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California's New General Corporation Law: Directors' Liability To Corporations

Always do right; this will gratify some people and astonish the rest.

Mark Twain

Any statute which attempts to regulate the conduct of corporate directors must do so within the confines of two competing policy considerations. The first of these is the necessity of attracting and retaining competent persons to fill directorship positions.[1] A scheme which exposes a director to numerous lawsuits may, by deterring responsible persons from accepting directorships, impede the efficient management of the corporation[2] and thereby harm the very stockholders and creditors the scheme is designed to protect. The second consideration is protection of shareholders and creditors from wrongful and negligent acts of directors.[3] A system which insulates directors from liability leaves injured stockholders and creditors little redress for their grievances and fails to deter unscrupulous directors from wrongdoing.

The newly enacted Division 1 (General Corporation Law) of the California Corporations Code[4] will significantly change California law

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1. *See* W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS §16.01, at 407 (2d ed. 1973) [hereinafter cited as KNEPPER].

2. Comment, *Indemnification of Directors and Officers; Public Policy vs. Corporate Responsibility*, 48 J. URBAN L. 957, 957 (1971).

In 1969 the Wall Street Journal reported that due to increased exposure to liability "scores of men are politely declining offers they once would have jumped at to serve on prestigious boards . . . . There now is a real shortage of competent men willing and able to serve as directors." Wall Street Journal, Mar. 13, 1969, at 1, *as quoted in* KNEPPER, *supra* note 1, §16.01, at 406.

3. *See, e.g.*, N. LATTIN, THE LAW OF CORPORATIONS §103 (2d ed. 1971) [hereinafter cited as LATTIN].

4. A.B. 376, CAL. STATS. 1975, c. 682 (*effective January 1, 1977*) [hereinafter all citations and references to the New General Corporation Law, *enacted*, CAL. STATS. 1975, c. 682, will be cited as or referred to as *New* CAL. CORP. CODE or New Code].

relating to directors' liability to the corporation. These changes include a statutory definition of the standards of loyalty and care imposed upon directors,[5] new procedures for bringing an action against a director including the creation of a creditors' derivative suit,[6] and expanded indemnification provisions.[7] While many of the new provisions are modeled after or are similar to statutes found in other states,[8] others, such as the creditors' derivative suit, appear to be wholly original and will therefore present novel questions of interpretation and practice. This comment will review those portions of the New Code relating to directors' liability which represent significant changes from existing California law. Further, the comment will attempt to identify the questions raised by the new provisions and suggest possible resolutions. Finally, the conclusion of this comment will offer suggestions as to the New Code's success at navigating between the *Scylla* of excessive director exposure to liability and the *Charybdis* of inadequate protection of stockholders and creditors.

DIRECTORS' STANDARDS OF LOYALTY AND CARE

Section 309 of the New Corporations Code sets forth the requirement that directors perform their duties "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."[9] This lan-

See generally REVIEW OF SELECTED 1975 CALIFORNIA LEGISLATION, this volume at 258 (General Corporation Law).

5. *New* CAL. CORP. CODE §309.
6. *New* CAL. CORP. CODE §316.
7. *New* CAL. CORP. CODE §317.
8. *See* note 11 *infra.*
9. *New* CAL. CORP. CODE §309 provides that

(a) A director shall perform the duties of a director, including the 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.

(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 subguage is based upon a proposed revision to the American Bar Association's Model Business Corporations Act[10] and, while new to California, it is similar to that used in the statutes of other states.[11] It is clearly intended that the standard set forth is exclusive, as the section provides that a director who conforms to this standard "shall have no liability based on any alleged failure to discharge the . . . obligations as a director."[12] The standard encompasses both the directors' duty of loyalty to the corporation and the directors' duty of care in managing corporate affairs. To analyze the impact Section 309 will have on California corporations, it will be necessary to determine existing California law defining each of these duties, and to examine interpretations of the language of the new section given by various commentators and the courts of other states.

A. Directors' Duty of Loyalty

California has long required directors of corporations to perform their duties in good faith.[13] This requirement is embodied in the Old Code,[14] which states that directors must exercise their powers "in good faith, and with a view to the interests of the corporation."[15] As Section 309 of the New Code retains essentially the same language, it may be assumed that previous decisions defining the contours of the good faith

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> divisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director.

10. CALIFORNIA LEGISLATURE, ASSEMBLY SELECT COMMITTEE ON THE REVISION OF THE CORPORATIONS CODE, REPORT OF THE ASSEMBLY SELECT COMMITTEE ON THE REVISION OF THE CORPORATIONS CODE 48 (1975) [hereinafter cited as ASSEMBLY REPORT].

11. *E.g.*, GA. CODE ANN. §22-713; IDAHO CODE ANN. §30-142; MICH. COMP. LAWS ANN. §450.1541; MINN. STAT. ANN. §310.31; N.Y. BUS. CORP. LAW §717 (McKinney 1963); N.C. GEN. STAT. ANN. §5-35; S.C. CODE ANN. §12-18.15.

12. The Assembly Select Committee Report states "[t]he purpose of this subdivision is to relieve a person from any liability by reason of being or having been a director of a corporation, if that person has exercised his duties in the manner contemplated by this section." ASSEMBLY REPORT, *supra* note 10, at 54.

Section 300 of the New Corporations Code provides an exception to the application of this standard to directors. This section permits shareholders in close corporations to enter shareholders' agreements which alter the traditional relationship between directors and shareholders. See Berger, *California's New General Corporation Law: Close and Closely-Held Corporations*, this volume at 585. *New* CAL. CORP. CODE §300(d) provides that such an agreement

> shall, to the extent and so long as the discretion or powers of the board in its management of corporate affairs is controlled by such agreement, impose upon each shareholder who is a party thereto liability for managerial acts performed or omitted by such person pursuant thereto that is otherwise imposed by this division upon directors, and the directors shall be relieved to that extent from such liability.

13. One of the earliest cases to so hold was Wright v. Oroville Mining Co., 40 Cal. 20, 27 (1870).

14. CAL. CORP. CODE §§100-35302, *enacted*, CAL. STATS. 1947, c. 1038 (*effective until January 1, 1977*) [hereinafter all citations and references to the General Corporation Law enacted in 1947 will be cited as or referred to as CAL. CORP. CODE or Old Code].

15. CAL. CORP. CODE §820.

standard remain "good law."[16] Thus an examination of the dimensions of permissible director conduct must begin with an analysis of existing case law concerning director good faith.

"Good faith" in the context of the director-corporation relationship has been judicially defined as a "state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, . . . being faithful to one's duty or obligation."[17] This good faith standard is often expressed in terms of a "fiduciary duty,"[18] though it is well settled that directors are not trustees of the corporation in the strict sense of the term.[19] The cornerstone of this fiduciary duty is the prohibition against any sort of personal gain from one's activities as director[20] unless all who have an interest in the corporation are informed and have consented.[21] Examples of situations in which the application of the good faith standard has rendered directors of California corporations liable for their conduct include entering a corporation into a harsh bargain with another corporation in which the director had an interest,[22] the use of the position of director to obtain a majority or controlling interest in the corporation,[23] the passing of trade secrets to a competitor,[24] the use of the position of director to recruit personnel for another corporation in which the director had an interest,[25] the purchase of

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16. It 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, there is a very strong presumption of intent to adopt the construction as well as the language of the prior enactment.

Holmes v. McColgan, 17 Cal. 2d 426, 430, 110 P.2d 428, 430 (1941).

17. Efron v. Kalmanovitz, 249 Cal. App. 2d 187, 192, 57 Cal. Rptr. 248, 251 (1967); *see also* 1 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS §87 (4th ed. 1975) [hereinafter cited as 1 BALLANTINE & STERLING].

18. National Auto. Cas. & Ins. Co. v. Payne, 261 Cal. App. 2d 403, 413, 67 Cal. Rptr. 784, 790 (1968); Brown v. North Ventura Road Dev. Co., 216 Cal. App. 2d 227, 232-33, 30 Cal. Rptr. 568, 571 (1963); Tevis v. Beigel, 174 Cal. App. 2d 90, 96, 344 P.2d 360, 364 (1959); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 420, 241 P.2d 66, 75 (1952); 6 B. WITKIN, SUMMARY OF CALIFORNIA LAW, *Corporations* §80 (8th ed. 1974).

19. Brown v. North Ventura Road Dev. Co., 216 Cal. App. 2d 227, 232-33, 30 Cal. Rptr. 568, 571 (1963); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 419, 241 P.2d 66, 74 (1952); 6 B. WITKIN, SUMMARY OF CALIFORNIA LAW, *Corporations* §80 (8th ed. 1974).

20. Sheppard v. Wilcox, 210 Cal. App. 2d 53, 59, 26 Cal. Rptr. 412, 417 (1962); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 419, 241 P.2d 66, 74 (1952); 6 B. WITKIN, SUMMARY OF CALIFORNIA LAW, *Corporations* §80 (8th ed. 1974).

21. Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 420, 241 P.2d 66, 74 (1952).

22. Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

23. Sheppard v. Wilcox, 210 Cal. App. 2d 53, 26 Cal. Rptr. 412 (1962).

24. Components for Research, Inc. v. Isolation Products, Inc., 241 Cal. App. 2d 726, 50 Cal. Rptr. 829 (1966).

25. Bancroft-Whitney Co. v. Glen, 64 Cal. 2d 327, 411 P.2d 921, 49 Cal. Rptr. 825 (1966).

property from the corporation on terms advantageous to the director,[26] and the distribution of dividends when the corporation had insufficient assets to cover the distribution.[27]

Under existing California law directors are *presumed* to act in good faith.[28] Thus a plaintiff who wishes to establish a director's liability must shoulder the burden of proving a lack of good faith.[29] The difficulty of sustaining this burden was demonstrated in *Fairchild v. Bank of America*,[30] wherein the plaintiffs alleged that defendant's directors were improperly selecting attorneys to represent trusts for which the defendant was trustee.[31] The complaint stated that the attorneys who recommended the defendant be named trustee were retained to represent the trusts, and that such attorneys had interests which conflicted with those of the defendant.[32] In denying declaratory relief the court stated:

> To warrant interference by the court . . . a case must be made out which plainly shows that such action is so far opposed to the true interests of the corporation itself as to lead to the clear inference that no one thus acting could have been influenced by any honest interest, but that he must have acted with an intent to subserve some outside purpose, regardless of the consequences to the company.[33]

By requiring a showing that "no one thus acting could have been influenced by any honest interest," this holding appears to require that the plaintiff establish a director's *subjective* bad faith before liability may be found.

