Study B-601 April 17, 1998

Memorandum 98-24

Business Judgment Rule: Issues on SB 2063

Senator Kopp has introduced the Commission's recommendation to codify the business judgment rule as SB 2063. (A copy of the Commission's printed report is attached to this memorandum.) The bill will be heard in Senate Judiciary Committee in early May. The Consumer Attorneys of California will be strongly opposed to the proposal. It will be supported by the State Bar Corporations Committee and most likely by some business interests.

Meanwhile, a number of issues on the bill have been raised by David Berger, a business litigator at Wilson, Sonsini, Goodrich & Rosati. (Mr. Berger's points are developed in a sequence of email interactions, which we will not attempt to reproduce but will summarize for convenience.) Mr. Berger thinks that in general it is important and necessary to codify the business judgment rule in California, but has some major concerns with the draft. As you will see from the analysis below, Mr. Berger's concerns are ones the Commission has struggled with in developing its recommendation. We should revisit them to ensure that the recommendation is clear on these issues.

If the Commission adopts any Comment revisions suggested in this memorandum, we will forward them to the Senate Judiciary Committee before the hearing so that they can be taken into account in the Committee's analysis of the bill.

Application of BJR to Hostile Tender Offers and Derivative Actions

As drafted, the business judgment rule codification would not apply in either of the following situations:

> (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.
>
> (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.

These exceptions are drawn from Delaware case law, which adopts the policy that these two types of corporate decisions are so fraught with potential conflicts for the directors that they must be scrutinized more carefully than other types of business decisions protected by the business judgment rule.

Mr. Berger reads the Delaware cases differently. He says that *Unocal* and its progeny simply place the initial burden on the board to show good faith and that it was reasonably informed. Once it satisfies this burden, the board is entitled to protections of the business judgment rule, and recent Delaware case law (*Unitrin*, *Wallace*, etc.) gives the board considerable discretion under the business judgment rule once it satisfies its *Unocal* obligations.

Our consultant — Professor Mel Eisenberg — and the State Bar Corporations Committee have different readings of the case law. Professor Eisenberg believes the cases impose a stricter standard of review in these types of cases, and that to apply the business judgment rule to them would not be sound policy.

The staff believes that for now the only feasible alternative is to leave these areas to continued case law development. We anticipate that if we can get the basic business judgment rule enacted we will do a followup project on these areas. We already have in hand Professor Eisenberg's background study on the derivative action issue. Meanwhile, both the statute draft and commentary make clear that codification does not limit the authority of the court to determine application of the business judgment rule in these key areas. See proposed Corp. Code §§ 321(c), 320 Comment.

Definition of Interested Director

The draft legislation denies business judgment rule protection to an "interested" director. For this purpose, a director is considered interested if the director is a party, has a material economic interest adverse to the corporation, or is subject to controlling influence by a party or person with an adverse material economic interest. Proposed Corp. Code § 321(a).

Mr. Berger is concerned that stock ownership in the corporation by the director might be considered a disabling interest under this definition. He points out that directors should be encouraged to be shareholders also, so that their interests are more directly linked with the shareholders. This is case in Delaware and also in modern corporate theory.

It is not the intent of the Commission's recommendation to make stock ownership in the corporation a disabling interest. Only a material economic

interest that is adverse to the corporation should be disabling. The proposal needs to be clear on this point. **The staff suggests that the Comment to Section 321(a) be augmented to emphasize the point with language along the following lines**:

> Subdivisions (a)(2) and (a)(3) relate to a director who has an economic interest or is subject to controlling influence. The mere existence of such an interest or influence does not cause a director to be "interested" within the meaning of these provisions; the director is interested only if the interest or influence is such that it would reasonably be expected to affect the director's judgment in a manner adverse to the corporation or its shareholders. For example, a director's interest in a transaction may be as a director, shareholder, officer or employee, or person having another direct or indirect economic interest. These interests may not necessarily affect the director's judgment adversely to the corporation or its shareholders. The interest of a director as a shareholder in a transaction that proportionately benefits all shareholders, for example, ordinarily would not be expected to affect the director's judgment in a manner adverse to the corporation or its shareholders.

Application of BJR to Officers

The draft statute would only apply to corporate directors, not corporate officers.

Mr. Berger is concerned that, because the statute would not apply to officers, an inside director (officer/director) might be denied business judgment rule protection. Such a person, when acting in the capacity of a director, rather than in the capacity of an officer, should be covered by the business judgment rule.

