WHETHER THE BUSINESS-JUDGMENT RULE SHOULD BE CODIFIED*

by Melvin A. Eisenberg

May 1995

CONTENTS

---

* This background study was prepared for the California Law Revision Commission by Professor Melvin A. Eisenberg. No part of this background study may be published without prior written consent of the Commission.

The Commission assumes no responsibility for any statement made in this background study, and no statement in this background study is to be attributed to the Commission. The Commission's action is reflected in its own recommendation which is separate and distinct from this background study. The Commission should not be considered as having made a recommendation on a particular subject until the final recommendation of the Commission on that subject has been submitted to the Legislature.

This is an edited version of the original photocopy circulated in 1995. See Eisenberg, *Background Study for the California Law Revision Commission on Whether the Business-Judgment Rule Should Be Codified* (May 1995) (on file with California Law Revision Commission). Authorities cited in the original study have been updated as of January 1998.

WHETHER THE BUSINESS-JUDGMENT RULE SHOULD BE CODIFIED

I. Introduction: Standards of Conduct and Standards of Review in Corporate Law

The issue addressed in this report is whether the business-judgment rule should be codified in California. To fully analyze this issue, it is necessary to distinguish between standards of conduct and standards of review. A *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief.

In many or most areas of law, these two kinds of standards are formulated in equivalent terms. For example, the standard of conduct that governs automobile drivers is that they should drive carefully and the standard of review in a liability claim against a driver is whether she drove carefully. Similarly, the standard of conduct that governs an agent who engages in a transaction with his principal is that the agent must deal fairly and the standard of review is whether the agent dealt fairly.

In corporate law, however, the standards of review pervasively diverge from the standards of conduct. A byproduct of this divergence has been the development of a great number of standards of review in this area. In the past, the major standards of review have included good faith, business judgment, prudence, negligence, gross negligence, waste, and fairness.

Traditionally, the two major areas of corporate law that involved standards of conduct have been the duty of care and the duty of loyalty. The duty of care concerns the standards of conduct and review applicable to a director or officer in taking action, or failing to act, in a matter that does not involve his own self-interest. (I will refer to such action or inaction as disinterested conduct.) The duty of loyalty concerns the standards of conduct and review applicable to a director or officer in taking action, or failing to act, in a matter that does involve his own self-interest. (I will refer to such action or inaction as self-interested conduct.) At least in the past, the standards of review in these areas have for the most part been bipolar. At one pole have been standards of review that are very easy for a defendant to satisfy, such as the standards of waste and business judgment. At the other pole have been standards of review that are harder for a defendant to satisfy, such as the standards of prudence and fairness.

II. Functions and Duties of Directors and Officers

The duty of care of corporate directors and officers is a special case of the duty of care imposed throughout the law under the general heading of negligence. Under the law of negligence, if a person assumes a role whose performance involves the risk of injury to others, she is under a duty to perform that role carefully and is subject to blame if she fails to do so. For example, one who assumes the role of driver is under a duty to drive carefully; one who assumes the role of doctor is under a duty to practice medicine carefully; one who assumes the role of judge is under a duty to judge carefully.

Under modern corporate law and practice, the role of *officers* is to manage the business of the corporation. Those who assume the role of *director* have several distinct although related roles to perform. Directors must monitor or oversee the conduct of the corporation's business. Directors must select, compensate, and replace the principal senior executives. Directors must approve, modify, or disapprove the corporation's financial objectives, major corporate plans and actions, and major questions of choice concerning the corporation's auditing and accounting principles and practices. Finally, directors must decide any other matters that are assigned to the board by law or by the articles of incorporation or by-laws, or assumed by the board under a board resolution or otherwise.[1]

---

1. See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §§ 3.02-3.03 (1994) [hereinafter ALI Principles of Corporate Governance].

The general standard of conduct applicable to directors and officers of California corporations in the performance of their functions, in relation to matters in which they are not interested, is set forth in California Corporations Code Section 309(a):

> A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

Presumably, this provision is applicable by analogy to officers.