A plaintiff may avoid the seemingly harsh requirement of proving subjective bad faith by proving that the defendant director received a personal benefit from a corporate transaction which he or she approved. It is well established that when personal benefit by a director is shown, the burden shifts to the director to demonstrate that the transaction was

26. Tevis v. Beigel, 174 Cal. App. 2d 90, 344 P.2d 360 (1959).
27. Southern Calif. Home Builders v. Young, 45 Cal. App. 679, 188 P. 586 (1920).
28. Burt v. Irvine Co., 237 Cal. App. 2d 828, 852, 47 Cal. Rptr. 392, 407 (1965); Fairchild v. Bank of America, 192 Cal. App. 2d 252, 257, 13 Cal. Rptr. 491, 493 (1961); Findley v. Garret, 109 Cal. App. 2d 166, 174, 240 P.2d 421, 426 (1952); Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 557, 274 P. 597, 600 (1929).
29. Fairchild v. Bank of America, 192 Cal. App. 2d 252, 257, 13 Cal. Rptr. 491, 493 (1961); Findley v. Garret, 109 Cal. App. 2d 166, 174, 240 P.2d 421, 426 (1952); Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 557, 274 P. 597, 600 (1929).
30. 192 Cal. App. 2d 252, 13 Cal. Rptr. 491 (1961).
31. *Id.* at 255, 13 Cal. Rptr. at 492.
32. *Id.*
33. *Id.* at 257, 13 Cal. Rptr. at 493.

entered in good faith.[34] In this situation the test used by the court to determine if liability attaches is whether, under all the circumstances, the transaction bears the earmarks of an "arms length" bargain.[35] Thus the director must show not only his or her subjective good faith, but also the inherent fairness of the transaction from the viewpoint of the corporation and those who have an interest therein.[36] For example, in *Sheppard v. Wilcox*[37] the defendant directors had caused an issue of stock of sufficient shares to divest the plaintiffs of control of the corporation in favor of the defendants. The defendants contended that at the time of the issue they were unaware that it would inure to their benefit.[38] Although the court noted that there was sufficient evidence to find wrongful intent, it was held that defendants' intent was immaterial when the complained of transaction worked to their benefit.[39] By refusing to consider the directors' actual intent, the court clearly demonstrated that it was measuring their conduct by an objective standard.[40]

Once bad faith is established or a showing has been made that the defendant director has benefitted from a corporate transaction, any defense based on a theory that the defendant complied with all the technical requirements of the regulating statute is foreclosed.[41] The leading case on this point is *Remillard Brick Co. v. Remillard-Dandini Co.*,[42] in which the defendant majority directors, over the objections of the minority directors, entered into various transactions with a sales corporation created and wholly owned by the majority directors.[43] These transactions were highly beneficial to the sales corporation at the expense of the plaintiff corporation. The defendant majority directors had complied with all statutory requirements, having given proper no-

34. Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 172, 260 P.2d 823, 832 (1953); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 420, 241 P.2d 66, 75 (1952); *accord*, Pepper v. Litton, 308 U.S. 295, 306 (1939).
35. Burt v. Irvine Co., 237 Cal. App. 2d 828, 851, 47 Cal. Rptr. 392, 407 (1965); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 420, 241 P.2d 66, 75 (1952).
36. Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 420, 241 P.2d 66, 75 (1952).
37. 210 Cal. App. 2d 53, 26 Cal. Rptr. 412 (1962).
38. *Id.* at 60, 26 Cal. Rptr. at 417.
39. *Id.* at 60, 26 Cal. Rptr. at 417-18.
40. *New* CAL. CORP. CODE §310 applies an objective standard to determine the validity of contracts in which a director has a material financial interest. When such a contract has not been authorized by vote of disinterested shareholders, it is valid only if it is "just and reasonable *as to the corporation* at the time it is authorized" (emphasis added).
41. Tevis v. Beigel, 174 Cal. App. 2d 90, 97, 344 P.2d 360, 365 (1959); Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 171, 260 P.2d 823, 832 (1953); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 420, 241 P.2d 66, 75 (1952).
42. 109 Cal. App. 2d 405, 241 P.2d 66 (1952).
43. *Id.* at 409, 241 P.2d at 68. The transactions provided that the sales corporation would exclusively handle the promotion and sales of all products manufactured by the plaintiff corporation. *Id.* at 411, 241 P.2d at 69.

tice and having voted on all the transactions.[44] Nevertheless, the court found for the plaintiff, saying that it would not condone the "mulcting" of the corporation simply because the majority notified the minority of its intent to do so.[45]

The foregoing discussion suggests that directors of California corporations are held to a high standard of loyalty. Directors are bound to perform their duties in good faith, the essence of which is the absence of any form of self-dealing.[46] Compliance with the good faith standard is presumed, placing the burden of proving a want of good faith upon the person seeking to establish liability.[47] The presumption may be overcome only by a showing of *subjective* bad faith on the part of the directors.[48] However, a showing of personal benefit from corporate transactions causes the burden to shift to the directors,[49] who must then establish their good faith in approving the disputed corporate action from an *objective* point of view.[50] By adopting substantially the same language as the Old Code,[51] Section 309 of the New Code reaffirms and perpetuates this standard of loyalty.

B. *Directors' Duty of Care*

While California law relating to directors' duty of *loyalty* appears to be well settled, the standard of *care* required of directors has not been satisfactorily defined.[52] Under the Old Code statutory liability for negligence is limited to three specific causes of action: (1) the unlawful purchase by the corporation of its own shares; (2) the making of an unlawful distribution; and (3) the making of an unlawful loan or guarantee.[53] Although the statute does not purport to exclude other causes

44. *Id.* at 416-17, 241 P.2d at 73. The defendants' contention was based on full compliance with the requirements of CAL. CORP. CODE §820.

45. Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 417, 241 P.2d 66, 73 (1952). *Cf.* Rankin v. Frebank Co., 47 Cal. App. 3d 75, 121 Cal. Rptr. 348 (1975), in which the defendant directors also had established a second corporation to do a portion of the original corporation's business. Unlike *Remillard*, however, the plaintiffs were shareholders who, due to a secret agreement, were unknown to the defendants. Because the defendants had made provisions protecting all known shareholders, they were found not to have breached their duty of good faith. *Id.* at 84-85, 121 Cal. Rptr. at 353-54.

46. See notes 20-21 and accompanying text *supra.*

47. See notes 28-33 and accompanying text *supra.*

48. See note 33 and accompanying text *supra.*

49. See note 34 and accompanying text *supra.*

50. See notes 35-40 and accompanying text *supra.*

51. CAL. CORP. CODE §820.

52. 6 B. WITKIN, SUMMARY OF CALIFORNIA LAW, *Corporations* §91 (8th ed. 1974).

53. CAL. CORP. CODE §824 provides:

> Except as otherwise provided in this division, the directors of a corporation shall not authorize or ratify the purchase by it of its shares, or declare or pay dividends, or authorize or ratify the withdrawal or distribution of any part of its assets among its shareholders.

CAL. CORP. CODE §825 provides:

of action based on negligence,[54] it appears that plaintiffs suing in the name of the corporation seldom allege director negligence. In addition, the business judgment rule, which exempts directors from liability for erroneous judgment in business matters, appears to have prevented most cases of alleged negligence from being decided on the merits.[55] Finally, the California courts have generally failed to distinguish between negligence and bad faith when addressing the standard of conduct required of directors.

One of the rare California judicial expressions of the corporate directors' standard of care is found in *National Automobile Casualty and Insurance Co. v. Payne.*[56] In that case the First District Court of Appeal held that it is a director's duty to possess a knowledge of the basic capital structure of the corporation, and that such a knowledge is a "minimal requirement of the reasonable exercise of [the director's] duties."[57] The court also found that for a director to remain unaware of stock options noted in corporation records after obtaining stock issue permits and participating in stock issues constituted, as a matter of law, a "failure to exercise prudent performance of a director's duties."[58] The court reached these two conclusions based upon the following formulation of the standard of care: "[Directors] occupy a fiduciary relationship to the corporation and are bound to exercise that degree of care that men of common prudence *take of their own concerns.*"[59]

The "own concerns" standard set forth in *National Automobile* is generally considered to be a higher standard of care than the "prudent person in a like position" standard set forth in the New Code.[60] There

In case of any wilful or negligent violation of Section 824, the directors in office at the time of the violation . . . are jointly and severally liable to the corporation or to its receiver . . . for the benefit of the creditors of the corporation or any of them and of the shareholders and owners of shares at the time of the violation, for its debts and liabilities existing at the time of the violation and for the full amount of any loss sustained by such holders and owners of shares, other than shares upon which any such payment or distribution was made, to the amount of the unlawful dividends, purchase price, withdrawal, or other distribution.

54. *See, e.g.,* Burt v. Irvine Co., 237 Cal. App. 2d 828, 852, 47 Cal. Rptr. 392, 407-08 (1965).

55. See text accompanying notes 70-77, and notes 70-73 *infra.*

56. 261 Cal. App. 2d 403, 67 Cal. Rptr. 784 (1968).

57. *Id.* at 412, 67 Cal. Rptr. at 790.

58. *Id.* at 413, 67 Cal. Rptr. at 790.

