Corporation Code Sections 309 and 1203: California Redefines Directors' Duties Towards Shareholders

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I. Introduction

With the amendment of Corporation Code section 309, and the enactment and later amendment of Corporation Code section 1203, the California Legislature sent out a signal that the days of corporate shareholder mistreatment by improvident or unloyal directors were numbered. This legislative action was not intended to benefit shareholders exclusively since directors themselves were given clearly delineated duties regarding their actions toward shareholders in general, and specifically in takeover contexts. As amended in 1987, section 309 specifically recognized that directors' duties flow not only to the corporation, but to its shareholders as well. With this small insertion, the legislature has statutorily confirmed the rights of shareholders to be protected as to the decisions of the corporations they own. Not only has the California Legislature further defined directors' standard of care regarding shareholders with amended section 309, but it has also provided a check for potential abuses in intracorporate reorganizations with the enactment of section 1203. This statute, when considered with section 309, indicates the California Legislature's intent not only to protect shareholders, but also to provide corporate directors with a firmer, clearer directive as to their fiduciary duties.

This article will primarily address sections 309 and 1203 and their impact on directors' duties to corporate shareholders in California. In doing so, the duty of care, the duty of loyalty, and the business judgment rule will be reviewed in their common law context. This will be followed by a discussion concerning the enactment of section 309 in 1977, which codified these principles. After this, the 1987 amendments to section 309 will be highlighted with a particular emphasis on their affect to both directors and shareholders. The enactment of section 1203 will then be addressed, first with a review of intracorporate reorganizations and the conflict of interest problems which surround them, followed by a discussion of the parameters of the statute itself. Finally, the two statutes will be viewed together as a legislative effort to protect shareholders and to provide California directors with greater guidance.

II. CALIFORNIA CORPORATIONS CODE SECTION 309

When directors act in their capacity as corporate directors, they are constrained by certain fiduciary duties that they owe to the corporation and its shareholders.[1] These fiduciary duties were originally defined in case law; however, commentators were not satisfied with the delineations of certain fiduciary duties and wanted a more general standard of care that could be used for guidance by directors.[2] In 1977, with the enactment of a comprehensive General Corporation Law (GCL), the California Legislature enacted a statute that did provide such guidance:[3] section 309 of the 1977 GCL defined the standard of care that directors had to use[4] in their compliance with section 300.[5] This standard of care is the counterpart to the directors' general policy-making function contained in Corporations Code section 300.[6] However, under the language of the 1977 statute, the duty

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1. *Cf.* 1 H. MARSH, MARSH'S CALIFORNIA CORPORATION LAW § 10.2, at 570 (1981) (that directors are fiduciaries "has been stated in innumerable decisions").

> Directors' basic fiduciary obligation in making decisions is to exercise reasonable judgment and to act honestly in what directors in good faith believe to be in the best interests of the corporation and its shareholders, after a reasonable investigation of the facts and the advantages and disadvantages of proposed action. Directors may not act solely or primarily for a personal or non-corporate purpose, such as to preserve their position as directors or officers.

2 H. LESSER & S. STAPLES, ABA NATIONAL INSTITUTE ON DYNAMICS OF CORPORATE CONTROL III: EVOLVING LEGAL STANDARDS APPLIED TO THE FRONTIERS OF CORPORATE STRATEGY 101 (1988) [hereinafter LESSER & STAPLES] (part of a National Institute on the dynamics of corporate control given by the Section of Corporation, Banking, and Business Law of the American Bar Association's Division for Professional Education).

2. *See, e.g.*, Calfas, *Boards of Directors: A New Standard of Care*, 9 LOY. L.A.L. REV. 820 (1976). Mr. Calfas points out that the California courts and those with direct interaction with the board were at odds with what a board of directors' function and scope is. *Id.* at 820-27. Mr. Stern points out that California statutes, cases, and treatises did not clearly delineate a general standard of care for directors to follow. Stern, *The General Standard of Care Imposed on Directors under the New California General Corporation Law*, 23 UCLA L. REV. 1269, 1269-73 (1976).

3. Calfas, *supra* note 2, at 820-21. The effective date of the GCL was January 1, 1977, and this was the reason for the use of 1977 instead of 1975.

4. CAL. CORP. CODE § 309 (West 1977). It provides in part that:

> [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 with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

Id.

5. CAL. CORP. CODE § 300 (West 1977). Although section 300 is not specifically referred to in section § 309's statutory language, the legislative committee comment following section 309 states that "[t]he duties of a director are specified in subd. (a) of 300." *Id.* § 309 (legislative committee comments). Thus, section 309 *must* be read in conjunction with section 300 and the legislative committee comment in section 300. *See also* Stern, *supra* note 2, at 1269 (discussing the background relating to the enactment of section 309); Comment, *California's New General Corporation Law: Directors' Liability to Corporations*, 7 PAC. L.J. 613 (1976) (discussing the scope of section 309 and its impact on already developed common law standards).

6. CAL. CORP. CODE § 300 (West 1977). The California Legislature codified this

was owed only to the corporation. Very few cases have actually interpreted section 309, leaving open the scope of its applicability.[7] Regardless of its scope, the legislature amended section 309 in 1987 to encompass a statutory duty not only towards the corporation, but to the shareholders of the corporation as well.[8]

This portion of the article will define the scope of section 309 as amended in 1987. A course of conduct which can be followed by directors will be set forth in the analysis. In defining the scope of amended section 309, it is necessary to examine the legislative history of the statute, the common law standards of care, and the general scope of the original 1977 statute. From this analysis, the importance of the 1987 amendments can be appreciated.

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general policy-making ability of directors in Corporations Code section 300, which states that the "business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board." *Id.* Section 300 also states:

> [t]he board may delegate the management of the day-to-day operation of the business of the corporation to a management company or other person provided that the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.

Id. The rationale behind this statute was explained in H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 207, at 562 (3d ed. 1983) [hereinafter HENN & ALEXANDER].

> In the exercise of their duty of management, the directors, usually as a board, are required to use their best judgment and independent discretion, and are responsible for the determination and execution of corporate policy. Their management functions usually include: (a) policy decisions with respect to products, services, prices, wages, labor relations, (b) selection, supervision, and removal of officers and possibly other executive personnel, (c) fixing of executive compensation, pension, retirement, etc., plans, (d) determination of dividends, financing, and capital changes, (g) participation, along with shareholders, in effecting various extraordinary corporate matters, and (h) supervision and vigilance for the welfare of the whole enterprise.

Id. (citations omitted). Further explanation can be found in H. MARSH, *supra* note 1, at 570. In general, directors owe their primary duties towards the corporation they manage, and are in a fiduciary relationship with the corporation, and must act within the confines of such a relationship. HENN & ALEXANDER, *supra*, at 562; *see infra* note 9 and accompanying text. Although the board is not expected to involve itself in the minute details of the everyday business of the corporation, it is expected to set major policy goals and to govern the direction of the corporation. In this respect, any decisions affecting the corporation in a major way, such as whether or not to approve a merger, consolidation, tender offer, or continue a shareholder's derivative suit, are ultimately made by the board and the board is ultimately responsible for the decisions. *See* 1 H. MARSH, *supra* note 1, at 570; Calfas, *supra* note 2, at 821-24 (discussing the scope of section 309 as enacted in 1977).

7. As of the time of this writing, only three reported cases discuss the statute in any depth: Jewel Cos. v. Pay Less Drug Stores N.W., 741 F.2d 1555 (9th Cir. 1984); Francis v. Village Green Owners Ass'n, 42 Cal. 3d 490, 723 P.2d 573, 229 Cal. Rptr. 456 (1986); Sanchez v. Grain Growers Ass'n of Cal., 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

8. CAL. CORP. CODE § 309 (West Supp. 1989).

A. *Legislative History*

Section 309 was part of a comprehensive revision of the corporations code. Before the revision, attempts at defining the various fiduciary duties owed by directors were limited to case law[9] and section 820 of the pre-1977 corporations code.[10] However, most case law focused on specific instances of director conduct and the application of specific fiduciary duties without any attempt at defining a general duty applicable to all director conduct.[11] Apart from section 820, which promulgated a very general standard, there were no other attempts by the legislature to define general standards of conduct which directors could follow.[12] As a result, directors were left without comprehensive guidance as to how their actions would be governed.

In 1975, as part of the newly conceived and soon to be enacted General Corporation Law, the drafting committee created a new statute, section 309, which defined a standard of care that directors could look to for guidance.[13] The drafting committee drew heavily from the then proposed revisions to section 35 of the 1969 Model Business Cor-

9. "The 1977 Law does not undertake to specify that the directors and officers are fiduciaries in their relationship to the shareholders, but this has been stated in innumerable decisions and its repetition in the statute was considered unnecessary." 1 H. MARSH, *supra* note 1, at 570; *see, e.g.*, Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 419, 241 P.2d 66, 74 (1952). The court in *Remillard* indicated that "[i]t is hornbook law that directors . . . bear a fiduciary relationship to the corporation." *Id.*; *see also* 6 Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING, § 127.02[1] (1987) ("Directors . . . stand in a fiduciary relationship").

10. Stern, *supra* note 2, at 1269-73. Only the first sentence of section 820 directly addressed a general duty of care. It stated that directors "shall exercise their powers in good faith, and with a view to the interests of the corporation." CAL. CORP. CODE § 820 (West 1955). One commentator stated:

> This is not a very meaningful standard of conduct. No statute is needed to declare that directors should not act in *bad* faith. The requirement that directors act "with a view to the interests of the corporation" appears to be more significant. But that phrase principally directs attention to the more specific provisions of section 820, which are intended to deal with a "conflict of interest" or "self-dealing" on the part of a director. Accordingly, California cases discussing the duties of directors have, with few exceptions, focused not on a general duty of care but on prohibitions of particular kinds of improper conduct. . . . Not one of these decisions imposes liability upon a director in his or her capacity as such for failing to act in compliance with a general standard of care.

Stern, *supra* note 2, at 1269-71 (emphasis in original) (citations omitted); *see also* Calfas, *supra* note 2, at 820 (discussing the scope and impact of section 309 as effective in 1977).

11. Stern, *supra* note 2, at 1270; *see, e.g.*, *Remillard*, 109 Cal. App. 2d at 419, 241 P.2d at 74.

12. Stern, *supra* note 2, at 1269-70; *see supra* note 10.

13. Comment, *supra* note 5, at 613-14. The standard of care reconciled the conflicts between requiring directors to participate in the everyday workings of the corporation to the detriment of corporate efficiency and protecting the corporation from capricious and arbitrary decisions made by the board. *Id.*

poration Act (MBCA)[14] which were being considered by the American Bar Association's Committee on Corporate Laws (ABA).[15] The revisions of MBCA section 35 were an attempt by the ABA to codify the case law concept of the "business judgment rule" as a part of the general fiduciary duty of due care owed by corporate directors.[16] Additionally, section 309 drew heavily from the ABA comments to proposed MBCA section 35 for the text in its own legislative committee comment.[17] Moreover, the drafting committee was also motivated by

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14. *Id.* at 614-15; *see* Stern, *supra* note 2, at 1274-75. The proposed MBCA statute was published in The Business Lawyer. *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act,* 30 BUS. LAW. 501, 502 (1974). This provides that a director must act "in good faith, in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances." *Id.* Except for the added phrase "including reasonable inquiry," the drafting committee retained the MBCA text. Stern, *supra* note 2, at 1275.

15. Stern, *supra* note 2, at 1274-75. The proposed revisions to section 35 can be found in *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act,* 29 BUS. LAW. 947 (1974).

16. *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act,* 29 BUS. LAW. 947 (1974). The attempt at codifying the business judgment rule by the Committee on Corporate Laws can be seen in their proposed comments to amended section 35:

> The standard provided in Section 35, as revised, sets forth the duty of care applicable to directors (including a director's right to rely on others), reflects the good faith concept embodied in the so-called "business judgment rule," which has been viewed by the courts as a fundamental precept for many decades, and to the extent possible parallels the Act's indemnification provisions. By combining the requirement of good faith with the statement that a director must act "with such care as an ordinarily prudent person would use under similar circumstances," section 35 incorporates the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business judgment.

Id. at 951. It is interesting to note that when the committee brought out the Revised Model Business Corporation Act, they backed away from trying to codify the business judgment rule. *See* 2 REVISED MODEL BUSINESS CORPORATION ACT ANNOTATED § 8.30, at 928 (3d ed. 1984). The committee stated:

> Even before statutory formulations of directors' duty of care, courts sometimes invoked the business judgment rule in determining whether to impose liability in a particular case. In doing so, courts have sometimes used language similar to the standards set forth in section 8.30(a). The elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts. In view of the continuing judicial development, section 8.30 does not try to codify the business judgment rule or to delineate the differences, if any, between that rule and the standards of director conduct set forth in this subsection. That is a task left to the courts and possibly later revisions of this Model Act.

Id. California is cited as one of the states which also codifies the standard of care required by directors. This standard is, of course, found in section 309.

17. CAL. CORP. CODE § 309 (West 1977)(legislative committee comment); *see also* Stern, *supra* note 2, at 1269; *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act,* 30 BUS. LAW. 501 (1975). The comments to the code

the fact that other jurisdictions were codifying case law concepts concerning applicable standards of care required by directors, in their exercise of the powers delegated to them by statute and/or by-laws.[18]

When first enacted in 1977, section 309 stated that the director would only owe duties of care and loyalty directly to the corporation.[19] In 1987, the California Legislature passed Assembly Bill 1530,[20] which partially amended section 309.[21] Assemblyman Brown, one of the sponsors of the bill, stated in the Legislative Counsel's Digest:

> Under existing law, a director of a corporation is required to perform the duties of a director in good faith and in a manner the director believes to be in the best interest of the corporation, and with the care of an ordinarily prudent person. This bill would also specify that the duty includes performing the duty in a manner the director believes to be in the best interest of the shareholders of a corporation. [22]

It would seem, from the language in the Digest, that the legislature specifically sought statutory protection for shareholders. However, section 6 of the Bill indicates that the amendments to section 309 were passed as an urgency statute in order to deal with the unavailability of liability insurance for directors.[23] From these amendments to section 309, the inference could be made that the statute was designed to protect directors and not shareholders.

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indicate that the business judgment rule has been codified and included in section 35. *See supra* note 15.

18. Stern, *supra* note 2, at 1274-75; *See, e.g.,* MASS. GEN. LAWS ANN. ch. 156B, § 65 (West Supp. 1989) (describing the standard of care required by directors, officers, and incorporators); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1989) (setting out a director's duty of care). *See generally* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (setting guidelines for breach of standard of care); CAL. CORP. CODE § 300 (West Supp. 1989). The legislative committee comment indicates that "[t]he board exercises its power subject to the provisions of this division and any limitations in the articles and bylaws relating to action required to be approved by the shareholders or the outstanding shares." *Id.*

19. CAL. CORP. CODE § 309 (West 1977).

20. A.B. 1530, 1987-88 Leg. Reg. Sess., § 2 [hereinafter Assembly Bill].

21. *Id.*

22. *Id.*

23. *Id.* Director and Officer Liability Insurance (D & O insurance) "protects the insured individual from potential liability and guarantees coverage when and if that liability actually occurs, [and] it is similar to other kinds of professional insurance." Note, *Protecting Corporate Directors and Officers: Insurance and Other Alternatives,* 40 VAND. L. REV. 775, 782 (1987). Over the past several years, D & O insurance premiums have risen remarkably. In one year alone they have risen by 360%. Hanks, *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification,* 43 BUS. LAW. 1207, 1209 (1988). This was a direct result of increased litigation and the court's willingness not to defer to the director's judgment, leading to less predictability respecting the liability of directors for decisions made. *Id.* In addition to increased premiums, carriers have been cutting back on the scope of coverage and requiring higher deductibles. Note, *supra* at 776-77. "For example, as a result of the recent wave of hostile takeovers, some insurers have excluded coverage for lawsuits stemming from actions taken in support of or in defense of takeover activities." *Id.* at 777-78 (footnotes omitted).

Assembly Bill 1530[24] included amendments or enactments of sections 204, 204.5, and 317, all of which addressed indemnification.[25] However, the legislature, with respect to amending section 309, sought to keep intact its established interpretation and its relation to section 35 of the MBCA.[26] The legislature's intent was to merely bring section 309 up to date with current case law with respect to the duties owed by directors to shareholders.[27] Additionally, with respect to affirmatively recognizing the need to legislatively protect shareholders, it may be argued that setting out specific statutory duties which directors can follow, whose specificity could satisfy liability carriers, will also benefit the shareholders as well. With distinct statutory duties, directors will be better apprised of their responsibilities and, as a result, will be able to work more efficiently at protecting the shareholders' interests. From this, one can conclude a willingness on the part of the California Legislature to directly and indirectly protect shareholder interests, despite the context of the bill in which the amended statute was incorporated.

B. Common Law

Historically, California courts have examined directors' conduct pursuant to the duty of loyalty, the duty of care, and the business judgment rule.[28] The duty of loyalty stems from the requirement that directors perform their duties in good faith, resolving any conflict of interest in favor of the corporation and its shareholders.[29] The duty of care mandates that directors exercise reasonable care in assessing information.[30] Under the business judgment rule, directors are protected from liability for most decisions exercised pursuant to their managerial decision-making power.[31] Because of their relevancy to section 309, these doctrines must be examined in depth.

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24. Assembly Bill, *supra* note 20.

25. *Id.* In fact, one author indicates that there was substantial debate as to limitation of liability inherent within the several proposed amendments to the corporations code. Unterman, *New Law on Liability and Indemnification of Officers, Directors and Agents Under California Law, After Adoption of AB 1530,* MORRISON & FOERSTER 6-7 (Nov. 1987).

26. Unterman, *supra* note 25, at 6.

27. *Id.*

28. LESSER & STAPLES, *supra* note 2, at 103; 1 H. MARSH, *supra* note 1, at 570; Comment, *supra* note 5, at 615.

29. Comment, *supra* note 5, at 615.

30. Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985).

31. HENN & ALEXANDER, *supra* note 6, at 661.

1. Duty of Loyalty and Due Care

Under the common law duty of loyalty, a director must exercise:

> the most scrupulous observance of his duty, not only affirmatively to protect the interest of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.[32]

An informative discussion of the duty can be found in *Remillard Brick Co. v. Remillard-Dandini.*[33] In *Remillard,* the two defendants, Stanley and Sturgis, were officers and directors of separate manufacturing companies, Remillard Brick Company and Remillard-Dandini Company.[34] At a directors meeting of the two companies, they proposed to separate the sales units of both and transfer them to Remillard-Dandini Sales Corporation, a company in which they were the sole owners and operators.[35] When votes were taken as to the proposal, both defendants voted for it. Then, acting in their capacity as officers, they obtained sales contracts between the two manufacturing companies and Remillard-Dandini Sales Corporation.

