STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

RECOMMENDATION

Business Judgment Rule

January 1998

California Law Revision Commission
4000 Middlefield Road, Room D-1
Palo Alto, CA 94303-4739

CALIFORNIA LAW REVISION COMMISSION

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NOTE

This report includes an explanatory Comment to each section of the recommended legislation. The Comments are written as if the legislation were already operative, since their primary purpose is to explain the law as it will exist to those who will have occasion to use it after it is operative.

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STATE OF CALIFORNIA PETE WILSON, Governor

CALIFORNIA LAW REVISION COMMISSION
4000 Middlefield Road, Room D-1
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January 23, 1998

To: The Honorable Pete Wilson
Governor of California, and
The Legislature of California

This recommendation proposes to codify California's business judgment rule based on the Principles of Corporate Governance of the American Law Institute. 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 would amend the General Corporation law, which applies only to business corporations. The Law Revision Commission has not studied the circumstances of directors of nonprofit corporations or corresponding managers of other types of organizations and makes no recommendation on the application of the business judgment rule to them.

This recommendation is submitted pursuant to Resolution Chapter 102 of the Statutes of 1997.

Respectfully submitted,

Edwin K. Marzec
Chairperson

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 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

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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) (on file with California Law Revision Commission). An edited edition of the background study is printed following this recommendation. See *infra* pp. 33-50.

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 considering whether a director has satisfied the standard of careful conduct in making a business judgment, the courts have used a lower standard of review, provided the director made the judgment in good faith, did not have an economic interest in it, and used a reasonable decisionmaking process. That standard of review applied in these circumstances is called the "business judgment rule."[4]

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 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

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4. See, e.g., Veasey, *The Defining Tension in Corporate Governance in America*, 52 Bus. Law. 393, 394 (1997):

> 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.

(Footnotes omitted.)

the director in effect an insurer of the corporation's acts, and would tend undesirably to promote risk-averse decision-making 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?[5] The trend in the law generally is to recognize that some risk is inherent in sound decisionmaking, and to make allowance for that fact.[6]

For these reasons there is general acceptance of the business judgment rule as a basic feature of corporate governance in the United States.[7]

CALIFORNIA LAW AND THE NEED FOR CLARIFICATION

California's formulation of the business judgment rule is confused. Some cases have articulated a reasonability

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5. See Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. Cal. L. Rev. 287 (1994). Professor Gevurtz concludes that corporate directors are not unique in the types of decisions they make, and should not receive special treatment. *Id.* at 336-37.

6. 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).

Risk is a necessary element of proper business decisionmaking, to an even greater degree than investment decisions of fiduciaries. See, e.g., J. Lockwood, Protecting Corporate Officers and Directors from Liability: Program Handbook (Cal. Cont. Ed. Bar 1994).

7. See, e.g., American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.01 (1994) [hereinafter ALI Principles of Corporate Governance].

standard,[8] others a good faith standard,[9] and still others have combined the two concepts or treated them as interchangeable.[10]

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.[11] But that section actually codifies a standard of careful conduct, not the rule governing when courts will review whether directors' action has satisfied that standard.[12]

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,[13] as well as protection from liability under the articles.[14] But these devices are not universal among California corporations, nor do they eliminate the benefit of a sound expression of the governing law for purposes of other legal remedies.

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8. See, e.g., Briano v. Rubio, 46 Cal. App. 4th 1167, 54 Cal. Rptr. 2d 408 (1996); Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 274 P. 597 (1929).

9. See, e.g., Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); Marble v. Latchford Glass Co., 205 Cal. App. 2d 171, 22 Cal. Rptr. 789 (1962).

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

11. See, e.g., *Briano*, 46 Cal. App. 4th at 1179; Barnes v. State Farm Mut. Auto. Ins. Co., 16 Cal. App. 4th 365, 379 n.12, 20 Cal. Rptr. 87 (1993); *Gaillard*, 208 Cal. App. 3d at 1264.

12. It could even be argued that the statement of the standard of care in Section 309 negates the business judgment rule by its failure to create a business judgment exception to the statutory standard. See discussion in 2 H. Marsh & R. Finkle, Marsh's California Corporation Law § 11.3 (3d ed. 1997).

13. Corp. Code § 317.

14. *Id.* § 204(a)(10).

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 resolve the ambiguity by codification of 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 — but also voluminous — guidance to corporate directors.[15] This might argue for codification in California based on Delaware law.

The Commission believes that a better starting point is the Principles of Corporate Governance 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

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15. The Delaware Law Study Group of the California 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.

Appendix to How Section 2115 Affects Your Delaware Clients: A Comparison of Delaware and California Law Applicable to Quasi-*California Corporations*, 15 Bus. L. News, Summer 1993, at 25, 28-29.

would resolve any concern about discrepancies between California and Delaware law on this matter. A significant added advantage to codification of the business judgment rule based on the ALI Principles of Corporate Governance is that, besides clarifying California law, it will benefit from 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.[16]

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:

> (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.

16. ALI Principles of Corporate Governance, *supra* note 7, § 4.01(c).

> (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.
>
> (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.[17]

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:

(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 specified relationships, including the director's spouse, children, parents, siblings, and other close relationships, 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 busi-

17. *Id.* § 1.23(a).

ness 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."[18] Although courts have announced various formulations of the business judgment rule, the rationality standard is the most prevalent.[19]

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…."[20] 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.[21]

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18. *Id*. § 4.01(c)(3).

