DIRECTORS' AND OFFICERS' LIABILITY

GOOD FAITH: A NEW SHERIFF IN TOWN?

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FEBRUARY 9, 2006

Corporate directors know that they must exercise their fiduciary duties to the company and its shareholders in good faith. They encounter the necessity of good faith conduct in the core protections against personal liability authorized by Delaware law, including the business judgment rule, an exculpatory provision in the corporate charter, reliance on the advice of experts reasonably selected, and as a prerequisite to advancement and indemnification of litigation expenses. A developing body of Delaware case law is grappling with whether good faith is a separate fiduciary duty in addition to the traditional duties of care and loyalty, and therefore an additional basis for judicial review of corporate governance decisions. Delaware Supreme Court statements that good faith is part of a "triad" of director fiduciary duties coexist with recent Court of Chancery decisions analyzing good faith as a component of care and loyalty, but not a separate duty. This debate is not merely minutia for "test your knowledge of the genre" devotees. Directors and their advisers need to understand that recent case law interpreting the elusive concept of good faith as a constituent element of the overarching notion of faithfulness to corporate interests may, in certain circumstances, give courts broader latitude to sustain breach of fiduciary duty allegations even when directors have acted with demonstrable care and loyalty. Fortunately, recent decisions have made important progress in taking good faith beyond a "know it when you see it" standard, and begun to enunciate standards that offer a measure of clarity and predictability.

Traditional Fiduciary Duties

A brief review of fundamental principles designed to insulate board decision-making from judicial scrutiny is in order. In Delaware, the business judgment rule is a rebuttable presumption that directors act in good faith, on an informed basis, honestly believing that their action is in the best interests of the company.[1] The presumption "initially attaches to a director-approved transaction within a board's conferred or apparent authority in the absence of any evidence of fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment."[2]

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If the plaintiff fails to meet its evidentiary burden of showing that that the board, in reaching its challenged decision, breached a fiduciary duty, the substantive aspect of the business judgment rule attaches to protect individual director-defendants from personal liability for making the challenged board decision. If the rule is rebutted, the burden shifts to the defendant directors, as proponents of the challenged transaction, to prove the "entire fairness" of the transaction to the shareholder plaintiff.

Traditionally, Delaware courts held that directors owe two fiduciary duties to the company and its shareholders: the duty of care and the duty of loyalty. The duty of care is process-oriented. A plaintiff arguing that directors breached their duty of care must establish that the directors failed to act on an informed basis, *i.e.*, failed to consider all material information reasonably available at the time they made their decision.[3] The standard for determining whether a business judgment made by the board was an informed one is gross negligence, defined as "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason."[4] Where a director in fact exercises a good faith effort to be informed and to exercise appropriate judgment, he or she should be deemed to satisfy the duty of care.

The duty of loyalty "mandates that the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."[5] If a majority of disinterested and independent directors exhibit undivided and unselfish loyalty to the corporation's interests in connection with a challenged decision, the fiduciary duty of loyalty ordinarily is satisfied. Disinterested directors are those that neither appear on both sides of a transaction nor expect to derive personal financial benefit from a proposed transaction apart from all stockholders generally, and "independence" here means that a director's decision is based on the corporate merits of the subject before the board and not extraneous considerations. All of these determinations must be made on a director-by-director basis.

Emphasis on Good Faith

With no fanfare, the Delaware Supreme Court in 1993 introduced a new formulation of directors' fiduciary duties. In the midst of an otherwise traditional recitation of the working of the business judgment rule, in *Cede & Co. v. Technicolor, Inc.*[6] the court stated that a plaintiff seeking to overcome the presumption must provide evidence that a majority of directors "breached any one of the triads of their fiduciary duty-good faith, loyalty or due care." Since *Cede*, "good faith" has joined the standard formulation of director duties by many Delaware courts, including the Supreme Court, which in several decisions has repeated its enumeration of good faith as a fiduciary duty separate and independent of those of care and loyalty, but never offered a definition of good faith nor based a decision addressing director conduct on the concept.[7] For example, in *Brehm v. Eisner*,[8] the Delaware Supreme Court stated that "good faith … is a key ingredient of the business judgment rule," and that "directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available."