The court indicated that the defendants had used their power for their own ends, which created a conflict of interest between their needs and the superseding needs of the corporation and its shareholders.[36] In affirming the trial court's decision to set aside the sales contracts as violative of the defendants' duty of loyalty, the court stated that these directors had a fiduciary relationship to the corporation and its shareholders requiring them to act in *good faith.*[37]

32. Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327, 345, 411 P.2d 921, 934-35, 49 Cal. Rptr. 825, 838-39 (1966) (quoting Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (1939)). The defendant in this case, Glen, was president and director of the plaintiff Bancroft-Whitney. When Matthew Bender & Co. succeeded in attracting the defendant as president of its western division, both Matthew Bender and the defendant proceeded to lure away key personnel from Bancroft-Whitney while the defendant was still president and a director of Bancroft-Whitney. *Id.* at 329-42, 411 P.2d at 925-34, 49 Cal. Rptr. at 829-38. Although Justice Mosk discusses the fiduciary duties breached by the defendant as president of the corporation, his discussion, by its nature and language, makes no distinction between officers and directors with respect to the fiduciary duties owed to the corporation and its shareholders. *Id.* at 345-47, 411 P.2d at 934-35, 49 Cal. Rptr. at 838-39. Focusing on the conflict of interest presented, the court indicated that an officer is not subject to a blanket rule of complete disclosure of his preparation to compete with the corporation in every situation, but here, where the defendant misled the plaintiff, there was a breach of the fiduciary duty. *Id.* at 348, 411 P.2d at 937, 49 Cal. Rptr. at 841.

33. 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

34. *Id.*

35. *Id.* at 410-11, 241 P.2d at 69.

36. *Id.* at 422, 241 P. 2d at 76.

37. *Id.* at 419, 241 P. 2d at 74. The court stated that this principal was "hornbook law." *Id.* Further support was found by the court in old corporations code section 820 (replaced by section 309 in 1977) which did not limit a director's fiduciary duties nor allow him to "drive a harsh and unfair bargain with the corporation he is supposed to represent." *Id.* at 418, 241 P.2d at 74. The California Supreme Court cited *Remillard* with approval in *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr.

Corporate directors are charged with an affirmative duty of care to keep reasonably informed of the affairs of the corporation and to use that information when exercising their decision-making authority.[38]

592 (1969). Although this case dealt mainly with majority shareholders' duties to the minority shareholders, the court did, in its discussion regarding majority shareholders' duties, examine the similar duties of directors. *Id.* In addition, the court reaffirmed the fact that directors must place their concerns second to that of the corporation and its shareholders. *Id.* at 108-09, 460 P.2d at 471-72, 81 Cal. Rptr. at 599-600. The court lists what the director cannot do:

> 'He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. . . . He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. . . . Where there is a violation of these principles, equity will undo the wrong or intervene to prevent its consummation.' This is the law of California.

Id. (quoting Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 420-21, 241 P.2d 66, 75 (1952)); *see also* Professional Hockey Corp. v. World Hockey Assoc., 143 Cal. App. 3d 410, 191 Cal. Rptr. 773 (1983) (suit brought by franchise holder against hockey league for failure to pay promissory notes). In *Professional Hockey* it was stated that the "duty of loyalty requires the directors . . . not to act in their own self interests when the interest of the corporation will be damaged thereby." *Id.* at 414, 191 Cal. Rptr. at 776. Additionally, case law also indicates that section 820 of the corporations code, repealed by the enactment of the 1975 General Corporation Law, embodied this concept of loyalty in its language. *See, e.g.*, Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327, 345, 411 P.2d 921, 935, 49 Cal. Rptr. 825, 839 (1966); *Remillard Brick Co.*, 109 Cal. App. 2d at 417-18, 241 P.2d at 73. In fact, *Remillard* affirmatively states:

> [t]hat section [820] does not permit an officer or director, by an abuse of his power, to obtain an unfair advantage or profit for himself at the expense of the corporation. The director cannot, by reason of his position, drive a harsh and unfair bargain with the corporation he is supposed to represent. If he does so, he may be compelled to account for unfair profits made in disregard of his duty.

Id. at 418, 241 P.2d at 74. The first sentence of section 820 encompasses the duty of loyalty by stating that "[d]irectors and officers shall exercise their powers in *good faith*, and with a view to the interests of the corporation." CAL. CORP. CODE § 820 (West 1955). *Compare Bancroft-Whitney*, 64 Cal. 2d at 345, 411 P.2d at 934-35, 49 Cal. Rptr. at 838-39 *with Remillard*, 109 Cal. App. 2d at 417-18, 241 P.2d at 73.

38. "[I]f 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." Burt v. Irvine Co., 237 Cal. App. 2d 828, 852, 47 Cal. Rptr. 392, 408 (1965).

> Directors and officers are liable to the corporation for negligence to it in the performance of their corporate duties. They can be negligent in acting or in failing to act. . . . Even when the required duty of care has not been exercised, the directors, officers, or controlling shareholders are only liable, under the causation rules of negligence law, for such loss to the corporations as was caused by their negligence.

HENN & ALEXANDER, *supra* note 6, at 621-24.

Thus, even absent any conflict of interest, they can be held liable for negligent performance of their duties.[39] In *Burt v. Irvine Co.*,[40] the court addressed the issue of due care raised during a shareholders' derivative suit.[41] Although initially addressing the duty of loyalty,[42] the court later indicated that liability for failure to exercise the common law duty of care occurs:

> 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 . . . 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.'[43]

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39. 1 H. MARSH, *supra* note 1, at 571.

40. 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965).

41. *Id.* at 833, 47 Cal. Rptr. at 396.

42. *Id.* at 850-51, 47 Cal. Rptr. at 406-07. The court quoted, with approval, from Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952). The court indicated:

> Any transaction between the corporation and a director or a dominant or controlling stockholder, or group of stockholders, is subject to the following test: Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. . . . The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.

Burt, 237 Cal. App. 2d at 850-51, 47 Cal. Rptr. at 406-07.

43. *Id.* at 852, 47 Cal. Rptr. at 407-08 (emphasis added). Regarding the standard used to measure director conduct, California courts have been less than effective in determining which standard applies. Three years later, the same appellate district discussed this issue, the common law duty of care, in National Auto. & Casualty Ins. Co. v. Payne, 261 Cal. App. 2d 403, 67 Cal. Rptr. 784 (1968). The case arose out of National's agreeing to guarantee 30% of a note issued to defendant, Eldorado Management Co. (Eldorado), in return for a 30% interest in all issued and outstanding Class "A" preferred stock of Eldorado. One of the individual defendants, Cleverdon, informed National that Eldorado had enough Class "A" preferred stock to cover this percentage when Eldorado, in fact, did not and the defendants knew it. *Id.* at 406-07, 267 Cal. Rptr. at 786-87. In addition to Eldorado, five of its officers and directors were named as individual defendants, including Cleverdon. *Id.* There was not enough preferred stock due to an option agreement which granted the individual defendants the option of purchasing 70,000 of the 100,000 authorized but unissued preferred shares. At the time of the agreement, National had two of its own individuals as directors of Eldorado and subsequently found out about the secret option agreement in October, 1962. The issue focused on by the court was whether or not the three year statute of limitations applied as early as October of 1957, the date National managed to get two of its own onto the board, or whether the statute started running in October 1962 when National became aware of the secret options. *Id.* at 406-09, 67 Cal. Rptr. at 786-88. Suit was brought by National alleging, primarily, fraud and constructive fraud by the defendants. The court indicated that the information available to the two National directors in 1957 was enough to put them on notice of the option agreements and thus the statute started running at that point. *Id.* at 414, 67 Cal. Rptr. at 791. In so holding, the court examined old corporations code section 820 which, from their view point, encompassed the duty of care that must be satisfied by directors. In addressing the duty of care, the appellate court stated that directors "occupy a fiduciary relationship to the corporation and are bound to exercise that degree of care that men of common pru-

The court then attempted to reconcile the business judgment rule and the duty of care by indicating that in order for the rule to be applicable, directors must first satisfy the common law duty of care.[44]

2. The Business Judgment Rule

In relation to board decisions, pursuant to their statutory powers to manage, any allegations of bad faith or lack of due care must be judged under the aegis of the business judgment rule,[45] within which the common law duties of loyalty and due care are subsumed.[46] Under the business judgment rule, directors' management decisions may not be questioned unless facts can be brought forth alleging a violation of the duty of loyalty or due care by directors.[47] However,

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dence take of their *own* concerns." *Id.* at 413, 67 Cal. Rptr. at 790 (citation omitted) (emphasis added). The court used, as its authority for such a standard, Sheppard v. Wilcox, 210 Cal. App. 2d 53, 26 Cal. Rptr. 412 (1955), which indicates that this standard came from the common law. However, at least one commentator has repudiated this statement of the duty of care and indicated that the standard presented is not the one followed by the California courts. *See* Comment, *supra* note 5, at 620-21. The author asserts that *Sheppard* discussed the duty of loyalty and not the duty of care, indicating that National's reading of the case is inaccurate. *Id.* Furthermore, in *Burt,* the court stated that directors are held to an ordinary person standard and not to a standard which requires them to treat the corporation's interests as if they were their own. Besides these two cases, California courts have done very little to reconcile these different rules. However, the standard set in *National* is questionable at best and is not the standard followed by contemporary courts. Therefore, in the context of the business judgment rule, the courts now follow the standard set forth in *Burt,* which is codified in section 309. *See infra* notes 44-75 and accompanying text.

44. *Burt,* 237 Cal. App. 2d at 852-53, 47 Cal. Rptr. at 408. This is one of the first indications that the common law duty of care is incorporated into the business judgment rule. See infra notes 47-77 and accompanying text for a further discussion of the business judgment rule and the presumption in favor of the directors.

45. Even in the context of a loss to the corporation and its shareholders, if the directors' conduct satisfies the business judgment rule the courts will not interfere. HENN & ALEXANDER, *supra* note 6, at 661.

46. Beehan v. Lido Isle Community Ass'n., 70 Cal. App. 3d 858, 137 Cal. Rptr. 528 (1977). The court in *Beehan* stated that when the directors exercise their business judgment in *good faith,* courts would not substitute their own judgment. *Id.* at 865, 137 Cal. Rptr. at 531 (emphasis added). Thus, the business judgment rule encompasses the common law duty of loyalty with a presumption in favor of the directors. Under the common law duty of due care a director must exercise skill in making his decisions. *See supra* notes 32-43 and accompanying text. Similarly, under the business judgment rule there is no liability where the director acts in a way which he believes is good business judgment. *Beehan,* 70 Cal. App. 3d at 865, 137 Cal. Rptr. at 531. It is presumed that if directors act in a manner that they believe to be good business judgment, they have acted with the skill necessary to satisfy the business judgment rule.

47. Comment, *Business Judgment Rule: A Benchmark for Evaluating Defensive Tactics in the Storm of Hostile Takeovers,* 31 VILL. L. REV. 1439, 1447 (1986). This is the case in California as illustrated by the language used by courts deciding the issue: "Neither the court nor minority shareholders can substitute their judgment for that of

the facts alleged must constitute more than mere negligence on the part of directors. This can be seen in several exemplary cases.

a. *Duty of Loyalty and Due Care Under the Business Judgment Rule*

In *Marsili v. Pacific Gas & Electric Co.*,[48] the defendant, Pacific Gas and Electric Co. (PG & E), made a requested donation to Citizens for San Francisco (Citizen) of $10,000. This was based upon PG & E's study indicating that Proposition T, which Citizen was opposing, would be repugnant to PG & E's interests.[49] The court, in its discussion of directors' duties, stated that there were no allegations of bad faith on the part of the complainant,[50] and indicated bad faith would only arise when directors acted in such a way as to demonstrate that they had not kept the interests of the corporation paramount. This, in turn, would indicate a breach of their duty of loyalty to the corporation.[51] However, because this was a management deci-

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the corporation 'where its board has acted in *good faith* and used its *best* business judgment in behalf of the corporation.'" Marsili v. Pacific Gas & Elec. Co., 51 Cal. App. 3d 313, 324, 124 Cal. Rptr. 313, 320 (1975) (quoting Olsen v. Basin Oil Co., 136 Cal. App. 2d 543, 559-60, 288 P.2d 952, 962 (1955)). *See generally* 6 Z. CAVITCH, *supra* note 9, § 127.03[2][b][ii] (overview of business judgment rule); R. HAMILTON, THE LAW OF CORPORATION IN A NUTSHELL § 14.3 at 305-10 (1987) (general discussion of the business judgment rule); HENN & ALEXANDER, *supra* note 6, § 242 (business judgment rule discussion); Calfas, *supra* note 2, at 827-31 (discussing the impact of section 309 as enacted in 1977). In Delaware, gross negligence is required to breach the business judgment rule. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985) (class action brought by shareholders seeking recission of merger and in the alternative damages against the board of directors).

48. 51 Cal. App. 3d 313, 124 Cal. Rptr. 313 (1975). The case was heard based on a summary judgment entered in favor of the defendant corporation.

49. *Id.* at 315, 124 Cal. Rptr. at 317. Proposition T would prohibit construction of any building higher than 72 feet in San Francisco without prior voter approval. The board's rational for opposing Proposition T was that:

> (a) [Proposition T would] cause an increase in the tax rate applicable to the company's facilities and thus an increase in the taxes it would have to pay; and
>
> (b) interfere with present and future building plans of the company, including the construction of the Embarcadero Substation at Fremont and Folsom. The Executive Committee also considered that the adoption of Proposition T would have an adverse impact on the City of San Francisco; specifically,
>
> (a) by increasing taxes, the passage of Proposition T would have depressed business growth in the downtown area; and
>
> (b) by imposing an immutable proscription on building heights, the well reasoned and flexible programs for balanced urban growth contained in the Urban Design Plan wold have been frustrated and impeded.

Id. at 319, 124 Cal. Rptr. at 317.

50. *Id.* at 324, 124 Cal. Rptr. at 320.

51. *Id.* at 322-24, 124 Cal. Rptr. at 318-20. The court began with the basic premise that the board was statutorily granted the power to manage the corporation and was responsible for the determination as to whether or not a particular transaction is within the best interests of the corporation. The court then reasoned that "where . . . the board of directors reasonably concludes that the adoption of a ballot proposition would have a direct, adverse effect upon the business of the corporation, the board of

sion, the complainant had to allege facts which would overcome the presumption in favor of directors' management decisions and, absent such facts, the court could not substitute its judgment for that of the board.[52] From the language used by the court, facts necessary to allege a breach must be more than allegations necessary to satisfy the common law breach of the duty of loyalty. Consequently, there must be a substantial breach of loyalty on the part of the director.[53]

The court in *Burt v. Irvine Co.*[54] discussed the business judgment rule in the context of the duty of due care, stating that, not only do directors owe their loyalty to the corporation,[55] but that in the context of making business judgments they must exercise due diligence and care.[56] Although it used the same language as that defining the

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directors has abundant statutory and charter authority to oppose it [through a political contribution]." *Id.* at 324, 124 Cal. Rptr. at 319. The decision to make a contribution to the political campaign, if the directors consider it to be "incidental to [the corporation's] business purpose," is protected by the business judgment rule. *Id.* at 323-24, 124 Cal. Rptr. at 320.

52. *Id.* at 323-24, 124 Cal. Rptr. at 319-20. The court explained that "in the absence of express restrictions . . . [directors have] discretionary authority to enter into contracts and transactions which may be deemed reasonably incidental to [the corporation's] business purpose." *Id.* (quoting 6 FLETCHER, CYCLOPEDIA CORPORATIONS § 2486, at 314-15 (1968)).

53. *Id.* at 324-25, 124 Cal. Rptr. at 320. Although not specifically stated in the opinion, the language used evokes the implication. The court gives tremendous credence to the business judgment of the directors since they are the ones entrusted and have the information necessary to make such judgments. *Id.*

54. 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965).

55. The court stated that decisions by directors must be made:

> in good faith, [with the directors] reasonably believing them to be for the best interest of the corporation . . . Every presumption is in favor of the good faith of the directors . . . [and] a case must be made out which plainly shows that such action is so far opposed to the true interest of the corporation itself as to lead to the clear inference . . . that he must have acted with an intent to subserve some outside purpose . . . .

Id. at 852, 47 Cal. Rptr. at 407. Although the court uses language which connotates a general negligence standard, it is qualified by the court's explanation that allegations must show more. *Id.* at 852, 47 Cal. Rptr. at 407-08.

56. *Id.* at 852, 47 Cal. Rptr. at 407-08. The court's language is as follows: "Directors are not merely bound to be honest; they must also be diligent and careful in performing the duties they have undertaken." *Id.* at 852, 47 Cal. Rptr. at 407. The court further explained that:

> A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. 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.

Id. at 853, 47 Cal. Rptr. at 408. Two other cases can be used to support that same principle. In *Beehan v. Lido Isle Community Ass'n*, 70 Cal. App. 3d 858, 137 Cal. Rptr. 528 (1977), the court faced the issue of whether the director's refusal to enforce the by-common law duty of care, the court held that under the business judgment rule, facts must support a finding of more than mere negligence on the part of directors in order for liability to attach.[57]

b. *The Standard for Breach*

In analyzing breaches under the business judgment rule, some courts have held that there must be a factual showing of gross negligence on the part of directors before the aegis of the rule can be re-

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laws was in violation of the business judgment rule. *Id.* at 865, 137 Cal. Rptr. at 531. The trial court found no abuse. The appellate court affirmed, stating that:

> [w]here a board of directors, in refusing to commence an action to redress an alleged wrong against a corporation, acts in good faith within the scope of its discretionary power and reasonably believes its refusal to commence the action is good business judgment . . . a stockholder is not authorized to interfere with such discretion by commencing the action . . . .

Id. (quoting Findley v. Garrett, 109 Cal. App. 2d 166, 174, 240 P.2d 421, 426 (1952)). In Johnson v. Tago, Inc., 188 Cal. App. 3d 507, 233 Cal. Rptr. 503 (1986), shareholders who were former officers of Tago sought injunctive relief to prevent the management of Tago from conducting any business until a shareholders meeting was convened. *Id.* at 511-12, 233 Cal. Rptr. at 504. The trial court granted the injunction, along with another requested by the corporation, and stated that "all of the fees, costs, and expenses of proxy solicitation on either side [should] be paid by the corporation." *Id.* at 511-12, 233 Cal. Rptr. at 505. The court stated that proxy expenses are "authorized by either the board of directors or the shareholders. Judicial review is available, but confined to the issues of whether the expenses recompensed were reasonable and not ultra vires." *Id.* at 514, 233 Cal. Rptr. at 506. The court further held that "[t]he manner and objects for which a corporation spends its money are among the most vital and sensitive of its internal affairs, entrusted to its officers, directors and shareholders. This is an area courts do not enter absent illegality or demonstrated abuse of *reasonable business judgment*." *Id.* at 515-16, 233 Cal. Rptr. at 507 (emphasis added). In both *Beehan* and *Johnson*, the courts indicated that directors would not be held liable for good or reasonable business judgment. The exercise of such judgment presupposes that directors have used proper skill and care in making their decision. *See* Smith v. Van Gorkham, 488 A.2d 858 (Del. 1985). In that case, the court found directors liable for failure to consider all factors before voting on a decision. *Id.* at 873.

