

California's Business Judgment Rule Is Not a Defense for Corporate Officers

by JAMES B. HARDIN and STEVEN R. TELLES

The business judgment rule establishes that actions which are reasonable exercises of business judgment, not forbidden by law, and fall within the discretion of a person who can assert the rule as a defense, are not legally actionable business practices. *Lee v. Interins. Exch.*, 50 Cal. App. 4th 694, 713-14 (1996).

Although in practice the fiduciary duties of corporate directors and officers are often equated, recent federal district court opinions have made it clear that, under California law, the business judgment rule *does not* apply to business decisions made by corporate officers. In *F.D.I.C. v. Van Dellen*, No. CV 10-4915 DSF (SHx), 2012 WL 4815159 (C.D. Cal. 2012) ("*Van Dellen*"), *F.D.I.C. ex rel. Cnty Bank v. Hawker*, No. CV F 12-0127 LJO (DLB), 2012 WL 2068773 (E.D. Cal. June 7, 2012) ("*Hawker*"), and *F.D.I.C. v. Perry*, No. CV 11-5561 ODW (MRWx), 2012 WL 589569 (C.D. Cal. Feb. 21, 2012) ("*Perry*"), the courts analyzed and applied California law and found that the business judgment rule does not apply to corporate officers.

In *Hawker* and *Perry* the courts denied motions to dismiss filed by former officers of IndyMac, F.S.B. ("*IndyMac*"), specifically rejecting their assertions that the alleged business decisions to have IndyMac invest in risky residential loans were insulated by the business judgment rule. Similarly, the *Van Dellen* court ruled against former officers of IndyMac who sought summary judgment based on the business judgment rule where it was claimed the officers had negligently approved homebuilder loans.

The business judgment rule "has two components—one which immunizes directors from personal liability if they act in accordance with its requirements, and another which insulates from court intervention those management decisions which are made by directors in good faith in what the directors believe is the organization's best interest." *Berg & Berg Enter., LLC v. Boyle*, 178 Cal. App. 4th 1020, 1045 (2009) (citations and quotations omitted). California

courts have traditionally applied the common law business judgment rule to shield from judicial scrutiny business decisions made by a corporation's board of directors. *See, e.g., Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n*, 21 Cal. 4th 249, 259 (1999).

Although some California courts have lumped officers and directors together when discussing the business judgment rule, there is little authority directly indicating whether this powerful defense applies to the business decisions of corporate officers. The courts above analyzed California common law and statutory law and found that the answer is "no" for several reasons.

First, the scant case law addressing this point indicates that the business judgment rule should not apply to officers. Indeed, the one case indirectly addressing this issue, *Gaillard v. Natomas Co.*, 208 Cal. App. 3d 1250 (1989), found the distinction between directors and officers to be the decisive factor in refusing to apply the business judgment rule to business decisions made by corporate directors *who were effectively acting as corporate officers*. The *Gaillard* court stated, in pertinent part: "[interested directors] were not 'perform[ing] the duties of director' as specified in § 309, but were acting as officer employees of the corporation. The judicial deference afforded under the business judgment rule therefore should not apply." *Id.* at 1265. (citation and quotations omitted).

Further honing in on the distinction between officers and directors, the *Gaillard*

court stated:

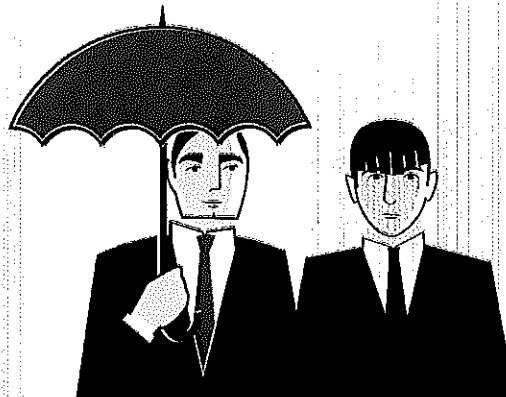
[A]n officer-director might be liable for particular conduct because of his capacity as an officer, whereas the other directors would not . . . This result is in accord with the premise of the business judgment rule that courts should defer to: the business judgment of disinterested directors presumably are acting in the best interests of the Corporation.

Id. (citation and quotations omitted). Somewhat surprisingly, there are no other cases any more on point. Accordingly, California Jurisprudence cites to *Gaillard* for the proposition that the "[business judgment] rule does not relate to the officers of the corporation but only to directors." Cal. Jur. 3d *Corporations* § 268 (2012).

Second, California statutory law limits the business judgment rule to directors. California Corporations Code § 309 (West 2013) ("§ 309"), which codifies California's common-law business judgment rule, explicitly discusses the duties and liabilities of "directors" but does not mention "officers" anywhere in the text. As the *Hawker* and *Perry* cases reasoned, courts are "not to insert what has been omitted, or to omit what has been inserted . . ." *Troppman v. Valverde*, 40 Cal. 4th 1121, 1135 n.10 (2007) (citing Cal. Code Civ. Proc. § 1858 (West 2013)).

Third, and perhaps most importantly, the comments of the legislative committee regarding § 309 clearly show that the drafters intended not to include officers under the protection of the business judgment rule. In addressing the standard of care, the legislative committee stated in pertinent part: "[I]t is the intent of the draftsman, by combining the requirement of good faith within the standard of care, to incorporate the familiar concept that, these criteria being satisfied, a director should not be liable for an honest mistake of business judgment." *See* Cal. Corp. Code § 309 (Legislative Committee Comment) (quotation omitted; emphasis added).

