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Directors' Monetary Liability for Actions or Omissions Not in Good Faith

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I. Introduction

It has long been established that damages are available against directors when they engage in self-dealing or similar actions in situations in which they have a conflict of interest. *See Cede & Co. v. Technicolor*, 634 A.2d 345, 361-62 (Del. 1993); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-14 (Del. 1983). Few issues in U.S. corporate law, however, are as controversial as whether directors should be exposed to damages for their actions or omissions in situations in which they do *not* have a conflict of interest. Advocates of such damages awards argue that they are appropriate in extreme cases of directorial misconduct and an important deterrent to future misconduct. *See* Symposium Transcript, *Director Liability*, 31 Del. J. Corp. L. 1011, 1014 (2006). Opponents of such awards argue that courts cannot reliably distinguish between extreme cases of misconduct and routine cases of negligence, and that well-qualified persons will not serve as directors if they are exposed to this type of monetary liability. *See Id*. at 1017-18, 1025.

About twenty five years ago, the Delaware Supreme Court, in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), moved the law markedly in favor of damages awards against directors. In that case the court held the directors of TransUnion liable in damages for being insufficiently careful in entering into a sale of the company transaction. Critics of the decision, noting that the sale price was at a very substantial premium to the market price and that no higher bid emerged between the signing of the merger agreement and closing despite no impediments to such a bid, asserted that the decision was unfair and would discourage outside director candidates from serving as directors. *See, e.g.* Daniel R. Fischel, *The Business Judgment Rule and the TransUnion Case*, 40 Bus. Law 1437, 1448-54 (1985).

The Delaware General Assembly reacted in 1986 by enacting section 102 (b)(7) of the Delaware General Corporation Law, which permitted Delaware corporations to amend their charters to eliminate the liability of directors for breach of the duty of care, though not permitting elimination of liability in damages for breach of the duty of loyalty, "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law" and in certain other circumstances. Within a relatively short time thereafter, most states had followed Delaware's example, and many, if not most, corporate charters were amended to add the exculpatory provision permitted by the relevant state's law. *See* Sarah Helen Duggin and Stephen M. Goldman, *Restoring Trust in Corporate Directors: The* Disney *Standard and the "New" Good Faith*, 56 Am. U. L. Rev. 211, 233 (2006).

After the enactment of section 102(b)(7) and the resulting mass amendment of corporate charters, it was clear that directors could still be responsible for damages for breaches of the duty of loyalty involving conflicts of interest – for example, being on both sides of a transaction to which the corporation was a party – and could not be held liable for money damages for breaching their duty of care, even if they were grossly negligent. *Id.* at 232-33. The question was whether there was any real-world basis for imposing damages on directors in situations in which they did not breach their duty of loyalty on conflict of interest grounds.

Beginning in the middle 1990s with the *Caremark* decision discussed below, the Delaware courts answered that question in the affirmative by making it clear that certain conduct of directors who did not have a conflict of interest could constitute acts or omissions not in good faith that would expose them to damages. As the law has developed, there has been no bright line rule defining such conduct. Consequently, there is no shortcut to examining the cases decided inside and outside of Delaware in determining where the law now stands. Most of these cases were brought as derivative lawsuits, and the reported decisions were issued in deciding defendants' motions to dismiss because of the plaintiffs' failure to make a demand on the company's board of directors. We will briefly analyze a number of these decisions, dividing them into cases in which the directors are accused of failing to act and therefore violating their duty of oversight and cases in which the directors are accused of acting improperly. We will then try to draw some useful conclusions from this analysis.

II. The Duty of Oversight

In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996)

Regulatory investigations showed that Caremark's employees had committed fraudulent activities, including overbilling and inappropriate referral payments, that resulted in penalties and fines for the company. Shareholders alleged that the directors breached their duty to be active monitors of corporate performance and employee activity by allowing this situation to develop.

The court, in assessing the fairness of a proposed settlement of the lawsuit, began by finding that directors do have a duty of oversight, including a duty to attempt in good faith to assure the existence of an adequate corporate information and reporting system. 698 A.2d at

970. The court noted that in order to hold the directors liable for failure to adequately control Caremark's employees, plaintiffs would have to show either that the directors knew or should have known that violations of law were occurring and in either event that the directors did not make a good faith effort to prevent or remedy the situation. *Id.* at. 971.

The court, stating that "[t]he theory here advanced is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment," held:

> Where the claim for director liability for corporate loss is predicated upon ignorance of liability creating activities with the corporation . . . only a sustained and 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. *Id*.

The court concluded that the facts did not support a finding of such a sustained failure. The facts showed that during the relevant period the company had begun centralizing its management structure to increase supervision, had revised a guide to assure that its agreements were in compliance with regulatory guidelines, had a policy in place requiring regional officers to approve contracts, and had an internal audit plan designed to ensure compliance with business and ethics policies. The fact that ultimately there was a huge liability resulting from a violation of criminal law did not create a breach of duty by the directors without a showing the defendants either lacked good faith in their exercise of their monitoring responsibilities or consciously permitted a known violation of law to occur.