57. The court indicates this in its statement that "a case must be made out which plainly shows that such action is *so far opposed* to the true interest of the corporation itself as to lead to the *clear inference* that [directors acted in violation of their duty] . . . ." Burt v. Irvine Co., 237 Cal. App. 2d 828, 852, 47 Cal. Rptr. 392, 407 (1965)(emphasis added). The court further explained that with respect to the business judgment rule and the concept of negligence, "[t]here is no conflict between the two [standards]." When the courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. *Id.* at 852-53, 47 Cal. Rptr. at 408. It is interesting to note the court required that the judgment be (1) reasonably exercised, and (2) honest and unbiased. *Id.* Application of the first principle directly relates to the duty of care standard a director is held to. However, the second principle focuses more upon the director acting with the interests of the corporation in mind which, of course, triggers a duty of loyalty analysis. The court, at least in the language it uses, places a negligence standard upon the directors concerning the satisfaction of the duty of care and loyalty. Under Delaware law, "directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). In *Aronson*, the court elaborated by stating that "[h]aving become so informed, they must then act with requisite care in the discharge of their duties." *Id.*

moved.[58] This was illustrated in *Smith v. Van Gorkom*,[59] in which the Delaware Supreme Court expressed the quintessential standard for breach under the business judgment rule. In *Smith*, the court focused on the duty of care prong of the business judgment rule,[60] and found that the board of directors of Trans Union Corporation were grossly negligent in approving a merger after only several hours of presentation by the chairman.[61]

In *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,[62] the Second Circuit had occasion to discuss the *Smith* court's application of the standard for breach in terms of New York law. Hanson Trust PLC (Hanson) was in the market to acquire a corporation and SCM Corporation (SCM) was an ideal target.[63] However, SCM did not want to be acquired and found a "white knight" in the form of Merrill Lynch.[64] After various negotiations, it was agreed between Merrill Lynch and the board of SCM that the former would submit a tender offer in excess of that offered by Hanson.[65] Additionally, Merrill

58. *Id.* at 805. The court in *Aronson* found that "under the business judgment rule, director liability [was] predicated upon concepts of gross negligence." *Id.* at 812. For a discussion on the recent developments in Delaware law about the business judgment rule, see Note, *supra* note 23, at 631.

59. 488 A.2d 858 (Del. 1985).

60. *Id.* at 872-73. The court indicated that,"[s]ince a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing." *Id.* The complainant, if he wishes to hold directors liable for violations of their duty of loyalty, must make "allegations of fraud, bad faith, or self-dealing" on the part of the director. *Id.* Furthermore, the content of these allegations must be tantamount to gross negligence before the court will impose liability. *Id.*

61. *Id.* at 865-70. The facts surrounding this approval shed light on the egregious nature of the board's conduct. The chairman and Chief Executive Officer of Trans Union Corporation, Mr. Van Gorkom, concerned with the company's tax credit problem, sought to find a better solution than that of acquiring small companies. A leveraged buy-out by management was seen as a feasible alternative. However, because of the conflict of interest involved, this idea was vetoed and Van Gorkom alone decided that takeover was the most viable solution. He and one other member of the board then did the necessary calculations for a takeover by Jay A. Pritzker. After preliminary negotiations, Pritzker told Van Gorkom that the Trans Union Board had three days in which to reply. Van Gorkom called a special meeting of the board with only one day notice and the board agreed to the merger without looking at the merger agreement and with only oral presentations and deliberations lasting about two hours.

62. 781 F.2d 264 (2d Cir. 1986).

63. *Id.* at 268.

64. *Id.* at 268-69. A "white knight" is a "competing tender offeror who has either been invited by management or who is viewed by them more favorably than the original offeror." Kreider, *Corporate Takeovers and the Business Judgment Rule*, CORP. PRAC. COMMENTATOR 119, 129 (1988).

65. *Hanson Trust*, 781 F.2d at 269-71. Initially, Merrill Lynch submitted a $70 per

Lynch would be given a "lock-up" option to purchase two lucrative divisions of SCM in the event a third party acquired more than one-third of SCM's outstanding common stock.[66] In determining whether the board of SCM fell under the protection of the business judgment rule with respect to their negotiations with Merrill Lynch,[67] the court stated that directors must act both in good faith and with "reasonable investigation" with respect to takeover decisions.[68] It indicated that management decisions so exercised would fall under the business judgment rule.[69] Although the facts in *Hanson Trust* were not equivalent to the gross negligence exercised by the board of directors in *Smith*, the court nonetheless found that the complainant had alleged a prima facie violation by the directors of their duty of care under the business judgment rule.[70]

Looking at the discussion of the business judgment rule in *Hanson Trust*, similarities between the standard for breach under New York law and California law can be seen; both discuss the necessity of a showing of bad faith, self-dealing, or absence of reasonable diligence,[71] and both indicate that the presumption is in favor of corpo-

share bid in response to Hanson's $60 per share proposal. However, when Hanson offered $72 per share, Merrill Lynch and SCM commenced another round of negotiations resulting in Merrill Lynch submitting a bid of $74 per share. *Id.*

66. *Id.* at 270-71. Merrill Lynch was to have an irrevocable option to acquire two divisions of SCM—the two responsible for about 50% of SCM's net operating income—in the event a third party acquired one-third or more of SCM's outstanding common stock. *Id.* at 267.

67. *Id.* The court framed the issue as "whether it was proper under New York law for SCM and Merrill to execute a lock-up option agreement as part of a $74 offer by Merrill for SCM common stock." *Id.*

68. *Id.* at 273-74. This merely states New York law. In Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984), the court stated that "[a] board member's obligation to a corporation and its shareholders has two prongs, generally characterized as the duty of care and the duty of loyalty."

69. *Hanson Trust*, 781 F.2d at 273. The court explained that "[i]n evaluating this duty [of care], New York courts adhere to the business judgment rule, which 'bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.' " *Id.* (quoting Auerbach v. Bennett, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926,(1979)).

70. *Id.* at 275. "The actions of the SCM Board do not rise to that level of gross negligence found in *Smith v. Van Gorkom* .... [However,] the SCM directors' paucity of information and their swiftness of decision-making strongly suggest a breach of the duty of due care." *Id.*

71. In *Marsili*, the court stated that "[n]either the court nor minority shareholders can substitute their judgment for that of the corporation 'where its board has acted in *good faith* and used its best business judgment in behalf of the corporation.' " *Marsili*, 51 Cal. App. 3d at 324, 124 Cal. Rptr. at 320 (emphasis added). In *Burt*, the court elaborated further and stated that "[t]he rule exempting . . . [directors] 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*." *Burt*, 237 Cal. App. 2d at 845, 47 Cal. Rptr. at 407 (quoting 3 FLETCHER, CYCLOPEDIA CORPORATIONS § 1040, at 628 (1965)) (emphasis added). The court further explained that "[w]hen courts say that they will not interfere in matters of business judgment, it is presupposed that judg-

rate directors.[72] When the facts of *Marsili* and *Burt* are compared with those of *Hanson Trust* and *Smith*, the California courts do not seem to be making out a case for gross negligence. In *Burt*, the court imposed liability when, after considering other offers, the board went with one offer out of self-interest despite the fact that a higher price could have been obtained.[73] The directors ratified the president's (also a director) acceptance of the offer after an initial presentation.[74] In *Hanson Trust*, the Second Circuit found a breach of the duty of care when the board voted in favor of the leveraged buyout after only a few days of discussion and examination of scant information.[75] This type of conduct does not come close to that in *Smith*, wherein the courts found gross negligence based on the board's vote in favor of a merger after a twenty minute presentation by the chairman and two hours of deliberation.[76] While California courts have not specifically delineated such a standard, based on the similar language used by both California and New York courts and the fact that the *Burt* court found a breach of the business judgment rule on facts similar to those in *Hanson Trust*, it is reasonable to conclude that the standard for breach is somewhere between negligence and gross negligence.

C. *Corporations Code Section 309 as Enacted in 1977*

Section 309 was enacted to provide more specific guidance to directors in the exercise of their managerial duties.[77]

> (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

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ment—*reasonable diligence*—has in fact been exercised." *Id.* at 852-53, 47 Cal. Rptr. at 408 (emphasis added). Under New York law, the *Hanson Trust* court held that "the exercise of fiduciary duties by a corporate board member includes more than avoiding fraud, bad faith and self-dealing . . . the duty of due care requires that a director's decision be made on the basis of 'reasonable diligence' in gathering and considering material information." *Hanson Trust*, 781 F.2d at 274. The language used by both jurisdictions in defining the standard is quite similar. The Delaware courts use similar language as well. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985).

72. *Compare Burt*, 237 Cal. App. 2d at 852, 47 Cal. Rptr. at 407 ("Every presumption is in favor . . . of the directors") *with Hanson Trust*, 781 F.2d at 273 ("a presumption of propriety inures to the benefit of directors").

73. *Burt*, 237 Cal. App. 2d at 854-55, 47 Cal. Rptr. at 409.

74. *Id.* at 845-46, 47 Cal. Rptr. at 403. The president was entrusted with most of the dealings concerning the sale of the property to Sturtevant, to whom the property was ultimately sold to. *Id.*

75. *Hanson Trust*, 781 F.2d at 269-75.

76. *Id.* at 275.

77. *See supra* notes 8-25 and accompanying text.

corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.
(b) 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:
(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, or
(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.
(c) 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.[78]

Considered in isolation, the statutory language places two distinct duties upon directors: (1) to serve "in good faith, in a manner such director believes to be in the best interest of the corporation"[79] and (2) to act "with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."[80] However, directors may also "rely on information, opinions, reports or statements, including financial statements and other financial data" presented by others as specified within the statute.[81] Additionally, if directors conform to these duties, they will have no liability for "any alleged failure" on their part.[82] Although it can tentatively be assumed that both the duties of loyalty and care have been incorporated into the statute, further consideration must be given to determine whether these incorporations reflect the common law standard as encompassed in the business judgment rule.

1. The Business Judgment Rule and Section 309

Evidence that the business judgment rule is encompassed within section 309 is found in the code comments, which state that "a director should not be liable for an honest mistake of business judgment."[83] Additionally, several other sources indicate that section 309 codified the business judgment rule.[84] Judicially, this was shown in *Sanchez v. Grain Growers Association*,[85] where the court held that certain by-laws providing that an expelled member's interest in an

78. CAL. CORP. CODE § 309 (West 1977).
79. *Id.* § 309(a).
80. *Id.*
81. *Id.*
82. *Id.* § 309(c).
83. *Id.* § 309 (legislative committee comment).
84. *See infra* note 89.
85. 126 Cal. App. 3d 665, 179 Cal. Rptr. 459 (1981).

agricultural association be determined by the board of directors "[were] subject to tests of good faith and reasonable business judgment."[86] Here, section 309 was raised as a shield against director liability in defense of management decisions made by directors in good faith and according to their business judgment. Further support for this incorporation can be found in the recent California Supreme Court opinion of *Frances v. Village Green Owners Association.*[87] In *Frances*, the court stated that the business judgment rule was codified in section 7231 of the Corporations Code as the statutory standard of care which a director must exercise in performance of his duties to a corporation.[88] In a footnote, the court stated that section 7231 contained the standard of care defined in section 309.[89] Since both statutes are identically worded as far as defining the duties of a director, section 309 by implication also encompasses the business judgment rule. Several authoritative commentators have also taken this approach.[90]

As previously stated, the drafting committee modeled section 309 after section 35 of the MBCA,[91] which was intended to codify the case law development of the business judgment rule. The drafting committee drew heavily from section 35's comments, which were also based on the common law business judgment rule,[92] thus indicating their intention that section 309 encompass the business judgment rule.

Finally, support for the proposition that section 309 incorporated the business judgment rule comes from the fact that it is the converse of section 300,[93] a statute which gives power to manage the corporation to directors. The legislative committee comments to section

86. *Id.* at 675, 179 Cal. Rptr. at 460.

87. 42 Cal. 3d 490, 723 P.2d 573, 229 Cal. Rptr. 456 (1986).

88. *Id.* at 507, 723 P.2d at 582, 229 Cal. Rptr. at 465.

89. *Id.* at 506 n.13, 723 P.2d at 582 n.13, 229 Cal. Rptr. at 465 n.13.

90. 1 BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS § 102.01[1] (R. Clark ed. 1988)[hereinafter BALLANTINE & STERLING]; 1 FABER & NILES, HANDBOOK OF CORPORATION LAW 3D WITH FORMS 110-11 (1983)[hereinafter FABER & NILES]; 2 C. Friedman, California Practice Guide: Corporations ¶ 6:243 to 6:246 (1988); 1 H. MARSH, *supra* note 1, at 574-75.

91. *See supra* notes 12-16 and accompanying text.

92. *See supra* notes 13-16 and accompanying text.

93. CAL. CORP. CODE § 300(a) (West Supp. 1989). Section 300(a) provides that the "business and affairs of the corporation shall be managed and all corporate powers exercised by or under the direction of the board." *Id.*; *see supra* note 1 and accompanying text. The Delaware Supreme Court has held that their business judgment rule flows from the Delaware statute granting managerial powers to the directors. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985).

309 indicate that the statute provides the standard by which the actions taken by the board, pursuant to the power granted them in section 300, will be judged.[94] Since section 300 deals with the management of the corporation, the standard by which directors' actions are judged must also take into account the fact that it is made pursuant to the management power. The standard that does this is the business judgment rule.[95]

Section 309 further provides in part that directors "shall perform the duties of a director. . . with *such care*, including *reasonable inquiry*, as an *ordinarily prudent person* in a like position would under similar circumstances."[96] This language is not concerned with what a director would do with his own assets and the transposition of that degree of skill and care to his actions as a director; rather it focuses on the director in his role solely as a director.[97]

The language mirrors that used by the courts when applying the business judgment rule under a duty of care analysis. For instance, in *Burt v. Irvine Co.*,[98] basic director attributes are defined as "*ordinary* prudence and skill."[99] On the other hand, section 309 uses "*common* sense, *practical* wisdom and informed judgment."[100] Section 309 also builds upon the *Burt* language by allowing for added responsibility commensurate with directors' special backgrounds, qualifications, and other responsibilities, or lack thereof, in the management of the business and affairs of the corporation. Similarly, a

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94. CAL. CORP. CODE § 309 (West Supp. 1989). The actual language quoted in the committee comments is as follows:

> The purpose of this section is to establish a standard by which the performance of a director in the exercise of his duties shall be judged. It is intended that a person who performs his duties as a director in accordance with this standard shall have no liability by reason of being or having been a director.

Id. (legislative committee comment).

95. *See supra* notes 44-75 and accompanying text.

96. CAL. CORP. CODE § 309 (West Supp. 1989). The legislative committee comments, derived substantially from the 1974 proposed amendments to MBCA § 35, define "ordinarily prudent person," "under similar circumstances," "in a like position," and "reasonable inquiry." *Id.* An "ordinarily prudent person" shall possess, at the minimum "*basic* director attributes of common sense, practical wisdom and informed judgment." *Id.* (emphasis added). "[U]nder similar circumstances" is self explanatory but the comments indicate that it also recognizes that any special knowledge which a director might possess in relation to the management "of the business and affairs of the corporation" *may* increase the director's responsibility. CAL. CORP. CODE § 309 (West Supp. 1989) (legislative committee comments). The phrase "in a like position" merely indicates that the care which must be exercised is that of the director of that particular corporation at issue. *Id.*

97. *See id.*

98. 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965).

99. *Id.* at 852, 47 Cal. Rptr. at 408 (emphasis added).

100. CAL. CORP. CODE § 309 (West Supp. 1989) (legislative committee comments)(emphasis added). From this can be drawn an interpretation of subsection (a) which coincides with the common law duty of loyalty as stated in the *Burt* and not the *National Automobile* cases.

director might have more than the *basic* attributes as a result of working for a particular corporation. The standard, as stated in section 309(a),[101] is never lower than that of a reasonably prudent person since *basic* attributes are minimal by their very nature.

As previously mentioned, the business judgment rule encompasses both the duty of loyalty and care with a presumption of good faith and fair dealing in favor of directors.[102] Section 309, as enacted in 1977, states that a "director shall perform the duties of a director . . . in *good faith*, in a manner such director believes to be in the *best interests of the corporation*."[103] Courts have used this language to define the duty of loyalty under the business judgment rule; thus, this language is indicative only of the business judgment rule within the duty of loyalty context.[104]

101. *Id.* § 309(a).

102. *See supra* notes 44-75 and accompanying text.

103. CAL. CORP. CODE § 309 (West 1977) (emphasis added).

104. In Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979), the court stated that "where its board has acted in *good faith* and used its *best* business judgment in behalf of the corporation" the decision will not be changed. *Id.* (quoting Marsili v. Pacific Gas & Elec. Co., 51 Cal. App. 3d 313, 324, 124 Cal. Rptr. 313, 320 (1975) (emphasis added)). Additionally, the only major change between the language in old corporation code section 820 and section 309 was the substitution of "with a view to the interests" to "in the best interest." This change in the wording was probably not meant to be of any significance. Stern, *supra* note 2, at 1273-74 (the change "may have been more form than substance"). In fact, the California Supreme Court stated:

> [i]t is a cardinal principle of statutory construction that where legislation is framed in the language of an earlier enactment on the same or analogous subject, which has been judicially construed [to embody a certain principle of law], there is a very strong presumption of intent to adopt the construction as well [in the new statute]. . . .

Holmes v. McColgan, 17 Cal. 2d 426, 430, 110 P.2d 428, 430 (1941)(quoting Union Oil Assoc. v. Johnson, 2 Cal. 2d 727, 734, 42 P.2d 291, 295 (1935)). Further support can be drawn from the fact that section 309 embodies the business judgment rule principle of loyalty as well. However, an exception lies where there is a transaction "between a corporation and one or more of its directors, or between a corporation and any corporation, firm or association in which one or more of its directors has a material financial interest." In such case, section 310 preempts section 309 and the duty of loyalty embodied within section 309. Subdivision (a) of section 310 states :

> (a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm or association in which one or more of its directors has a material financial interest, is either void or voidable because such director or directors or such other corporation, firm or association are parties or because such director or directors are present at the meeting of the board or a committee thereof which authorizes, approves or ratifies the contract or transaction . . . .

