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Good Faith Issues Present New Risks for Directors and Officers

The massive corporate scandals that accompanied the new millennium resulted in a host of high-profile legislative and regulatory responses by, among others, Congress, the Securities and Exchange Commission, and the national securities exchanges. Fearful of being marginalized by the incursion of these entities into matters of corporate governance, the Delaware courts appear to be using the threat of enhanced exposure to potential personal liability as a means to encourage directors and officers to be more attentive in the performance of their managerial responsibilities.

By virtue of their managerial prerogatives, directors and officers of a corporation owe fiduciary duties to the corporation and its stockholders. These duties govern the conduct of corporate fiduciaries both in making corporate decisions on an episodic basis and in overseeing the corporation's business and affairs on an ongoing basis. Historically, these duties have been characterized as duties of loyalty and care, with the duty of loyalty having an integral good faith component.

In recent years, Delaware courts have begun to refer to a "triad" of fiduciary duties—consisting of loyalty, care, and good faith—thereby suggesting that good faith constitutes a duty separate from the duty of loyalty. More importantly, recent opinions of the Delaware courts have indicated that conduct that traditionally would have been viewed as implicating only the duty of care may be found to constitute a breach of the duty of good faith. This analytical shift is significant: Directors are typically exculpated, and both directors and officers are typically indemnified and insured, for breaches of their duty of care, while exculpation and indemnification by the corporation are impermissible, and insurance coverage exclusions may apply, in respect of conduct that constitutes bad faith.

The Traditional Duties of Loyalty and Care

The Duty of Loyalty. With regard to both decision-making and oversight functions, the duty of loyalty requires that directors and officers act in the interests of the corporation and its stockholders, and that they subordinate any conflicting interests they may have. Courts have described the duty of loyalty as requiring that corporate fiduciaries act in good faith and in the honest belief that their actions are in the best interests of the corporation and its stockholders. Thus, the duty of good faith has always had an integral good faith component.

Although the core concepts underlying the duty of loyalty would appear to be susceptible to expansive interpretation and application, under traditional analyses directors and officers have generally been viewed as having complied with their duty of loyalty so long as they were not engaged in self-dealing and did not otherwise have a financial interest that was not shared by the corporation's stockholders generally. Consequently, duty of loyalty analyses have historically focused primarily on whether a financial conflict of interest was present and, if so, whether the conflict was mitigated through the use of a decision-making process that included the informed approval of disinterested and independent directors or stockholders or, alternatively, the action or transaction in question was entirely fair to the corporation and its stockholders. Scant attention was given to the good faith component of the duty of loyalty in these analyses, and the absence or appropriate mitigation of any conflict of interest was generally outcome determinative.

The Duty of Care. The duty of care requires that, prior to making corporate decisions, directors and officers inform themselves of all material information reasonably available to them. It also requires them to oversee and monitor corporate personnel to whom managerial authority has been delegated to ensure that they carry out their responsibilities in furtherance of the corporation's interests and in compliance with law.

With regard to the decision-making function, the Delaware courts have held that the standard for determining whether a corporate fiduciary's decision was sufficiently informed is one of gross negligence. Gross negligence in this context has been described as reckless indifference to or a deliberate disregard of corporate interests or otherwise outside the bounds of reason. Conversely, with regard to the oversight function, Delaware case law suggests that the standard for determining whether a corporate fiduciary has complied with the duty of care may be one of simple negligence. Simple negligence in this context has been described as the failure to use the amount of care that an ordinarily careful and prudent person would use in similar circumstances.

The Recent Judicial Focus on Good Faith

Despite the recent judicial focus on good faith, the Delaware courts have not provided a definition of the term. Apparently, as with Justice Potter Stewart's approach to identifying obscenity, the Delaware courts will know good faith (or bad faith) when they see it. Although the cases discussed below have addressed good faith in the context of directors' conduct, it would be prudent to assume that the conduct of officers would be subject to similar legal analyses.