A similar provision is found in many other statutes, including the Revised Model Business Corporation Act, on which a predecessor of California Corporations Code Section 309(a) was based:

> § 8.30. General Standards For Directors
>
> (a) A director shall discharge his duties as a director, including his duties as a member of a committee:
>
> (1) in good faith;
>
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (3) in a manner he reasonably believes to be in the best interests of the corporation.

A similar principle was also adopted in Section 4.01(a) of the American Law Institute's Principles of Corporate Governance:

> A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to

> exercise in a like position and under similar circumstances. . . .[2]

California Corporations Code Section 309(a) reflects both general law and California case law.

I will call the standard of conduct in Corporations Code Section 309(a), Revised Model Business Corporation Act Section 8.30(a), and Principles of Corporate Governance Section 4.01(a) "the standard of careful conduct." This standard has both objective and subjective elements. The portion of the standard that requires the care that "an *ordinarily prudent person* in a like position would use under similar circumstances" is an objective standard. The portions of the standard that require "good faith," and actions that the director "believes to be in the best interests of the corporation and its shareholders," are subjective standards, although, as will be discussed below, they may have at least a minimal objective component as well.

The application of the standard of careful conduct to the functions of directors results in several distinct duties:

> (i) Directors must reasonably monitor or oversee the conduct of the corporation's business to evaluate whether the

---

2. ALI Principles of Corporate Governance, *supra* note 1. Section 4.01(a) reads in full:

> (a) A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. This Subsection (a) is subject to the provisions of Subsection (c) (the business judgment rule) where applicable.
>
> (1) The duty in Subsection (a) includes the obligation to make, or cause to be made, an inquiry when, but only when, the circumstances would alert a reasonable director or officer to the need therefor. The extent of such inquiry shall be such as the director or officer reasonably believes to be necessary.
>
> (2) In performing any of his or her functions (including oversight functions), a director or officer is entitled to rely on materials and persons in accordance with §§ 4.02 and 4.03 (reliance on directors, officers, employees, experts, other persons, and committees of the board).

> business is being properly managed, by regularly evaluating the corporation's principal senior executives and ensuring that appropriate information systems are in place. This is known as the duty to monitor.
>
> (ii) Directors must follow up reasonably on information acquired through monitoring systems, or otherwise, that should raise cause for concern. This is known as the duty of inquiry.
>
> (iii) Directors must make reasonable decisions on matters that the board is obliged or chooses to act upon.
>
> (iv) Finally, directors must employ a reasonable decision-making process to make decisions.

Officers have comparable duties, although for most officers decision-making is likely to be more important than monitoring.

On its face, the standard of careful conduct is fairly demanding. This is particularly true of the element of prudence or reasonability. For example, in *San Leandro Canning Co. v. Perillo*, the court said that "[the directors] were bound to exercise *that degree of care which men of common prudence* take of their own concerns …."[3] In *Burt v. Irvine Co.*, the court, quoting other authority, said:

> "The rule exempting officers of corporations from liability for mere mistakes and errors of judgment does not apply where the loss is the result of failure to exercise proper care, skill and diligence. 'Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. *They cannot excuse imprudence* on the ground of their ignorance or inexperience, or the honesty of their intentions; and, if they commit an error of judgment through mere recklessness, or *want of ordinary prudence* and skill, the corporation may hold them responsible for the consequences.'"[4]

3. 84 Cal. App. 627, 633, 258 P. 666, 669 (1927) (emphasis added).

4. 237 Cal. App. 2d 828, 852, 47 Cal. Rptr. 392, 407-08 (1965) (citations omitted) (emphasis added).

III. The Business-Judgment Rule

Despite the apparently demanding quality of the standard of careful conduct, in practice the standard of *review* of disinterested conduct by directors or officers is often significantly less stringent, especially when the *substance* or *quality* of a decision — that is, the reasonableness of the decision, as opposed to the reasonableness of the decision-making process that has been used — is called into question. In such cases, a much less demanding standard of review may apply, under the business-judgment rule. The business-judgment rule consists of four conditions and a special standard of review that is applicable, if the four conditions are satisfied, in suits that are based on the substance or quality of a decision a director or officer has made. The four conditions are as follows:

First, a judgment must have been made. So, for example, a director's failure to make due inquiry, or any other simple failure to take action, does not qualify for protection of the rule. (However, a deliberately made decision to not take a certain action would normally satisfy this condition.)