CAL. CORP. CODE § 310(a) (West 1977). Section 310 provides for ratification of those transactions either through full disclosure of material facts to the shareholders, directors, or proof that the transaction was "just and reasonable". *Id.* § 310(a)(2). The legislative committee comment stated specifically that "[t]his section deals with conflicts of

2. Reliance on Others

The legislative committee comments indicate that subdivision (b) of section 309, "due to the number and complexity of the matters considered by directors, enlarges the right of reliance to encompass all matters for which the board is responsible and broadens the range of materials upon which a director may rely."[105] The code indicates that there are three different situations where a right of reliance by directors arises:

> (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, or
> (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.[106]

The legislature indicated that reliance on information provided by others is contingent on the director either reading written reported information or being present when the information was orally given.[107] Additionally, section 309(b) places an affirmative duty upon directors to make a reasonable inquiry regarding the information provided by others, as deemed necessary by the circumstances.[108] However, the comments state that the language cannot be interpreted as requiring a duty to make an inquiry all the time, but rather only when the information would cause one to suspect its validity.[109] Thus, "reasonable care under some circumstances could include a duty of inquiry . . . if [the director] is put on notice by the presence of suspicious circumstances . . . [causing] an ordinarily prudent person in [the director's] position [to make the inquiry]."[110]

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interest arising out of business transactions between a corporation and one or more of its directors or another organization in which such persons have an interest." *Id.* § 310(a)(legislative committee comment).

105. *Id.* § 309(b).

106. *Id.* One commentator indicates that the legislature did not intend to make these three provisions exclusive. BALLANTINE & STERLING, *supra* note 90, at 6-12 (4th ed. 1988).

107. CAL. CORP. CODE § 309(b) (West 1977) (legislative committee comment). The comment states:

> in order to be entitled to rely on such reports, statement, opinions and other matters, the director must have read, or been present at the meeting at which is orally presented, the report or statement in question and must not have any pertinent knowledge which would cause him to conclude that he should not rely thereon.

Id.

108. *Id.*

109. *Id.* (legislative committee comment).

110. *Id.* § 309(a) (legislative committee comment).

D. Corporations Code Section 309 as Amended in 1987

During the debates over the amendments to section 309, the legislature decided not to change its framework, but rather to keep it up to date with current case law of other jurisdictions, particularly in the mergers and acquisitions area.[111] Thus, the legislature decided to add the phrase "and its shareholders" in subsection (a) after "in a manner such director believes to be in the best interests of the corporation."[112] Although basically unchanged, it now provides an affirmative statement as to how directors must conduct themselves in situations where they exercise their management powers under section 300.[113] As with the 1977 statute, the business judgment rule applies in any context in which the director's exercise of business judgment is warranted. For example, it is used in situations where directors make political contributions,[114] decisions on whether or not to retain an attorney,[115] and in the conveyance of real property.[116]

111. Unterman, *supra* note 25, at 6.

112. CAL. CORP. CODE § 309 (West Supp. 1988).

113. *Id.* § 300.

114. Marsili v. Pacific Gas & Elec. Co., 51 Cal. App. 3d 313, 323, 124 Cal. Rptr. 313, 319 (1975). The court stated that "in the absence of express restrictions . . . [directors have] discretionary authority to enter into contracts and transactions which may be deemed reasonably incidental to . . . [the corporation's] business purpose." *Id.* (quoting 6 FLETCHER, CYCLOPEDIA OF CORPORATIONS § 2486, at 314-15 (1968)). The court went on to hold that "where . . . the board of directors reasonably concludes that the adoption of a ballot proposition would have a direct, adverse effect upon the business of the corporation, the board of directors has abundant statutory and charter authority to oppose it [by making a political contribution]." *Id.* at 324, 124 Cal. Rptr. at 319. The decision to make a contribution to the political campaign, if the directors consider it to be "incidental to [the corporation's] business purpose" is protected by the business judgment rule. *Id.* at 323-24, 124 Cal. Rptr. at 319-20.

115. Fairchild v. Bank of Am., 192 Cal. App. 2d 252, 13 Cal. Rptr. 491 (1961). The complaint alleged that the attorney retained by the bank, when the bank was appointed to a fiduciary position, was the same attorney who suggested that the bank be made the fiduciary in each particular case. *Id.* at 255, 13 Cal. Rptr. at 492. The court stated that "[t]he question of choice of counsel is a matter of the internal management of the corporation [*i.e.*, business judgment] and, in the absence of fraud, illegal or *ultra vires* acts, the courts will not interfere therewith." *Id.* at 257, 13 Cal. Rptr. at 493 (emphais added).

116. Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 274 P. 597 (1929). The complaint alleged that the assignment of real property owned by the corporation resulted in substantial loss to the corporation and its shareholders. *Id.* at 551-52, 274 P. at 598. The court stated that "[g]ood business judgment would seem to recommend the safe and sure plan which was adopted by the directors." *Id.* at 557, 274 P. at 600. Such a decision will be sustained by the courts absent "fraud, breach of trust, or transactions which are ultra vires."

1. Transactions Falling Under the Section 309 Business Judgment Rule Which Directly Affect Shareholders

With the addition of "and its shareholders" to section 309, shareholders are directly affected in three areas falling under the business judgment rule: derivative suits, mergers, and tender offers. Although section 309 supersedes the application of the common law business judgment rule doctrines, the basic common law business judgment rule concepts remain the same, thus retaining the theme of the statute. In order to more fully understand the changes that were made, however, it is necessary to examine these common law concepts in greater detail.

a. *Derivative Suits*

In a shareholder's derivative suit, the shareholder alleges an injury to the corporation and seeks to recover for damages.[117] A decision by the board on whether or not to pursue this cause of action is within its sound business discretion.[118] The primary rationale is that a civil suit for damages is a business question and thus a "matter of internal management and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders."[119] When the board decides that it is within the best business interests of the corporation not to pursue the action, there being no instructive vote by shareholders, a stockholder cannot commence or continue his own derivative action.[120]

One example of the application of the business judgment rule to derivative suits can be found in *Lewis v. Anderson*.[121] Here, Walt Disney Productions (Disney) created a stock option plan which favored key employees.[122] Because of this, two minority shareholders filed a derivative suit alleging that the option plan violated federal

117. Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 107, 460 P.2d 464, 470, 81 Cal. Rptr. 592, 598 (1969).

> The management owes to the stockholders a duty to take proper steps to enforce all claims which the corporation may have. When it fails to perform this duty, the stockholders have a right to do so. Thus, although the corporation is made a defendant in a derivative suit, the corporation nevertheless is the real plaintiff and it alone benefits from the decree; the stockholders derive no benefit therefrom except the indirect benefit resulting from a realization upon the corporation's assets.

Id. (quoting the RULES OF CIVIL PROCEDURE FOR THE U.S. DISTRICT COURTS, ADVISORY COMMITTEE NOTES, H.R. DOC. NO. 391, 89th Cong., 2d sess. 40 (1966)).

118. Lewis v. Anderson, 615 F.2d 778, 781 (9th Cir. 1979).

119. *Id.* at 782 (quoting United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917)).

120. *Id.* (citing Findley v. Barrett, 109 Cal. App. 2d 166, 174, 240 P.2d 421, 426 (1952)).

121. 615 F.2d 778 (9th Cir. 1979).

122. *Lewis*, 615 F.2d at 780.

securities laws.[123] The board of directors set up a "special litigation committee" to consider whether the action should be maintained, and after several meetings, and the advice of independent legal counsel, the committee decided not to pursue the claim.[124] The circuit court upheld the decision, reasoning that when directors use "their best 'business judgment' in making those decisions . . . [n]either the court nor minority shareholders can substitute their judgment for that of the corporation."[125] The court also stated that the business judgment rule does not apply "where the directors . . . stand in a dual relation which prevents an unprejudiced exercise of judgment."[126] In this case, the committee was made up of disinterested directors who made their own determination of the merits of the facts. Because there were no interested directors, the court went on to hold that "the good faith exercise of business judgment by a special litigation committee of disinterested directors is immune to attack by shareholders or the courts."[127] Since these types of decisions hinge upon directors' sec-

123. *Id.*

124. *Id.*

125. *Id.* at 781 (quoting Marsili v. Pacific Gas & Elec. Co., 51 Cal. App. 3d 313, 324, 124 Cal. Rptr. 313, 320 (1975)).

126. *Lewis*, 615 F.2d at 782 (quoting United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917)); *cf.* Parkoff v. General Tel. & Elecs. Corp., 53 N.Y.2d 412, 425 N.E.2d 820, 442 N.Y.S.2d 432 (1981) (business judgment rule does not bar inquiry into directors neutrality and investigation procedures). New York law is in accord with California law on this point. "[T]he business judgment rule does not foreclose judicial inquiry in cases such as this into the disinterested independence and good faith of the members of the special litigation committee and the adequacy and appropriateness of that committee's investigative procedures and methodologies." *Id.* at 417, 425 N.E.2d at 822, 442 N.Y.S.2d at 434.

127. *Lewis*, 615 F.2d at 783. A further example is *Burt v. Irvine Co.*, 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965), where the court stated that minority shareholders could maintain an independent action to recover property which had been disposed of pursuant to the "fraud or malversation of officers or directors." *Id.* at 851, 47 Cal. Rptr. at 407 (quoting Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 556, 224 P. 597 (1929)). When there is no fraud, breach of trust, or ultra vires, the business judgment rule applies in full force and "[e]very presumption is in favor of the good faith of the directors." *Id.* Before the business judgment rule can apply, it is necessary that the director has "exercised reasonable diligence" in gathering the necessary information in order to make the decision. *Id.* at 852-53, 47 Cal. Rptr. at 408. In this context, liability is predicated upon the breach of the standard of due care. Such due care may include reliance upon information furnished by others, but in either case the director is to engage in "reasonable inquiry" where needed. CAL. CORP. CODE § 309(a) (West Supp. 1989). Failure to exercise reasonable diligence will result in inapplicability of the business judgment rule and liability on the director for negligence. *Burt*, 237 Cal. App. 2d at 852, 47 Cal. Rptr. at 407-08. "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."

tion 300 managerial powers, section 309 preempts the common law business judgment rule.

b. Mergers

In *Eldridge v. Tymshare, Inc.*,[128] an appellate court considered the business judgment rule and its application to failures to disclose that merger negotiations had resumed. In *Eldridge,* Tymshare and McDonnell Douglas Corp. (McDonnell) entered into an agreement in which McDonnell would purchase Tymshare stock at $31 per share or exchange it for McDonnell's shares.[129] Prior to that agreement, the plaintiff Eldridge had purchased shares in Tymshare. McDonnell later withdrew from the merger discussions and sometime later plaintiff sold his shares for less than $25 per share.[130] About the time that the plaintiff sold his shares, McDonnell and Tymshare resumed the merger negotiations but the price per share was then $25.[131] After the agreement was made public,[132] Eldridge alleged, in part, that "the directors wrongfully rejected offers made by McDonnell in the course of merger negotiations at prices higher than" the final $25 per share.[133]

In response, the court stated that the board of directors "are best able to evaluate the numerous and often complex financial factors which must be considered in determining whether the takeover proposal serves the best interest of the corporation."[134] Thus, the directors of the target corporation are in the best position to make a determination as to whether to accept or decline a takeover proposition and will exercise their business judgment accordingly. "A plaintiff challenging a decision made in this context must be able to make specific allegations of malfeasance or bad faith. Where an improper motive is claimed, plaintiff must allege that it was the sole or primary reason for the directors' actions."[135] Absent these allegations, the directors' business judgment stands.[136] As previously stated, this area is now governed by section 309.

Calfas, *supra* note 2, at 831. Yet a causal relation between the negligence and the damages to the corporation still must be shown. H. MARSH, *supra* note 1, at 374.

128. Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 230 Cal. Rptr. 815 (1986).

129. *Id.* at 771, 230 Cal. Rptr. at 816.

130. *Id.* at 771, 230 Cal. Rptr. at 816-17.

131. *Id.* at 771, 230 Cal. Rptr. at 817.

132. *Id.*

133. *Id.* at 776, 230 Cal. Rptr. at 820.

134. *Id.* at 777, 230 Cal. Rptr. at 820 (quoting Enterra Corp. v. SGS Assocs., 600 F. Supp. 678, 686 (1985)).

135. *Id.* (citing Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980); Starbird v. Lane, 203 Cal. App. 2d 247, 21 Cal. Rptr. 280 (1962)).

136. *Id.*

c. Tender Offers

In *Jewel Cos. v. Pay Less Drug Stores Northwest, Inc.*,[137] Jewel entered into a merger agreement with Pay Less Drug Stores (Pay Less). This agreement included a clause requiring the board of directors of both companies to use their "best efforts" to get approval of the merger from their respective shareholders and prohibited acceptance of competing offers.[138] After the agreement was made public, Pay Less Drug Stores Northwest, Inc. (Northwest) began purchasing shares in Pay Less, followed by a public announcement of its intent to submit a tender offer in order to compete with the attempted acquisition by Jewel. The board of Pay Less concluded a merger agreement between Pay Less and Northwest and unanimously recommended the Northwest merger over the Jewel merger in a letter to shareholders.[139]

In response to this strategy, the Ninth Circuit held that "under California law a corporate board . . . may lawfully bind itself in a merger agreement to forbear from negotiating or accepting competing offers until the shareholders have had an opportunity to consider the initial proposal."[140] In doing so, the court reversed the district court's determination that any such contractual provision would violate the board's duty of loyalty towards the shareholders.[141] The court reasoned that although shareholders may lose an opportunity

137. 741 F.2d 1555 (9th Cir. 1984). Takeovers are defined as any "attempt to obtain control of a corporation by dealing directly with the owners of the corporation in their capacities as individual shareholders without securing approval of the management, the board of directors, or the shareholders as a group." Kreider, *Corporate Takeovers and the Business Judgment Rule*, CORP. PRAC. COMMENTATOR 119, 120 (1988). Mr. Kreider's article discusses the recent developments in case law regarding the business judgment rule and tender offers. *Id.* In defining the business judgment rule, Mr. Kreider states that "[a]ctions of directors will not be overturned by a court if those actions are taken by directors who (1) have no interest in the subject matter and (2) make an informed, rational judgment that (3) the directors reasonably believe is in the best interest of the corporation." *Id.* at 119-20. The author combines both a director's interest in the subject matter and acting in the best interests of the corporation under the single subject of loyalty.

138. *Jewel*, 741 F.2d at 1557.

139. *Id.* at 1559.

140. *Id.* at 1564 (footnote omitted).

141. Jewel Cos. v. Pay Less Drug Stores N.W., Inc., 510 F. Supp. 1006, 1011-12 (N.D. Cal. 1981), *rev'd*, 741 F.2d 1555 (9th Cir. 1984). The district court found that the directors' duty of loyalty to shareholders overrode any contractual duty to third parties where the shareholders' interest would increase as a result of any breach. *Id.* at 1011. The district court cited both Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952), and CAL. CORP. CODE § 309(a) (West 1977) as authority for its conclusion.

to receive a higher price for their shares with an exclusive merger agreement, such an agreement was not binding upon them because they possessed the ultimate decision on whether or not to accept the offer.[142] Additionally, the board had an affirmative duty, under the duty of loyalty, to disclose any information regarding more favorable competing offers.[143] Lurking in the background is the fact that the potential merger partner might be more willing to enter into a merger agreement which does not germinate into a bidding war for the corporation.[144] An exclusive merger may also lessen any costs which might result from any transactions concerned with hostile takeovers.[145] The court then concluded that because of the benefits to shareholders, duties owed to them by directors were not breached.[146] Thus, under the duty of loyalty, a board can enter into exclusive merger agreements but must also disclose competing offers. This was statutorily sanctioned by subsection (b) of section 1203, which requires target directors to disseminate third party proposals when an intracorporate offer is pending.[147]

2. Issuance of Dividends and Section 309

The issuance of dividends to shareholders is regulated under section 316 of the General Corporation Law. Directors will not be subject to joint and several liability for breach of the provisions in section 316 unless they first breach section 309.[148] Although distribu-

142. *Jewel*, 741 F.2d at 1564.

143. *Id.* The district court had taken this argument one step further and had stated that not only must the directors inform the shareholders of the proposal, but they must also refrain from entering into any exclusive agreement. *Jewel*, 510 F. Supp. at 1011. It also argued that such an agreement would inhibit the strong public policy of "maintaining freedom of action for shareholders when there still exists a competitive market for shares." *Id.*

144. *Jewel*, 741 F.2d at 1563.

145. *Id.* The court cited litigation and proxy expenses as two possible costs of hostile takeovers. *Id.*

146. *Id.* at 1564. Although there was no discussion of the reasonableness of actions taken by directors in response to negotiated or hostile tender offers, it must be noted that in other leading jurisdictions the reasonableness of the directors' actions are an integral part of the analysis under the business judgment rule. Kreider, *Corporate Takeovers and the Business Judgment Rule*, CORP. PRAC. COMMENTATOR 119, 125-36 (1988).

147. *See infra* notes 263-305 and accompanying text.

148. 1 H. MARSH, *supra* note 1, at 582. Section 316 provides that:

> (a) Subject to the provisions of Section 309, directors of a corporation who approve any of the following corporate actions shall be jointly and severally liable to the corporation for the benefit of all of the creditors or shareholders entitled to institute an action under subdivision (c):
>
> (1) The making of any distribution to its shareholders to the extent that it is contrary to the provisions of Sections 500 to 503, inclusive.
>
> (2) The distribution of assets to shareholders after institution of dissolution proceedings of the corporation, without paying or adequately providing for all known liabilities of the corporation, excluding any claims not filed by creditors within the time limit set by the court in a notice given to creditors under

tion of dividends is within the sound discretion of directors,[149] any violation of section 316 would indicate that they were not acting within the best interests of the corporation and the shareholders. Such an assumption rests upon the fact that, in general, liability under section 316 is hinged upon a distribution which puts the solvency of the corporation into jeopardy.[150] If the corporation is in peril, so are the shareholder's interest in the corporation. Thus, directors cannot, consistent with the duty of care owed to shareholders, issue dividends in violation of both section 309 and 316.

3. Common Law Concepts Affecting Shareholders

Arguably, the inclusion of "and its shareholders" in amended section 309 encompasses all doctrines relating to dealings with shareholders. However, this theory may not be viable in all cases. Although certain fiduciary doctrines such as the corporate opportunity doctrine, certain conflict of interest scenarios, and oppression of minority shareholders deal with conduct on the part of directors, upon examination, only shareholder oppression may be perceived as falling under the scope of section 309.