Although defined nowhere in the Delaware General Corporation Law, the concept of good faith arises in myriad contexts as a protection against potential liability for directors in the performance of their duties. For example, 8 Del. C. §144(a)(1) will prevent a transaction from being voided on grounds of director interest if a majority of disinterested directors "in good faith authorizes the … transaction." Subject to federal law, officers and directors may buy and sell shares of their corporation at will so long as they act in good faith.[9] Section 141(e) of Delaware's corporation law "fully" protects directors from liability when, in discharging their duties, they rely "in good faith" on the professional opinion of an expert selected with reasonable care. DGCL §102(b)(7) authorizes a provision in the certificate of incorporation eliminating or limiting the liability of directors for damages, unless based on: (i) the duty of loyalty (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) unlawful payment of dividends or unlawful stock purchase or redemption; or (iv) receipt of an improper personal benefit. The principal effect of an exculpatory provision is to insulate directors from liability for duty of care damage claims.[10] And Section 145 of the DGCL requires that directors and officers seeking indemnification from the corporation have acted in good faith and for a purpose that they reasonably believed to be in the corporation's best interests.

Traditionally, good faith has been viewed principally as a component or subset of the duty of loyalty.[11] Indeed, it is difficult to envisage a situation where conduct that is disloyal to the company and its shareholders could be said to be in good faith as to those constituencies. On occasion, however, good faith also enters into the due care analysis, which is chiefly concerned with prudence. Specific allegations that directors failed to act in good faith have in certain circumstances removed conduct from the protection of a charter exculpation clause even though the conduct is not alleged to be disloyal. For example, Delaware courts have recognized a board's "duty to monitor" the activities of the corporation, under which a sustained or systematic failure of the board to exercise oversight of activities that create corporate liability may create director liability.[12] The duty to monitor is not a separate fiduciary duty, but is principally a branch of the duty of care. In the leading *In re Caremark* decision, the Court of Chancery analyzed a monitoring-based duty of care claim for purposes of approving a derivative claim settlement with keen emphasis on good faith performance of duty, not good faith as a separate line of inquiry with its own substantive standard. Thus, the court held "that a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists," and "only a sustained or systematic failure of the board to exercise oversight-such as an utter failure to attempt to assure a reasonable information and reporting system exists-will establish the lack of good faith that is a necessary condition to liability. Such a test of liability-lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight-is quite high." In other words, "good faith performance of duty" was the benchmark. This seems to place good faith in due care contexts in proper perspective, insisting on a good faith attempt to be informed of relevant facts – the essence of the duty of care. In 2000, Vice Chancellor Strine proposed a similar role in *Nagy v. Bistriar*,[13] stating that "[i]f it is useful at all as an independent concept, the good faith iteration's utility may rest in its constant reminder (1) that a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and (2) that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes."

The notion that the obligation of good faith can be removed from the duties of care and loyalty, and transformed into a distinct duty that can form the basis for a claim separate from care and loyalty, merits close examination. Duty of care violations rarely are established because of the gross negligence standard and because charter exculpatory provisions typically foreclose money damage claims to plaintiffs who could theoretically prove such a violation. Such provisions reflect a legislative judgment that shareholders should be able to insulate directors from care-based liability unless they act in bad faith, *i.e.*, disloyally. If failure to act in good faith is a potential avenue for director liability even though a majority of disinterested and independent directors (i) approved a transaction (eliminating a loyalty claim), and (ii) acted on a deliberate, fully-informed basis (or a due care claim is foreclosed by an exculpatory provision), good faith might become a trailing net to create potential exposure for conduct that satisfies the established fiduciary standards of care and loyalty.