59. *Id.* (emphasis added).

60. For example, one commentator has written:

It must be considered that directors are frequently men having other business pursuits who serve as directors gratuitously, and that few responsible men would want to serve as directors if they were required to be constantly in attendance as directors and were compelled to guard against injury or loss as they would in their own concerns. In view of the more practical aspect of the situation, a more satisfactory definition of the care which a director of a corporation is bound to exercise in the performance of the functions of his position is such care as a prudent man should exercise in like circumstances and is considerable doubt, however, whether *National Automobile* provides a true representation of the standard by which the liability of directors is presently assessed, as in that case the liability of directors was not at issue. The plaintiff directors had discovered alleged bad faith dealing by defendant directors, but the discovery came many years after the disputed transactions had occurred.[61] The court made these determinations as to the *plaintiff* directors' duty in the course of deciding that the statute of limitations had begun to run on the date of the disputed transactions rather than the date of discovery.[62] Furthermore, the sole authority given for the proposition that directors are held to that degree of care that men of common prudence take of their own concerns was *Sheppard v. Wilcox.*[63] A close reading of *Sheppard,* however, reveals no formulation of such a standard. The dispute in *Sheppard* involved corporate transactions which benefitted the directors to the derogation of the rights of certain shareholders.[64] Thus the *Sheppard* holding concerns directors' duty of loyalty and seems to be inapposite to directors' duty of care.[65]

At times California courts appear to have found director liability based upon negligence without expressly stating so. Such a case is *Brown v. North Ventura Road Development Co.,*[66] which involved a corporation formed for the purpose of developing a housing project. Although cross-plaintiffs sought monetary damages for injury to the corporation based on allegations of fraud and misrepresentation,[67] the cross-defendant director was held to have breached his "fiduciary duty" in that "by reason of his mismanagement" he

> failed and neglected to obtain (1) the financing of the subject land on the terms and conditions originally agreed upon; (2) the requisite contracts for the construction and development of said project;

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charged with a like duty, which care is usually but not necessarily that which such a person would show in the conduct of his own affairs of a similar kind.
19 AM. JUR. 2d, *Corporations* §1277 (1965); *see also* KNEPPER, *supra* note 1, §1.03.

61. National Auto. & Cas. Ins. Co. v. Payne, 261 Cal. App. 2d 403, 405-08, 67 Cal. Rptr. 784, 786-87 (1968).

62. *Id.* at 414-15, 67 Cal. Rptr. at 791.

63. Sheppard v. Wilcox, 210 Cal. App. 2d 53, 26 Cal. Rptr. 412 (1962).

64. *Id.* at 58, 26 Cal. Rptr. at 416.

65. Perhaps the court in *National Automobile* inferred the "own concerns" standard from the *Sheppard* court's refusal to accept the defendants' excuse of ignorance of the impermissible benefits received from the corporate transactions. 210 Cal. App. 2d 53, 60, 26 Cal. Rptr. 412, 417-18 (1962). However, the defendants in *Sheppard* admitted that the impermissible benefit was "clearly evident." *Id.* at 60, 26 Cal. Rptr. at 418. Since a failure to observe something which is "clearly evident" would seem to constitute negligence under *any* standard, a holding that directors are held to the standard of care men of common prudence take of their own concerns may not justifiably be inferred from the *Sheppard* decision.

66. 216 Cal. App. 2d 227, 30 Cal. Rptr. 568 (1963).

67. *Id.* at 229, 30 Cal. Rptr. at 570.

> (3) construction and development of said land by subcontractors in return for a percentage share of the capital stock of the corporate defendant; (4) a release of the land by the sellers to the corporation for subdivision purposes whenever required by the corporation.[68]

As there was no showing of benefit to the director, it appears that *Brown* was decided on a theory of negligence rather than a lack of good faith. It is significant that in *Brown* liability was based entirely on omissions rather than any positive act of the defendant.[69] It appears that in most cases in which negligent *acts* have been alleged the director has escaped liability by invoking the business judgment rule.[70]

The business judgment rule provides that in the absence of fraud, breach of trust, or ultra vires act, the conduct of directors is not subject to attack where the challenged acts are discretionary and performed in good faith with a reasonable belief that they are in the best interests of the corporation.[71] Thus directors are not liable for incorrect decisions as long as they remain faithful to the corporation and use their best business judgment.[72] The rationale for this rule is that it is not the proper function of a court, often with the benefit of hindsight, to substitute its judgment for the good faith business judgment of directors.[73] The rule assumes particular importance when it is remembered that good faith on the part of directors is presumed.[74] It has even been stated that a court "*has no power* to intermeddle in the business affairs of the corporation when there is no fraud."[75] This last statement seems

68. *Id.* at 233, 30 Cal. Rptr. at 572.

69. Professor Lattin has written:

> When directors have been charged with negligence in handling the company's affairs, the facts usually show one of three types of *inactivity*: (1) the director has not attended board meetings as he should and has no valid excuse for being absent; or (2) he has not taken the time to acquaint himself with the general aspects of the business so that he is qualified to act upon propositions when they are discussed at board meetings; or (3) he has sat quietly at board meetings when there were indications of bad management by the officers, or perhaps downright crookedness, and has been so unconcerned or perhaps unaware of what was in the offing that he did not object or did not suggest an investigation or did not do something else that a director reasonably capable, under similar circumstances, would have done.

LATTIN, *supra* note 3, §78, at 275 (emphasis added).

70. *E.g.*, Fairchild v. Bank of America, 192 Cal. App. 2d 252, 13 Cal. Rptr. 491 (1961).

71. Burt v. Irvine Co., 237 Cal. App. 2d 828, 852, 47 Cal. Rptr. 392, 407 (1965); Fairchild v. Bank of America, 192 Cal. App. 2d 252, 257, 13 Cal. Rptr. 491, 493 (1961); Olson v. Basin Oil Co., 136 Cal. App. 2d 543, 559, 288 P.2d 952, 962 (1955); Findley v. Garret, 109 Cal. App. 2d 166, 174, 240 P.2d 421, 426 (1952); Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 557, 274 P. 597, 600 (1929).

72. Findley v. Garret, 109 Cal. App. 2d 166, 178, 240 P.2d 421, 428 (1952).

73. Marble v. Latchford Glass Co., 205 Cal. App. 2d 171, 178, 22 Cal. Rptr. 789, 793-94 (1962); Fairchild v. Bank of America, 192 Cal. App. 2d 252, 257, 13 Cal. Rptr. 491. 493 (1961).

74. See note 28 *supra*.

75. Marble v. Latchford Glass Co., 205 Cal. App. 2d 171, 179, 22 Cal. Rptr. 789,

inconsistent with the holdings in *Brown*[76] and is probably an overstatement of the law. Nevertheless, the rule appears to have effectively foreclosed most actions by corporations against their directors based on misfeasance as distinguished from nonfeasance and malfeasance.[77] Specific situations in which the business judgment rule has been applied by California courts to absolve directors of liability include cases involving the poor choice of counsel,[78] the creation of a subsidiary corporation which led to the loss of profits by the parent corporation,[79] the decision not to exercise an option to purchase land which would have resulted in profits to the corporation,[80] and the issuance of preferred stock as a dividend.[81]

The California courts have not clarified how the business judgment rule, which exempts directors from liability for erroneous judgment, may be reconciled with the notion that directors must be accountable to the corporation for their negligence. In the only case which appears to have addressed the problem,[82] the court found that:

> There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. 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 the corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.[83]

The court seems to be saying that liability may attach when a director negligently fails to make a judgment. Such a statement sheds little light on the relationship between the business judgment rule and the directors' standard of care as it merely illuminates the obvious: the business judgment rule has no application when there has been no judgment.[84]

794 (1962) *and* Fairchild v. Bank of America, 192 Cal. App. 2d 252, 256, 13 Cal. Rptr. 491, 493 (1961) (emphasis added).

76. Although fraud was alleged, in *Brown* the court enjoined the cross-defendant from holding the office of director based upon his *neglect* and *mismanagement*. 216 Cal. App. 2d at 233, 30 Cal. Rptr. at 572. See notes 66-68 and accompanying text *supra*.

77. See note 70 *supra*.

78. Fairchild v. Bank of America, 192 Cal. App. 2d 252, 13 Cal. Rptr. 491 (1961).

79. Findley v. Garret, 109 Cal. App. 2d 166, 240 P.2d 421 (1952).

80. Fornaseri v. Cosmosart Realty & Bldg. Corp., 96 Cal. App. 549, 274 P. 597 (1929).

81. Marble v. Latchford Glass Co., 205 Cal. App. 2d 171, 22 Cal. Rptr. 789 (1962).

82. Burt v. Irvine Co., 237 Cal. App. 2d 828, 47 Cal. Rptr. 392 (1965).

83. *Id.* at 852-53, 47 Cal. Rptr. at 408, *quoting* Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944).

84. The court's statement that judgment must be "reasonably exercised" may also be interpreted as requiring that directors' judgment be *reasonable*. However, such an

Section 309 of the New Code appears designed to bring order to the confusion surrounding the standard of care required of directors of California corporations.[85] The relevant portion of this section provides that a "director shall perform the duties of a director . . . with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."[86] The language of the new section is similar to that found in the statutes of several other states.[87] As there exists a principle of statutory construction which provides that the adoption of the language of a statute of another state raises a very strong presumption of adoption of the judicial interpretation of that statute,[88] an examination of judicial interpretations of these other statutes is necessary to determine the dimensions of the prescribed standard of care. A review of the decisions in these states reveals that only New York has conducted extensive litigation on the subject of directors' duty of care.[89] The New York decisions, however, prove very instructive on four issues raised by the language of Section 309 of the New Code.