The corporate opportunity doctrine most often arises when directors, not acting in their official capacity, engage in conduct which is perceived as competing with the interests of the corporation, usually by acquiring for themselves opportunities which could arguably be considered opportunities into which the corporation could expand.[151]

> Chapters 18 (commencing with Section 1800), 19 (commencing with Section 1900) and 20 (commencing with Section 2000).
>
> (3) The making of any loan or guaranty contrary to Section 315.

CAL. CORP. CODE § 316(a) (West Supp. 1989). Sections 500 to 503 provide for the distributions of shares and junior shares only if certain conditions are met with respect to the corporation's retained earnings or assets and liabilities. *See id.* §§ 500-503. The rest of section 316:

> specifies in greater detail the persons who are entitled to sue, the amount of the damages recoverable, the right of the director to contribution or indemnification and some of the procedural details of an action based upon these specific wrongful actions authorized by the board, and the fact that the prohibitions themselves are absolute.

1 H. MARSH, *supra* note 1, at 582.

149. R. HAMILTON, THE LAW OF CORPORATIONS IN A NUTSHELL § 16.1 (1980).

150. *See supra* note 130.

151. Industrial Indem. Co. v. Golden State Co., 117 Cal. App. 2d 519, 256 P.2d 677 (1953). The court stated that:

> [g]enerally, it is held that the directors or officers of a corporation are not, by reason of the fiduciary relationship they bear towards the corporation and the stockholders thereof, precluded from entering into and engaging in a business enterprise independent from, though similar to, that conducted by the corpo-

In such instances, California courts apply the corporate opportunity doctrine, inquiring as to whether the directors usurped an opportunity that was "in the company's line of activities."[152] If the court answers this in the affirmative and determines that the corporation had the resources to pursue the opportunity, it will prevent directors from usurping the opportunity.[153] In sum, the doctrine deals with situations in which directors are not acting as directors but in their own personal capacity. Since section 309 is only applicable where directors exercise their management powers and not when they act for themselves alone, the corporate opportunity doctrine does not lend itself to inclusion under section 309.

In instances where directors deal with the corporation in their individual capacities, a conflict of interest arises on their part. On the one hand, they have a duty of loyalty to the corporation; on the other, they are not completely prohibited from conducting business in their individual capacities.[154] Although section 309 can be applied to these situations, the legislature has enacted section 310 to address this concern.[155] Under section 310, interested directors' conduct can be approved either by the rest of the board or the shareholders.[156]

With respect to dealings between minority shareholders and directors, the courts have also developed a separate doctrine as well. The California Supreme Court, in *Jones v. H.F. Ahmanson & Co.*,[157] held that when directors transact with minority shareholders, they must do so in good faith and with inherent fairness.[158] *Jones* has never

> ration itself, provided in doing so they act in good faith and do not interfere with the business enjoyed by the corporation.

Id. at 533, 256 P.2d at 686. However, there is difficulty in determining whether or not a director has been offered a corporate opportunity in his capacity as director or in his individual capacity. Courts in those instances resolve the doubt in favor of the corporation. 1 H. MARSH, *supra* note 1, at 627.

152. *Industrial Indemnity*, 117 Cal. App. 2d at 533, 256 P.2d at 686. The court explained that "it has been generally accepted that a corporate officer or director may not seize for himself to the detriment of his company business opportunities in the company's line of activities which the company has an interest and prior claim to obtain, and that if he seizes them in violation of his fiduciary duty the corporation may claim for itself all benefits so obtained by him." *Id.*

153. *Industrial Indemnity*, 117 Cal. App. 2d at 519, 256 P.2d at 677, *cf.* New v. New, 148 Cal. App. 2d 372, 389, 306 P.2d 987 (1957) (finding no corporate opportunity).

154. 1 H. MARSH, *supra* note 1, at 594-98.

155. CAL. CORP. CODE § 310 (West 1977).

156. *Id.* § 310(a)(1)-(2).

157. 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

158. *Id.* at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602. Prior to *Jones*, when directors dealt directly with shareholders, case law mandated that "[w]here special facts exist which make it inequitable for the director to withhold information, a duty to disclose arises." 6 B. WITKIN, SUMMARY OF CALIFORNIA LAW § 88 (8th ed. 1974); *see also* BALLANTINE & STERLING, *supra* note 91, 102.03[2]. Although not exactly falling within a strict interpretation of the director's duty of loyalty, this "special facts" rule flows from the duty of loyalty. Shareholders have an interest in the corporation by virtue of ownership of stock and when this interest is affected by the actions of the directors, a

been overruled and is still binding in this area. However, because section 309 purports to govern the conduct of directors when they are acting within their managerial scope, there is a strong indication that section 309 would preempt this area. Support for this idea can be found in the statute's legislative committee comments, which state that section 309 was exclusively intended to define the standard of care directors must use in exercising their managerial powers under section 300.[159] Thus, oppression of minority shareholders is likely to be governed by section 309.

duty of loyalty arises on the part of the directors to the shareholders. *See supra* notes 31-38 and accompanying text. When directors transact directly with shareholders for their shares, courts hold that there is also a fiduciary duty owed by the director. The rationale being that, once again, the shareholder's interest is affected, only this time by a direct transaction between directors and shareholders. "The confidential relationship arises as a result of the officer's possession of special knowledge gained in his capacity as a corporate fiduciary." Hobart v. Hobart Estate Co., 26 Cal. 2d 412, 433, 159 P.2d 958, 970 (1945). Because the shareholder does not possess that special knowledge, he could be induced to enter into transactions that he would not consider to his advantage if he did possess the special knowledge. Thus, case law mandates that when a director buys or sells to a shareholder, he must "inform him of those matters relating to the corporate business of which the officer has knowledge and which the shareholder has a right to know about, so that the latter may have the benefit of such information in judging the advantages of the deal." *Id.*; *see, e.g.*, Haussler v. Wilson, 164 Cal. App. 2d 421, 427, 330 P.2d 670, 674 (1958); Taylor v. Wright, 69 Cal. App. 2d 371, 159 P.2d 980 (1945). In Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969), the court held that majority shareholders owed a "duty of good faith and inherent fairness to the minority" shareholders in transactions dealing with the sale or transfer of stocks. *Id.* at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602. This case was brought by a minority shareholder, on behalf of all minority shareholders of the United Savings and Loan Association of California (United), for breach of fiduciary duty by the majority shareholders. The majority shareholders had formed United Financial Corporation of California (Financial), a holding company which owned 87% of the outstanding stock of United. Transactions in the publicly offered shares of Financial were brisk while sales of United shares decreased during that same time frame. The plaintiff alleged that the majority shareholder's machinations "rendered [United] stock unmarketable except to . . . Financial, and then refused to either purchase plaintiff's [United] stock at a fair price or exchange the stock on the same basis afforded to the majority." *Id.* at 105, 460 P.2d at 469, 81 Cal. Rptr. at 597. Plaintiff alleged that the conduct of the majority shareholders breached the fiduciary duty owed by them to minority shareholders. *Id.* The "special facts" rule was discarded in favor of a rule giving more protection to minority shareholders. *Id.* at 111-12, 460 P.2d at 473-74, 81 Cal. Rptr. at 601-02; BALLANTINE & STERLING, *supra* note 90, § 102.03[2], at 6-17. This rule applies not only to majority shareholders, but to directors and officers as well. *Jones*, 1 Cal. 3d at 110, 460 P.2d at 472, 81 Cal. Rptr. at 601. Thus, directors also owe a duty of loyalty to minority shareholders in the context of direct transactions between directors and minority shareholders.

159. *See supra* note 1 and accompanying text.

4. Reliance on Others and Limitations of Liability

Section 309(b) as enacted in 1987 contains a notable change from the 1977 statute.[160] It would seem that the legislature is now making it obvious that a director need not rely on all three opinions, but on any one of them so long as "the director acts in good faith, after reasonable inquiry when the need therefore is indicated by the circumstances."[161]

Under subsection (c) of 309, a director's monetary liability can be limited by section 204.[162] Section 204 speaks of limitation of liability provisions within the articles of incorporation themselves. Thus, directors cannot automatically create these limitations of liability provisions, they must be voted in by the shareholders. It must also be noted that subdivision (10) of section 204 sets out eight qualifications to any such provision. These qualifications cover all the duties set forth in section 309 as well as section 310 and 316.[163]

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160. CAL. CORP. CODE § 309(b) (West Supp. 1989). The 1977 statute stated in part:

> (b) 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:
>
> (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, or
>
> (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.

CAL. CORP. CODE § 309 (legislative committee comments) (West 1977). In contrast, the 1987 amendment states "(b) 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* . . . ." The rest of the statute remains unchanged. Because the legislative committee comments remain the same in both versions, with no manifestation of intent otherwise, it can be assumed that the prior interpretation under the 1977 statute is valid for the 1987 amendments as well. A word for word comparison of the comments relating to subdivision (b) will indicate no change in the language at all.

161. CAL. CORP. CODE § 309(b) (West Supp. 1989).

162. *Id.* § 204. The pertinent part states:

> The Articles of incorporation may set forth:
>
> (a) Any or all of the following provisions, which shall not be effective unless expressly provided in the articles: . . . .
>
> (10) Provisions eliminating or limiting the personal liability of a director for monetary damages in an action brought by or in the right of the corporation for breach of a director's duties to the corporation and its shareholders as set forth in Section 309.

Such a provision, resulted from the legislature's concern over the inability of directors to obtain liability insurance. A.B. 1530, 1987-88 Leg., Reg. Sess. § 6.

163. CAL. CORP. CODE § 204(a)(10) (West Supp. 1989).

III. CALIFORNIA CORPORATIONS CODE SECTION 1203

Although section 309 promulgates the standards which directors must follow in the exercise of their section 300 managerial powers, there are certain instances in the corporate arena which require more specific guidelines. This is most notable in merger and takeover situations, where target directors are faced with significant conflict of interest problems. Section 309 may not provide sufficiently specific guidelines to effectively aid directors in these circumstances. It appears that the California Legislature has remedied this problem with the enactment of section 1203. This section can be viewed as the necessary corollary to section 309 in the context of mergers and takeovers.

With the number of corporate reorganizations on the rise,[164] the problems that accompany their effectuation have come under greater scrutiny from target shareholders,[165] third-party bidders, and legislatures alike.[166] Due to their often intimate involvement in these transactions, target directors[167] in particular have been singled out as perpetrators of the abuses which shareholders often face.[168] With an acknowledged lack of useful tools in California to check these abuses,

164. *The Top 200 Deals*, BUS. WEEK, Apr. 17, 1987, at 276; L.A.D.J., May 20, 1987, at 1, col. 6 (nationwide, there were 3,300 takeover deals in 1986 measuring $276 billion in value, as compared to $10 billion in 1975); *see also*, *The Top 100*, MERGERS & ACQUISITIONS, May-June 1987, at 47 (buyouts in particular have reached a zenith in recent years). In California, a number of recent reorganizations have attracted wide attention. These include First Interstate's attempt to wrest control of Bank of America, Chevron's takeover of Gulf Oil, American Airlines purchase of AirCal, and Wells Fargo's acquisition of Crocker Bank. San Francisco has recently lost 23 of its top 50 corporate headquarters in the takeover boom. L.A.D.J., May 20, 1987, at 1, col. 6.

165. This article refers to all shareholders entitled to vote on a merger or sale-of-assets transaction as "target shareholders."

166. In California, State Senator Dan McCorquodale, in particular, has advocated the need for greater corporate takeover regulation to protect target shareholders. Senator McCorquodale chaired the Committee on Corporate Governance and Takeover Laws (the Committee) which initiated discussions on the subject in the summer of 1986. The Committee included representatives from NASEC and the SEC among others, and was primarily concerned with the takeover problems that California shareholders and directors face and a law limiting liability for corporate directors. L.A.D.J., May 20, 1987, at 1, col. 6.

167. This article refers to "target directors" as those of the acquired or disappearing corporation. Because of the nature of intracorporate restructurings, the directors of the disappearing corporation often become the equity owners of the acquiring or surviving corporation.

168. Senator McCorquodale's view of California shareholders embodies retired persons, unskilled in corporate affairs, whose fortunes are dictated by the whims of tough management teams, and who are particularly vulnerable to takeover situations. L.A.D.J., May 20, 1987, at 1, col. 6.

it was recognized that some legislative action was needed.[169] The enactment of section 1203 in 1987 indicated the California Legislature's intent to protect corporate shareholders by delineating more fully target directors' responsibilities to the equity owners of the corporation in intracorporate reorganizations.[170] Known in embryonic form as Senate Bill 1464,[171] the statute was unanimously passed by both the State Assembly and the State Senate in September, 1987, without any amendments attached,[172] thus demonstrating an unusual willingness on the part of California legislators to support the basic premise of the bill. After becoming effective on January 1, 1988, section 1203 was amended seven months later as part of a 'clean up' effort to remove some of the ambiguity surrounding the statute as originally enacted.[173]

Although accompanied by little legislative history, the statute's *raison d'être* becomes clear upon a closer examination of the intracorporate reorganizations to which it applies, as well as the abuse target shareholders often experience in their effectuation. After considering these abuses, the statute itself will be dissected, proceeding first with the fairness opinion requirement, followed by subdivision (b) and its mandate to encourage competition among bidders. In sum, section 1203 can be seen as an effort to provide target shareholders with greater protection in corporate control contests, as well as giving guidance to directors in performing their fiduciary duties in these situations.

169. While initially there was some question as to which side the state should support in corporate control contests, the enactment of section 1203 indicates that the verdict has gone to the shareholder. One of the rationales for the legislature's delay in enacting these types of measures was the fear that the entire issue of reorganization legislation was preempted by the William's Act. This provision amended the Securities Exchange Act of 1934 by adding 13(d) and (e), and 14(d), (e), and (f) for the purpose of regulating takeovers to protect investors from heavy-handed purchasing tactics. However, in CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987), in which an Indiana corporate takeover statute was upheld, the Court determined that state statutes concerning tender offers and takeover issues do not necessarily conflict with federal regulation of interstate commerce or the William's Act. In so ruling, the Court paved the way for the California Legislature to provide greater protection than shareholders enjoy under federal law. L.A.D.J., May 20, 1987, at 1, col. 6; *see also SEC Pre-Emption Idea Gets Plaudits,* NAT'L L.J., Oct. 5, 1987, at 2, col. 2 (after the Court's decision in *CTS*, nine states have enacted antitakeover statutes). Even those preferring less restriction in corporate transactions acknowledge that California has an interest in regulating takeovers. *Id.*

170. *See supra* notes 73-110 and accompanying text.

171. In addition to creating section 1203, Senate Bill 1464 amended section 181 which defines reorganizations in California. Specifically, section 181(b) was altered to include as stock-for-stock exchange reorganizations, those in which the acquiring corporation at the time of the effectuation, does not have control of the acquired corporation.

172. S.B. 1464, 1987-88 Leg., Reg. Sess. § 2.

173. The clean up effort not only explained in greater detail the procedures under which section 1203 is to be applied, but also altered several key points.

Briefly, the current form of section 1203 addresses the duties of intracorporate persons, and directors in particular, in reorganizations and sale-of-assets transactions. Divided into two parts, the statute seeks to obtain a fair price for target shareholders in a corporate sale by shielding them from unfair proposals and anti-competitive measures by inside parties. The first part of section 1203 encourages this by requiring that all "interested party" bidders provide an independent opinion indicating that their offer is fair and equitable to target shareholders.[174] The statute defines an "interested party" as one who not only appears as a party in the transaction, but is also either: (1) directly or indirectly in control of the target corporation;[175] (2) an officer or director of the target;[176] (3) directly or indirectly controlled by an officer or director of the target;[177] or (4) an entity in which a director or executive officer[178] of the target holds a material financial interest.[179] Second, subdivision (b) attempts to protect shareholders by preventing the consummation of intracorporate bids until they have been able to vote on or consider a pending third-party offer.[180]

While portions of section 1203 are applicable to non-directors, it clearly focuses on those with a fiduciary relationship to shareholders, most notably, target directors. The first part of section 1203 extends this to interested directors, those who have a stake in the proposed transaction, while subdivision (b) applies to both interested and disinterested directors.[181] Before discussing the statute in depth, this arti-

174. CAL. CORP. CODE § 1203 (West Supp. 1989).
175. *Id.*
176. *Id.*
177. *Id.*
178. *Id.*

> [A]n executive officer means the president, any vice president in charge of a principal business unit, division, or function such as sales, administration, research or development, or finance, and any other officer or other person who performs a policymaking function or has the same duties as those of a president or vice president.

Id.

179. *Id.* The term "material financial interest" is ambiguously defined in corporations code section 310(a). This section provides only that a "material financial interest" does not include a mere common directorship, nor is a director "interested" when involved in a resolution fixing the compensation of another director in their duties as a director, officer or employee of the corporation concerned, even though the aforementioned director is receiving compensation from the corporation as well. *Id.* § 310(a).

180. CAL. CORP. CODE § 1203(b) (West Supp. 1989).

181. In this article, the term "interested director" indicates one who is a director of the target corporation, as well as one having a personal stake in the reorganization or sale-of-assets transaction involved. Frequently, this term is synonymous with that of "inside director," which is defined as one who, in addition to being part of a management team and having a seat on the target board, is also often involved in an intra-

cle will examine the problems target directors face in takeover situations, most notably, their inherent conflict of interest. This problem, in particular, can be viewed as an impetus for the amendment of section 309, as well as the enactment of section 1203.

A. *Directors' Conflict of Interest*

By definition, the directors' duty of loyalty requires that they place the corporation and the interests of its shareholders first, rather than their own.[182] Adherence to this duty becomes problematic in reorganizations and sale-of-assets transactions when directors have a personal interest in the venture, for not only are they bidders for the corporation's shares, but they are also the body recommending the acceptance of that bid to the target shareholders.[183] Although their primary responsibility is to consider shareholders' interests first,[184] inside directors can make a greater profit by obtaining target shares for a low price. It is this situation that places them in a fiduciary quagmire: if they offer shareholders their own estimation of the securities value, their ultimate profit will be reduced, however, by making a lower bid, they appear to breach their duty of loyalty to the target shareholders.[185] Because of the tendency of inside directors to choose the latter path, all other involvements in intracorporate reorganizations become tainted from the 'fairness opinions' that normally accompany their proposals[186] to defensive actions taken to thwart third-party bidders.[187] At this point, they are faced with the bottom line challenge of whose interests are they really serving—the shareholders or their own?[188] Other criticisms of intracorporate reorgani-

corporate reorganization. *See* HENN & ALEXANDER, *supra* note 6, § 204. For the sake of continuity, the terms "interested director" and "inside director" will be used interchangeably. The term "disinterested director" will indicate one who is a director of the target corporation, but has no personal stake in the venture. This term is often synonymously used with that of "outside director."

182. This reflects the common law duties of care and loyalty. *See* Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965).

