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CORPORATE

# Business judgment rule loses ground in California

By Gregg Amber and Ryan Chavez

The business judgment rule is, in essence, a common law construct that shields those individuals that it applies to against liability to shareholders for business decisions made in good faith even if, in hindsight, those decisions prove to have been poorly reasoned or even negligent. In general, the business judgment rule creates a presumption in favor of such good faith business decisions that can only be overcome by proof of gross negligence (or worse) in the decision process. The business judgment rule is codified for the benefit of corporate directors in California Corporations Code Section 309.

The majority of courts addressing the issue of whether the business judgment rule applies to corporate officers have held that it does apply. However, California courts have now definitively ruled that the business judgment rule does not apply to corporate officers. In *FDIC as Receiver for IndyMac Bank FSB v. Matthew Perry,* C.D. Cal., No. CV 11-5561 ODW (Dec. 13, 2011), the U.S. District Court for the Central District of California held that the business judgment rule does *not* provide protection for decisions made by officers of California corporations. Prior to the *Perry* case, it was generally thought that the common law business judgment rule did apply to corporate officers, albeit perhaps in a slightly different and more variable fashion given the access of officers, depending on their position, to information about the company and its business, and provided that they were acting within the scope of their authority. Although the decision in *Perry* was at an early stage in the proceeding (a motion to dismiss was filed before defendants answered to the complaint) and is in the process of being appealed, the decision, as it stands, completely strips corporate officers in California of protection under the business judgment rule.

*What does this mean for officers of California corporations?* Absent the protection of the business judgment rule, corporate officers can be second-guessed in a way that boards of directors cannot, and they can be held liable for decisions made in good faith that, had they been ratified by a board of directors, would not be the subject of potential liability for the directors that ratified the action. Most commentators agree that the policy justifications for the business judgment rule are relevant to both directors and officers. See "Liability of Corporate Officers and Directors" (Eighth Edition, LexisNexis Matthew Bender Publishing) Section 2.03, footnote 1, which cites multiple publications that suggest the business judgment rule should apply to both directors and officers.

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*How does this compare to other jurisdictions?* As Professor Lawrence A. Hamereshand A. Gilchrist Sparks III noted in a 2005 article, "cases decided since 1992 ... are virtually unanimous in their willingness to apply the business judgment rule to officers. Since we wrote on the subject in 1992, in fact, *no court* has stated that the business judgment rule does not apply to officers, and quite of number of opinions have held that it does." 60 The Business Lawyer 865 et seq. (May 2005). Obviously their article pre-dates the *Perry* decision. Granted, there is not an abundance of case law that addresses this issue. However, drafters of the Model Business Corporation Act and the American Law Institute have both opined that the business judgment rule should apply to corporate officers.

*What does this mean for California and California businesses?* The effect of the Perry decision is likely to be an additional competitive disadvantage for California, something we can ill afford with businesses already leaving the state due to regulatory, tax and other concerns. First, this decision creates an incentive to incorporate elsewhere and, in the case of corporations potentially subject to the effect of Corporations Code Section 2115, an incentive to relocate, as executive talent is not going to want their personal wealth placed at risk for business decisions that, in hindsight, appear ill advised. Second, although it may take a little time for this to work its way through the system, it is likely that directors and officers liability insurance premiums will increase for California corporations corresponding to the increase in the number of business decisions that are now the subject of potential liability.

*What should a corporate officer in California do?* The first scenario: In the case of a person seeking a position as an officer of a California corporation, that person should seek to obtain an agreement with the corporation, prior to commencement of employment, that provides a release of

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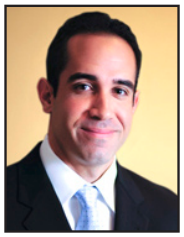

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liability for actions taken in good faith and within the scope of authority, even if they prove with hindsight to be negligent, along with appropriate indemnity. In the case of a person already in such a position, that person should request that the employer corporation enter into such an agreement (with retroactive effectiveness), or seek a retroactive amendment to an existing agreement (such as an employment agreement already in force).

The second scenario: Hope for a reversal of the *Perry* case on its appeal or, if the appeal is unsuccessful, apply pressure to state senators and state representatives to take legislative action, which is clearly a better solution than our suggestion number 1 above. As Professor Melvin A. Eisenberg has noted in his treatise, "Corporations and Other Business Organizations: Cases and Materials," it is better to have "good rules that the parties probably would have agreed to had they addressed the issue," rather than "bad rules that the [parties] can contract around." A good example is of such a rule California Civil Code Section 1542, which parties routinely contract around when entering into settlements. Similarly, if *Perry* is not reversed, we should expect a proliferation of language contracting around the decision in executive employment agreements.

If the second scenario does not occur, and the first is not possible (for whatever reason), only seek employment with companies that are not incorporated in California and not subject to Corporations Code Section 2115. This is obviously not a desirable result for California, but may be the only result for an executive who does not want to put his or her personal net worth on the line when the other solutions are unavailable.

*Rutan & Tucker LLP partner Tom Brockington contributed to this article.*