The first of these is the degree of knowledge of corporate affairs required of directors. New York directors have a duty to know what is transpiring in their corporations,[90] and this knowledge includes not only actual knowledge, but also what a director should reasonably know or discover.[91] Consequently, directors may be held liable for acts of omission, including failure to attend meetings of the board of direc-

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interpretation renders meaningless the entire discussion of the business judgment rule, as reasonableness is the standard by which negligence is determined for *any* act.

85. The standard set forth would apply also to directors of foreign corporations which fulfill the requirements of *New* CAL. CORP. CODE §2115. *See generally* Comment, *California's New General Corporation Law: Quasi-Foreign Corporations*, this volume at 673.

86. The standard is applicable in all cases, as the section provides that a person who performs the duties of a director in accordance with this standard shall not have liability based upon any alleged failure to discharge the person's obligations as director. See note 9 *supra.*

87. See note 11 *supra.*

88. Erlich v. Municipal Court, 55 Cal. 2d 553, 558, 360 P.2d 334, 337, 11 Cal. Rptr. 758, 761 (1961); Los Angeles M.T.A. v. Brotherhood of Railroad Trainmen, 54 Cal. 2d 684, 688-89, 355 P.2d 905, 907, 8 Cal. Rptr. 1, 3 (1960); Holmes v. McColgan, 17 Cal. 2d 426, 430, 110 P.2d 428, 430 (1941); Estate of Potter, 188 Cal. 55, 68, 204 P. 826, 832 (1922).

89. N.Y. BUS. CORP. LAW §717 (McKinney 1963) provides:

> Directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions. In discharging their duties, directors and officers, when acting in good faith, may rely upon financial statements of the corporation represented to them to be correct by the president or the officer of the corporation having charge of its books of accounts, or stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation.

90. Platt Corp. v. Platt, 249 N.Y.S.2d 1, 6 (Sup. Ct. 1964).

91. *Id.*

tors.[92] A belief that the defendant's directorship is merely honorary does not excuse a person from this duty of knowledge, or from other obligations of a director.[93]

The second issue addressed by the New York courts is whether the nature of the corporation affects the standard of care required of directors. This issue was considered in *Syracuse Television, Inc. v. Channel 9, Syracuse, Inc.*,[94] which held that "[c]are and skill in management are relative concepts depending not only on the type of corporation, the circumstances involved, but also the corporate role of the Directors."[95] The intent of the drafters of the New California Code to adopt a similar interpretation is made apparent in the Report of the Assembly Select Committee on the Revision of the Corporations Code, which states in part:

> (2) The phrase "under similar circumstances" is intended both to recognize that the nature and extent of oversight will vary, depending upon such factors as the size, complexity and location of activities carried on by the particular corporation, and to limit the critical assessment of a director's performance to the time of action or nonaction and thus prevent the harsher judgments which can invariably be made with the benefit of hindsight. . . .
>
> (3) The phrase "in a like position" simply recognizes that the "care" under consideration is that which would be used by the "ordinarily prudent person" if he were director of the particular corporation.[96]

It should be noted that in *Syracuse Television* the consideration of the role of the director in the corporation was used to find a *higher* standard of care than that imposed on other directors of the corporation.[97] The facts indicated that the defendant directors were members of an "executive committee" and had assumed greater responsibility in the management of the corporation than other directors not on the committee.[98] Therefore, it is doubtful that the holding in *Syracuse Television* was intended to permit directors to avoid liability by lessening the extent of their participation in corporate affairs.[99]

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92. *Id.* at 6.
93. *Id.* at 8.
94. 273 N.Y.S.2d 16 (Sup. Ct. 1966).
95. *Id.* at 27.
96. ASSEMBLY REPORT, *supra* note 10, at 49, *quoting* Committee on Corporate Laws, *Changes in the Model Business Corporation Act*, 29 BUS. LAWYER 947, 954 (1974).
97. Syracuse Television, Inc. v. Channel 9, Syracuse, Inc., 273 N.Y.S.2d 16, 27 (Sup. Ct. 1966).
98. *Id.* at 26-27.
99. California presently does not permit a director to avoid liability by pleading that the position of director was accepted only as an accommodation and with the under-

A third issue on which New York decisions are instructive is whether the language of the statute abrogates the business judgment rule. The New York courts continue to utilize the business judgment rule when applying the statutory standard of care to conduct of directors.[100] Thus, the business judgment of directors is not reviewable by the court even though their judgment appears to have been unsound.[101] Evidence that the drafters of the New Corporations Code intended to retain the business judgment rule is found in the Assembly Select Committee Report, wherein it is stated that " 'a director should not be liable for an honest mistake of business judgment.' "[102]

If the business judgment rule is considered to delineate a standard of care, the continued use of the rule seems inconsistent with the New York and California codes, as the codes set forth a different standard of care. The courts, however, do not seem to apply the business judgment rule as a standard of care, as a "standard" is a measure by which conduct is judged, and the courts have invoked the rule to *avoid* passing judgment.[103] Because the essence of the rule is the courts' refusal to review good faith business judgment,[104] it would seem that the proper formulation of the rule is that there exists no cause of action based upon the good faith business judgment of directors.[105] Stated in this manner, the rule is not inconsistent with any statute that sets forth a standard of care.

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standing that the performance of duties would not be required. Minton v. Cavaney, 56 Cal. 2d 576, 580, 364 P.2d 473, 475-76, 15 Cal. Rptr. 641, 643-44 (1961).

Georgia has also interpreted its statute, which uses the same language as found in Section 309 of the New Corporations Code, as imposing a standard which varies according to the type of corporation and the role of the director. GA. CODE ANN. §22-713, *Comment* (P. Bowman II, Reporter of the Special Advisory Committee of the Section of Corporate and Banking Law of the State Bar of Georgia) (1970). A director may, however, be found liable for nonparticipation in corporate affairs. Boddy v. Theiling, 129 Ga. App. 273, 276-77, 199 S.E.2d 379, 382 (1973).

100. Hanson v. Ontario Milk Products Coop., Inc., 294 N.Y.S.2d 936, 941 (Sup. Ct. 1968); *but see* LATTIN, *supra* note 3, §78.

101. Hanson v. Ontario Milk Products Coop., Inc., 294 N.Y.S.2d 936, 941 (Sup. Ct. 1968).

> Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their [directors'] honest and unselfish opinion, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.

Greenbaum v. American Metal Climax, Inc., 278 N.Y.S.2d 123, 129-30 (Sup. Ct. 1967). Minnesota, the only other state with a comparable statute which appears to have considered the issue, also employs the business judgment rule. Warner v. E. C. Warner Co., 226 Minn. 565, 573-75, 33 N.W.2d 721, 726-28 (1948).

102. ASSEMBLY REPORT, *supra* note 10, at 48-49, *quoting* Committee on Corporate Laws, *Changes in the Model Business Corporation Act*, 29 BUS. LAWYER 947, 951 (1974).

103. See text accompanying notes 71-75 *supra*.

104. See note 73 and accompanying text *supra*.

105. This formulation of the rule does not preclude actions based upon directors' negligence in preparation for making a business decision, such as failure to consult commonly used market reports.

Furthermore, the retention of the business judgment rule seems highly desirable. First, the imposition of liability for errors of business judgment would greatly inhibit those responsible for managing corporations from investing or entering any but the most secure of enterprises. When it is remembered that many of today's major industries were once high-risk enterprises, it becomes obvious that inhibiting corporate risk-taking would have a deleterious effect on the nation's economy. Second, if dissatisfied shareholders were permitted to maintain actions anytime they disagree with a decision of the board of directors, corporations would soon be run by the courts instead of those to whom the law entrusts their management.[106] Last, in a business context, it is simply inequitable to judge a person's conduct on the basis of wisdom acquired after the event.[107] Thus the retention of the business judgment rule is not only consistent with the New Code, but is wise in terms of public policy.

The fourth and final issue addressed by the New York courts is procedural. New York requires that a plaintiff suing under its statute specify whether the action is brought under a theory of bad faith or a theory of negligence.[108] A failure to distinguish between the two theories renders a complaint deficient.[109] Such a requirement would seem to be beneficial, as distinguishing in the complaint between negligence and acts of bad faith will aid the courts in developing a clearly defined body of law relating to director negligence. The development in the New York courts of separate bodies of law for director bad faith and negligence has led to a clearer exposition of the director duty of care than is found in the California decisions.[110]

An important issue not addressed by the courts in states which have a similar statutory standard of care is the extent to which a director may rely on information received from other persons. Section 309 of the New Code specifically permits a director to rely on information, opinions, reports or statements, including financial statements and other financial data prepared by officers, employees, counsel, independent accountants, or any committee or board on which the director does not sit, as long as such director's reliance is in good faith and with reasonable inquiry.[111] The new section greatly expands the reliance permitted

106. Carson, *Current Phases of Derivative Actions Against Directors*, 40 MICH. L. REV. 1125, 1130 (1942).
107. *Id.* at 1145.
108. Kutik v. Taylor, 364 N.Y.S.2d 387, 389 (Sup. Ct. 1975).
109. *Id.*
110. A plaintiff may still plead negligence and bad faith as alternative theories. *See*, 3 B. WITKIN, CALIFORNIA PROCEDURE, *Pleading* §§290-92, 296 (2d ed. 1971).
111. See note 9 *supra*.

by a director, as the Old Code permits a director to rely only on a balance sheet or profit and loss statement of the corporation furnished to him by the president or officer in charge of supervision of accounts, or by a certified public accountant.[112] The Assembly Select Committee Report, in referring to the new reliance provision, states:

> [N]o duty of inquiry comparable to that contained in Section 11 of the United States Securities Act of 1933 was intended to be imposed upon directors in judging the competence and reliability of the persons on whom they rely, unless there are circumstances which would cause any reasonable man in a like position to make such an inquiry.[113]

The report sheds further light on the reliance provision:

> Inherent in the good faith standard is the requirement that, in order to be entitled to rely on such reports, statements, 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.[114]

The expanded reliance provision seems to be desirable in that it recognizes the realities of management in the modern corporation, and by doing so, should attract competent persons to assume directorships without seriously jeopardizing the protection afforded stockholders.