We had addressed this issue early in this study, including language in the commentary making clear that the statutory business judgment rule would apply to the officer acting as director. We ultimately dropped this language due to concern that an officer acting as a director may nonetheless be held to a higher standard of inquiry than an outside director. **The staff suggests we deal with this issue with Comment language to proposed Corporations Code Section 320 along the following lines**:

> The codification of the business judgment rule in this section is applicable by its terms only to directors, but nothing in this section precludes application of a common law business judgment rule to officers or other employees, where appropriate. If a person serves

> as both an officer and a director of a corporation, this section would be applicable to a business judgment of the person acting as a director. It should be noted, however, that application of the requirement of subdivision (a)(3) that a director be reasonably informed may be affected by the person's role in the corporation as an officer, in relation to the subject of the business judgment. It should also be noted that the requirement that a director be reasonably informed does not relieve the director from applying to the business judgment whatever information the person actually has, or is required by the person's duties as an officer to have, which may differ from the information possessed or required to be possessed by other directors.

Foreign Corporations

Corporations Code Section 2115 seeks to apply the California law of corporate governance to corporations incorporated in another jurisdiction where more than 50 percent of the corporation's property, payroll, sales, and voting shares are in California. Among the rules Section 2115 seeks to apply to such corporations is the California duty of care of directors (Corp. Code § 309). The business judgment rule proposal would amend Section 2115 to also apply the California business judgment rule to such corporations.

Mr. Berger's concern here is that, by doing this, we not change or interfere with the internal affairs doctrine. Of course we do not intend to say any more than if Section 309 applies to a foreign corporation, the business judgment rule also should apply. **If it would help, we can augment the Comment to read**, "Section 2115 is amended to include the business judgment rule (Sections 320-321) ~~among the provisions applicable to foreign corporations under this section~~ as it affects applicability of Section 309 (duties of directors) to foreign corporations subject to this section, but not otherwise to affect the scope or application of the section."

Protection for Board (as opposed to Individual Director)

Suppose there is a board of five directors making a business decision to approve a contract with a third party. Suppose further that one of the directors is "interested" because of a substantial ownership interest in the third party, but the other four directors are not interested. The business judgment rule would protect the four disinterested directors from liability, and probably ultimately the board's decision itself from injunctive relief. The interested director would not be protected by the business judgment rule.

Mr. Berger questions whether it makes sense to deny business judgment protection to the fifth director. This creates the possibility that the individual director may be subject to a lawsuit even though a majority of the directors (and consequently the board's decision) may be protected by the business judgment rule. He asks, if a shareholder cannot challenge the board's decision as a whole, how is that shareholder injured by the decision of the particular director agreeing with it?

When the Commission has considered this issue in the past, the sense has been that it would not be sound policy to protect a director who does not meet the requirements of the business judgment rule. For example, the interested director may have actively participated in the discussions and influenced the other directors, regardless whether the interested director may have disclosed the conflict of interest to the other directors. Similar reasoning would apply to a director who has not acted in good faith. To provide business judgment protection to such a director, just because that director has persuaded the others to go along, would encourage improper behavior and create a substantial loophole in the law.

On the other hand, there may be situations where, although the director's conduct is not protected by the business judgment rule, the circumstances are such that liability would be inappropriate. For example, the director's only failure may be one of not being reasonably informed, whereas the other directors are reasonably informed in making a proper corporate decision and are protected by the business judgment rule. In this case the director's failure is not the proximate cause of damage to the corporation and there should be no liability.

We could augment the Comment to proposed Corporations Code Section 320 on these points:

> 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~~. There may also be cases in which a disinterested director fails to satisfy the business judgment rule, violates the duty of care, or both, respecting a decision, but the director is not liable because the decision has been approved by a majority of disinterested directors

who have satisfied the business judgment rule or Section 309. For example, suppose that A, B, C, D, and E are directors of Corporation S, and A violates the duty of care by failing to properly prepare to make a decision. However, B, C, D, and E do properly prepare; their conduct satisfies the business judgment rule; and there is no reason to believe that if A had properly prepared a different decision would have been made. In that case, A's failure to prepare, although a violation of A's duty of care, does not result in damage to the corporation and would not result in liability.

It should be noted that this section concerns only the duties of directors under Section 309, and not the duties of directors under other provisions, such as Section 310 (interested director transactions), 315 (loans and guarantees), and 316 (distributions).

Respectfully submitted,

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Executive Secretary