In *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), the Delaware Supreme Court invented, without explanation, a "triad" of duties consisting of loyalty, care, and good faith. Initially, the articulation of fiduciary duties in this more expansive manner appeared to have reflected only a change in semantics, because both *Technicolor* and subsequent Delaware cases precisely equated the newly christened duty of good faith with the pre-existing duty of loyalty. For example, in quoting from its earlier holding *Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279 (Del. 1989), the court in *Technicolor* added clarifying bracketed language as follows: "A board's actions must be evaluated in light of the relevant circumstances to determine if they were undertaken with due diligence [care] and good faith [loyalty]." *Technicolor*, 634 A.2d at 368 n.36.

Several post-*Technicolor* opinions of the Delaware Chancery Court have been critical of an analytical construct that would recognize a duty of good faith separate and apart from the duty of loyalty. For example, in *Nagy v. Bistriar*, 770 A.2d 43 (Del. Ch. 2000), Vice Chancellor Strine observed 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." *Id.* at 49 n.2.

It is noteworthy that Vice Chancellor Strine's remarks in *Nagy*, and the analyses of the Delaware courts in a number of other cases, suggest that there may exist a level of inattention to managerial responsibilities that transcends mere negligence or gross negligence and raises loyalty concerns. While this proposition is supported by a certain force of logic (*i.e.*, conscious disregard by a director or officer of his or her duties is inconsistent with the best interests of the corporation and its stockholders), its logical boundaries are disturbingly unclear. For example, one conceivably could posit with equal force that grossly negligent (or even simply negligent) conduct is inconsistent with the best interests of the corporation and its stockholders.

Any analytical construct that would have the effect of transforming traditional duty of care claims into duty of loyalty claims would undermine the legal protections that historically have served to shield directors from personal liability for their care-related conduct. To the extent the Delaware courts are intent on reducing these protections to incentivize greater attentiveness, the use of a separate, yet-to-be-defined duty of good faith may at least provide a greater opportunity for the courts to limit, in a logically supportable manner, the erosion of the historical protections accorded care-related conduct.

In *Caremark Int'l, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the court addressed allegations that Caremark's board had breached its fiduciary duties by failing adequately to supervise the conduct of Caremark employees, thereby exposing Caremark to liability for violations of federal law prohibiting it from making payments to induce referrals of Medicare or Medicaid patients. Because no duty of loyalty issues were presented, the court nominally engaged in a duty of care analysis. However, because Caremark's certificate of incorporation eliminated the directors' personal liability to the extent permitted by Section 102(b)(7) of the Delaware General Corporation Law (the "DGCL"), the allegations would be actionable only if the directors' conduct constituted bad faith. With respect to directors' oversight function, the *Caremark* court opined that "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure that a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." *Id.* at 971. In this regard, the *Caremark* court further noted that "[s]uch 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." *Id.*

In the *Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003), the court analyzed allegations that the directors of The Walt Disney Company ("Disney") breached their fiduciary duties in connection with their approval of the employment of Michael Ovitz as Disney's president, and their implicit approval of a subsequent non-fault termination of Mr. Ovitz's employment. The plaintiff alleged that, within a 14-month time frame, Ovitz's employment and severance arrangements cost Disney more than $140 million. The plaintiff further alleged that Disney's board failed to receive any relevant documents or presentations regarding these arrangements, failed to ask any questions about the details of Mr. Ovitz's salary, stock options, or severance package, and failed to consider the possible cost of his severance package upon a non-fault termination of his employment. The defendant directors contended that, at most, the plaintiff had alleged breaches of the duty of care, and as a result, the directors were shielded from liability under Disney's certificate of incorporation. Noting that it is rare for a court to impose liability on directors for a breach of the duty of care, the *Disney* court concluded that the facts alleged did not implicate merely negligent or grossly negligent conduct, but instead suggested a knowing and deliberate indifference to a potential risk of harm to the corporation. In this regard, the court held that where a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the directors' actions are either not in good faith or involve intentional misconduct, and therefore are not protected by the limitations on liability contemplated by Section 102(b)(7) of the DGCL. (It is important to note that this controversial decision was only in response to a motion to dismiss the complaint for failure to state a cause of action, and therefore did not constitute a decision on the merits. No decision in the highly publicized trial had been reached as this is written, and it remains to be seen whether the plaintiff will be found to have proved its allegations.)

