set forth in the preceding sentence above. If you do this, the sentence now following the two cited cases could well be deleted as not necessary to the thrust of the comment.

Applicability of the BJR to Others than Business Corporations Subject to the GCL

I understand the Commission's thinking about the way the proposed codification would deal with whether it would apply to business judgments by entities other than corporations subject to the General Corporation Law ("GCL"): the codification would only add sections to the GCL and the comments only deal with those sections as so added. I have to say, however, that I am disappointed that there is not at least some recognition that the language as to directors' duties contained in the Nonprofit Corporation Law and the Consumer Cooperative Corporations Law is substantially identical to that in the GCL.

As I indicated in one of my earlier letters to the Commission, the drafters of the Nonprofit Corporation Law (which in its three component laws contains three iterations of the duties of directors) and Consumer Cooperative Corporations Law, made a conscious effort to keep their language the same as that in the GCL if it appeared that the underlying concept or rule was or ought to be the same. This was done partly in realization that it would be useful for cases arising under any of those laws to be used appropriately for guidance as to all of them. It was also done so that those particularly familiar with one of the laws could more readily understand and apply the others. This concept appeared to me and other drafters (the Nonprofit Organizations Committee of the Business Law Section of the State Bar) to be applicable to the BJR. When we drafted these four sets of essentially identical standards, we tried carefully to consider the need to change any of them. In doing so we did make some changes we believed responsive to special needs, but none were intended to affect applicability of the BJR to business decisions.

Further, as I have also already pointed out, the cases do not suggest different rules for these different organizations. What may be the latest California judicial decision articulating the BJR arose in a nonprofit context, as indicated in the Commission's citation of Lee v. Interinsurance Exchange in its comments on the proposed codification.

For these reasons, I would hope the Commission will add to its comments something like "Because sections 320-322 are added to the General Corporation Law, they apply directly only to

corporations subject to it. However, the facts that they codify judicial decisions applying the same business judgment rule to entities other than business corporations and that the standards of duty of directors set forth in the statutes governing those entities are essentially identical to Corp. Code § 309 should be taken into account in cases involving those other entities."

I hope the foregoing will be helpful to the Commission in pursuing this proposed codification and if I can be of any further assistance, I would be glad to do my best to provide it.

Sincerely yours,

R. Bradbury Clark

RBC:bas