McCall v. Scott, 239 F.3d 808 (6th Cir.), *amended on denial of rehearing*, 250 F.3d 997 (6th Cir. 2001)

Plaintiffs, citing *Caremark*, contended that the directors of Columbia/HCA should be held liable in damages for failing to monitor and prevent the company's senior management from engaging in fraudulent activities such as improper cost reporting, improper billing practices, improper referral incentives, and improper acquisition practices. The complaint alleged that the directors either recklessly or intentionally disregarded "red flags" that warned of the systematic fraudulent practices of management, and failed to act in the face of "red flags" such as audit information, ongoing acquisition practices, allegations brought against the company in a legal proceeding, an extensive federal investigation, and a New York Times investigation. The Sixth Circuit found that plaintiffs had alleged, with the requisite specificity to survive a motion to dismiss for failure to make a demand, that the directors had consciously disregarded known risks, which proven, could not have been undertaken in good faith. 250 F.3d at 1000-01. The court considered the prior experience of the board members as directors or managers of health care organizations that were acquired by the company in reaching its decision. 239 F.3d at 819-20.

In re Abbott Laboratories Derivative Shareholder Litigation, 325 F.3d 795 (7th Cir. 2001)

Shareholders alleged that Abbott's directors breached their fiduciary duty by failing to provide appropriate oversight to prevent findings of violations of FDA rules with respect to Abbott's diagnostics division. The plaintiffs contended not that the reporting system in place was inadequate, but rather that the members of the Abbott board were aware of prior FDA violations and warnings and took no corrective steps. The complaint further alleged that, given six years of noncompliance, inspections, warning letters and notice of violations in the press, the directors' failure to act was not in good faith. The Seventh Circuit held that the facts alleged were sufficient to show demand futility and supported the reasonable inference that there was an intentional, sustained and systematic failure of the board to exercise oversight, which if true, would be a breach of the duty of good faith and therefore not protected under Abbott's charter. 325 F.3d at 809.

***Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003)**

Plaintiff alleged that the directors of NVIDIA engaged in misconduct related to the company's failure to accurately account for and disclose its financial results during an approximately two and half year period. In addition to allegations of insider trading, the plaintiff asserted a *Caremark* claim for a failure to ensure that there was an adequate system of financial controls in place at the company.

The court reviewed the applicable law, stating that *Caremark* "articulates a standard for liability for failures of oversight that requires a showing that the directors breached their duty of loyalty by failing to attend to their duties in good faith." The court held, however, that "*Caremark* premises liability on a showing that the directors were conscious of the fact that they were not doing their jobs." 823 A.2d at 506.

On the motion to dismiss for failure to make a demand upon the board, the court found that the plaintiff did not come close to pleading a *Caremark* claim. The complaint was conclusory and devoid of critical particularized facts that would show that the directors were conscious that they were acting improperly. *Id* at 506-07.

***Stone v. Ritter*, 911 A.2d 362 (Del. 2006)**

Shareholders of AmSouth Bancorporation brought a derivative action against the board alleging a breach of its duties after the company was found to be in violation of the Bank Secrecy Act and anti-money laundering regulations, which resulted in $50 million in fines and penalties. The regulators determined that the bank's compliance program lacked adequate board and management oversight and that reporting was materially deficient.

The court adopted the *Caremark* standard for director liability for the failure of oversight, holding that, to establish the liability of the directors for conduct not in good faith, plaintiffs would need to show that the directors must have (a) utterly failed to implement any reporting or information system or controls or (b) having implemented such a system or controls, consciously failed to monitor or oversee their operations, thus disabling themselves from being informed of risks or problems requiring their attention. 911 A.2d at 370. Imposition of liability required a showing that the directors *knew* that they were not discharging their obligations of oversight. The court also made clear that the duty of good faith is not an independent duty alongside those of care and loyalty, but rather is a sub-element of the duty of loyalty. *Id*. at 369-70.

According to the court, an independent auditor's report showed that the board received and approved relevant policies and procedures, delegated the responsibility for filing suspicious activity reports and monitoring compliance, and exercised oversight by relying on periodic reports. The ultimate failure of employees to report deficiencies to the board was not a basis for an oversight claim seeking to hold the directors personally liable for those failures. *Id*. at 372-73. The court concluded that the plaintiffs, with the benefit of hindsight, sought to equate a bad outcome with bad faith. Having found no "red flags," the court reiterated that good faith in the context of oversight must be measured by the directors' actions to assure that a reasonable information and reporting system exists and not by second guessing after the occurrence of employee conduct that results in an unintended adverse outcome. *Id*.

***Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007)**

The plaintiff brought a derivative action against the directors of Sycamore Networks, alleging a breach of their duties in connection with unlawful stock option backdating, spring loading (granting options shortly before the release of positive information that is likely to drive the stock price higher) and bullet dodging (granting options just after the release of negative news that is likely to drive the stock price lower) that occurred in connection with option grants made to Sycamore's officers and directors. After an anonymous memorandum tipped off management, an internal investigation revealed that certain options had been backdated, causing the company's financial statements to be inaccurate. The uncontroverted facts showed that a non-director officer (who was properly delegated authority under the terms of the plan) oversaw the grants at issue. Further, the facts showed that a concerted effort had been undertaken to hide the backdating from the directors. The plaintiff pled no facts showing that the directors knowingly approved any backdated options.

The plaintiff alleged that even if the board was ignorant of the backdating activity, this ignorance resulted from a failure to monitor. The court found that the plaintiff had not alleged any facts to suggest that the company's internal controls were deficient, nor that the board, the audit committee or the auditors had any reason to suspect that the controls were deficient. 924 A.2d at 939-40. Instead, the ignorance was the result of a cover-up effort by the very employees who were culpable. The court emphasized that in order to state a viable *Caremark* claim, "a plaintiff must plead the existence of facts suggesting that the board knew that internal controls were inadequate, that inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed." *Id*. Because the plaintiff failed to do so, the complaint was dismissed.

Wood v. Baum, 953 A.2d 136 (Del. 2008)

Shareholders of MMC, a limited liability company, brought a derivative suit asserting that the directors breached their *Caremark* duties by failing properly to institute, administer and maintain adequate accounting and reporting controls that would have prevented the damage to the company that occurred because its employees improperly valued assets, issued false financial statements, made improper charitable contributions through related party transactions and executed a series of transactions that improperly inflated the company's financial performance. The court noted that the LLC operating agreement exculpated the directors from liability except in the case of fraudulent or illegal conduct, and that the LLC statute further limited exculpation for bad faith violations of the implied contractual covenant of good faith and fair dealing. To survive a motion to dismiss for failure to make a demand, the court required plaintiff to allege particularized facts that demonstrated that the directors acted with scienter -- that they had "actual or constructive knowledge" that their conduct was legally improper. 953 A.2d at 141.

The plaintiff argued that the board should have had knowledge of certain related party transactions because it had to authorize the transactions under the LLC operating agreement. The court, however, concluded that board approval of improper transactions, without more, was an insufficient basis to infer culpable knowledge or bad faith on the part of individual directors. *Id*. at 142. The court refused to infer simply from the allegation that the board approved the transactions that each member knew that the alleged transactions were improper or that the board consciously and in bad faith failed to discharge fiduciary or contractual responsibilities. The court also rejected the plaintiffs' assertion that membership on the audit committee was sufficient to infer the requisite scienter. *Id*. Finally, the plaintiff claimed that the board ignored "red flags." The court found no cognizable "red flags" pled with particularity from which it could be inferred that the defendants knew that accounting rules were being improperly applied or that the defendants otherwise consciously and in bad faith ignored improprieties. *Id*. at 143.

AIG Consolidated Derivative Litigation, 965 A.2d 763 (Del. Ch. 2009)

Plaintiffs alleged that AIG's officers and directors participated in various fraudulent schemes that ultimately resulted in the restatement of shareholder equity by $3.5 billion and $1.6 billion in costs to settle governmental investigations. Four types of fraud were alleged, including transactions intended to hide AIG's true financial situation, illegal schemes to avoid taxes, selling illegal financial products to other companies, and schemes to rig markets. The defendants were very high level officers as well as directors who were in the "inner circle" of AIG's CEO and chairman, Maurice Greenberg. Greenberg allegedly knew everything that occurred at the company and offered lucrative financial incentives to those in his trusted inner circle. The shareholders' claims included a *Caremark* breach of loyalty claim against management directors for knowingly tolerating inadequate internal controls and knowingly failing to monitor their subordinates' compliance with legal duties. The question for the court on a motion to dismiss under Rule 12(b)(6) was whether the complaint pled facts sufficient to support an inference that these directors knew that AIG's internal controls were broken. (The court did not have to consider the sufficiency of the pleadings under Rule 23.1 because demand was excused by virtue of a special litigation committee's neutral stance).

In denying the motion to dismiss, the court noted that the plaintiffs did not rest their *Caremark* claim on the failure of AIG's internal controls in only one discrete instance of wrongdoing. Rather, the court found that the complaint fairly supported the assertion that AIG's inner circle led a "criminal organization." "The diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG" alleged was "extraordinary." 965 A.2d at 799. The defendants held "sensitive positions" and were on the committees and served as heads of the business departments that were involved in the alleged wrongdoing. Further, the "top dog" status of each of the defendants made it unlikely in the court's view that any of the novel and substantial financial investments at the heart of the fraudulent activities could have been made without the knowledge of these directors. *Id* at 797-98. The court held that since the complaint fairly alleged that the directors were directly knowledgeable of and involved in much of the wrongdoing, it could not be said that they did not also know that AIG's internal controls were inadequate. *Id*. at 799. It was inferable that even when the directors were not directly implicated in the alleged wrongful schemes, they were aware of them and knowingly failed to stop them. This rose to the level of consciously failing to monitor or oversee the company's internal controls, thus disabling them from being informed of risks or problems requiring their attention and constituting bad faith. The requirement of scienter was met by the pled facts that supported an inference that the directors were conscious of the fact that they were not doing their jobs. *Id*.