Assuming that California will adopt the interpretations of similar statutory language in other states[115] as well as the intent expressed by the drafters in the Assembly Select Committee Report, a discernible standard of care emerges from Section 309 of the New Code. A director is required to perform his or her duties as would an ordinarily prudent person in like circumstances.[116] The diligence required of a director varies with the nature, size and type of the corporation, as well as the director's role in the management of the corporation.[117] This varying standard does not, however, excuse a director from attendance at meetings or a basic knowledge of the corporation's structure and operations.[118] This standard for determining negligence may be applied in cases arising from omissions or negligent acts other than business decisions.[119] A director may not incur liability for decisions

112. CAL. CORP. CODE §829.
113. ASSEMBLY REPORT, *supra* note 10, at 53-54.
114. *Id.* at 53, *quoting* Committee on Corporate Laws, *Changes in the Model Business Corporation Act*, 29 BUS. LAWYER 951, 954 (1974).
115. See note 88 and accompanying text *supra*.
116. See note 9 *supra*.
117. See notes 94-96 and accompanying text *supra*.
118. See notes 90-92, 97-99 and accompanying text *supra*.
119. Odd Fellows Mutual Aid Ass'n v. James, 63 Cal. 598 (1883) (defendant direc-

relating to business matters, even though those decisions prove to be unwise,[120] and a director may not incur liability for good faith reliance on reports of officers, employees, counsel, or other experts.[121] The standard of care set forth in this section is exclusive, as a person may incur no liability by virtue of being a director if he or she conforms to this standard.[122]

The foregoing suggests that the New Corporations Code has satisfactorily defined the standard of conduct that will be required of directors of California corporations. Such a standard has little value, however, if the procedures available for enforcement of the standard are so costly and time consuming as to fail to provide adequate protection for those injured. In apparent recognition of this fact, the New Corporations Code contains new procedures for enforcement of certain violations of the directors' duties.

STATUTORY CAUSES OF ACTION AND PROCEDURES

Section 316 of the New Corporations Code provides that directors who fail to conform to the required standards of loyalty and care in approving any of the following actions may be held jointly and severally liable to the corporation and those entitled to sue in its name: (1) the making of any unlawful distribution to the corporation's shareholders;[123] (2) the distribution of corporate assets to shareholders after the institution of dissolution proceedings without providing for all known liabilities; and (3) the making of an unlawful loan or guarantee.[124] A

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tor placed plaintiff non-profit corporation's funds in an insecure place, resulting in their theft).

120. See notes 101-102 and accompanying text *supra.*

121. See text accompanying notes 111-114 *supra.*

122. See notes 9 and 12 *supra.*

123. *New* CAL. CORP. CODE §§500-503 define unlawful distributions. *See generally* Comment, *California's New General Corporation Law: Dividends and Reacquisitions of Shares,* this volume at 645.

124. *New* CAL. CORP. CODE §316 provides:

(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 through 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 in a notice given to creditors under Chapters 18, 19 and 20.

(3) The making of any loan or guaranty contrary to Section 315.

(b) A director who is present at a meeting of the board, or any committee thereof, at which action specified in subdivision (a) is taken and who abstains from voting shall be considered to have approved the action.

(c) Suit may be brought in the name of the corporation to enforce the liability under subdivision (a) against any or all directors liable by any one or director who is present at a meeting of the board at which one of the above transactions is approved and who abstains from voting in that transaction shall be deemed to have approved it for the purposes of affixing liability.[125] These causes of action are not new to California as similar provisions are contained in the Old Corporations Code.[126] The New Code does, however, change the procedures for enforcing liability under these three causes of action by creating a *creditors'* derivative suit and by removing procedural obstacles in *shareholders'* derivative actions based thereon. To determine the propriety and effect of these changes it is necessary to examine the purposes for which they were enacted and the manner in which they may be applied.

A. The Creditors' Derivative Action

The Old Corporations Code requires that a creditor seeking a judgment against a director on the basis of a statutory cause of action must

more creditors of the corporation whose debts or claims arose prior to the time of any of the corporate actions specified in subdivision (a) and who have not consented to the corporate action, whether or not they have reduced their claims to judgment, or by any one or more holders of shares outstanding at the time of any violation of Section 502 or 503 specified in subdivision (a)(1) who have not consented to the corporate action, without regard to the provisions of Section 800.

(d) The damages recoverable from a director under this section shall be the amount of the illegal distribution or the loss suffered by the corporation as a result of the illegal loan or guaranty, as the case may be, but not exceeding the liabilities of the corporation owed to nonconsenting creditors at the time of the violation and the injury suffered by nonconsenting shareholders, as the case may be.

(e) Any director sued under this section may implead all other directors liable and may compel contribution, either in that action or in an independent action against directors not joined in that action.

(f) Directors liable under this section shall also be entitled to be subrogated to the rights of the corporation:

(1) With respect to subdivision (a)(1), against shareholders who received the distribution.

(2) With respect to subdivision (a)(2), against shareholders who received the distribution of assets.

(3) With respect to subdivision (a)(3), against the person who received the loan or guaranty.

Any director sued under this section may file a cross-complaint against the person or persons who are liable to such director as a result of the subrogation provided for in this subdivision or may proceed against them in an independent action.

If enacted, A.B. 2849, 1975-76 Regular Session, *as amended*, April 21, 1976 will amend subdivision (c) to read as follows:

(c) Suit may be brought in the name of the corporation to enforce the liability (1) under subdivision (a)(1) against any or all directors liable by the persons entitled to sue under Section 506 (b), (2) under subdivision (a)(2) or (a)(3) against any or all directors liable by any one or more creditors of the corporation whose debts or claims arose prior to the time of any of the corporate actions specified in subdivision (a)(2) or (a)(3) and who have not consented to the corporate action, whether or not they have reduced their claims to judgment, or (3) under subdivision (a)(3) against any or all directors liable by any one or more holders of shares outstanding at the time of any corporate action specified in subdivision (a)(3) who have not consented to the corporate action, without regard to the provisions of Section 800.

125. *New* CAL. CORP. CODE §316.

126. CAL. CORP. CODE §§824, 825.

first bring an action against the corporation.[127] A creditor may do this either by bringing an action against both the corporation and its directors or by first obtaining a judgment against the corporation and then suing the director.[128] While such a requirement may be desirable insofar as it protects directors from having to defend against meritless claims by placing the resources of the corporation on the side of the defense, it appears to have two major disadvantages. The first of these is that the procedure creates multiple litigation by requiring an action against the corporation as well as against the director. The second disadvantage is that the existing procedure may not protect all creditors injured by a wrongful act of a director, as it gives an individual creditor a right of action, rather than giving a creditor a right of action in a representative capacity for all creditors.[129] The existing procedure creates a "first-come, first-served" situation in which the first creditor to sue may recover all his or her damages while creditors who subsequently sue may find the director without assets to pay further judgments.[130]

Subdivision (c) of Section 316 of the New Code permits a creditor to institute an action *in the name of the corporation* against any and all directors who approve one or more of the actions proscribed by subdivision (a) of that section.[131] This provision is designed to alleviate the problem of multiple litigation by eliminating the requirement of an action against the corporation.[132] However, whether the new procedure eliminates the problem of first-come, first-served recoveries depends on the interpretation given to the language found in subdivision (d) of new Section 316. This subdivision provides that in a creditors' suit brought under Section 316, the damages recoverable from a director are the amount of loss suffered by the corporation, "but not to exceed the liabilities owed to nonconsenting creditors . . . ."[133] If this language is construed to mean the "nonconsenting creditors" who brought the suit, the result is little different than the situation which presently exists, as this allows only the creditor suing to recover and requires other creditors to bring their own actions. If, however, the language is construed to mean *all* nonconsenting creditors entitled to recover, the new procedure

127. CAL. CORP. CODE §826.
128. CAL. CORP. CODE § 826.
129. Note, *Corporations: Civil Liability of Directors for Unlawful Distributions: California Corporations Code Sections 825 and 826: Who May Sue: Nature and Extent of Recovery: Proposed Amendments*, 39 CAL. L. REV. 562, 563 (1951).
130. *Id.*
131. See note 124 *supra*. Oddly, the creation of the creditors' derivative suit is not addressed in the Report of the Assembly Select Committee on the Revision of the Corporations Code.
132. Elimination of multiple litigation is the sole reason given by the Assembly Select Committee Report for the changes made by new Section 316. ASSEMBLY REPORT, *supra* note 10, at 60.
133. See note 124 *supra*.

will avoid the problems of the existing code by protecting the rights of all creditors. In such a case, as with *shareholders'* derivative suits, the judgment will be paid to the corporation for the benefit of all creditors entitled to recovery. Presumably, when the amount recoverable from a director is insufficient to cover all claims of creditors, the judgment will be apportioned.[134]

While the language contained in subdivision (d) of Section 316 is susceptible to either interpretation, a reading of the entire section seems to favor the latter. Subdivision (c) states that creditors may sue in the name of the corporation "to enforce the liability under subdivision (a)." Subdivision (a) proclaims that directors 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)." Thus it would seem that the language "nonconsenting creditors" in subdivision (d) in fact refers to *all* nonconsenting creditors entitled to bring an action.

Not all creditors of the corporation are entitled to bring an action under Section 316 of the New Code. The section limits creditors who may sue in the name of the corporation to those whose debts or claims arose prior to the time of the director's wrongful act.[135] This limitation is analogous to the contemporaneous ownership requirement generally found in shareholders' derivative suits,[136] and would seem designed to serve the same purpose. As in shareholders' actions, the limitation prevents those who knew or should have known of the conduct sued upon at the time they entered into a transaction with the corporation from receiving an unjust recovery, and prevents persons from entering a transaction with the corporation for the sole purpose of instigating or joining an action against a director.[137] Section 316 further limits the creditors who may bring suit in the name of the corporation to those who did not consent to the challenged corporate action.[138] This limitation appears to be designed to prevent an unjust recovery by those who knew and agreed to, or perhaps even encouraged, the directors to take the action for which they are now being sued.