183. Under California law, approval of a proposed merger is required by the board of directors as well as the shareholders. Moreover, a board has the unilateral power to abandon a merger proposal. *See* CAL. CORP. CODE §§ 1200, 1201 (West 1977 & Supp. 1989).

184. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (when directors sit on both sides of the transaction, they have the responsibility to demonstrate the utmost good faith and fairness in the bargain). Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. Super. Ct. 1986) (directors are responsible for obtaining the highest price possible for shareholders when the target is for sale). Directors often argue that while they have a fiduciary responsibility to shareholders, they must also look after other constituencies as well, which include employees, creditors, local residents, and the communities in which the corporate interests are located.

185. *See infra* notes 31-37 and accompanying text.

186. *See infra* notes 33-35 and accompanying text.

187. *See infra* notes 117-120 and accompanying text.

188. *See* Crane Co. v. Harsco Corp., 511 F. Supp. 294, 305 (D. Del. 1981) (citing Ben-

zations tend to mirror this conflict.

1. Amount of the Proposal

Inside directors' conflict of interest becomes most pronounced in the amount of consideration they bid for the target shares. Because the decision to make an initial reorganization proposal normally arises when the target is undervalued,[189] shareholders argue that this figure should represent the offeror's actual estimation of their shares' worth.[190] In reality, the initial bid, while above the market price,[191] will normally be less than the offeror's actual estimation.[192] This, cry shareholders, violates directors' primary duty to place shareholder interests first. There is some justification for this argument,[193] and it has posed serious problems for directors desiring to make a profit in reorganizations, who are nevertheless fearful of

nett v. Propp, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (1962)) (there is an inherent conflict of interest for directors participating in a stock purchase within the context of a tender offer); Brudney, *A Note On Going Private*, 61 VA. L. REV. 1019, 1029-30 (1975) (taking corporations private forces fiduciaries into a classic self-dealing environment); *See also* Address by Commissioner A.A. Sommer, Jr., *"Going Private": A Lesson in Corporate Responsibility*, at The Notre Dame Law School, November, 1974, *reprinted in* Sec. Reg. & L. Rep. (BNA), No. 278, at D-3-4 (management buyouts present a clear example of a director's conflict of interest).

189. *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 323-25 (1974).

190. This argument is countered by interested directors who claim that if the price paid to target shareholders is above the market price, it is fair and equitable. This has been refuted by others as shortchanging the shareholders' negotiating position which should allow them to bargain with a knowledge of where the bid lies in the range of offering prices the purchasing group is willing to pay. Note, *Management Buyouts: Creating or Appropriating Shareholder Wealth*, 41 VAND. L. REV. 204, 256 n.170 (1988); *see also* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. Super. Ct. 1983) (subsidiary directors were found to violate their fiduciary duties by not disclosing the true price the target was worth to the parent company).

191. *See* Jensen & Ruback, *The Market for Corporate Control*, 11 J. FIN. ECON. 5, 9-16, 39-40 (1983).

192. This identifies a Reservation Price, one that the bidder is ultimately willing to pay but does not want to disclose so that the selling shareholders will tender at the initial price. *See, e.g.,* Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986).

193. Shareholders maintain that if the reservation price more accurately shows the figure at which the buyer feels the company is ultimately worth, directors have a duty to make this bid up-front. The contrary argument is that inside directors will lose their incentive to participate in buyout transactions because the disclosure of their reservation price will reduce their ultimate profit. Thus, the benefits that buyouts offer will be unavailable to target shareholders. Moreover, inside directors will have more of an incentive to cheat by creating false reservation prices through fraudulent documentation. *See* Note, *supra* note 190, at 245.

breaching their fiduciary duties.[194]

Inside directors have attempted to alleviate the visibility of this fiduciary conflict in several ways. First, they have argued that their initial bid does represent the ultimate price they are willing to pay for the target shares. However, if this is untrue, it is ultimately exposed when a third-party bidder makes a higher offer and the inside directors respond with a more competitive bid of their own, thus indicating that their initial proposal was not intended to be their final one.[195] Second, inside directors often try to convince target shareholders of the reasonableness of their bid through the use of appraisals stating that their bid is fair and equitable. These appraisals[196] are regularly provided by investment bankers[197] whose neutrality in assessing the value of the bid is considered suspect, since they often stand side by side with inside directors as participants in buyout transactions.[198] This fact often translates into made-to-order recommendations which are no more valuable than if the inside directors produced them on their own.

2. Inside Information

Inside directors also face conflict of interest questions regarding their use of inside information with which they formulate their proposals.[199] Because these fiduciaries normally remain in power for a

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194. *Id.*

195. This is illustrated in the buyout of National Gypsum, Inc. Management made an initial offer of $1.1 billion which was 30% above the market price. This was countered by Wickes own offer of $1.46 billion. Thereafter, management raised its bid to $1.64 which was a 50% increase over its initial bid. Gogel, *Corporate Restructuring*, MGMT. REV., July 1987, at 31.

196. These opinions are normally provided to calm target shareholder's fear of unfair management bids. Their credibility is categorically low, however, and some commentators have suggested that they are, in reality, a deceptive practice aimed at the public and the marketplace in general. Stein, *Investment Banking's Dirty Little Secret,* N.Y. Times, June 8, 1986, at K2, col. 3; *see also* McGough, *Fairness for Hire*, FORBES, July 29, 1985, at 52.

197. Investment bankers play a major role in corporate reorganizations, providing large, short-term loans with which the recipients make tender offers. *See* Edelman v. Fruehauf Corp., 798 F.2d 882, 884 (1986) (Merrill Lynch put up $375 million of the buyout funds, while the target's participating directors contributed $100 million). These groups as well as providing price evaluations, also help in securing financing, issuing new securities, structuring bids, and developing defensive strategies. *See* Note, *supra* note 183, at 211.

198. *See Merrill Lynch Leads Wall Street's Buy-Out Business*, Wall St. J., Aug. 5, 1987, at 6, col. 1; *Deep-Pocketed Deal Makers*, N.Y. Times, Apr. 14, 1987, at D1, col. 1. Some have even assessed that the recent frequency in merger activity is attributable to investment bankers attempting to garner large fees. *Investment Bankers Feed a Merger Boom and Pick Up Fat Fees*, Wall St. J., Apr. 2, 1986, at 1, col. 6.

199. Because of their fiduciary relationship, target directors are required to disclose all material facts involved in the transaction. *See, e.g.,* Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985) (citing Lynch v. Vickers Energy Corp., 383 A.2d 278, 279 (Del. 1978)). "[C]orporate directors owe to their stockholders a fiduciary duty to disclose all

period of time after an intracorporate reorganization, their rationale for initiating these transactions appears to be based on an interpretation that the corporation's assets and earning power with the existing management personnel intact, exceed its market value as identified in the share prices.[200] Critics contend that this can only come through the procurement of inside information,[201] the use of which violates SEC rules prohibiting insider trading.[202] Moreover, they maintain that the use of information regarding the value and future earnings of the company is prejudicial to third-party bidders who do not have similar access.[203] Finally, these critics contend that directors have the ability to color the information that is disclosed, either to calm angry shareholders or to extinguish any potential interest from third-party bidders,[204] and to time the use of this information opportunistically, allowing inside directors to buy at lower prices.[205]

The landmark Delaware case of *Weinberger v. UOP, Inc.*[206] demonstrates how directors' use of inside information results in prejudice to target shareholders. Weinberger involved a cash-out merger between UOP, Inc. and its parent and majority owner, Signal Compa-

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facts germaine [sic] to the transaction at issue in an atmosphere of complete candor." *Id.*

200. *See* Note, *supra* note 190, at 217.

201. Note, *Corporate Morality and Management Buyouts*, 41 WASH. & LEE L. REV. 1015, 1016 (1984) (the general public does not have access to information concerning the value and future earnings of public companies); Thomas, *A Free Ride for Management Insiders*, N.Y. Times, Jan. 22, 1984, at D2, col. 1 (management has in their exclusive possession the figures that indicate the corporation's real value and earnings).

202. Securities & Exchange Act of 1934, 15 U.S.C. § 78p(b) (1976) (prohibiting inside persons from trading on information not generally available to public shareholders for personal gain); *See* Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 475 (9th Cir. 1961) (insider trading constitutes a fiduciary breach).

203. Directors contend that predictions as to the firm's future earnings and value are simply "soft information" which tends to be more misleading than beneficial to shareholders, and that they are not required to disclose it as such. This is buoyed to some extent by the SEC's position. Initially, the Commission concluded that "predictions as to specific future market values, earnings or dividends" may be misleading when included in proxy statements. Exchange Act Release No. 5276 (Jan. 30, 1956). This position was later criticized, and the Commission has taken somewhat of a middle ground by adopting rule 175, which provides a "safe harbor" for "forward-looking statements" which are made in good faith. *See* 17 C.F.R. § 230.175 (1985); Safe Harbor Rule for Projections, Exchange Act Release No. 6084 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (June 25, 1979).

204. *E.g.*, Dolgow v. Anderson, 438 F.2d 825, 828 (2d Cir. 1971) (directors are not allowed to use inside information for personal gain).

205. *See* Note, *supra* note 190, at 218 (The timing may involve information which indicates that the corporation will experience better fortunes in the future; encouraging directors to bid now).

206. 457 A.2d 701 (Del. Super. Ct. 1983).

nies, Inc. (Signal).[207] Prior to the merger's effectuation, Signal delegated two of its representatives on UOP's board to determine the feasibility of purchasing the remaining UOP shares.[208] Although they concluded that these shares would be a good investment for Signal at any price up to $24 per share,[209] this information was never disclosed to UOP's shareholders, who eventually sold their shares for $21 each.

The Delaware Supreme Court stated that it was prejudicial for UOP's shareholders not to be privy to the information contained in the feasibility study. Moreover, use of the feasibility study by UOP's inside directors for the exclusive benefit of Signal was a breach of Signal's fiduciary duty to UOP's shareholders.[210] In suggesting how to resolve these difficulties in the future, the court stated that the appointment of an independent negotiating committee of outside directors to deal with buyers at arm's length would be "strong evidence that the transaction meets the test of fairness."[211]

In *Weinberger*, the court determined that the conflict of interest problem could have been somewhat neutralized by the use of an independent negotiating committee to deal with Signal at arm's length.[212] A similar remedy appears to have been envisioned by the California Legislature when it enacted section 1203. This statute attempts to minimize the effect of the conflict of interest that inside directors face as offerors in corporate reorganizations. First, by requiring that a non-affiliated party attest to the fairness of the intracorporate bid, and second, by encouraging competition among bidders for the target shares.[213] In this way, directors are given more specific guidance in takeover situations, potentially decreasing the likelihood of a breach of their duty of loyalty to target shareholders. Additionally, the shareholders are protected by this arrangement because they are likely to receive higher prices for their shares.

207. *Id.* at 703.
208. *Id.* at 705.
209. *Id.*
210. *Id.* at 710-11.
211. *Id.* at 709-10 & n.7.
212. *Id.*
213. The purpose of section 1203 was to make the environment surrounding an interested party proposal a fair one. The California Legislature encouraged this statutorily with the fairness opinion requirement and subdivision (b). CAL. CORP. CODE § 1203 (West Supp. 1989). Some courts, however, have found intracorporate proposals equitable so long as the transaction appears to be negotiated in an arm's length atmosphere. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 945-46 (Del. 1985) (court determined that Getty dealt fairly with minority shareholders with the inclusion of an indepedent bargaining structure and with the active help of the outside directors).

B. Transactions Falling Under Section 1203

1. Reorganizations and Sale-of-Assets Transactions

Section 1203 was enacted to confront reorganization proposals made by parties working from within the corporate structure. Specifically, the statute includes reorganizations subject to section 1200,[214] as well as sale-of-assets transactions subject to subdivision (a) of section 1001.[215] Section 1200 recognizes three types of reorganizations: merger reorganizations,[216] stock-for-stock exchange reorganizations,[217] and sale-of-assets reorganizations.[218] The latter variety differs from sale-of-assets transactions in the form of consideration received by target shareholders; a sale-of-assets reorganization nor-

214. CAL. CORP. CODE § 1200 (West 1977). The reorganizations to which section 1200 are applicable are specified in section 181 of the California Corporations Code. *Id.* § 181. The rationale of section 181 is to treat different types of corporate fusion as different means to the same end. This approach was intended to encompass and codify the de facto merger doctrine, therefore ensuring that the rights of shareholders in corporate reorganizations do not depend on the name with which they are identified. *See id.* § 1200 (legislative committee comment).

215. *Id.* § 1001 (West Supp. 1989). As amended, section 1203 specifically excludes proposals for short-form mergers. These transactions, which were originally included in section 1203, allow a parent company holding 90% or more of its subsidiary's outstanding shares, to effectuate a cash-out of the minority interests. Codified in the California Corporations Code as section 1110, the statute makes approval by the minority shareholders unnecessary, as their vote could not prevent the merger, although they are given the right to dissent and receive in cash, the fair market value of their holdings. *Id.* § 1110 (West 1977 & Supp. 1989). The reason for the omission of short-form mergers in the amended version was most likely due to the burden it would place on holders of 90% or more of a subsidiary's stock. Requiring these parties to wait, pending a third-party offer, would be futile, since the eventual outcome would result in the majority's favor.

216. *Id.* § 181(a) (a "merger reorganization" otherwise referred to as the "statutory merger" is made pursuant to Chapter 11 and specifically excludes the short-form merger).

217. *Id.* § 181(b). This subdivision defines stock-for-stock exchange reorganizations as "[t]he acquisition by one corporation in exchange in whole or in part for its equity securities (or the equity securities of a corporation which is in control of the acquiring corporation) of shares of another corporation." *Id.*

218. *Id.* § 181(c). This is defined as "the acquisition by one corporation in exchange in whole or in part for its equity securities (or the equity securities of a corporation which is in control of the acquiring corporation) . . . which are not adequately secured and which have a maturity date in excess of five years after the consummation of the reorganization, or both, of all or substantially all of the assets of another corporation." *Id.* The legislative committee comments indicate that the idea behind this provision is that "debt securities which are not adequately secured and which have a maturity date in excess of five years involve a degree of risk at least similar to that of equity securities for the shareholders who are to receive them and that, accordingly, such shareholders should be entitled to voting and dissenter's rights to the same extent as if they were to receive equity securities in the transaction." *Id.* (legislative committee comment).

mally provides shares in a newly-formed corporation, rather than actual cash to the target shareholders under a sale-of-assets transaction.[219] With the participation of target directors, the abovementioned ventures frequently translate into management or leverage buyouts, as well as freezeout or takeout mergers, all of which are well-documented in the financial and legal communities.[220] Buyouts in particular have almost achieved a status position among inside directors in the past few years,[221] with frequent headlines touting former directors who have taken public entities private only to reap substantial rewards for their efforts.[222]

2. Management Buyouts

A management buyout normally occurs when inside directors, often accompanied by a small group of institutional investors,[223] acquire sufficient stock in the target corporation to take it from the public sector and place it into private hands.[224] Arising when these bidders believe the market value of the target shares does not reflect its actual value,[225] management buyouts are often executed by way of a tender offer and are usually financed by inside directors taking on substantial debt which is leveraged by the assets of the corporation.[226] In this way, they are not required to expend a significant amount of their own capital.[227] After taking the corporation private,

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219. *Id.* § 1001(c).

220. *See* Jewel Cos. v. Pay Less Drug Stores N.W., 741 F.2d 1555 (9th Cir. 1984); Steinberg v. Amplica, Inc., 42 Cal. App. 3d 1198, 233 Cal. Rptr. 249 (1987); Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

221. *The Top 200 Deals*, BUS. WEEK, Apr. 17, 1987, at 276; *see also The Top 100*, MERGERS & ACQUISITIONS, May-June 1987, at 47.

222. Glynn, *The Joy of Going Private*, INSTITUTIONAL INVESTOR, Dec. 1986, at 111, 114.

223. These include banks, insurance companies, and pension funds. Their willingness to participate in buyouts has increased in part because deregulation has permitted new types of investments which have decreased the demand by traditional borrowers. This, in turn, has increased the search for lending opportunities yielding high profits. *See* Gogel, *Corporate Restructuring: Management Fights The Raiders*, MGMT. REV., July 1987, at 28.

224. This usually entails purchasing all of the outstanding shares through a buyout or freezeout process. *See infra* notes 236-37 and accompanying text. Going private is attractive for several reasons. Among the more prominent is the fact that private firms are not required to file information reports with the SEC.

225. *See* Note, *supra* note 183, at 210-11 (discussing the procedures for effecting a management buyout).

226. *Private Lives*, TIME; June 20, 1983, at 62 (leveraged buyouts are financed through loans secured by the corporation's assets); *see also* Labich, *Is Business Taking on Too Much Debt?*, FORTUNE, July 22, 1985, at 82.

227. Wantuck, *When Managers Become Owners*, NATION'S BUS., Aug. 1983, at 60 (buyout participants invest a small amount of cash in the venture and obtain the majority of the purchase price by borrowing against the corporation's assets); Hill & Williams, *Buyout Boom: Leverage Deals for Companies Gain in Popularity*, Wall St. J., Dec. 29, 1983, at 6 (buyout participants contribute little personal equity because they allow the corporation to incur debt to finance the venture).

these former directors, who have now become the new equity owners,[228] pay off these leveraged debts by selling off portions of the corporation's assets and businesses.[229] The bankroll success is finally achieved either by becoming the equity owners of a well-run, profitable company,[230] or by returning the entity to public hands, or both.[231] Thus, management buyouts are a potent way for directors to share in the success of their corporations without incurring substantial personal risk.

When a management team owns less than a majority of the target's outstanding shares, the buyout must be effected by utilizing a two-step merger technique to freezeout or takeout the minority shareholders.[232] In the first step, the directors purchase enough shares to

228. Ross, *How The Champs Do Leveraged Buyouts*, FORTUNE, Jan. 23, 1984, at 70 (management buyouts enable participants to acquire significant equity interests in the transaction).

229. Williams & Cohen, *Buyout of Burlington Industries Inc. May Force Firm to Become Much Smaller*, Wall St. J., May 22, 1987, at 6, col 2; *see* Note, *supra* note 190, at 216 (this action requires that the target be financially sound, having consistant earnings and saleable assets which do not include the core of the business).

230. Many companies have experienced great success in financing buyouts through these sales. *See* Johnson & Cohen, *Beatrice Buy-Out May Net Investors Fivefold Return*, Wall St. J., Sept. 4, 1987, at 5, col. 1. These successes seem to arise for several reasons. First, the former officers altered managing techniques which tend to be more innovative and aggressive; second, as a private corporation, they are not required to pay dividends; third, they are absolved from having to comply with SEC filings. *See* Note, *supra* note 190, at 227 n.89.