***In re Citigroup Inc. Shareholder Litigation*, 964 A.2d 106 (Del. Ch. 2009)**)

Shareholders alleged that the directors of Citigroup breached their fiduciary duties by failing to adequately oversee and manage the company's exposure to problems in the subprime mortgage market, even in the face of "red flags," and by failing to ensure that the company's financial reporting and other disclosures were thorough and accurate.

The plaintiffs' theory of director personal liability in this case was a twist on the traditional *Caremark* claim. They alleged a failure to monitor business risk in the face of "red flags" that should have put the directors on notice of the problems in the subprime market, rather than a failure to monitor employee misconduct that violated the law. The court observed that, although they framed their complaint as a *Caremark* claim, the shareholders were really trying to hold the directors liable for making poor business decisions. 964 A.2d at 124. The court characterized the plaintiffs' allegations as a claim that Citigroup suffered large losses and that there were certain warning signs that could or should have put defendants on notice of the business risks related to Citigroup's investments in subprime assets. *Id*. Plaintiffs were asking the court to conclude that because the defendants failed to prevent the company's losses associated with subprime risks, they must have consciously ignored the warning signs or knowingly failed to monitor the company's risk. *Id*. at 126-27.

The court found these allegations conclusory and insufficient to state a claim for failure of oversight. *Id*. at 129-30. Citigroup had established an asset and risk management committee to review with management and auditors the company's financial statements and to evaluate Citigroup's internal core structure and its major credit, market, liquidity, and operational risk exposures and the steps taken to monitor and control such exposures. The committee met over ten times per year in the relevant period. Plaintiffs relied on "red flags" that they believed showed that the defendants did not make a good faith effort to comply with oversight procedures. These red flags included the drastic rise in foreclosure rates, large subprime lenders filing for bankruptcy, and losses reported by Citigroup's peers. The court found that these warning signs were not evidence that the directors consciously disregarded their duties, but at most that they made bad business decisions. *Id* at 128. None of the red flags showed any misconduct at the company; instead, they only reflected worsening conditions in the subprime market. Knowledge of such worsening conditions was not sufficient to find that the directors were consciously disregarding a duty to prevent Citigroup from suffering losses.

The court concluded that to recognize liability in this situation would undermine the protections of the business judgment rule. The court distinguished the situation from that in the AIG case, where the defendants allegedly failed to exercise oversight over fraudulent and criminal conduct. "Oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk." *Id*. at 131. The court concluded that allowing a shareholder to succeed on a theory of liability for failure to monitor business risk would invite a hindsight evaluation of directors' business decision, which would be contrary to well-settled policies underlying Delaware law. *Id*. at 126.

The plaintiffs also alleged that the directors were liable for corporate waste for approving a payment and benefit package for the departing CEO Charles Prince, for allowing the company to purchase $2.7 billion in subprime loans, for approving the buyback of $645 million of Citigroup's shares and for allowing the company to invest in structured investment vehicles that were unable to pay off maturing debt. The court dismissed the waste claims as to the subprime loan purchases and the SIV investments because it was not adequately pled that those events were the result of board action, which is an element of a claim for corporate waste.

In order to survive a motion to dismiss under rule 23.1, the plaintiffs had to allege particularized facts leading to a reasonable inference that the director defendants "authorized an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." *Id*. at 136. According to the court, "to prevail on a waste claim . . . the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interest." *Id*.

The court found that the plaintiffs had not met this pleading standard in alleging that the directors approved a share repurchase at the market price. The only other support offered by the plaintiffs were the "red flags" in the subprime market and the conclusory allegation that the board should be liable for approving the share repurchase at market price before the stock price dropped as a result of Citigroup's subprime exposure. *Id*. at 137.

The court did sustain the claim for waste relating to the retirement package, however. Noting that the directors of a Delaware corporation have the authority and broad (but not unlimited) discretion to make executive compensation decisions, the court stated that the standard for waste is whether there was "an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." *Id*. at 138. The outer limit to board discretion on executive compensation is the point at which a decision "on executive compensation is so disproportionately large as to be unconscionable and constitute waste." *Id*.

Here, the plaintiffs pled facts showing that a letter agreement provided the officer with a $68 million package upon his departure from Citigroup, as well as an office, an administrative assistant, a car and a driver for five years or until he began working full time elsewhere. They alleged that this compensation was "so one sided" as to constitute waste because it was paid to a CEO whose failures were responsible for the billions of dollars of losses at Citigroup. Although the letter agreement required the CEO to sign a non-compete agreement, a non-disparagement agreement, and a release of claims against Citigroup, the court was "left with very little information regarding (1) how much additional compensation Prince actually received as a result of the letter agreement and (2) the real value, if any, of the various promises given by Prince." *Id*. The plaintiffs had adequately alleged that demand was excused, as the court concluded that there was a reasonable doubt as to whether the agreement met the stringent "so one sided" standard or whether the letter agreement awarded compensation that was beyond the "outer limit" for executive compensation. *Id*.