In most cases shareholders who wish to prosecute a derivative action

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134. The problem of insufficient funds to pay all liabilities to creditors is also somewhat mitigated by provisions giving a defendant director rights of contribution and subrogation. See note 124 *supra.*

135. See note 124 *supra.*

136. The contemporaneous ownership requirement is somewhat relaxed in the New Code. *Compare New* CAL. CORP. CODE §800 *with* CAL. CORP. CODE §834.

137. Ballantine, *Abuses of Shareholders Derivative Suits: How Far Is California's New "Security For Expenses" Act Sound Regulation?*, 37 CAL. L. REV. 399, 413-15 (1949).

138. See note 124 *supra.*

must comply with certain procedural requirements imposed by statute.[139] These requirements include a prior demand upon the corporation to take the action desired by the complaining shareholder,[140] and the furnishing, upon motion of defendant and order of the court, of sufficient security for the anticipated costs of litigation to the corporation.[141] The New Code, however, does not impose these procedural requirements on *creditors* who seek to sue in the name of the corporation. To determine if this exemption is justified, it is necessary to examine the rationale for the procedural requirements as applied to shareholders.

1. Creditors' Derivative Actions—Absence of the Demand Requirement

The derivative suit is considered an extraordinary remedy which should be made available only after all other means of redress have failed.[142] The demand requirement has been called "fundamental" to the concept of the shareholders' derivative suit[143] and is based on the premise that the corporation should be given the opportunity to conduct its own litigation as it is the primary party in interest.[144] It is only after the proper representatives of the corporation have failed in their duty to act in its behalf that the complaining shareholders' right to act arises.[145] This rationale for the demand requirement appears to be particularly compelling when it is remembered that directors of corporations are presumed to act in good faith.[146]

In addition to the theoretical aspects of the rule, the demand requirement in shareholders' actions serves several practical functions. For example, a demand made upon the board serves to enlighten directors who are unaware of the alleged wrong, and may precipitate action when directors are aware of a wrong but are hesitant to act.[147] The demand requirement also gives directors the opportunity to demonstrate to complaining shareholders that the information on which they base their

139. *New* CAL. CORP. CODE §800. See text accompanying notes 185-188 *infra* for exceptions.
140. *New* CAL. CORP. CODE §800.
141. *New* CAL. CORP. CODE §800; *see also* CAL. CORP. CODE §834.
142. Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 748 (1960).
143. Note, *Shareholders' Derivative Suits in Minnesota: Function and Operation of the Control Requirements*, 54 MINN. L. REV. 978, 987 (1970).
144. *Developments in the Law—Multiparty Litigation in the Federal Courts*, 71 HARV. L. REV. 874, 952 (1958).
145. Note, *Shareholders' Derivative Suits in Minnesota: Function and Operation of the Control Requirements*, 54 MINN. L. REV. 978, 987 (1970).
146. LATTIN, *supra* note 3, §105. See note 28 *supra*.
147. Note, *Shareholders' Derivative Suits in Minnesota: Function and Operation of the Control Requirements*, 54 MINN. L. REV. 978, 988 (1970).

complaint is erroneous or their conclusions are mistaken, thereby avoiding unnecessary litigation.[148] Furthermore, the cumulative effect of such demands may have a beneficial effect on the management of the corporation.[149] Finally, and perhaps most importantly, compliance with the complaining shareholders' demands entirely precludes the need for litigation.[150] It should also be noted that the law will excuse complainants from the demand requirement where such a demand would be futile,[151] as where fraud, conspiracy, or criminal conduct by a majority of the board is alleged.[152] It would seem that the rationale for the demand requirement in *shareholders'* actions applies equally as well to *creditors'* derivative suits. The strong practical and theoretical considerations appear to far outweigh the very slight burden the requirement imposes on potential plaintiffs.

2. Creditors' Derivative Actions—Absence of the Security For Expenses Requirement

The New California Corporations Code imposes no security deposit requirement on creditors who wish to maintain a derivative action. In contrast, both the Old and the New Corporations Codes provide that in most *shareholders'* derivative actions the court, upon motion by the defendant or the corporation, may require plaintiffs to post security for the anticipated expenses of the corporation arising from the litigation.[153] Should the shareholders fail in the action, the corporation is reimbursed from the deposit. The security deposit requirement first appeared in a New York statute[154] and has been adopted in only a handful of states.[155] The New York statute,[156] which requires only those with small holdings to post security, was adopted after a special committee of the New York Chamber of Commerce reported that the filing of meritless deriva-

148. *Id.*
149. Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 HARV. L. REV. 746, 748 (1960).
150. *Id.* Compliance with a shareholders' demand that an action be brought against a director obviously would not avoid litigation. However, compliance would place the corporation behind the suit, which removes the danger of a secret settlement between the complaining shareholders and the defendant director. *Id.* at 749.
151. Gottesfeld v. Richmaid Ice Cream Co., 115 Cal. App. 2d 854, 860, 252 P.2d 973, 978 (1953); Reed v. Norman, 152 Cal. App. 2d 892, 898, 314 P.2d 204, 207 (1957).
152. Reed v. Norman, 152 Cal. App. 2d 892, 898, 314 P.2d 204, 208 (1957).
153. CAL. CORP. CODE §834; *New* CAL. CORP. CODE §800. For a discussion of security deposits in shareholders' actions under the New Code, see Comment, *California's New General Corporation Law: Prospects for Minority Shareholders*, this volume at 706.
154. Ballantine, *Abuses of Shareholders Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?*, 37 CAL. L. REV. 399, 400 (1949).
155. Article, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J. L. SOC. PROB. 50, 54 n.27 (1968).
156. N.Y. BUS. CORP. LAW §627 (McKinney 1963).

tive suits with the intent of obtaining a settlement had become a "racket" reaching "epidemic proportions."[157] Thus the primary purpose of the security deposit requirement is to deter so-called strike suits.[158]

The California provisions differ significantly from those found in other states. The court may impose the requirement on *any* shareholder, regardless of the number of shares owned,[159] upon motion by either the defendant directors or the corporation.[160] The court may grant a motion for security on either of two grounds: (1) there is no reasonable possibility that the prosecution of the action will benefit the corporation or its shareholders; or (2) the movant, if other than the corporation, did not participate in the transaction complained of.[161] Thus the California statute proceeds on the theory that a preliminary inquiry into the good faith of a "voluntary champion" is appropriate.[162] The requirement is also considered by some to be necessary to offset the expenses arising from provisions requiring the corporation to indemnify directors who successfully defend against derivative actions,[163] although this consideration seems less compelling with the advent of director and officer indemnification insurance.[164] California's security for expenses provisions are generally considered by legal commentators to be more fair than those found in other states.[165] Many legal writers, however, disapprove of any form of security requirement as an unjustified impediment to the maintaining of a derivative action.[166]

157. For a critique of this report and the New York statute, see Hornstein, *Death Knell of Stockholders' Derivative Suits in New York*, 32 CAL. L. REV. 123 (1944).

158. LATTIN, *supra* note 3, §115; Ballantine, *Abuses of Shareholders Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?*, 37 CAL. L. REV. 399, 399-400 (1949); Note, *Shareholders' Derivative Suits in Minnesota: Function and Operation of the Control Requirements*, 54 MINN. L. REV. 978, 1005 (1970); Article, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J.L. SOC. PROB. 50, 50 (1968); *Developments in the Law—Multiparty Litigation in the Federal Courts*, 71 HARV. L. REV. 874, 957 (1958); Note, *Security for Expenses Legislation—Summary, Analysis, and Critique*, 52 COLUM. L. REV. 267, 281 (1952).

159. CAL. CORP. CODE §834; *New* CAL. CORP. CODE §800.

160. CAL. CORP. CODE §834; *New* CAL. CORP. CODE §800.

161. CAL. CORP. CODE §834; *New* CAL. CORP. CODE §800.

162. 2 G. HORNSTEIN, CORPORATION LAW AND PRACTICE §722, at 224 (1959) [hereinafter cited as 2 HORNSTEIN].

163. M. FEUER, PERSONAL LIABILITIES OF CORPORATE OFFICERS AND DIRECTORS 180 (2d ed. 1974); W. KNEPPER, *supra* note 1, §14.01, at 374; Ballantine, *Abuses of Shareholders Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?*, 37 CAL. L. REV. 399 (1949). Existing California indemnification provisions are found in CAL. CORP. CODE §830. For new indemnification provisions, see note 195 *infra*.

164. *See* CAL. CORP. CODE §830; *New* CAL. CORP. CODE §317.

165. Ballantine, *Abuses of Shareholders Derivative Suits: How Far Is California's New "Security for Expenses" Act Sound Regulation?*, 37 CAL. L. REV. 399, 417 (1949); *Developments in the Law—Multiparty Litigation in the Federal Courts*, 71 HARV. L. REV. 874, 958 (1958).

166. 2 HORNSTEIN, *supra* note 162, §722; Article, *Security for Expenses in Shareholders' Derivative Suits: 23 Years' Experience*, 4 COLUM. J. L. SOC. PROB. 50, 50 & n.1 (1968).

Assuming that California's security requirements serve a valid purpose in some situations, it may be that they are unnecessary in creditors' derivative actions brought under Section 316 of the New Code. This section does not permit creditors to bring a derivative action based on vague allegations of fraud or mismanagement, but limits such suits to three specific, well defined causes of action.[167] The limited application of the section appears to render it ill-suited for use in a strike suit. As the primary purpose of the security requirement is deterrence of strike suits,[168] there is little need to impose this requirement.[169]

3. *Creditors' Derivative Actions—Attorneys' Fees*

Shareholders who successfully prosecute a derivative action are entitled to an award of their attorneys' fees.[170] With the creation of the creditors' derivative action under Section 316 of the New Code, the question arises as to whether creditors who successfully sue in the name of the corporation should also be entitled to reimbursement for their attorneys' fees.