231. This normally occurs within a five year period, with some recent management buyouts returning to public hands in only a year's time. *See* Johnson & Cohen, *supra* note 220, at 80; Sterngold, *Wall St. Buys Into the Action*, N.Y. Times, June 19, 1986, at D1, col. 3. In addition, there is a greater incentive among investment bankers, who make large commitments of their own funds, to return the private entity to public hands quickly in order to realize their gains and increase their future capital. *See* Ferenbach, *The IPO Market Welcome for LBOs in Transition*, MERGERS & ACQUISITIONS, Nov.-Dec. 1987, at 54 (discussing the market for round-trips). The October 19, 1987 stock market crash substantially reduced the share values of many companies that had only recently returned to public ownership after having spent time as private entities. Due to the low share prices, these companies are again appearing as potential buyout targets for inside directors. *See* Smith, *Depressed Prices Might Spawn New Buy-outs*, Wall St. J., Jan. 25, 1988, at 42, col. 3. These round-trips become easier to execute a second time due to the buyout groups' normal practice of retaining a large stake in the company after it returns to public hands. It has been suggested that this may make "periodic round trips or 're-LBO's' a common solution to the problems that may develop in publicly held companies, including agency cost problems that may be a function of corporate over expansion or risk aversion." *See* Note, *supra* note 190, at 227 n. 89.

232. A one-step merger technique, which is permitted in all states, is utilized by offerors when they already possess a controlling block of the target's shares. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (successful suit by minority shareholders who were subsequently "frozen out" by the ensuing parent-subsidiary merger).

aquire a majority shareholder status, which is followed by the second-step acquisition of the target's minority interests. As the minority shareholders cannot override the majority's vote in the action, the former are summarily divested of their equity holdings for cash.[233] This freezing out action is generally approved by state appraisal statutes which allow minority shareholders to object to the purchase price only, but not to the merger itself.[234]

Initially, management buyouts arose as last ditch defensive tactics used by the target's management to thwart a hostile takeover bid. When third-party raiders began finding ways to penetrate some of management's favorite defensive measures,[235] the latter began using leverage and a redeployment of assets to make the target appear less attractive.[236] Not only did this work in averting hostile takeovers, but it introduced management to a potential gold mine; by using leverage as an offensive measure, they could reap for themselves some of the same profits sought by the hostile bidder. In so doing, they were viewed not as defenders of the corporate interest, but rather as mavericks seeking to capitalize on their belief that the target's stock prices were undervalued. This review illuminates the fact that the central problem with buyouts and other intracorporate reorganizations in which target directors maintain a controlling force is their

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See generally Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974) (discussing the legality of transactions which freeze out public shareholders).

233. *See* Note, *Delaware Corporation Law: Weinberger v. UOP, Inc.—A Limitation On Singer Fairness Standards?*, 42 U. PITT. L. REV. 915 (1981) (majority shareholders force minority shareholders to accept cash rather than an equity interest in the newly-formed corporation); *see also* Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 473 N.E.2d 19, 8 N.Y.S.2d 667 (1984) (the exclusion of minority interests does not violate the majority shareholders' fiduciary obligations to the minority where the former can justify their actions by way of an independent corporate business purpose); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1357 (1978).

234. Sections 1301, 1304, and 1305 of the California Corporations Code contain California's appraisal remedy. Under section 1301(a), the corporation involved must offer the dissenting shareholder a fair and reasonable price for its shares. *See* CAL. CORP. CODE § 1301(a) (West 1977 & Supp. 1989). Sections 1304 and 1305 state that if agreement on a price cannot be reached, the shareholders may file an action to determine such value. At this point, the court can either determine a fair price themselves or refer the matter to an appraiser. *See id.* §§ 1304, 1305; Steinberg v. Amplica, Inc., 42 Cal. 3d 1198, 1201-02, 729 P.2d 683, 685, 233 Cal. Rptr. 249, 250 (1986) (discussing whether appraisal is a minority shareholder's exclusive remedy in dissenting from a merger). The appraisal remedy is perhaps an example the California Legislature looked to in enacting section 1203. The rationale behind both the appraisal remedy and section 1203 is the same—to protect shareholders from being forced to sell their securities at unfair values by those who dominate the corporate structure, such as a parent group or majority shareholder.

235. *See supra* notes 116-119 and accompanying text.

236. *See* Cowan, *The New Way to Halt Raiders*, N.Y. Times, May 29, 1987, at D1, col. 3 (leveraged recapitalizations are used by substituting debt for equity in the capital structure of the corporation).

potential conflict of interest. This is a particular problem that section 1203 appears to have been enacted to address.

C. *The "Fairness Opinion" Requirement*

Section 1203 clearly indicates the circumstances under which an intracorporate offeror must provide a fairness opinion to target shareholders. The relevant portion states that:

> [i]f a tender offer or a written proposal for approval of a reorganization subject to Section 1200 or for a sale of assets subject to subdivision (a) of Section 1001 is made to some or all of a corporation's shareholders by an interested party (herein referred to as an "Interested Party Proposal," an affirmative opinion in writing as to the fairness of the consideration to the shareholders of that corporation shall[237] be delivered . . . .[238]

Therefore, if the proposal involved is for a reorganization or sale-of-assets transaction, made by one of the intracorporate parties referred to in the statute,[239] an opinion as to the fairness of the price being offered must accompany the proposal. In delineating the above-mentioned parties, section 1203 excludes proposals made by third-parties; thus, outside bidders would not be required to ensure the same credibility for their offers as would an intracorporate party. This is so because target shareholders would tend to give more credence to a proposal made by intracorporate parties, since they generally have a fiduciary duty to protect shareholders' interests.[240] The rationale behind this requirement appears obvious: if intracorporate offerors are required to obtain an independent opinion that their bids to target shareholders are fair, they will be more wary of underbidding their own valuation of the target shares in the first place.[241]

As a caveat, section 1203 states that the fairness opinion requirements do not apply to an Interested Party Proposal if the target cor-

237. This language indicates that those making an interested party proposal have no choice in whether or not to supply an opinion.

238. CAL. CORP. CODE § 1203 (West Supp. 1989).

239. *Id.*; *see supra* notes 12-16 and accompanying text.

240. *See* Longstreth, *Fairness of Management Buyouts Needs Evaluation*, Legal Times, Oct. 10, 1983, at 20, col. 2 (fairness opinions provided by management will heavily influence shareholders as to the merits of the transaction without actually assuring that the offer is equitable).

241. In Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court determined that the deliberations of the directors involved in a cash-out merger of the target were insufficient to adequately inform them of the merits of the transaction. This case was helpful in promoting the use of fairness opinions from independent financial advisors, even though this promotion arose via the threat of liability. *See Business Briefs, Trans Union Corp.*, Wall St. J., Aug. 2, 1985, at 18, col. 3; *see also* Weinberger v. UOP, Inc. (court suggested that a fairness opinion by the target's outside directors might have removed the taint surrounding the merger).

poration has fewer than one hundred shares outstanding.[242] This would obviate the need for most closely-held corporations[243] to obtain an affirmative opinion concerning a reorganization or sale-of-assets transaction. In addition, the fairness opinion requirement is inapplicable if the proposed transaction has been qualified under sections 25113[244] or 25120,[245] and no order is in effect either postponing, suspending or revoking that qualification.[246] Finally, section 1203 specifically states that nothing in the fairness opinion requirement shall limit the application of the standards of review under section 310[247] or subdivision (c) of section 1312[248] in the event that the transaction involved is challenged.[249]

1. Identifying the Opining Party

As originally enacted, section 1203 was ambiguous as to who could provide what was then called the "report of an independent appraiser."[250] The statute merely stated that such a report must accompany an intracorporate proposal for a reorganization, and that it had to indicate that the proposal was "just and reasonable as to the shareholders of the target corporation."[251] As amended, the statute adds more detail as to possible opining parties. In so doing, some confusion is created as to the reason for the fairness opinion's existence. The pertinent portion states:

> The opinion required by this subdivision shall be provided by a person who is not affiliated with the offeror and who, for compensation, engages in the business of advising others as to the value of properties, businesses, or securities. The fact that the opining person previously has provided services to the offeror or a related entity *or is simultaneously engaged in providing advice or assistance with respect to the proposed transaction in a manner which makes its compensation contingent on the success of the proposed transaction shall not, for those reasons, be deemed to affiliate the opining person with the offeror.*[252]

As originally enacted, this section merely defined opining party as an independent appraiser who could attest to the reasonableness of the proposal to target shareholders. As amended, the subdivision provides more specificity regarding the character of this party, requiring

242. CAL. CORP. CODE § 1203 (West Supp. 1989).

243. *Id.* § 158 (a close corporation is one whose number of shareholders does not exceed 35).

244. *Id.* § 25113 (West 1977) (allowing securities to be qualified by permit).

245. *Id.* § 25120 (no security may be offered or sold in an issuer transaction unless it is qualified for sale or exempted under Chapter 1).

246. *Id.* § 1203 (West Supp. 1989).

247. *Id.* § 310 (West 1977).

248. *Id.* § 1312 (controlling person involved in a reorganization has the burden of proving the fairness of the transaction to shareholders).

249. *Id.* § 1203 (West Supp. 1989).

250. *Id.*

251. *Id.*

252. *Id.* (emphasis added).

that they be nonaffiliated as well as regularly compensated for this type of service. The clarity of these additions are overshadowed, however, by the potential problems created with the subdivision's broad definition of affiliates, which includes those who provide advice or assistance in the transaction, even when the success of the venture will determine their compensation. This language appears to include the services often provided by investment bankers. If so, the opinion would be subject to the same contentions with which investment banker's opinions are often viewed, and it is doubtful that this section would be as powerful in encouraging intracorporate bidders to provide a fair price to target shareholders.

Not only might inside directors, among other proposers, continue to rely on the opinions of investment bankers involved in the transaction, but they may feel more secure in knowing that this practice is statutorily sanctioned. So long as an investment banker, or any other opining party can be "simultaneously engaged in providing advice or assistance"[253] regarding the making of the proposal, target shareholders will find little comfort in knowing that the fairness opinion requirement exists.[254] To prevent this situation from arising, target directors would be well-served in obtaining these opinions from disinterested parties, whether they be an investment banking group or other financial consultant.

Although the statute mandates that the opining party must be nonaffiliated, it fails to indicate who selects that party. If the statute is read to infer that the party making the proposal must select the independent appraiser, this necessarily opens up the conflict of interest question again. It is not difficult to imagine a group of inside directors, planning a buyout or preparing to merge a subsidiary into a parent, selecting an appraiser who would give their bid a favorable report. Indeed, shareholders would almost presume such conduct regardless of the appraiser's nonaffiliated status. To alleviate this problem, inside directors would benefit by allowing the disinterested outside directors to select either an independent investment banker or financial consultant.[255] In this way, inside directors would be re-

253. *Id.*

254. It has been argued that investment bankers will continue to proliferate made-to-order fairness opinions until they become more accountable to the target shareholders. Note, *supra* note 190, at 214; *see* Note, *The Standard of Care Required of an Investment Banker to Minority Shareholders in a Cash-Out Merger: Weinberger v. UOP, Inc.*, 8 DEL. J. CORP. L. 98 (1983); Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119 (1986).

255. Many courts have encouraged the use of independent outside directors to alle-

moved from the selection process, and the appraiser's report would be given more credence. Finally, recognizing that inside directors have access to the crucial information necessary for an accurate appraisal, section 1203 does not specify how the opining party can ensure that the information upon which the party's bid is based will be credible.[256] At the very least, the independent appraiser must be given the same degree of access to the inside information that is available to inside directors in making their bids. Anything short of this would allow them to conceal information damaging to their proposal.

2. Delivering the Opinion: Time and Place Requirements

Section 1203 clearly indicates not only under what circumstances the use of an independent opinion is required, but also, the time and place for the opinion's delivery. Concerning this, the statute states:

> (1) If no shareholder approval or acceptance is required for the consummation of the transaction, the opinion shall be delivered to the corporation's board of directors not later than the time that consummation of the transaction is authorized and approved by the board of directors.
> (2) If a tender offer is made to the corporation's shareholders, the opinion shall be delivered to the shareholders at the time that the tender offer is first made in writing to the shareholders.
> (3) If a shareholders' meeting is to be held to vote on approval of the transaction, the opinion shall be delivered to the shareholders with the notice of the meeting.
> (4) If consents of all shareholders entitled to vote are solicited in writing, the opinion shall be delivered at the same time as that solicitation.
> (5) If the consents of all shareholders are not solicited in writing, the opinion shall be delivered to each shareholder whose consent is solicited prior to that shareholder's consent being given, and to all other shareholders at the time they are given the notice required by subdivision (b) of Section 603.[257]

As can be seen, the statute provides directors with greater guidance as to the logistics of the opinion's delivery. At the same time, the specificity inhibits unscrupulous fiduciaries from providing the opinion at the last moment when the Interested Party Proposal has already been made, a time when target shareholders may feel hurried

viate an interested director's conflict of interest in a proposed transaction. *See* Polk v. Good, 507 A.2d 531, 537 (Del. 1986) The use of ten outside directors on the Texaco board, "coupled with the advice rendered by the investment banker and legal counsel constitute[d] a *prima facie* showing of good faith and reasonable investigation." *Id. See also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (the reasonableness of the target director's actions was "materially enhanced . . . where . . . a majority of the board favoring the proposal consisted of outside independent directors").

256. This may be partially remedied by including the requirement that the opining party "engages in the business of advising others as to the value of properties, businesses, or securities." CAL. CORP. CODE § 1203 (West Supp. 1989). Thus, even if the inside directors fail to provide them with adequate information upon which to base their opinion, their previous experience as professionals in the field may compensate for this and enable them to provide appraisals that are as accurate as possible under the circumstances.

257. *Id.*

into tendering their shares for fear of forsaking a substantial opportunity.

D. Ensuring the Potential for Third-Party Bids

If the first part of section 1203 proves to be ineffective in ensuring that target shareholders obtain a fair price, either for lack of actual independence on the part of the opining party or because of a flawed appraisal, the California Legislature appears to have provided them with another shield in the form of subdivision (b).[258] This provision promotes an auction environment for the target shares by encouraging third-party bids, which will most likely be higher than the initial offer made by the inside party.[259] In this way, target shareholders inevitably receive the highest price for their shares. Chronologically, subdivision (b) requires that a third-party bid, made at least ten days before action is to be taken on a pending Interested Party Proposal,[260] must be publicized to the target shareholders.[261] These shareholders then have the opportunity to withdraw their acquiescence to the Interested Party Proposal or any shares tendered for the same, if this is accomplished within ten days from their notice of the Later Proposal.[262]

258. *Id.* § 1203(b).

259. *Id.*; *see also* S.B. 2552, 1987-88 Leg., Reg. Sess.; S.B. 1464, 1987-88 Leg., Reg. Sess. § 2 [hereinafter Senate Bill]. If the opinion provided through subdivision (a) is ultimately tainted, the competitive environment promoted by subdivision (b) will most likely bring the selling price to an equitable level.

260. CAL. CORP. CODE § 1203 (West Supp. 1989). This clause allows target shareholders sufficient time in which to compare the merits of the opposing bids. Without this, a third-party bidder could conceivably make a last minute offer in which shareholders would be pressured into tendering their securities without adequate time. As originally submitted, section 1203 did not specify what the nature of a third-party proposal made under subdivision (b) could be, merely that it included proposals for reorganizations and short-form mergers. This left open the potential for sham offers, vague as to price and principle terms, that could trigger an open bidding war. The revised version primarily alleviates this problem by requiring that the later proposal be made at least ten days before the interested party proposal is to be voted on or approved.

261. As originally submitted, subdivision (b) of section 1203 required that target directors transmit to their shareholders, the third-party proposal, "along with any documents provided by the offeror." Senate Bill, *supra* note 259.

262. CAL. CORP. CODE § 1203 (West Supp. 1989). This provision precludes the third-party bid from holding up the interested party proposal indefinately by giving target shareholders only ten days in which to consider the former offer. This is a change from subdivision (b) as originally enacted, which merely stated that the intracorporate proposal could not be "effected or closed until the targeted corporation's shareholders have had a reasonable opportunity to consider and respond to the later offer." Senate Bill, *supra* note 259.

Subdivision (b) provides detailed guidance on what constraints both intracorporate and outside offerors must work under. The langugage of the provision is as follows:

> (b) If a tender of shares or vote or written consent is being sought pursuant to an Interested Party Proposal and a later tender offer or written proposal for a reorganization subject to Section 1200 or sale of assets subject to subdivision (a) of Section 1001 that would require a vote or written consent of shareholders is made to the corporation or its shareholders (herein referred to as a "Later Proposal") by any other person at least 10 days prior to the date for acceptance of the tendered shares or the vote or notice of shareholder approval on the Interested Party Proposal, then each of the following shall apply:
>
> (1) The shareholders shall be informed of the Later Proposal and any written material provided for this purpose by the later offeror shall be forwarded to the shareholders at that offeror's expense.
>
> (2) The shareholders shall be afforded a reasonable opportunity to withdraw any vote, consent, or proxy previously given before the vote or written consent on the Interested party Proposal becomes effective, or a reasonable time to withdraw any tendered shares before the purchase of the shares pursuant to the Interested Party Proposal. For purposes of this subdivision, a delay of 10 days from the notice or publication of the Later Proposal shall be deemed to provide a reasonable opportunity or time to effect that withdrawal.[263]

By ensuring that a third-party bid can be considered before an interested party proposal is effected, subdivision (b) removes the barriers to competition among offerors.[264] Thus, courts will be content that even an unopposed Interested Party Proposal will be fair, because it may indicate that a third-party stayed away simply because they could not compete with the intracorporate offeror's price, rather than being inhibited from doing so.[265]

The practitioner should note several inferences drawn from subdivision (b). First, it appears to be the responsibility of the target directors to inform their shareholders of the Later Proposal, even though the third-party offerors are charged with the expense of providing any supplementary written materials accompanying their bid.[266] Second, the provision speaks only of third-party proposals subject to section 1200 or subdivision (a) of section 1001, which require the target shareholder's vote or written consent. This would, by necessity, exclude stock-for-stock exchange reorganizations as no shareholder approval is required to effectuate a reorganization under this procedure.[267] Finally, subdivision (b) as originally enacted speci-

263. CAL. CORP. CODE § 1203(b) (West Supp. 1989).

264. *See* Jewel Cos. v. Payless Drug Stores N.W., 741 F.2d 1555, 1564 (9th Cir. 1983) "[A] board may not, consistent with its fiduciary obligations to its shareholders, withhold information regarding a potentially more attractive competing offer." *Id.*

265. *See* Note, *supra* note 190, at 235-36 (discussing procedural mechanisms courts have used to regulate buyouts).