III. Director Action Alleged to Be in Bad Faith

In re Emerging Communications, Inc. Shareholders Litigation, 2004 WL 1305745 (Del. Ch. 2004)

After the controlling shareholder of Emerging Communications acquired the publicly held shares through a two-step tender offer and squeeze out merger, shareholders brought an action for, among other things, breach of fiduciary duties by the directors of the company. The court reviewed the transaction under an entire fairness standard and determined that the merger price should have been $38.05 per share rather than $10.25 per share.

In determining which of the defendants would be liable for the underpayment to the public shareholders, the court found that one of the directors had acted in bad faith, and therefore was liable, because he voted to approve the transaction even though, based on his significant experience in finance and his position as a principal of an investment advisory firm, he "knew, or at the very least had strong reasons to believe" that the merger price was unfair. 2004 WL 1305745 at 40. The court concluded that the director's specialized investment banking experience and ability to understand the company's intrinsic value made it incumbent upon him as a fiduciary to advocate rejection of the deal terms. *Id*.

The court found that the director's behavior could be explained by only "one of two possible mindsets." It was either (1) a deliberate decision to keep quiet in order to benefit the majority shareholder (in an effort to further his own personal business interests) or (2) a "[conscious and intentional disregard for] his responsibility to safeguard the minority stockholders from the risk, of which he had unique knowledge, that the transaction was unfair." *Id*. In either case, he violated his duties of loyalty and/or good faith and would not be exculpated under the company's charter.

Gesoff v. IIC Industries, Inc, 902 A.2d 1130 (Del. Ch. 2006)

On facts somewhat similar to those in *Emerging Communications*, the court dealt with a claim by a cashed-out shareholder that the price in a controlling shareholder buyout was unfairly low. There was only one independent director on the target's board, and he was the sole member of the special committee charged with responding to the controlling shareholder's buyout proposal. The transaction was initially designed to be a two-step tender offer followed by a short form merger, but after the tender offer was unsuccessful, the parent quickly initiated a long-form merger without significant further negotiations with the special committee. The court found that the process was flawed for many reasons, including that the special committee did not have a clear mandate or authority to say "no" to the transaction, that it retained the same outside counsel that represented the conflicted board (and the controlling shareholder, although this was unknown to the defendant), and its financial advisor was suggested by the controlling shareholder. 902 A.2d at 1149-52. It also turned out that the financial advisor was sharing its valuation and other information with the controlling shareholder throughout the process, and was essentially participating in a scripted negotiation, which from the beginning the controlling shareholder had no intention of conducting fairly. *Id*. at 1152.

After determining that both the process and price were unfair, the court turned to the question of personal liability for the director on the one-man special committee. The court held that this director was definitely in breach of his duty of care, and that "a more diligent independent director would have uncovered the controlling stockholder's nefarious plan to conclude an unfair merger." 902 A.2d at 1167. However, the court found that, unlike the director in *Emerging Communications*, this director was unaware of the key facts that made the transaction so clearly unfair. Although he knew that the buyer had initially anticipated that the minority shareholders would demand a purchase price near $13, and he failed to ask for this during negotiations, the court found that his "successful" negotiation upwards from the initial offer of $10.00 to the final price of $10.50 (well below the appraised value of $14.30 per share) evidenced "some good faith effort to negotiate" with the buyer. *Id*.

Ultimately, the court held that "nothing in the record in this case suggests that [defendant] 'intentionally conspired . . . to engage in a process that would create the illusion, but avoid the reality, of arm's length bargaining to obscure the true purpose of benefiting [the controlling shareholder] at the expense of the minority.'" *Id*. Because the defendant clearly violated his duty of care, but did not act in bad faith, he was protected against personal monetary liability.

***In re the Walt Disney Company Derivative Litigati*on, 906 A.2d 27 (Del. 2006)**

In this celebrated case Disney shareholders brought a derivative action claiming, among other things, that the directors of Disney were liable in damages because they had acted in bad faith in approving an employment agreement with Michael Ovitz and in approving a severance payment to Ovitz upon his termination just 16 months after becoming president of Disney. The Disney board, led by the CEO Michael Eisner, was concerned with the plan of succession at the company and sought to hire Ovitz because it thought that his reputation and experience would help remedy weaknesses in the Disney organization such as poor talent relationships and stagnant foreign growth. Ovitz would have to give up his lucrative business as an agent and therefore was in a position to demand a favorable employment agreement. The contract was negotiated by Eisner and certain compensation committee members, and then presented to the full compensation committee for approval. The presentation included a term sheet summarizing the deal, a spreadsheet analysis, and a discussion of comparables such as Eisner's option grants and other factors that had been considered in determining the size of option grants and no-fault termination provisions in the contract. The committee approved the contract and Ovitz was then elected as president by the full board.