In California the award of attorneys' fees in derivative actions is not based on a statute, but on the equitable doctrine of the "common fund."[171] This doctrine provides that when a plaintiff obtains a judgment for the benefit of others, a common fund is created from which the plaintiff may be reimbursed for his or her attorneys' fees.[172] Thus the fees are not paid by the unsuccessful party, but by all those who benefit from the judgment.[173] The doctrine is applied to prevent persons who did not participate in the litigation from profiting at the expense of those who did participate[174] Further justification for the doctrine is that it encourages minority shareholders, who may have a small monetary stake in the outcome, to initiate proper litigation by assuring payment of their litigation expenses.[175] In *Fletcher v. A. J. Industries, Inc.*,[176] the

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167. See note 124 *supra*.
168. See note 158 *supra*.
169. It is unfortunate that the drafters of *New* CAL. CORP. CODE §316, in properly deleting the security deposit requirement, used language which sweeps a little too broadly and thereby deleted the desirable demand requirement. See text accompanying notes 142-152 *supra*.
170. 1 BALLANTINE & STERLING, *supra* note 17, §90.06.
171. Fletcher v. A. J. Indus., Inc., 266 Cal. App. 2d 313, 320, 72 Cal. Rptr. 146, 150 (1968).
172. 1 BALLANTINE & STERLING, *supra* note 17, §90.06.
173. *Id.* 2 HORNSTEIN, *supra* note 162, §732. For a discussion of the evolution of this doctrine, *see generally* Hornstein, *The Counsel Fee in Stockholder's Derivative Suits*, 39 COLUM. L. REV. 784 (1939).
174. Fletcher v. A. J. Indus., Inc., 266 Cal. App. 2d 313, 324, 72 Cal. Rptr. 146, 152-53 (1968).
175. Professor Fletcher has written:

> The liberal allowance of counsel fees to the champion of the rights of a group is the dynamic factor giving the necessary impetus and incentive to the volun-

common fund doctrine was extended to require the corporation to pay the attorneys' fees of the complaining shareholder when a derivative action results in a non-pecuniary "substantial benefit" to the corporation.[177] The court maintained that the shareholders' derivative suit is an effective tool for policing the management of a corporation and that therefore the recovery of attorneys' fees should not be limited to cases which produce a monetary judgment.[178] The court went on to declare that a "substantial benefit" arises whenever the action either maintains the health of the corporation by raising the standards of fiduciary relationships or prevents an abuse which would be prejudicial to the rights and interests of the corporation or affects the enjoyment of a right essential to the shareholders' interests.[179] Applying this holding to the facts before it, the court ordered payment of attorneys' fees because the suit resulted in a removal of some directors, even though the suit was settled and the issue of wrongdoing by the removed directors was left for future arbitration.[180]

The "common fund" rationale for awarding attorneys' fees in shareholders' actions seems to apply equally well to creditors' derivative suits when a monetary judgment is recovered.[181] Awarding fees prevents creditors who did not join in the action from recovering at the expense of the creditors who prosecuted the action. However, the appropriateness of these awards is not as apparent when a creditors' action results only in a non-monetary "substantial benefit" to the corporation, as the articulated rationale for such awards in shareholders' actions[182] is not necessarily apposite to creditors' derivative suits. First, the award is not necessary to encourage proper litigation, as creditors, unlike many mi-

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teer method of representation in class and derivative suits. Otherwise no one individual could afford to begin a suit of such size and difficulty or undertake to resist an unfair settlement.

13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §6045, at 563 (perm. ed. rev. 1970).

The doctrine encourages proper litigation by assuring that successful attorneys will be compensated. Fletcher v. A. J. Indus., Inc., 266 Cal. App. 2d 313, 324, 72 Cal. Rptr. 146, 152-53 (1968).

176. 266 Cal. App. 2d 313, 72 Cal. Rptr. 146 (1968).

177. *Id.* at 320-22, 72 Cal. Rptr. at 150-51.

178. *Id.* at 324, 72 Cal. Rptr. at 153.

179. *Id.*; *see also* 1 BALLANTINE & STERLING, *supra* note 17, §90.06.

180. Fletcher v. A.J. Indus., Inc., 266 Cal. App. 2d 313, 325, 72 Cal. Rptr. 146, 153 (1968).

181. Professor Hornstein, discussing recovery of fees in class actions, noted that "[c]reditors suits were the earliest and still the most frequent illustration" of the application of the common fund doctrine. Hornstein, *Legal Therapeutics: The "Salvage" Factor in Counsel Fee Awards*, 69 HARV. L. REV. 658, 662 (1956).

The award of attorneys' fees would encourage proper litigation in situations where, due to limited assets recoverable from a director, a creditor may be discouraged from suing in light of the probable division of the recovery among several creditors. See text accompanying note 134 *supra*.

182. See notes 174-175 and accompanying text *supra*.

nority shareholders, will generally have a sufficient financial interest at stake to prompt action when directors act to impair that interest. One may even wonder whether suits to police corporate management[183] are "proper litigation" when prosecuted by outsiders whose interests may be inimical to those of the corporation. Second, the award is not necessary to prevent non-participating creditors from receiving a recovery at the suing creditors' expense, as there is no recovery by creditors when the judgment provides only a substantial benefit to the corporation. The sole basis for awarding attorneys' fees to the creditor who prosecutes a creditors' derivative suit which results only in a substantial benefit to the corporation would seem to be the notion that the corporation should pay for the benefit it has received. If the courts choose to award fees on this basis, they should take care to do so only when the value of the non-monetary "substantial benefit" approximates the amount of fees awarded.[184]

B. Suits by Shareholders Under Section 316

Subdivision (c) of Section 316 of the New Code[185] permits shareholders to sue directors in the name of the corporation *without* meeting the demand and security requirements normally required in derivative actions[186] when either of the following causes of action is alleged: (1) a distribution on any shares which are junior to other outstanding shares with respect to a liquidation of assets, when such distribution is in derogation of the senior shares' liquidation preference;[187] or (2) a distribution on any shares which are junior to other outstanding shares with respect to payment of a dividend, when such distribution is in derogation of the senior shares' dividend preference.[188]

As already noted, the requirement of a demand on the corporation is based on the notion that a shareholder should pursue all his or her

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183. See text accompanying note 178 *supra*.

184. The dissent in *Fletcher* noted:

> if the existence of a "common fund" protected or increased by stockholders' actions is not a prerequisite to the allowance of fees the officers and directors may well be faced with a liquidation of assets to pay fees, even though the resulting harm to the corporation might be disproportionate to the "substantial benefits" derived from the lawsuit.

Fletcher v. A. J. Indus., Inc., 266 Cal. App. 2d 313, 329-30, 72 Cal. Rptr. 146, 156-57 (1968) (Christian, J., dissenting). Apparently this consideration was not sufficient to prevent awarding attorneys' fees in the *shareholders'* action in *Fletcher*. However, such a consideration must be accorded greater weight in *creditors'* suits, where the *sole* rationale for awarding fees is to cause the corporation to pay for the benefit it has received.

185. See note 124 *supra*.

186. *New* CAL. CORP. CODE §800.

187. *New* CAL. CORP. CODE §502.

188. *New* CAL. CORP. CODE §503; *see generally* Comment, *California's New General Corporation Law: Dividends and Reacquisitions of Shares*, this volume at 645.

remedies within the corporation before bringing a suit against its directors.[189] Further, the demand requirement serves several practical purposes, such as affording the directors an opportunity to comply with the demand and thereby avoid litigation.[190] Finally, a demand relative to unlawful distributions would not necessarily be a futile act, as such distributions may occur through director negligence.[191] In light of the small burden the demand requirement places on the complaining shareholder and the possible benefit to be derived from such a requirement, it is difficult to understand why it should not be applied to shareholders' derivative actions arising under Section 316 of the New Code.

Section 316 of the New Code further excuses complaining shareholders from the security deposit requirement when a derivative suit is brought on one of the specified causes of action.[192] As noted in the discussion of creditors' derivative suits, the security deposit requirement is primarily designed to deter meritless suits brought solely for the purpose of obtaining a settlement.[193] Because the actions which may be prosecuted pursuant to Section 316 are limited and strictly defined,[194] they arguably are unsuitable for this purpose. Therefore the rationale for requiring a security deposit does not apply to suits under this section, and the requirement is properly deleted.

INDEMNIFICATION OF DIRECTORS

California's indemnification provisions have been expanded to provide greater protection for the corporate director by permitting advance payment of indemnification and by requiring indemnification when a director successfully defends an action.[195] The extent of indemnifica-

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189. See notes 142-146 and accompanying text *supra.*
190. See notes 147-150 and accompanying text *supra.*
191. See notes 151-152 and accompanying text *supra.*
192. See text accompanying notes 185-188 *supra.*
193. See text accompanying notes 154-158 *supra.*
194. See text accompanying notes 185-188 *supra.*
195. *New* CAL. CORP. CODE §317 provides:

(a) For the purposes of this section, "agent" includes any person who is or was a director, officer, employee or other agent of the corporation, or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, or was a director, officer, employee or agent of a corporation which was a predecessor corporation of the corporation or of another enterprise at the request of such predecessor corporation; "proceeding" includes any threatened, pending or completed action or proceeding, whether civil, criminal, administrative or investigative; and "expenses" includes attorneys' fees and any expenses of establishing a right to indemnification under subdivision (d) or subdivision (e)(3).