Several recent Court of Chancery decisions have attempted to map the boundaries of good faith as a separate claim on which liability may be predicated. The starting place must be *In re Walt Disney Co. Deriv. Litig.*,[14] in which Chancellor Chandler in 2003 denied a motion to dismiss a derivative action for failure to make pre-suit demand because plaintiffs alleged particularized facts that raised doubt about whether the challenged decisions were entitled to the protection of the business judgment rule. The complaint challenged decisions of Disney's board of directors approving an executive compensation contract for Michael Ovitz as president of Disney, and subsequently impliedly approving a non-fault termination agreement that resulted in Ovitz receiving approximately $140 million after 14 months of employment. The court acknowledged that the duty of loyalty was not at issue because a majority of the board was disinterested in the Ovitz hiring decision, and indicated "hesitance to second-guess the business judgment of a disinterested and independent board of directors." The directors argued that the complaint therefore alleged, at most, breach of the duty of care, a claim which ordinarily would be barred by Disney's exculpatory provision. But the court concluded that the allegations of the complaint detailing the minimal attention given by the full board and its compensation committee to the negotiation of the employment agreement, which it left to Disney CEO Michael Eisner, who had recruited his close friend Ovitz, and the board's purported "ostrich-like approach regarding Ovitz's non-fault termination," raised questions about whether the directors exercised "any business judgment" or made "any good faith attempt to fulfill their fiduciary duties to Disney and its stockholders." The conduct alleged, the court concluded, gave "reason to doubt whether the board's actions were taken honestly and in good faith," allegations which, if proved, would trigger the exclusion in the charter exculpatory provision for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law." In the court's view, the complaint did not allege a classic breach of due care in which directors acted with gross negligence in failing to inform themselves or to deliberate adequately about an issue of material importance to the corporation. Rather, the abdication of director review and approval of employment-related terms for a member of senior management, and leaving the negotiations to a close personal friend of the party across the table, compelled the conclusion that "our corporation law's theoretical justification for disregarding honest errors simply does not apply to intentional misconduct or to egregious process failures that implicate the foundational director obligation to act honestly and in good faith to advance corporate interests." The court emphasized that the complaint, viewed on a motion to dismiss, alleged conscious and intentional disregard of directorial responsibilities, and portrayed a "'we don't care about the risks' attitude concerning a material corporate decision." In essence, the court sustained allegations of a lack of care in the decision-making process so deliberate and striking that it "may not have been taken honestly and in good faith to advance the best interests of the company." The decision is notable for its reliance on lack of good faith -- which on the facts alleged it described as a kind of alloy of director lapses in both care and loyalty – as a basis to take a care-based claim outside the scope of an exculpatory provision.

Disney's reliance on a good faith standard was expressly adopted in *Official Comm. of Unsecured Creditors of Integrated Health Serv's, Inc. v. Elkins*,[15] in which a bankruptcy debtor's unsecured creditors committee challenged the board's approval of certain executive compensation and loan arrangements as breaches of its duties of loyalty and good faith. The court dismissed the loyalty claim because the challenged transactions were approved by a majority of a board consisting of a majority of disinterested, independent directors. Turning to what it called the "*Disney* standard" to determine if any of the challenged transactions were approved with the level of "intentional and conscious disregard to a director's duties that sustains fiduciary duty claims and avoids the §102(b)(7) exculpatory provision," the court emphasized that this standard is a "high bar" that is "beyond gross negligence." But if a board "acts with knowing and deliberate indifference to its duties to act faithfully and with appropriate care, it acts in such a way as to be denied the protection of a §102(b)(7) provision." Evaluating a series of compensation and loan arrangements, the court began by declining to announce a minimum period of time that directors must devote to review of a transaction in order for it enjoy business judgment protection. Rather, "[a]s long as the Board engaged in action that can lead the Court to conclude it did not act in knowing and deliberate indifference to its fiduciary duties, the inquiry of this nature ends. The Court does not look at the reasonableness of a Board's actions in this context, as long as the Board exercised some business judgment." The court dismissed good faith claims based merely on allegations that the board relied on the advice of a compensation consulting firm recommended by the executive whose compensation was under review. However, allegations that the board approved or ratified compensation or loans without deliberation, or advice from any expert, implicated a knowing and intentional indifference to the conduct of an informed decision-making process, which took the care-based claim outside the protection of an exculpatory provision.

