#B-601

STATE OF CALIFORNIA

CALIFORNIA LAW REVISION COMMISSION

DISCUSSION DRAFT

Business Judgment Rule

November 1996

This discussion draft is being distributed so that interested persons will be advised of the Commission's tentative conclusions and can make their views known to the Commission. Any comments sent to the Commission will be a part of the public record and will be considered at a public meeting when the Commission determines the provisions it will include in legislation the Commission plans to recommend to the Legislature. It is just as important to advise the Commission that you approve the draft as it is to advise the Commission that you believe revisions should be made in the draft. The Commission also solicits your views as to whether or not the Business Judgment Rule should be codified.

COMMENTS ON THIS DISCUSSION DRAFT SHOULD BE RECEIVED BY THE COMMISSION NOT LATER THAN **March 15, 1997.**

The Commission often substantially revises drafts as a result of the comments it receives. Hence, this discussion draft is not necessarily the recommendation the Commission will submit to the Legislature.

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BUSINESS JUDGMENT RULE

Summary of Discussion Draft

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

The Commission solicits views both as to whether or not the Business Judgment Rule should be codified and as to the details of the proposed codification.

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 and 1996.

This recommendation 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.[4]

STANDARD OF CARE AND BUSINESS JUDGMENT RULE

Standard of Care of Directors

Corporate directors are held to a standard of careful conduct. The standard of careful conduct has evolved from basic fiduciary concepts, reflected in the

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

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

3. See Eisenberg, *Background Study for the California Law Revision Commission on Whether the Business-Judgment Rule Should Be Codified* (May 1995). The background study is available electronically at the following URL: http://www.clrc.ca.gov/. A photocopy version of the 21-page Background Study is available from the Law Revision Commission for $8.50 plus tax.

4. Cf. Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, (October 31, 1996) (application of common law business judgment rule to reciprocal insurer).

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

statutory formulation of the standard found in Corporations Code Section 309(a). That statute requires a director to act in good faith in a manner the director believes to be in the best interests of the corporation and shareholders, and "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."

Standard of Judicial Review

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

There are various formulations of the business judgment rule. One standard that has been applied is subjective — whether the director has acted in good faith. A more common standard is objective — whether the decision of the director is rational, as distinct from prudent.

Rationale of Business Judgment Rule

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

But given the fact that other fiduciaries are held to a standard of prudence and due care, is the special protection of the business judgment rule necessary or proper?[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] Risk is a necessary element of proper business decisionmaking, to an even greater degree than investment decisions of fiduciaries.[7]

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

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).

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

CALIFORNIA LAW AND THE NEED FOR CLARIFICATION

California's formulation of the business judgment rule is confused. Some cases have articulated a reasonability 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 the standard of careful conduct, with which the business judgment rule is inconsistent. In fact, it could be argued that the statement of the standard of care in Section 309 negates the business judgment rule by its failure to create a business judgment exception to the statutory 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] These devices are not universal among California corporations, nor do they eliminate the benefit of a sound expression of the governing law.

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

PRINCIPLES OF CODIFICATION

Models for Codification

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

It is generally thought that the California and Delaware business judgment rules are basically similar, although the California law is subject to some confusion. One attraction of Delaware law for many corporations is the substantial body of

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

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

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

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

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

13. Corp. Code § 317.

14. Corp. Code § 204(a)(10).

law that has developed in Delaware, offering useful guidance to corporate directors.[15] This would argue for codification in California based on Delaware law.

The Commission believes that a better model is the Principles of Corporate Governance (1992) of the American Law Institute (ALI). This compilation of principles represents a fair statement of the general law in a way that is not inconsistent with either Delaware law or existing California law, and would resolve any concern about discrepancies between California and Delaware law on this matter. A significant added benefit to codification of the business judgment rule in the form of the ALI Principles of Corporate Governance is that, besides clarifying California law, it will pick up an instant 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:[17]

> (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

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

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

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

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

17. American Law Institute, Principles of Corporate Governance §1.23 (1992).

affect the director's judgment with respect to the transaction or conduct in a manner adverse to the corporation.