(b) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any proceeding (other than an action by or in the right of the corporation) by reason of the fact that such person is or was an agent of the corporation, against expenses, judgments, tion permitted depends on the type of action brought against the direc-

fines, settlements and other amounts actually and reasonably incurred in connection with such proceeding if such person acted in good faith and in a manner such person reasonably believed to be in the best interests of the corporation and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct of such person was unlawful. The termination of any proceeding by judgment, order, settlement, conviction or upon a plea of nolo contendere or its equivalent shall not, of itself, create a presumption that the person did not act in good faith and in a manner which the person reasonably believed to be in the best interests of the corporation or that the person had reasonable cause to believe that the person's conduct was unlawful.

(c) A corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action by or in the right of the corporation to procure a judgment in its favor by reason of the fact that such person is or was an agent of the corporation, against expenses actually and reasonably incurred by such person in connection with the defense or settlement of such action if such person acted in good faith, in a manner such person believed 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. No indemnification shall be made under this subdivision (c):

(1) In respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation in the performance of such person's duty to the corporation, unless and only to the extent that the court in which such action was brought shall determine upon application that, in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for the expenses which such court shall determine;

(2) Of amounts paid in settling or otherwise disposing of a threatened or pending action, with or without court approval; or

(3) Of expenses incurred in defending a threatened or pending action which is settled or otherwise disposed of without court approval.

(d) To the extent that an agent of a corporation has been successful on the merits in defense of any proceeding referred to in subdivision (b) or (c) or in defense of any claim, issue or matter therein, the agent shall be indemnified against expenses actually and reasonably incurred by the agent in connection therewith.

(e) Except as provided in subdivision (d), any indemnification under this section shall be made by the corporation only if authorized in the specific case, upon a determination that indemnification of the agent is proper in the circumstances because the agent has met the applicable standard of conduct set forth in subdivision (b) or (c), by:

(1) A majority vote of a quorum consisting of directors who are not parties to such proceeding;

(2) Approval of the shareholders (Section 153), with the shares owned by the person to be indemnified not being entitled to vote thereon; or

(3) The court in which such proceeding is or was pending upon application made by the corporation or the agent or the attorney or other person rendering services in connection with the defense, whether or not such application by the agent, attorney or other person is opposed by the corporation.

(f) Expenses incurred in defending any proceeding may be advanced by the corporation prior to the final disposition of such proceeding upon receipt of an undertaking by or on behalf of the agent to repay such amount unless it shall be determined ultimately that the agent is entitled to be indemnified as authorized in this section.

(g) No provision made by a corporation to indemnify its or its subsidiary's directors or officers for the defense of any proceeding, whether contained in the articles, bylaws, a resolution of shareholders or directors, an agreement or otherwise, shall be valid unless consistent with this section. Nothing contained in this section shall affect any right to indemnification to which persons other than such directors and officers may be entitled by contract or otherwise.

(h) No indemnification or advance shall be made under this section, except as provided in subdivision (d) or subdivision (e)(3), in any circumstance where it appears:

(1) That it would be inconsistent with a provision of the articles, bylaws, a resolution of the shareholders or an agreement in effect at the time of the

tor.[196] Subdivision (b) of Section 317 of the New Code deals with indemnification when the action is not brought in the name of the corporation. It permits the corporation to indemnify a director for expenses, judgments, fines, and settlements, provided only that the director acted in good faith and in a manner he or she reasonably believed to be in the best interests of the corporation. It is specifically provided that a judgment against the director does *not* create a presumption that the director acted in bad faith.

Subdivision (c) of Section 317 of the New Code sets forth the indemnification permitted when a director is sued in the name of the corporation. A corporation may indemnify its directors for their *expenses* if they acted in good faith *and* without negligence. Court approval is required before indemnification may be paid for expenses when a director is adjudged liable or when an action is settled. Court approval of settlements in derivative actions appears to be desirable in that it prevents wrongdoers from quickly disposing of actions by settlement without compromising the public policy favoring settlements.[197]

Regardless of whether the action is maintained in the name of the corporation, the New Code requires a corporation to provide indemnification to a director when he or she is successful on the merits of the action.[198] This provision seems to have merit as it protects those who, even though successful in the action, are in disfavor with the management. Furthermore, the provision violates no public policy as those who are vindicated at trial are presumed to be free from fault and therefore should be entitled to reimbursement for expenses arising by

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accrual of the alleged cause of action asserted in the proceeding in which the expenses were incurred or other amounts were paid, which prohibits or otherwise limits indemnification; or

(2) That it would be inconsistent with any condition expressly imposed by a court in approving a settlement.

(i) A corporation shall have power to purchase and maintain insurance on behalf of any agent of the corporation against any liability asserted against or incurred by the agent in such capacity or arising out of the agent's status as such whether or not the corporation would have the power to indemnify the agent against such liability under the provisions of this section.

If enacted, A.B. 2849, 1975-76 Regular Session, will add the following subdivision:

(j) This section does not apply to any proceeding against any trustee, investment manager or other fiduciary of an employee benefit plan in such person's capacity as such, even though he may also be an agent as defined in subdivision (a) of the employer corporation. Nothing contained in this section shall affect any right to indemnification to which such a trustee, investment manager or other fiduciary may be entitled by contract or otherwise.

196. This distinction existed at common law. When a director was sued by a third party, normal agency rules for indemnification of an agent by his or her principal were applied. Agency rules of indemnification were considered inapposite, however, when a corporation sued its directors. Cheek, *Control of Corporate Indemnification: A Proposed Statute*, 22 VAND. L. REV. 255, 278 (1969) [hereinafter cited as Cheek].

197. *Id.* at 285-86.

198. *New* CAL. CORP. CODE §317(d). See note 195 *supra*.

virtue of their service to the corporation.[199] In situations where indemnification is not mandatory, the director seeking to be indemnified is not permitted to vote on the decision to provide indemnification.[200]

Unlike existing law,[201] subdivision (f) of Section 317 of the New Code permits the corporation to advance expenses to the director with the agreement that the director shall return the amount of such advance to the corporation if it is subsequently determined that he or she is not entitled to indemnification. Under the old indemnification provisions a director who does not have the resources to wage a protracted legal battle is often forced to settle an action regardless of how confident he or she may be as to the ultimate success on the merits.[202] By advancing expenses, the director will be able to defend such an action to a successful conclusion.[203] This should provide the added benefit of deterring strike suits as it will reduce the likelihood that frivolous claims will be settled. This provision somewhat offsets the loss of protection against meritless claims that results from the elimination of the requirement that a creditor obtain a judgment against a corporation before suing the director.[204]

CONCLUSION

Newly enacted Section 309 of the California Corporations Code will bring order to the existing confusion in California law relating to the standard of conduct of directors by clearly defining that standard and its application. The standard set forth requires corporate directors to act in good faith and without negligence. Directors may avoid liability for negligence by performing their duties as would a reasonably prudent person in like circumstances. The degree of care required varies according to the size, type and nature of the corporation and the role of the director in the corporation. Nevertheless, liability may be imposed for failure to remain knowledgeable of corporate affairs. No liability may be incurred for good faith business judgment. This clarification of the standard of care should enable directors to perform their duties with less anxiety as to possible liability and should therefore encourage responsible persons to assume directorships. The creation of a straight-

199. Cheek, *supra* note 196, at 282.
200. *New* CAL. CORP. CODE §317(e). See note 195 *supra*.
201. CAL. CORP. CODE §830.
202. ASSEMBLY REPORT, *supra* note 10, at 61-62; Cheek, *supra* note 196, at 287.
203. Formerly, advancing directors their litigation expenses was opposed on the grounds that placing the assets of the corporation behind defendant directors caused minority shareholders to be overwhelmed. Comment, *Corporate Responsibility for Litigation Expenses of Management*, 40 CAL. L. REV. 104, 105 (1952).
204. See text accompanying notes 127-128 *supra*.

forward standard also affords benefits to shareholders and creditors by encouraging directors to act within the now discernible borders of permissible conduct.

Section 316 of the New Code has created a creditors' derivative suit which is available when directors make an unlawful distribution or loan. The section exempts creditors' suits and certain shareholders' actions from the procedural requirements normally found in derivative actions. While the security for expenses requirement may be inapposite to such suits due to the limited causes of action which may be prosecuted under this section and is therefore properly excluded, there appears to be little reason for abandoning the demand requirement as it places a small burden on the complaining creditor while permitting the corporation to avoid litigation by meeting the demand or taking other suitable action. The section is silent as to whether attorneys' fees may be awarded in creditors' derivative actions, but it appears that fees may be awarded when a common fund is created by a judgment.

Indemnification provisions have been expanded by Section 317 of the New Code to permit a corporation to advance litigation expenses to directors who are sued by virtue of their position in the corporation. This provision allows directors to defend against meritless suits which they formerly may have been forced to settle. By affording added protection to directors, this provision will assist California corporations in attracting competent personnel. The advance indemnification provision does not jeopardize protection of shareholders as it places no restrictions on bringing an action but merely permits directors to adequately defend actions and thereby deter meritless suits.

The New California Corporations Code appears to carefully tread the narrow ground between the twin pitfalls of inadequate shareholder and creditor protection and excessive director exposure to liability. The New Code's requirement of absolute good faith is inherent in the trust relationship which exists between a corporation and its directors. The prescribed standard of care of the ordinarily prudent person in a like position under similar circumstances provides reasonable protection to shareholders by requiring directors to actively participate and remain cognizant of corporate affairs. On the other hand, this standard conforms to corporate realities by recognizing the varying roles of directors in corporations of diverse nature and size, and by permitting directors to rely in good faith upon information received from knowledgeable and trusted persons. The newly created creditors' derivative action enhances creditors' protection by assuring equitable distribution of judgments recovered from errant directors. *Liability* of directors is largely unaffected by this provision, as it creates no new causes of action. Whatever increase in directors' *exposure to suits* may result would seem to be more than offset by the new provisions permitting *advance* indemnification and *requiring* indemnification when a director successfully defends an action.

Douglas Paul Wiita