In *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*, No. Civ. A. 20228-NC, 2004 WL 1949290 (Del. Ch. Aug. 24, 2004), the plaintiff alleged that the directors of Integrated Health Services breached their fiduciary duties in approving a series of certain executive compensation and loan arrangements, primarily for the benefit of its chief executive officer. Finding that the compensation and loan arrangements had been approved by a majority of disinterested directors, the court dismissed the plaintiff's allegations relating to the duty of loyalty. The court then focused on whether the challenged actions were authorized with the intentional and conscious disregard to the directors' duties necessary to state a fiduciary duty claim not subject to exculpation as authorized by Section 102(b)(7) of the DGCL. In this regard, the court noted that, in analyzing whether an action was taken with intentional and conscious disregard of directors' duties, it is necessary to determine that the action is beyond unreasonable, and that it is in fact irrational. Emphasizing that allegations of nondeliberation are different from allegations of inadequate deliberation, the court held that compensation decisions that were allegedly made without *any* consideration, deliberation, or advice from any expert stated claims sufficient to survive the defendants' motion to dismiss.

Taken at face value, the standards of good faith articulated by the courts in *Disney* and *Integrated Health Services* would not appear to be unduly worrisome for directors and officers who are making a genuine effort to attend to their managerial responsibilities. It is unclear, however, whether these more recent articulations will have any effect on the holding in *Caremark*, which is more troublesome due to its possible imposition on directors and officers of an affirmative duty to assure that reporting systems exist that are reasonably designed to provide senior management and the board with information sufficient to reach informed decisions concerning the corporation's business and compliance with law. It is also unclear what additional "duties" may be determined to be subject to an intentional and conscious disregard that could constitute bad faith, and whether that relatively deferential standard will withstand future efforts by plaintiffs to impose liability for care-related conduct.

Conclusion

Both as a matter of good practice and in order to minimize the possibility of being found to have acted in bad faith, directors and officers should endeavor to perform their duties in a conscientious manner. As an initial matter, directors and officers should ascertain and understand the functions that they are required to perform under the DGCL and other statutes, common law, and the corporation's governing documents (including corporate governance guidelines, codes of ethics, compliance policies, and committee charters). Once directors and officers understand the functions for which they are responsible, they should endeavor to be actively engaged and well-informed in their performance of those functions. And, of course, they should in all events seek to protect and advance the interests of the corporation and its stockholders (or, in certain circumstances involving insolvency, its creditors).

In their decision-making functions, directors and officers should endeavor to identify and consider in a deliberate manner the rationale for any proposed action or transaction, the alternatives thereto, and the relative pros and cons associated with the proposal and the alternatives (including the relative costs, benefits, and risks). To the extent that they are relying on the corporation's professional advisers, directors should seek to be informed regarding competence of the advisers and the care with which they were selected. Directors should also seek to determine whether any director, member of management, or professional adviser to the corporation has any conflict of interest or other impediment to objectivity in connection with the proposed action or transaction and, if so, take appropriate steps to ensure that the decision-making process is not tainted thereby.

Both the duty of care and the exercise of good faith in care-related contexts are process oriented. Thus, directors and officers should endeavor to ensure that an effective process designed to achieve the objectives described in the preceding paragraphs is employed and properly documented. In this regard, directors should be aware that the requirement that they act in an informed and deliberate manner applies with equal force to actions taken by written consent, and should therefore pay special attention to the documentary record that is created in connection with any such actions.

Finally, it would be advisable to carefully review director and officer liability insurance policies for any "bad faith" exclusions and to consider deleting or appropriately limiting any such exclusions.

Further Information

For further information, readers are encouraged to contact their regular Jones Day attorney or the principal authors of this *Commentaries*, Mark E. Betzen (telephone: 214.969.3704; e-mail: mbetzen@jonesday.com) in the Dallas Office and Jeffrey D. Litle (telephone: 614.281.3886; e-mail: jdlitle@jonesday.com) in the Columbus Office. General e-mail messages may be sent using our web site feedback form, which can be found at www.jonesday.com.