(3) The director, an associate of the director, or a person with whom the director has a business, financial, or familial relationship, has a material pecuniary interest in the transaction or conduct (other than usual and customary directors' fees and benefits) and that interest and (if present) that relationship would reasonably be expected to affect the director's judgment in a manner adverse to the corporation.

(4) The director is subject to a controlling influence by a party to the transaction or conduct or by a person who has a material pecuniary interest in the transaction or conduct, and the controlling influence could reasonably be expected to affect the director's judgment with respect to the transaction or conduct in a manner adverse to the corporation.

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

The Commission recommends two qualifications of these standards:

(1) Paragraphs (2) and (3) refer to a "familial" relationship to the director. Because of the potentially open-ended nature of this concept, the codification narrows the concept to named close relationships, including the director's spouse, children, parents, siblings, and other near relatives, including step, in-law, and adoptive relations.

(2) Under paragraph (3), 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 a material pecuniary interest. The director should not be considered interested for purposes of the business judgment rule unless the director knows or should be aware of the existence of the material pecuniary 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 totally irrational. "Unlike a subjective-good-faith standard, a rationality standard preserves a minimum and

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

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

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]

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 benefits that it is consistent with the mainstream of case law in other states, including Delaware law. And it picks up the useful explanatory material set out in the ALI Principles of Corporate Governance.

Presumption and Burden of Proof

The business judgment rule is sometimes described as a presumption in favor of the regularity of acts of the directors.[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 requirements of the business judgment rule, the burden of proof of these matters being on the person alleging a violation. This would codify existing law.[26]

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

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

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

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

23. See Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282 (October 31, 1996).

24. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282-4 (October 31, 1996); Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 261 Cal. Rptr. 868 (1989).

25. Evid. Code §§ 500, 521.

26. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13284 (October 31, 1996); Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Fornaseri v. Cosmosart Realty Corp., 96 Cal. App. 549, 274 P. 597 (1929).

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.[27] 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.[28] The Commission would leave application of the business judgment rule in proceedings to enjoin or set aside board action to common law development.

DERIVATIVE ACTIONS

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.[29] This matter will be addressed in a separate recommendation by the Commission.

CODIFICATION INAPPLICABLE TO OFFICERS

Most of the development of the law relating to business judgments has occurred in connection with directors, particularly in derivative action litigation. There is relatively little law concerning corporate officers. The Commission recommends that the codification of the business judgment rule should be limited to directors, and that its possible application to officers be made the subject of a separate study. Codification of the business judgment rule for directors should not affect the common law protection of officers.[30]

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27. See. e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13284 (October 31, 1996); Heckman v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

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

29. 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).

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

PROPOSED LEGISLATION

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

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

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

Article 1. General Provisions

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

Corp. Code §§ 320-321 (added). Business judgment rule

SEC. 2. Article 2 (commencing with Section 320) is added to Chapter 3 of Division 1 of Title 1 of the Corporations Code, to read:

Article 2. Business Judgment Rule

§ 320. Business judgment rule

320. (a) A director 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 failure of the director to satisfy the requirements of subdivision (a) and, if that burden is sustained, of proving the director's failure to satisfy the requirements of Section 309, and in a damage action under Section 309, the burden of proving that the breach was the proximate cause of damage suffered by the corporation or its shareholders.

Comment. Section 320 expresses the business judgment rule in terms drawn from American Law Institute (ALI), Principles of Corporate Governance: Analysis and Recommendations (1992). The Introductory Note and Comments to that treatise provide extensive discussion of the meaning and interpretation of the business judgment rule as codified in this section; those materials should be consulted in connection with questions of construction and intent of this section.

Section 320 codifies the business judgment rule for business corporations. The codification does not affect common law application of the business judgment rule, if any, to other entities, such as partnerships and nonprofit corporations.

Section 320 is a qualification of Section 309, which prescribes the duty of care of directors. Therefore, this section by its terms applies only to conduct of directors. To qualify as a "business judgment" of a director within the meaning of this section, a decision must have been consciously made and judgment must, in fact, have been exercised. It is important to recognize that a business decision may involve a judgment either to act or to abstain from action.