Second, the director or officer must have informed himself with respect to the decision to the extent he *reasonably* believes appropriate under the circumstances — that is, he must have employed a *reasonable* decision-making process.

Third, the decision must have been made in subjective good faith — a condition that is not satisfied if, among other things, the director or officer knew that the decision violates the law.

Fourth, the director or officer may not have a financial interest in the subject matter of the decision. For example, the business-judgment rule is inapplicable to a director's decision to approve the corporation's purchase of his own property.

If these four conditions are met, then the substance or quality of the director's or officer's decision will be reviewed, not under the standard of careful conduct to determine whether the decision was prudent or reasonable, but only under a much more limited standard.

There is some difference of opinion as to how that limited standard should be formulated. A few courts have stated that the standard is whether the director or officer acted in good faith. It is often unclear, however, whether good faith, as used in this context, is purely subjective or also has an objective element. One of the few places where a definition of good faith is codified is the Uniform Commercial Code, but even the Code lacks clarity on this point. The Code's General Provisions (Part I) provide that good faith means "honesty in fact in the conduct or transaction concerned."[5] Although that definition seems to be subjective, it may not be. A person may be deemed to act honestly if he acts according to his own best lights, or a person may be deemed to act honestly only if he acts according to his own best lights and without transgressing the basic moral standards set by society. Furthermore, under the Code's Sales provisions (Part II) a merchant's duty of good faith includes an explicitly objective element — "the observance of reasonable commercial standards of fair dealing in the trade."[6] Similarly, Judge Friendly held, in another context: "Absent some basis in reason, action could hardly be in good faith even apart from ulterior motive."[7]

Correspondingly, most courts have not limited the standard of review under the business-judgment rule to subjective good faith, but instead have employed a standard that involves some objective review of the quality of the decision, however limited. As William Quillen, formerly a leading Delaware judge, has stated: "[T]here can be no question that for years the courts have in fact reviewed directors' business decisions to some extent from a quality of judgment point of view. Businessmen do not like it, but courts do it and are likely to continue to do it because directors are fiduciaries."[8] Even courts that seem to use the term "good faith" in a rel-

5. U.C.C. § 1-201(19).

6. U.C.C. § 2-103(1)(b).

7. Sam Wong & Son, Inc. v. New York Mercantile Exch., 735 F.2d 653, 678 n.32 (2d Cir. 1984).

8. Quillen, Trans Union, *Business Judgment, and Neutral Principles*, 10 Del. J. Corp. L. 465, 492 (1985).

atively subjective way nevertheless almost always review the quality of decisions, under the guise of a rule that the irrationality of a decision *shows* bad faith.[9]

Courts have adopted an objective standard in applying the business-judgment rule because a purely subjective good faith standard would depart too far from the general principles of law that apply to actors who have a duty of care, and serious problems would arise if even an irrational business decision was protected solely because it was made in subjective good faith.

Accordingly, the prevalent formulation of the standard of review, under the business-judgment rule, is that if the four conditions to that rule have been satisfied the decision must be *rational*.[10] This *rationality standard of review* is much easier to satisfy than the standard of careful conduct, which demands prudence or reasonability. In everyday life, for example, it is common to characterize a person's conduct as imprudent or unreasonable, but very uncommon to characterize a person's conduct as irrational. Unlike a subjective-good-faith standard, a rationality standard preserves a minimum and necessary degree of director and officer accountability, and allows courts to enjoin directors and officers from taking actions that would waste the corporation's assets.

An obvious example of a decision that fails to satisfy the rationality standard is a decision that cannot be coherently explained. For example, in *Selheimer v. Manganese Corp. of America*,[11] man-

---

9. *See In re* RJR Nabisco, Inc., Shareholders Litig., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,715 (Del. Ch. Jan. 31, 1989).