During his brief tenure at Disney, Ovitz and Eisner clashed, and eventually the situation became so acrimonious that Eisner and other members of management tried to find grounds on which to terminate Ovitz for cause. Having failed to find any legal basis for firing Ovitz with cause, the decision was made to terminate him without cause. This triggered a severance package worth $130 million.

The plaintiffs asserted that the directors had both breached their duty of care and acted in bad faith in hiring and then paying severance to Ovitz. The Delaware Chancery Court denied defendants' motion to dismiss under rules 12(b)(6) and 23.1 and suggested that a claim for damages based on bad faith might be successful. After a trial, however, the Chancery Court concluded that the facts did not support such a claim. The Delaware Supreme Court affirmed, holding that, although the compensation committee may not have followed "best practices" in its process of setting and approving the terms of Ovitz' employment contract, it was not so inadequately informed as to be in breach of the duty of care. 906 A.2d at 58.

The court next turned to the shareholders' allegations that the directors had breached their duty of good faith in approving the contract and the severance payment. The plaintiffs argued that the failure to exercise due care by making a material decision without adequate information and adequate deliberation constituted a failure to act in good faith that would expose the directors to damages. The court observed that, even if it accepted this view of the law, the plaintiffs would not prevail because of the finding that no breach of the duty of care occurred. *Id*. at 63.

Acknowledging that its analysis of the bad faith claim could end at this point, for future guidance the court went on to discuss the meaning of good faith. It noted the existence of conduct motivated by subjective bad intent (classic bad faith) and conduct resulting from gross negligence (not bad faith), and observed that. the hard question was how to treat behavior that is in between those two categories, which it described as "intentional dereliction of duty, a conscious disregard for one's responsibilities." *Id*. at 63-67. The lower court had defined a violation of the duty of good faith this way, and the Court upheld that an accurate, but not exclusive, definition of bad faith. The court finished its discussion by opining that "a failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Id*. at 67. The court noted that this list may not be exhaustive.

***Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007)**

A shareholder derivative complaint alleged that the directors of Maxim Integrated Products breached their fiduciary duties of due care and loyalty by approving or accepting backdated stock option grants to the CEO and Chairman of the Board that violated the "clear letter" of shareholder-approved option and incentive plans. The plans required that options be granted at no less than the publicly traded closing price of the company's common stock on the date of the grant.

The plaintiff survived a motion to dismiss for failure to make a demand on the board where half of the board was part of the compensation committee that had been delegated the task of awarding stock options and the plans did not give the board discretion to alter the exercise price by falsifying the date on which an option was granted. The particularized facts alleged by the plaintiff included "specific grants, specific language in the option plans, specific public disclosures, and supporting empirical analysis which sufficiently alleged knowing and purposeful violations of shareholder plans and intentionally fraudulent public disclosures." 918 A.2d at 355.

The court also held that plaintiffs had sufficiently pled bad faith conduct in breach of the duty of loyalty under rule 12(b)(6). The court discussed *Stone v. Ritter* and concluded that bad faith includes "any action that demonstrates a faithlessness or lack of true devotion to the interests of the corporation and its shareholders." *Id*. at 357. The court held that "the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors' purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith." *Id*. at 358.

***In re Tyson Foods Consolidated Shareholder Litigation*, 919 A.2d 563 (Del. Ch. 2007)**

Plaintiffs accused the directors of Tyson Foods of a breach of fiduciary duties relating to the approval of "spring loaded" stock options. The complaint pled a multi-year pattern of extraordinary options grants to insiders just prior to the release of material, market-moving positive information.

The question for the court was "whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder-approved incentive option plan, at a time when he *knows* those shares are actually worth more than the exercise price." 919 A.2d at 593. The court held that a director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot be said to be acting loyally and in good faith as a fiduciary. *Id*.

The court further held that, in making a case for breach of the duty of good faith for spring-loading or bullet-dodging, a plaintiff must show that (1) options were issued according to a shareholder-approved plan and (2) the directors that approved spring-loading or bullet-dodging options (a) possessed material non-public information soon to be released that would impact the company's share price, and (b) issued those options with the intent to circumvent otherwise valid shareholder-approved restrictions upon the exercise price of the options. *Id*. Such a showing sufficiently alleges that a director acted disloyally and in bad faith for the purposes of surviving a motion to dismiss. The court denied the directors' motion to dismiss in the case before it.

In a later stage in the *Tyson* litigation, the defendants presented new information that showed that, while certain spring loaded options did not literally violate the pricing terms of a shareholder-approved plan, disclosures relating to the nature of pricing of the grants were misleading. On a motion for judgment on the pleadings, the Chancellor held that he was "not convinced that allegations of an implicit violation of a shareholder-approved stock incentive plan [is] absolutely necessary for the Court to infer that the decision to spring-load options lies beyond the bounds of business judgment. Instead, I find that where I may reasonably infer that a board of directors later concealed the true nature of a grant of stock options, I may further conclude that those options were not granted consistent with a fiduciary's duty of utmost loyalty." *In re Tyson Foods, Inc.*, 2007 WL 2351071 at 5 (Del. Ch. 2007).