Section 320 specifies nonexclusive conditions under which Section 309 is deemed to be satisfied. Section 309(a) and (b) codifies the duty of care by stating the manner in which a director must perform the duties of a director. Section 309(c) addresses the liability of a director for failure to perform the duties under Section 309(a) and (b). Therefore, Section 320 would apply to liability actions against directors under Section 309 based on the duty of care, as well as to actions against directors seeking other remedies based on alleged violations of the duty of care under Section 309(a) and (b).

Strictly speaking, Section 320 would not apply in an action in which remedies are sought against the corporation to enjoin or set aside a business transaction with a third party, as opposed to an action against individual directors. However, since any such transaction of importance is likely to have taken place as a consequence of the exercise of directors' business judgment, the substantive issue in such an action would normally be whether the directors exercised their business judgment in a manner that satisfies Section 320. 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 other for other cause.

Section 320 codifies the business judgment rule. Courts of other jurisdictions that apply the business judgment rule in duty of care cases have limited the application of that rule in certain kinds of cases that fall between traditional duty of care cases and traditional duty of loyalty cases; in particular, in cases involving transactions incident to contests for control, such as defensive actions to takeover bids, and in cases involving the effect of a board or committee determination that a derivative action against a corporate director or officer is not in the best interests of the corporation. See, e.g., Unocal v. Mesa Petroleum Corp., 493 A.2d 946 (Del. 1985); Zapata Corp. v. Maldonado, 420 A.2d 799 (Del. 1981). 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 Exchange, 96 Daily Journal D.A.R. 13278, 13284 (October 31, 1996)

The business judgment rule provides a "safe harbor" for determining a director's liability for breach of the director's duty of care under Section 309, but it does not provide the exclusive means for this determination. An interested director, for example, is not entitled to protection of the business judgment rule but the director's actions 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.

In a judicial proceeding, a person challenging the conduct of the director has the burden of showing the director's failure to satisfy the requirements of this section and, if that burden is sustained, of showing the director's failure to satisfy the requirements of Section 309. Subdivision (b).

The business judgment rule applies only to satisfaction of a director's duty of care to the corporation and its shareholders under Section 309. It does not apply to the director's duty of care, if any, to third persons. Nor does it limit any protection otherwise available for a director, including a provision in the articles eliminating or limiting the liability of a director for monetary damages for breach of the duty of care of the director 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 require directors to focus collectively on each subsidiary issue. It simply requires that, in general, the directors become informed about and consciously reach a decision with regard to the overall issue.

Subdivision (a)(1) codifies the principle of existing law that the business judgment rule applies only to a good faith action of a director. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282-4 (October 31, 1996); Barnes v. State Farm Mutual Auto Ins. Co., 16 Cal. App. 4th 365, 20 Cal. Rptr 2d 87 (1993); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); Marsili v. Pacific Gas and Electric Co., 57 Cal. App. 3d 313, 124 Cal. Rptr. 313 (1975); Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Fornaseri v. Cosmosart Realty Corp., 96 Cal. App. 549, 274 P. 597 (1929).

Subdivision (a)(2) codifies the principle of existing law that the business judgment rule applies only to a disinterested decision. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282-4 (October 31, 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 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 applies only to an informed decision. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13284 (October 31, 1996); Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989).

Existing California case law formulations of the business judgment rule lack clarity. Some cases have articulated a reasonability standard (see, e.g., Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Fornaseri v. Cosmosart Realty Corp., 96 Cal. App. 549, 274 P. 597 (1929)). Other cases have articulated a good faith standard (see, e.g., Marble v. Latchford Glass Co., 205 Cal. App. 2d 171, 22 Cal. Rptr. 789 (1962); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986)). Yet other cases have combined the two concepts or treated them as interchangeable (see, e.g., Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989)). Subdivision (a)(4) applies a rationality standard that represents a middle ground among the various standards articulated by the California cases, and is consistent with the most recent articulation of the standard in California. See Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282 (October 31, 1996) (court will not interfere with decision that has "rational business purpose").