10. *See, e.g.*, ALI Principles of Corporate Governance, *supra* note 1, § 4.01(c); Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir. 1981) (courts will not disturb a business judgment if "any rational business purpose can be attributed" to a director's decision); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) ("any rational business purpose" test); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("rational business purpose" test); Arsht, *The Business Judgment Rule Revisited*, 8 Hofstra L. Rev. 93, 119-21 (1979). *See also* Meyers v. Moody, 693 F.2d 1196, 1211 (5th Cir. 1982) (jury instructed on exercise of reasonable business judgment); McDonnell v. American Leduc Petroleums, Ltd., 491 F.2d 380, 384 (2d Cir. 1974) (under California law, a business judgment must be reasonable).

11. 224 A.2d 634 (Pa. 1966).

agers poured a corporation's funds into the development of a single plant even though they knew the plant could not be operated profitably because of various factors, including lack of a railroad siding and proper storage areas. The court imposed liability, because the managers' conduct "defie[d] explanation; in fact, the defendants have failed to give any satisfactory explanation or advance any justification for [the] expenditures."[12]

Why should the standard of *review* applicable to the quality of decisions by corporate directors and officers be only rationality, when the standard of *conduct* is reasonability or prudence? The answer to this question involves considerations of both fairness and policy. To begin with, the application of a reasonableness standard of review to the quality of disinterested decisions by directors and officers could result in the unfair imposition of liability. In paradigm negligence cases involving relatively simple decisions, like automobile accidents, there is often little difference between decisions that turn out badly and bad decisions. In such cases, typically only one reasonable decision could have been made under a given set of circumstances, and decisions that turn out badly therefore almost inevitably turn out to have been bad decisions. In contrast, in the case of business decisions it may often be difficult for factfinders to distinguish between bad decisions and proper decisions that turn out badly. Business judgments are necessarily made on the basis of incomplete information and in the face of obvious risks, so that typically a range of decisions is reasonable. A decision-maker faced with uncertainty must make a judgment concerning the relevant probability distribution and must act on that judgment. If the decision-maker makes a reasonable assessment of the probability distribution, and the outcome falls on the unlucky tail, the decision-maker has not made a bad decision, because some outcomes will inevitably fall on the unlucky tail of any normal probability distribution.

For example, an executive faced with a promising but expensive and untried new technology may have to choose between investing in the technology or forgoing such an investment. Each alternative

12. *Id.* at 646.

involves certain negative risks. If the executive chooses one alternative and the associated negative risk materializes, the decision is "wrong" in the very restricted sense that if the executive had it to do all over again he would make a different decision, but it is not for that reason a bad decision. Under a reasonableness standard of review, however, factfinders might too often erroneously treat decisions that turned out badly as bad decisions, and unfairly hold directors and officers liable for such decisions.

The business-judgment rule protects directors and officers from such unfair liability, by providing directors and officers with a large zone of protection when their decisions are attacked. Other kinds of decision-makers who must make decisions on the basis of incomplete information and in the face of obvious risks can often shield themselves from liability for decisions by showing that they followed accepted protocols or practices.[13] In contrast, directors and officers can seldom shield themselves in that way, because almost every business decision is unique. Furthermore, unlike most types of negligence cases, negligent decisions by directors or officers characteristically involve neither personal injury to a plaintiff nor catastrophic economic damages to an individual. The law may justifiably be less willing to take the risk of erroneously imposing liability in such cases.

Furthermore, the shareholders' own best interests may be served by conducting only a very limited review of the quality of directors' and officers' decisions. It is often in the interests of shareholders that directors or officers choose the riskier of two alternative decisions, because the expected value of a more risky decision may be greater than the expected value of the less risky decision. For example, suppose that Corporation *C*, a publicly held corporation, has $100 million in assets. *C*'s board must choose between Decision *X* and Decision *Y*. Decision *X* has a 75% likelihood of a $2 million gain and a 25% likelihood of a $1 million loss. Decision *Y* has a 90% chance of a $1 million gain, a 10% chance of breaking