The drafters expressly excluded officers from the protection of the business judgment rule, stating: "The standard



of care does not include officers.” *Id.* The committee’s rationale was as follows:

Although a non-director officer may have a duty of care similar to that of a director [], his ability to rely on factual information, reports or statements may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation.

Id. Based on this omission in the rationale noted above, the *Perry* court concluded that “when the California legislature had the opportunity to codify common law [business judgment rule], it purposely excluded its application to corporate officers.” 2012 WL 589569, at *4.

As a legal matter, there is no California state case law holding or directly indicating that the business judgment rule applies to the business decisions of corporate officers.

In our view, the conclusions of the *IndyMac* courts were correct based on California law and the policy underlying the business judgment rule. As a legal matter, there is no California state case law holding or directly indicating that the business judgment rule applies to the business decisions of corporate officers.

Instead, there are various cases which uncritically combine directors and officers when addressing the application of the business judgment rule. *See, e.g., Frances T. v. Village Green Owners Ass’n*, 42 Cal. 3d 490, 507 n.14 (1986) (stating in dicta “directors should be given wide latitude in their handling of corporate affairs because the hindsight of the judicial process is an



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imperfect device for evaluating business decisions . . . [t]he [business judgment] rule recognizes that shareholders . . . voluntarily undertake the risk of bad business judgment; investors need not buy stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers"); *Biren v. Equal. Emergency Med. Grp., Inc.*, 102 Cal. App. 4th 125, 136-37 (2002) (grouping officers and directors together in business judgment rule analysis without discussing why the rule would apply to officers); *PMC, Inc. v. Kadisha*, 78 Cal. App. 4th 1368, 1386-87 (2000) (stating, "an officer or director who commits a tort because he or she reasonably relied on expert advice or other information cannot be held personally liable for the resulting harm").

As noted above, the only case indirectly addressing this matter is *Gaillard*: its holding distinguished directors from officers and withheld the protections of the business judgment rule to corporate directors who were effectively acting as corporate officers.

As a policy matter, the business judgment rule originated to protect directors of a corporation, who are generally less involved in the day-to-day operations and must often rely on the factual information, reports, and statements made to them by corporate officers. It is sensible to allow directors acting in good faith (and not recklessly) to take these reports at face value and rely on them. It makes less sense to extend the same protections to the officers themselves, whose basic duties require them to work full-time, to be fully informed regarding corporate affairs, and to make daily decisions aiming to generate revenue while rewarding them with incentive compensation unavailable to directors.

Of course, there has been scholarly debate on both sides of this issue. The American Law Institute's *Principals of Corporate Governance* has indicated that the business judgment rule should apply to officers. 1 *Principles of Corporate Governance: Analysis and Recommendations* § 4.01(c) (Am. Law Institute 1994). At least one law professor has concluded that the business judgment rule should apply to officers "with respect to their exercise of discretionary delegated authority." Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 *The Business Lawyer* 865 (May 2005). An article from *Aspen Law & Business* opined that it would be "sound policy" to extend the business judgment rule to officers. Charles Hansen, *The Business Judgment Rule: Is There Any Doubt It Applies To Officers?*, CORP., at 15 (*Aspen Law & Bus.* Sept. 1, 2001).

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On the other hand, Lyman P. Q. Johnson, a law professor at Washington and Lee University, concluded in 2005 that the business judgment rule "should not be extended to corporate officers in the same broad manner in which it is applied to directors" because of the "central roles played by officers in our corporate system." Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439 (2005). In the same vein, law professor David Millon has proffered that the scope of fiduciary duties for officers should be greater than those of directors, who are able to assert the business judgment rule as a defense. Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 Wm. & Mary L. Rev. 1597 (2005). And another law review article has reasoned that the business judgment rule should not be extended to officers where the claims against them are commenced by the board of directors or encouraged by the board. Gregory Scott Crespi, *Should the Business Judgment Rule Apply to Corporate Officers, and Does It Matter?*, 31 Okla. City U. L. Rev. 237 (2006).

In some other states, Delaware, Ohio, and Texas courts have not directly held whether the business judgment rule applies to officers, although directors and officers have been sometimes grouped together under the business judgment rule without explanation. *Int'l Ass'n of Heat and Frost Insulators and Asbestos Workers Local Union 42 v. Absolute Envtl. Servs., Inc.*, 814 F. Supp. 392, 400 (D. Del. 1993); *Pogostin v. Rice*, 1983 WL 17985, at *3 (Del. Ch. Aug. 12, 1983) (unpublished state case); *F.D.I.C. v. Schreiner*, 892 F. Supp. 869, 881-2 (W.D. Tex. 1995) (citing Texas district court cases); *Worth v. Huntington Bancshares, Inc.*, 43 Ohio St. 3d 192, 197 (1989); *but see Selcke v. Bove*, 258 Ill. App. 3d 932, 936 (1994) (holding business judgment rule applies to officers) and N.Y. N.-P.C.L. § 717 (McKinney 2012) (indicating that officers in New York "may rely on information, opinions, reports or statements" in "good faith").

Overall, given the cogent analysis of the three district courts in the IndyMac cases, under California law the basic reasonable person standard of care should apply to corporate officers accused of mismanagement or misconduct.



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