McPadden v. Sidhu, 964 A.2d 1262 (Del. Ch. 2008)

Plaintiff alleged that the board of i2 Technologies caused the company to sell a subsidiary to members of the subsidiary's management for a price that defendants knew was a fraction of its fair market value and that this constituted bad faith. A competitor of the subsidiary had earlier offered to purchase it for $25 million, but the board refused that offer. Meanwhile, the lead manager of the subsidiary was manipulating the earnings of the subsidiary to negatively affect its value. When the board decided to sell the subsidiary, it put that manager in charge of conducting the sale process, even though the board knew both about the prior $25 million offer and about the manager's interest in leading a management buyout. The manager did not solicit bids from any of the subsidiary's direct competitors, its most likely buyers, and he used valuation projections based on the same numbers he had been manipulating. The sale process produced only three bids, including the one from the manager's own buyout group and another "lowball" offer produced by a former partner of the manager. In considering whether to accept the buyout offer, the board obtained a fairness opinion that showed that the $3 million offer was within, albeit at the low end, of the range of fair value. However, this fairness opinion also utilized the financial information provided by the buyer. Plaintiff contended that because of the lack of reliability of the fairness opinion, the special committee and the board could not have relied in good faith on that opinion in approving the sale of the subsidiary. Less than two years after the board accepted the $3 million offer, the subsidiary was resold for more than $25 million.

The court found that demand was excused as futile because plaintiff pled a duty of care violation with particularity sufficient to create a reasonable doubt that the transaction was the product of a valid exercise of business judgment. The court found that material and readily available information was not considered by the board and this lack of consideration constituted gross negligence. The most egregious fact, in the court's view, was putting the manager in charge of the sale process when the board knew he was interested in purchasing the subsidiary. In addition, the board appeared to have engaged in little to no oversight of the sale process, providing no check on his half-hearted efforts in soliciting bids, which were against his own interest to maximize. The board became aware of his failure to contact competitors and knew that its fairness opinion was based on "buyer" projections. Finally, despite knowing all of this, the board still agreed to a sale price at the very low end of the acceptable valuation range. The court found this unusual set of facts sufficient to demonstrate demand futility. 964 A.2d at 1271-73.

However, the court nonetheless granted the directors' motion to dismiss for failure to state a claim because the plaintiff had not pled facts showing that the directors acted in bad faith and therefore were not protected by the company's charter. The court stated that "Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason." *Id*. at 1274. Having run through the three *Disney* categories of behavior, the Court found that the behavior exhibited by the company's board in this case fell into the category of gross negligence. *Id* at 1274-75. The court found that placing the purchaser in charge of the sale and then failing to act in any way so as to ensure the sale process was thorough and complete, while likely constituting reckless indifference, did not raise sufficient allegations that the defendants acted with the conscious disregard for their duties required to show bad faith. *Id.*

***In re Lear Corporation Shareholder Litigation*, 2008 WL 5704774 (Del. Ch. 2008)**

After shareholders of Lear voted to reject a merger with a group controlled by Carl Icahn, shareholders filed a derivative suit alleging that the directors breached their duty of loyalty when they granted the acquirer a "no-vote" termination fee in exchange for a $1.25 per share increase in its offer. The board made this negotiated exchange based on reports that a proxy advisory firm was likely to recommend a vote against the merger at its original purchase price. Lear's charter contained the typical exculpatory provision, so the shareholders had to plead specific facts to support an inference that the Lear directors breached their duty of loyalty in order to survive a motion to dismiss for refusal to make a demand. Since the challenged conduct was a discrete transaction as to which the board had affirmatively acted, the court declined to apply an oversight liability analysis, and also rejected a claim of "bad faith" as defined in *Disney* (an intentional disregard of duties) because the facts showed that the board employed a special committee that met frequently, hired reputable advisors, and met frequently itself. 2008 WL 5704774 at 11.

The plaintiffs' last effort to show a breach of the duty of loyalty was to allege that that the directors acted in bad faith because they granted the no-vote termination fee while knowing that the $1.25 per share price increase was not guaranteed to be enough to convince the majority of the shareholders to vote in favor of the merger. The court held that it would be inconsistent with the business judgment rule to find that directors act disloyally if they adopt a merger agreement in good faith, believing the terms to be beneficial to the shareholders, simply because shareholders might or even were likely certain to reject it. *Id* at 12.

Lyondell Chemical Company v. Ryan, 2009 WL 790477 (Del. 2009)

In a very recent decision, the Delaware Supreme Court rejected a claim that the directors of Lyondell failed to act in good faith in conducting the sale of the company to Basell. In May, 2007, an affiliate of Basell filed a Schedule 13D with the SEC disclosing its right to purchase an 8.3% stake in Lyondell, as well as its interest is possible transactions with Lyondell. The board of Lyondell held a special meeting, and decided to take a "wait and see" approach. On July 9, Basell made an offer to acquire Lyondell at a substantial premium to the market price. Basell was also in the bidding for another chemical company and demanded that the Lyondell board give Basell a firm indication of Lyondell's interest in the transaction by July 11.