---

13. *See, e.g.*, Osborn v. Irwin Mem'l Blood Bank, 5 Cal. App. 4th 234, 278 n.13, 7 Cal. Rptr. 2d 101 (1992) ("'compliance with accepted [medical] practice is generally taken as conclusive evidence of due care'").

even, and no chance of a loss. It is in the interest of *C*'s shareholders that the board make Decision *X*, even though it is riskier, because the expected value of Decision *X* is $1.25 million (75% of $2 million, minus 25% of $1 million) while the expected value of Decision *Y* is only $900,000 (90% of $1 million). If, however, the board was concerned about liability for breaching the duty of care, it might choose Decision *Y*, because as a practical matter it is almost impossible for a plaintiff to win a duty-of-care action on the theory that a board should have taken greater risks than it did. A standard of review that imposed liability on a director or officer for unreasonable, as opposed to irrational, decisions might therefore have the perverse incentive effect of discouraging bold but desirable decisions. Putting this more generally, under a standard of review based on reasonability or prudence, directors might tend to be unduly risk-averse because if a desirable although highly risky decision had a positive outcome the corporation but not the directors would gain, while if it had a negative outcome the directors might be required to make up the corporate loss. The business-judgment rule helps to offset that tendency.

IV. California Case Law

Undoubtedly as a result of the considerations discussed in Section III, the business-judgment rule is part of the common law of corporations, and various formulations of the rule have been accepted by the California courts. However, these formulations often lack clarity. Some cases have articulated a reasonability standard. For example, in *Fornaseri v. Cosmosart Realty & Building Corp.*, the court said:

> In the absence of fraud, breach of trust or transactions which are *ultra vires*, the conduct of directors in the management of the affairs of a corporation is not subject to attack by minority stockholders in a suit at equity, where such acts are discretionary and are performed in good faith,

> *reasonably believing* them to be for the best interest of the corporation.[14]

In *Burt v. Irvine Co.*, the court, quoting other authority, said:

> "The rule exempting officers of corporations from liability for mere mistakes and errors of judgment does not apply where the loss is the result of failure to exercise proper care, skill and diligence. 'Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken. *They cannot excuse imprudence* on the ground of their ignorance of inexperience, or the honesty of their intentions; and, if they commit an error of judgment through mere recklessness, or *want of ordinary prudence* and skill, the corporation may hold them responsible for the consequences.'"
>
> … "Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is *reasonably exercised* by them."[15]

In *Findley v. Garrett*, the court said that "[w]here a board of directors … acts in good faith within the scope of its discretionary power and *reasonably believes* … [its] action is good business judgment in the best interest of the corporation, a stockholder is not authorized to interfere with such discretion.… "[16]

Other cases have articulated a good-faith standard. For example, in *Marble v. Latchford Glass Co.*,[17] the court said that it would "not substitute its judgment for the business judgment of the board of directors made in good faith." Similarly, in *Eldridge v. Tymshare, Inc.*,[18] the court stated that the business judgment rule

14. 96 Cal. App. 549, 557, 274 P. 597, 600 (1929) (emphasis added).

15. 237 Cal. App. 2d 828, 852-53, 47 Cal. Rptr. 392, 407-08 (1965) (citations omitted) (emphasis added).

16. 109 Cal. App. 2d 166, 174, 240 P.2d 421, 426 (1952) (emphasis added).

17. 205 Cal. App. 2d 171, 178, 22 Cal. Rptr. 789, 794 (1962).

18. 186 Cal. App. 3d 767, 776, 230 Cal. Rptr. 815, 820 (1986).

"sets up a presumption that directors' decisions are based on sound business judgment. This presumption can be rebutted only by a factual showing of fraud, bad faith or gross overreaching."