266. In section 1203(b), as originally submitted, the statute inferred that it was up to the target directors to incur the cost of disseminating any documents provided by the third-party offeror. Amended subdivision (b) makes it clear, however, that this cost is to be borne by the party making the bid.

267. Senate Bill 1464, which contained the original version of section 1203, also sig-

fied that "[i]n no event shall the offeror under subdivision (a) be precluded from amending that offer in light of the later offer . . . ."[268] While mirroring the earlier version's mandate that pending third-party bids be publicized to target shareholders before an interested party proposal can be effected, the amended version omits this phrase entirely. At best, the effect of this omission will be to de-emphasize a perpetual auction in which the bidders continue to up the ante until the target shares are no longer a viable investment. While it can be inferred that omitting this passage precludes an Interested Party Proposal from being increased, this is incompatible with the purpose behind the statute in general. Therefore, the omission is most likely inconsequential. More important is the effect subdivision (b) will have on target directors' use of defensive tactics to defeat a Later Proposal.

1. Effect of Subdivision (b) on Target Directors' Use of Defensive Tactics

Target directors tend to invoke defensive tactics either as a legitimate method for protecting shareholders from a financially unsettled or otherwise unsuitable company,[269] or, more frequently, as a vehicle to protect their own interests.[270] This latter situation normally arises in one of two ways. First, the situation may occur where a reorgani-

nificantly altered the definition of reorganizations in California. The acquiring company in a stock-for-stock exchange reorganization was no longer required to be in control of the target corporation immediately after the transaction was effected to be considered a reorganization. This meant that a tender of even a few shares could pass as a stock-for-stock exchange reorganization. With the original version of section 1203(b) specifically including all reorganization offers proposed by a third-party, this introduced the significant possibility that an outside party could make a small tender offer and effectively stall the intracorporate proposal. Since there was not a ten day limitation in which target shareholders had to decide on the outside offer in the original version of subdivision (b), the possibilities for drawn out takeover battles were seemingly endless. Thus, the "clean up" amendment specifically excluded stock-for-stock exchange reorganizations as transactions with which a third-party was allowed to use subdivision (b) to introduce its proposal.

268. Senate Bill, *supra* note 259.

269. Courts have been unenthusiastic about this rationale when the outside bid is substantially higher than either the intracorporate bid or the price at which the target shares are currently traded. *See* Plaza Sec. Co. v. Fruehauf Corp., 643 F. Supp. 1535, 1537 (E.D. Mich. 1986)(In the bidding war over the Fruehauf Corporation, the outside parties bid of $41 and $42 per share was rejected by the target directors, even though the stock at that time was hovering in the mid-$20 range).

270. The fact that the majority of cases on this issue involve potential director abuse of defensive tactics points to this. *See, e.g.,* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

zation or sale-of-assets transaction is made by a hostile party, either from outside the corporation or from an inside entity, and the target directors' efforts to thwart the bid are done for the purpose of entrenching themselves in office.[271] The second situation appears when an Interested Party Proposal in which directors are affiliated has been made, and the defensive tactics are used as roadblocks to prevent shareholders from having the option of approving an opposing bid.[272]

Whether directors are attempting to entrench themselves in office[273] or cement the approval of their own Interested Party Proposal with the target shareholders, the defensive measures used are often the same. Potentially the most successful are tactics such as lock-up options,[274] no-shop provisions,[275] cancellation or break-up fees,[276] and poison pills,[277] all of which cloud the attractive light with which the third-party initially viewed the target. The application of these measures to subdivision (b) can arise either with an initial Interested Party Proposal, or as an amendment to that proposal, made in response to a third-party bid. Regardless of how they arise, it is quite

271. *See* Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985) (target directors participated in a "greenmail" action to retain their position).

272. *See Hanson*, 781 F.2d 264 (court found that SCM directors failed to make an adequate investigation of pricing before they granted a lock-up option to the management buyout team). In *Revlon*, 506 A.2d at 173, the Revlon board's approval of lock-up and no-shop clauses in favor of the management buyout team ended the competition for the target shares. Additionally, Revlon's directors excluded the hostile bidder from certain financial data, as well as making face-to-face presentations to the entire board, both of which the buyout team was allowed.

273. This situation would most often arise where disinterested directors prefer the interested party proposor over the third party.

274. Lock-up options generally involve a promise by the target board to allow a certain bidder the right to purchase a business or division of the target should the latter be outbid by another suitor. These agreements are not *per se* illegal, and in fact have been approved when their use encourages the involvement of a prospective bidder. *See Revlon*, 506 A.2d at 1250 (stating that a lock-up option must encourage bidding rather than preclude it); Thompson v. Enstar Corp., 509 A.2d 578 (Del. 1984) (lock-up used to retain the interest of the one genuine bidder involved).

275. No-shop provisions are arrangements between the target board and a preferred bidder which prohibit the directors from actively seeking other offers as alternatives to the one proposed by the preferred bidder. *See* Edelman v. Fruehauf Corp., 798 F.2d 882, 885 (6th Cir. 1986)(no-shop clause restricted Fruehauf's ability to negotiate a better deal with other bidders); *Revlon*, 506 A.2d at 1249 (no-shop provision approved by the Revlon board prohibited it from entertaining further bids from any third party, including the initial hostile bidder).

276. These fees are normally paid to the investment banking group involved in the promotion of the intracorporate bid upon the failure of a management buyout or other transaction. Buyout participants argue that these fees are necessary to encourage investment bankers or other financing groups to arrange the buyout bid when the target is already being pursued by another suitor.

277. This would include a share purchase rights plan which dilutes a hostile bidder's holdings in the target. For a more in depth view of poison pills, see 3 R. WINTER. R. ROSENBAUM, M. STUMPF & L. PARKER, SHARK REPELLENTS AND GOLD PARACHUTES: A HANDBOOK FOR THE PRACTITIONER 505-08 (1988).

possible that subdivision (b) will alter the frequency with which directors use these tactics. This is primarily due to the subdivision's language encouraging competition among bidders, along with the higher burden directors face in using the business judgment rule to shield their invocation of defensive measures.

a. Decreasing Use of Defensive Tactics as a Result of Subdivision (b)'s Pro-Competitive Language

Understanding that defensive tactics generally stifle competition, subdivision (b) has the potential for making directors more apprehensive about using them to thwart third-party bids for the target, primarily for fear that the statute requires a greater duty on their part to promote competition among prospective purchasers. Generally, directors do have the duty to ensure that target shareholders obtain the highest price possible for their shares in a corporate sale.[278] The language of subdivision (b) reflects this duty by requiring that shareholders have an opportunity to consider other pending bids before an Interested Party Proposal can be effected.[279] Although the statute does not specifically prohibit the use of defensive measures intended to prevent a competing bid, this would certainly violate the spirit, if not the clear intent of subdivision (b). If target directors can initiate lock-up options or no-shop provisions powerful enough to discourage a third party from entertaining a bid, they could seemingly circumvent the rationale behind subdivision (b).[280]

As an example, in *Edelman v. Freuhauf Corp.*,[281] the target directors were faced with a hostile takeover threat to which they responded with a two-tiered leverage buyout supported by their investment banker.[282] The liaison between the two included several defensive measures intended to thwart the outside party from sucessfully obtaining control of the target. Significantly, the agreement provided a no-shop clause which restricted the target's ability to negotiate a better deal with another suitor, as well as a substantial break-up fee to the investment banker should the buyout fail.[283] The

278. *See Hanson*, 781 F.2d at 281.
279. S.B. 2552, 1987-88 Leg., Reg. Sess. § 2.
280. Target directors would be most inclined to initiate defensive tactics when they favor an interested party proposal, because they either are personally involved or protected by it (through the use of golden parachutes), or actually feel the third-party bid is not in the shareholders' best interests.
281. 798 F.2d 882 (6th Cir. 1986).
282. *Id.* at 884.
283. *Id.* at 885.

court determined that these actions were detrimental to the target shareholders because they inhibited competition by discouraging the outside party from providing a higher bid.[284]

Not only might subdivision (b) potentially inhibit target directors from abusing defensive measures when they have a stake in a rival bid, but it may also prevent disinterested directors from using the same tactics in an effort to favor one bidder over another.[285] In *Edelman*, the outside directors were held liable for providing a rubber-stamp approval to the interested director's buyout proposal.[286] The Sixth Circuit determined that the outside director's use of defensive tactics to promote the buyout over the opposing bid stifled competition for the target, and that this act was a breach of their fiduciary duty to obtain the highest price possible for the shareholders when the target was, in fact, placed on the auction blocks.[287]

Therefore, subdivision (b) may have an inhibiting effect on both interested and disinterested directors' use of abusive defense tactics. Unfortunately, it may also inhibit them from using these measures when they would be beneficial to shareholders, such as when tactics are used to stimulate the bidding process rather than retard it. For example, the use of a lock-up agreement when there is only one genuine bidder involved creates an imminent risk of losing their participation in a rapidly-moving sale environment.[288] If directors become too leery of using defensive tactics for fear of breaching their fiduciary duties, target shareholders may be the real losers in situations where these measures would have enabled them to sell their shares at a higher price.

b. Alteration in the Presumption of the Business Judgment Rule in Takeover Situations

Considered in isolation, the competitive environment promoted by subdivision (b) may be insufficient to cause some target directors to

284. *Id.* (Fruehauf board rejected Edelman's offer to acquire the company on the same terms as those proposed by the buyout team).

285. It has been argued that a disinterested director's loyalty to insiders may encourage this type of bias. Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987). *But see* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), which found liability for the target's outside directors based on their sole reliance on the chief executive. This opinion has done much to encourage these fiduciaries to exercise a greater degree of care and objectivity in takeover situations.

286. *Edelman*, 798 F.2d at 886 (quoting Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986). The *Edelman* court stated that where disinterested director's 'methodologies and procedures' are 'so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or sham,' then inquiry into their acts is not shielded by the business judgment rule." *Id.*

287. *Id.*

288. *See* Thompson v. Enstar Corp., 509 A.2d 578 (Del. 1984).

use defensive tactics with greater reserve.[289] If so, the recent shift in the business judgement rule regarding their use of these tactics may buoy up subdivision (b) and achieve the same result. In the past few years, several notable judicial decisions have altered target directors' use of the business judgment rule in takeover situations when their defensive actions stagnated competition.[290] This was initially presented by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*,[291] which acknowledged that the traditional interpretation of the business judgment rule, with its heavy presumption in favor of directors use of good faith and fair dealing, made it difficult to check abusive defense tactics.

In *Unocal*, the target board, responding to a hostile takeover attempt from a minority shareholder, initiated a selective stock repurchase offer making Unocal a less attractive target. This action, approved by a majority of Unocal's outside directors, was considered by the court to be reasonable in relation to the threat posed by the hostile offeror.[292] In altering the business judgment rule's presump-

289. Indeed, instead of utilizing obvious defensive measures, target directors may cash in on their ability to quell a merger simply by failing to recommend the proposal to the shareholders for a vote. *See* CAL. CORP. CODE §§ 1001(b), 1201(f) (West 1977). Thus, neither a third-party bid nor an interested party proposal can be effected without director acquiescence. It is readily apparent that those directors involved in the interested party proposal will be more inclined to recommend their offer to target shareholders. Also, in the same vein, a third-party bid will receive a much less favorable expression from these same fiduciaries. Directors, therefore, may not be daunted by their inability to use obvious defensive tactics against a third-party bidder, because they can simply fail to recommend that bid to the shareholders and achieve the same result. *See Edelman*, 798 F.2d at 885 (board rejected a third-party offer made on the same terms but at a higher price than the management buyout they subsequently approved). Were this to occur, the business judgment rule would probably be used as the yardstick upon which the directors failure to recommend would be measured. If this remedy proved unsuccessful, the target shareholders only other option would be to remove the directors from office. The venue would be of little comfort to shareholders who have accepted the interested party proposal, as the interested directors, among others, will have become the equity owners of the new entity, and the former public shareholders will have no say in the future management of the now private structure.

290. Due to the sparse amount of California case law discussing the business judgment rule in takeover contexts, the decisions of Delaware and New York courts are used as examples, due to their status as leaders in the area of corporation law. One California case does discuss an alteration in the business judgment rule in takeover situations. *See* Heckmann v. Ahmanson, 168 Cal. App. 3d 110, 128, 214 Cal. Rptr. 177, 183 (1985) (stating that when a director is found to have received a personal benefit from a particular transaction, "the burden shifts to the director to demonstrate not only the transaction was entered in good faith, but also to show its inherent fairness from the viewpoint of the corporation and those interested therein").

291. 493 A.2d 946 (Del. 1985).

292. *Id.* at 948.

tion in takeover contexts, the court stated that before a board could obtain the protections of the business judgment rule in takeover situations, where the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders" exists, a threshold examination of the director's actions must be made.[293] What followed was a two-prong test which shifted the burden of proof by requiring that directors must first show "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and that based on these grounds, they acted in "good faith and reasonable investigation" in using defensive measures; the second step required that these actions be "reasonable in relation to the threat posed" by the third-party bidder.[294] The court concluded that only after satisfaction of the two prongs could directors invoke the aegis of the business judgment rule.

In *MacAndrews & Forbes v. Revlon, Inc.*,[295] the court followed *Unocal* in initially taking the business judgment rule's shield away from target directors in takeover situations. In *Revlon*, the target board responded to a takeover threat by co-sponsoring, along with its investment banker, a leverage buyout of the firm's outstanding shares.[296] In so doing, the board approved the use of a lock-up option, a no-shop clause, and a twenty-five million dollar cancellation fee with the investment bankers.[297] The court stated that once the Revlon board made its buyout proposal, it proceeded under the assumption that a breakup of the company was inevitable. At this point, its role changed from "that of a board fending off a hostile acquiror bent on a breakup of the corporation to that of an auctioneer attempting to secure the highest price for the pieces of the Revlon enterprise."[298] In sum, the use of defensive tactics by the target board inhibited rather than fostered competition, and the court determined that its conduct indicated a lack of good faith. This shift in the business judgment rule,[299] in addition to the language of subdivision (b), may prove to be an indirect bar to the abuse of defensive tactics by target directors who see a greater fiduciary peril in their use.[300]

293. *Id.* at 954.
294. *Id.* at 955.
295. 501 A.2d 1239 (Del. 1985).
296. *Id.* at 1243.
297. *Id.* at 1245-46.
298. *Id.* at 1248.
299. *Revlon* was one of several decisions to follow in the footsteps of Unocal. *See also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985); Ivanhoe Partners v. Newmont Mining Corp., 533 A.2d 585 (Del. Ch. 1987); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 108, 112 (1986). *But see* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 273 (2d Cir. 1986) (not accepting the *Unocal* standard, and indicating that plaintiffs would be better off in Delaware).
300. *See* Veasey, *The New Incarnation of the Business Judgment Rule in Takeover*

E. Application of Section 1203 to Section 309

Although the requirements of section 1203 are statutorily mandated, it is likely that in determining a target director's degree of adherence to its provisions, courts will also look to the presumptions of the business judgment rule as dictated in section 309 for guidance. For example, a director personally participating in an Interested Party Proposal would appear to have strictly complied with subdivision (a) by including a fairness opinion provided by a nonaffiliated appraiser. However, the fact that the opining party meets section 1203's technical definition of a nonaffiliate may not be commensurate with adhering to section 309 if that party is, in reality, partial to the director's bid. Likewise, a directors use of tactics having the effect of blocking a third-party bid might also find its way into a duty of loyalty analysis under the business judgment rule, as the failure to disclose additional third party bids may raise an inference that directors have not acted in good faith towards the shareholders as required by section 309(a).

For example, under subdivision (2) of section 309(b), directors are allowed to rely on:

> [c]ounsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence . . . so long as . . . the director acts in good faith, after reasonable inquiry when the need therfor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.[301]

Thus, if the selection of an opining party was reviewed under section 309, it would be scrutinized more carefully regarding the good faith involved. This, coupled with the statute's added directive that directors' duties flow to the shareholders of a corporation as well as to the

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Defenses, 11 DEL. J. CORP. L. 503, 512 (1986) (predicting that courts which apply Delaware law in the future will more strictly scrutinize target board decisions to use defensive tactics).

301. CAL. CORP. CODE § 309(b)(2) (West Supp. 1989). Subdivision (2) of section 309(b) can be correlated to the provision in Tentative Draft No. 4 of the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations*:

> 4.02. Reliance on Directors, Officers, Employees, Experts, and Other Persons
> In performing his duty and functions, a director or officer who acts in good faith, and reasonably believes that his reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other financial data), and decisions, judgments, or performance . . . prepared, presented, made, or performed by:
> . . . .
> (b) Legal counsel, public accountants, engineers, or other persons whom the director or officer reasonably believes merit confidence.

PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.02, (Tent. Draft No. 4, Apr. 12, 1985).

corporation itself, would indicate that fiduciaries cannot obtain an opinion which fails to consider the interests of target shareholders. In sum, while adherence to the requirements of section 1203 will not categorically absolve directors of liability in a takeover context, it will probably be seen as strong evidence that they acted reasonably and in good faith.[302]

IV. CONCLUSION

With the amendment of section 309, and the enactment of section 1203, the California Legislature has responded to the unaddressed needs of shareholders, particularly in takeover situations. These statutes have put directors on notice that their duties toward shareholders have been, at the very least, highlighted, and in the case of section 1203, significantly increased. Section 309, as amended in 1987, has refined the standard of care that directors must use in the effectuation of their duties. The legislature accomplished this by affirmatively providing that directors' duties run to the shareholders as well as to the corporation. Although directors are given some leeway with respect to their business judgment, their conduct will likely be scrutinized more carefully by courts who perceive that the intent of the statute is to protect shareholders.

Although sections 309 and 1203 will benefit both shareholders and directors through greater protection and added guidance respectively, the statutes create potential adverse consequences. Seemingly, the most critical is the perception by corporate directors that they have greater fiduciary duties to shareholders, which may increase their risk of liability. This could result in a small exodus of California corporations to states which appear to be less shareholder oriented. In addition, for those entities deciding where to incorporate, California may appear to be a less attractive alternative. Finally, the increased demands placed on directors in takeover situations by section 1203 may sharply decrease the number of corporate reorganizations. At this point, it is difficult to determine the precise effect the statutes will have. What does seem clear, however, is that California shareholders have received a substantial boon through sections 309 and 1203. At the same time, corporate directors can fulfil their duties with added guidance emanating from these statutes, and to this end

302. *See* Longstreth, *Fairness of Management Buyouts Needs Evaluation*, Legal Times, Oct. 10, 1983, at 19, col. 3 (the use of fairness opinions provide substantial legal support for the judgment use by directors); *see also* Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 BUS. LAW. 1185, 1187 (1982).

can breathe easier and focus on what they do best, managing the corporation.

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