The rationality standard of subdivision (a)(4) is drawn from ALI Principles of Corporate Governance § 4.01(c) (1992). The ALI Comment to § 4.01 notes that:

> This standard is intended to provide directors and officers with a wide ambit of discretion. It is recognized that the word "rational," which is widely used by the courts, has a close etymological tie to the word "reasonable" and that, at times, the words have been used almost interchangeably. But a sharp distinction is being drawn between the words here. The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable," and to give a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonable" but are not so removed from the realm of reason when made that liability should be incurred. Stated another way, the judgment of a director or officer will pass muster under § 4.01(c)(3) if the director or officer believes it to be in the best interest of the corporation and that belief is rational.

Subdivision (b) is drawn from ALI Principles of Corporate Governance § 4.01(d) (1992). It codifies the burdens of proof in existing law on a person challenging the conduct of a director as a breach of Section 309. See, e.g., Lee v. Interinsurance Exchange, 96 Daily Journal D.A.R. 13278, 13282 (October 31, 1996); Will v. Engebretson & Co., 213 Cal. App. 3d 1033, 261 Cal. Rptr. 868 (1989); Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 256 Cal. Rptr. 702 (1989); Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986); Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Fornaseri v. Cosmosart Realty Corp., 96 Cal. App. 549, 274 P. 597 (1929). The burden of proof is proof by a preponderance of the evidence. Evid. Code § 115.

§ 321. Interested director

321. (a) For the purpose of Section 320, a director is "interested" in a transaction or conduct that is the subject of a business judgment only if any of the following conditions is satisfied:

(1) The director, or an associate of the director, is a party to the transaction or conduct.

(2) The director or an associate of the director has a material pecuniary 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 a controlling influence by a party to the transaction or conduct (other than the corporation) or by a person who has a material pecuniary interest in the transaction or conduct, and that 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 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 financial relationship other than 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. For the purpose of this paragraph, the following presumptions affecting the burden of proof apply:

(A) The director's judgment is presumed not to be adversely affected solely because the director is a director or principal manager of the business organization.

(B) The director's judgment is presumed not to be adversely affected if the director is the beneficial owner or record holder of not more than 10 percent of any class of equity interest.

(C) The director's judgment is presumed to be adversely affected if the director is the beneficial or record holder (other than in a custodial capacity) of more than 10 percent of any class of equity interest.

Comment. Subdivision (a) of Section 321 is drawn from American Law Institute (ALI) Principles of Corporate Governance § 1.23 (1992). See also Model Business Corporation Act § 8.31, Comment 5 ("a director should normally be viewed as interested in a transaction if he or the immediate members of his family have a financial interest in the transaction or a relationship with the other parties to the transaction such that the relationship might reasonably be expected to affect his judgment in the particular matter in a manner adverse to the corporation.") 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 will not receive business judgment rule protection for that action. However, this does not imply that the director is liable under Section 309, since, despite the fact that the director is interested, the director's actions may nonetheless satisfy the duty of care (but not necessarily the duty of loyalty) that an ordinarily prudent person in a like position would use under similar circumstances.

Unlike ALI Principles of Corporate Governance § 1.23 (1992), subdivision (a)(2) is limited to pecuniary 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 pecuniary dealing. However, where senior executives of two corporations sit on each other's board of directors, and each senior executive is in a position to review the other's compensation, or other transactions or conduct in which the other senior executive is pecuniarily interested, a court could consider that fact in determining whether in the circumstances of a particular case each of the senior executives is interested when reviewing each other's conflict of interest transactions or conduct.

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

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.

The presumptions created by subdivision (b)(3) are rebuttable. Whether the director's relationship with a business organization would reasonably be expected to affect the director's judgment with respect to a transaction or conduct in a manner adverse to the corporation or its shareholders will depend on the circumstances. An interest greater than 10% might not reasonably be expected to affect the director's judgment, for example, if the interest is in a small, privately held business and the value of the ownership interest is insubstantial for that director. On the other hand, an interest less than 10% might reasonably be expected to affect the director's judgment, for example, if the interest is in a large, publicly held business and the value of the ownership interest is substantial for that director.