The board decided that it was interested, and instructed the company's CEO to explore a transaction. Between July 12 and 15, the parties negotiated the terms of a deal. The board attempted to negotiate a higher price, a go-shop provision, and a reduced break up fee. On July 16, the board met and was presented with reports by its legal and financial advisors (who characterized the purchase price as "an absolute home run"), and considered whether there were any other potential acquirers. The board then voted to approve the merger.

In the ensuing shareholder litigation, the board was accused of violating its duties under *Revlon* to obtain the best available price in selling the company. The Chancery Court denied the directors' motion for summary judgment, holding that it was possible the plaintiff could prove at trial not only a violation of the directors' *Revlon* duties but also that the directors had acted in bad faith. The Supreme Court reversed, concluding that the Chancery Court erred by (1) imposing *Revlon* duties before the directors had decided to sell, (2) reading *Revlon* and its progeny as creating a strict set of requirements that must be satisfied during the sale process, and (3) equating an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of a director's duties that constitutes bad faith. 2009 WL 790477 at 5-7.

A crucial element of the Chancery Court's finding of a violation of *Revlon* was the two month period "of inactivity" between Basell's Schedule 13D filing and the beginning of the week-long negotiations between Basell and the board. The Supreme Court, however, found that *Revlon* duties did not arise until the negotiations began. *Id*. at 6. Next, the Supreme Court emphasized that there is no fixed set of requirements that a board must follow in fulfilling its *Revlon* duties. *Id* at 7. The Chancery Court appeared to have required one of three courses: either a market check, an auction or a demonstration that the directors had an "impeccable knowledge of the market." The Supreme Court disagreed that *Revlon* required one of these three courses and therefore concluded that the directors' failure to follow one of these courses could not constitute the required "knowing and complete failure to undertake their responsibilities" that would constitute a breach of the duty of loyalty. *Id*. The proper inquiry was not whether the directors arguably did everything they should have done to obtain the best sale price (which is a duty of care inquiry), but whether they "utterly failed to attempt" to obtain the best sale price (a good faith inquiry, from which the court drew heavily on its approach in *Stone v. Ritter*). *Id*.

In holding that the directors had not "utterly failed to attempt" to obtain the best sale price, the Supreme Court found that it was enough that, during the one week period of negotiations, the board met several times (for 7 hours), was generally aware of the value of the company and knew the chemical company market, solicited and followed the advice of financial and legal advisors, and at least attempted to negotiate a higher offer before approving the merger. *Id*. The court found no bad faith by the board in carrying out its *Revlon* duties.

IV. Conclusions

Here are some conclusions that we have drawn from the cases described above:

1. The courts are anxious to limit monetary liability for bad faith to situations in which directors *knowingly* countenanced wrongdoing or *knowingly* engaged in wrongful conduct. The test laid down in *Stone* for bad faith oversight is that the directors *knew* that they were not discharging their obligations of oversight because they utterly failed to implement any reporting or information system or controls or, having implemented such a system or controls, *consciously* failed to monitor or oversee their operations. The test for bad faith action laid down in *Disney* is *intentional* dereliction of duties or a *conscious* disregard of one's responsibilities. Thus, the case law, in both the oversight and the action situations, indicates that bad faith has a *mens rea* requirement: bad faith requires scienter, *i.e.*, an illicit state of mind. Anything less is no more than gross negligence, which *Disney* defined as not bad faith.

2. However, the line between bad faith and negligence or gross negligence can be blurry, especially in merger or sale cases. It is arguably difficult to distinguish between the bad faith conduct of the director held liable in *Emerging Communications* for permitting an unfair transaction and the director in *Gesoff* or the directors in *McPadden* who permitted unfair transactions but were exonerated because their conduct, while negligent or grossly negligent, did not rise to bad faith. It is possible that *Emerging Communications* is an anomaly because lawsuits challenging directors' good faith, absent a conflict of interest, in merger and sale transactions have been mostly unsuccessful. *See*, in addition to *Gesoff* and *McPadden*, *Lear* and *Lyondell*.

3. *McCall* and *Abbott Labs* suggest (admittedly based on a small sample) that courts outside of Delaware may be more inclined to allow oversight claims to proceed than Delaware courts are. Indeed, *Guttman*, *Stone*, *Desimone*, *Wood* and *Citigroup* all dismissed oversight claims, with *AIG* being the only counterexample.

4. The courts appear to be drawing a distinction between directors' oversight or actions resulting in bad business decisions that did not result in illegality or fraud and those that did. In the former case the courts tend not to find bad faith. *See Citigroup*, *Gesoff*, *Disney*, *McPadden*, *Lear* and *Lyondell*. In the latter case the courts will find bad faith if the complaint supplies particularized allegations of a knowing failure of oversight or knowing misconduct. *See McCall*, *Abbott*, *AIG*, *Ryan* and *Tyson*. The courts are concerned that the availability of damages for bad faith not lead to directors being second-guessed for business decisions that were merely wrong.