In August 2005, Chancellor Chandler revisited good faith in his *Disney* decision after trial on the merits.[16] The court ruled that while the Disney board's discharge of its fiduciary duties "fell significantly short of the best practices of ideal corporate governance," best practices are not mandatory and the board acted in conformity with its fiduciary duties in connection with the hiring and termination of Michael Ovitz. *Disney II* offers the most thorough judicial analysis to date of the role of good faith in director duties. The court asserted upfront that while directors have duties of due care and loyalty, "[p]erhaps these categories of care and loyalty, so rigidly defined and categorized in Delaware for many years, are really just different ways of analyzing the same issue."[17] "Fundamentally," the court reasoned, "the duties [of loyalty and care] are but constituent elements of the overarching concepts of allegiance, devotion and faithfulness that must guide the conduct of every fiduciary." The court stated that "issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty," and acknowledged that distinctions between care and loyalty have very real practical significance because of the operation of exculpatory provisions under DGCL §102(b)(7). Turning to whether the Disney directors acted in good faith, the court began by noting that it is unclear under Delaware law whether a separate fiduciary duty of good faith exists. What is clear, Chancellor Chandler observed, is that good faith conduct is an integral part of business judgment and 102(b)(7) protection, and while good faith defies a one-size-fits-all definition, the court adopted a subjective standard of good faith that included elements of care, but emphasized the intent-based concept of loyalty: "[T]he concept of *intentional dereliction of duty, a conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act is* . . . conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct." On the facts developed in *Disney*, the court concluded that plaintiffs had failed to prove by a preponderance of the evidence that Disney's directors acted in bad faith. Ordinary negligence had arguably been shown, but that was insufficient to overcome the business judgment rule.

To illustrate its bad faith standard for future cases, the court offered non-exhaustive examples of bad faith conduct, each of which clearly would constitute disloyalty: (i) intentional acts with a purpose other than advancement the best interests of the corporation; (ii) intentional violations of positive legal requirements; and (iii) intentional failure to act despite a known duty to act, demonstrating a conscious disregard for duty. "In the end," the court summarized, "so long as the role of good faith is understood, it makes no difference whether the words 'fiduciary duty of' are placed in front of 'good faith,' because acts not in good faith (regardless of whether they might fall under the loyalty or care aspects of good faith) are in any event non-exculpable because they are disloyal to the corporation." Bad faith conduct always is disloyal.

At the same time, the court emphasized that circumstances may arise where the duties of care and loyalty, as traditionally defined, may be insufficient to protect shareholders, so that even where duties of care and loyalty are discharged, a failure of good faith by directors could give rise to director liability. Directors and their advisers should take note of footnote 487 in *Disney II*, in which the court cautioned boards that good faith is likely to have particular independent significance for companies that combine "an imperial CEO or controlling shareholder with a supine or passive board." For such companies, the court asserted, duties of care and loyalty "may not be aggressive enough to protect shareholder interests when the board is well advised, is not legally beholden to the management or a controlling shareholder and when the board does not suffer from other disabling conflicts of interest, such as a patently self-dealing transaction." As boards endeavor to manage corporate affairs in a manner calculated to maximize shareholder interests and avoid judicial intervention in decision-making, it is more important than ever that they be mindful of -- and document steps taken to act with -- honesty of purpose, and fidelity to the welfare of the corporation.

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1 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

2 *Citron v. Fairchild Camera & Instrument Corp*., Del. Supr., 569 A.2d 53, 64 (1989).

3 *Ash v. McCall*, 2000 WL 1370341, at *8 (Del. Ch. Sept. 15, 2000).

4 *Benihana of Tokyo, Inc. v. Benihana, Inc*., 2005 WL 3462255, at *30 (Del. Ch. Dec. 8, 2005); *Parnes v. Bally Entertainment Corp*., 2001 WL 224774, at *10 (Del. Ch. Feb. 23, 2001).

5 *Weinberger v. UOP, Inc*., 457 A.2d 701, 710 (Del. 1983).

6 634 A.2d 345 (Del. 1993).

7 *See, e.g*., *McMullin v. Beran*, 765 A.2d 910 (Del. 2000); *Emerald Partners v. Berlin*, 726 A.2d 1215 (Del. 1999).

8 746 A.2d 244, 264 (Del. 2000).

9 *Beam*, 833 A.2d at 974.

10 *In re Lukens, Inc. S'holders Litig*., 757 A.2d 720, 734 (Del. Ch. 1999)

11 *See, e.g*., *Orman v. Cullman*, 794 A.2d 5, 14 n.3 (Del. Ch. 2002).

12 *In re Caremark Int'l Inc. Derivative Litig*., 698 A.2d 959 (Del. Ch. 1996).

13 770 A.2d 43, 49 n.2 (Del. Ch. 2000).

14 825 A.2d 275 (Del. Ch. 2003).

15 2004 WL 1949290 (Del. Ch. Aug. 24, 2004).

16 *In re Walt Disney Co. Derivative Litig*., 2005 WL 2056651 (Del. Aug. 9, 2005).

17 *Id*. at *31 n. 402.