Still other cases seem to treat good-faith and reasonability standards as if they were interchangeable. For example, in *Gaillard v. Natomas Co.*, the court said:

> The common law "business judgment rule" refers to a judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions.… Under [the business judgment] rule, a director is not liable for a mistake in business judgment which is made *in good faith* and in what he or she believes to be the best interests of corporation, where no conflict of interest exists.
>
> … "'Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is *reasonably exercised* by them.'"[19]

V. California Corporations Code Section 309

In *Gaillard v. Natomas Co.*, the court stated that Corporations Code Section 309 "codifies California's business-judgment rule."[20]

---

19. 208 Cal. App. 3d 1250, 1263-64, 256 Cal. Rptr. 702 (1989) (citations omitted) (emphasis added). In *Katz v. Chevron Corp.*, 22 Cal. App. 4th 1352, 27 Cal. Rptr. 2d 681 (1994), the court stated that "'[a] hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision "can be attributed to *any rational business purpose*,"'" *id.* at 1366 (quoting Unocal v. Mesa Petroleum, 493 A.2d 946, 954 (Del. 1985)) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720, (Del. 1971)) (emphasis added), and that "'director liability is predicated upon concepts of gross negligence,'" *id.* (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). This case involved Chevron, a Delaware corporation, and was presumably decided under Delaware law.

20. 208 Cal. App. 3d at 1264. *See also* Barnes v. State Farm Mut. Auto. Ins. Co., 16 Cal. App. 4th 365, 379 n.12, 20 Cal. Rptr. 2d 87, 95 (1993).

This is incorrect. Section 309 codifies the standard of careful conduct, with which the business-judgment rule is inconsistent.

Indeed, an argument could be made that Section 309 overturns the business-judgment rule, because the business-judgment rule is established by case law, while the standard of Section 309, which is inconsistent with the business-judgment rule, is statutory. The better position, however, is that although Section 309 does not codify the business-judgment rule, neither does it overturn the rule. Thus, Harold Marsh, who was chair of the State Bar Committee that authored Section 309(a), states:

> This subdivision is largely copied from a proposed revision of former Section 35 of the Model Business Corporation Act adopted by the Committee on Corporate Laws of the American Bar Association …. It can be seen at a glance that it incorporates the two seemingly contradictory ideas which have been voiced by the courts, i.e., the idea of good faith and acting "in a manner such director believes to be in the best interests of the corporation", … and the idea of reasonable care, expressed as "such care as an ordinarily prudent person in a like position would use under similar circumstances" ….
>
> While these are not expressed as alternatives or as being applicable in different situations, but as *cumulative* requirements of the director, the ABA committee which drafted this language apparently considered that it was not overruling the business judgment rule by this formulation. The Report of the ABA Committee on Corporate Laws with respect to this revised Section 35 of the Model Act stated that it intended by this language to incorporate "the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business judgment." While it could be argued that the qualifying phrase, "these criteria being satisfied," means that the director must always satisfy the standard of reasonable care imposed and therefore is always liable for negligence, that would make this comment nonsensical. A director then *would be* liable for an honest mistake of business judgment, if it was made negligently. Since this distinguished commit-

> tee of corporate lawyers presumably meant to say something by this comment, it can only be interpreted as an indication that they, at least, intended to preserve the business judgment rule.
>
> In the light of this background, it is highly doubtful that the California courts will hold that this section was intended to abolish the business judgment rule, although it would certainly be open to a court to interpret it in that fashion, if it simply focused on the literal words of the statute.[21]

VI. Conclusion and Recommendation

Given the justifications and importance of the business-judgment rule, and the uncertainty of its status and formulation in California, it would be desirable to codify the rule legislatively. The simplest approach would be to amend California Corporations Code Section 309 by incorporating the formulation of the business-judgment rule in the American Law Institute's Principles of Corporate Governance Section 4.01(c). Revised Section 309 would read as follows:

> (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.
>
> *(b) A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:*
>
> > *(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 or officer*

21. 2 H. Marsh & R. Finkle, Marsh's California Corporation Law § 11.3 (3d ed. 1997) (footnote omitted).

reasonably believes to be appropriate under the circumstances; and

(3) rationally believes that the business judgment is in the best interests of the corporation.

~~(b)~~ *(c)* In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented.

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence.

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(d) A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care, including the inapplicability of the provisions as to the fulfillment of duty under subdivision (a) or (b), and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.

~~(c)~~ *(e)* A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director. In addition, the liability of a director for monetary damages may be eliminated or limited in a corporation's articles to the extent provided in paragraph (10) of subdivision (a) of Section 204.