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

20. Eisenberg, *Whether the Business-Judgment Rule Should Be Codified*, 28 Cal. L. Revision Comm'n Reports 33, 42 (1998).

21. ALI Principles of Corporate Governance, *supra* note 7, § 4.01 comment d reads:

The rationality standard represents a middle ground among the various standards that have been articulated in the California cases[22] and would codify the most recent California case law formulation.[23] It has the added benefit that it is consistent with the mainstream of case law in other states, including Delaware. It also incorporates 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.[24] 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.[25] 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 require-

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> 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 interests of the corporation and that belief is rational.

22. See *supra* text accompanying notes 8-10.

23. See Lee v. Interinsurance Exch., 50 Cal. App. 4th 694, 710-11, 57 Cal. Rptr. 2d 798 (1996).

24. See, e.g., *id*. at 709-15; Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 261 Cal. Rptr. 868 (1989).

25. Evid. Code §§ 500, 521.

ments of the business judgment rule; the person alleging a violation bears the burden of proof on these matters. This would codify existing law.[26]

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, 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.[27] 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.[28] The proposed legislation is not intended to preclude California courts from developing standards to

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26. See, e.g., *Interinsurance Exch.*, 50 Cal. App. 4th 694; 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 & Bldg. Corp., 96 Cal. App. 549, 274 P. 597 (1929).

27. See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

28. 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) (on file with California Law Revision Commission).

determine whether and under what circumstances the business judgment rule should apply to these cases.[29]

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.[30] 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.[31] 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

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29. See proposed Section 321(c) (interested director) and Comment to proposed Section 320 (business judgment rule). *Cf. Interinsurance Exch.*, 50 Cal. App. 4th 694.

30. See. e.g., *Interinsurance Exch.*, 50 Cal. App. 4th 694; Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

31. See, e.g., ALI Principles of Corporate Governance, *supra* note 7, § 6.02(d) (action that has foreseeable effect of blocking unsolicited tender offer).

affect the common law and existing statutory protection of officers and employees.[32]

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.

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.[33] In particular, the Commission has not studied the circumstances of directors of nonprofit corporations and makes no recommendation on the application of

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32. See *id*. § 4.01 comment d. 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).

33. *Cf. Interinsurance Exch.*, 50 Cal. App. 4th 694 (application of common law business judgment rule to reciprocal insurer).

the business judgment rule to directors of nonprofit corporations.[34]

34. 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 or may not be the same in the nonprofit as in the for-profit context. To the extent the managers of a nonprofit corporation are subject to the same duty of care as a director of a business corporation, it may be appropriate that they be judged by the same rules. *Cf. id*. 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 for their own actions. A description of the existing provisions may be found in Sproul, *Director and Officer Liability in the Nonprofit Context*, 15 Bus. L. News, Spring 1993, at 7.

PROPOSED LEGISLATION

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"); see also Barnes v. State Farm Mut. 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 (1994). 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 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 Exch., 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (1996).

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. 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.

Courts of other jurisdictions that have applied the business judgment rule have limited the application of that rule in certain kinds of 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 Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). Nothing in Section 320 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 Exch., 50 Cal. App. 4th 694, 57 Cal. Rptr. 2d 798 (1996). For application of this principle in the context of the definition of an "interested" director, see Section 321(c) & Comment.

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 under Section 309. It does not apply to the director's liability, if any, to third persons on tort, contract, or other bases. 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 Exch., 50 Cal. App. 4th 694, 709-15, 57 Cal. Rptr. 2d 798, 807-11 (1996); Barnes v. State Farm Mut. 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 & Elec. Co., 51 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 & Bldg. 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 Exch., 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 Exch., 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 & Bldg. Corp., 96 Cal. App. 549, 274 P. 597 (1929). Other cases have articulated a good faith standard. See, e.g., Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); Marble v. Latchford

Glass Co., 205 Cal. App. 2d 171, 22 Cal. Rptr. 789 (1962). 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 Exch., 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 Section 4.01(c). The ALI's comment d to Section 4.01 notes:

> 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 interests of the corporation and that belief is rational.

Subdivision (b) is drawn from ALI Principles of Corporate Governance Section 4.01(d). 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 Exch., 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 & Bldg. 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.

(c) Nothing in this section 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 the following circumstances:

(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.

Comment. Subdivision (a) of Section 321 is drawn from Section 1.23 of American Law Institute (ALI), Principles of Corporate Governance: Analysis and Recommendations (1994). 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 Section 1.23, 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 economically 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.

Fraud by a director may be an independent legal basis for a challenge to an action, regardless of whether the director is subject to controlling influence or is otherwise interested within the meaning of this section.

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

Paragraph (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.

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. 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 Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Zapata Corp. v. Maldonado, 430 A.2d 779 (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).

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~~

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 and 321 (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 320-321) 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).

WHETHER THE BUSINESS-JUDGMENT RULE SHOULD BE CODIFIED*

by Melvin A. Eisenberg

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* 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.

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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

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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-

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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-

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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

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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]

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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*

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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.