

## NO FREE RIDE FOR DIRECTORS: THE DELAWARE EXCULPATORY STATUTE AND THE DUTY OF GOOD FAITH

By David M. Finz

### The Unanswered Question:

Delaware law is known to provide some measure of protection to corporate board members as respects shareholder litigation. Nevertheless, it remains unclear whether and to what extent independent directors have a separate fiduciary duty of good faith, the breach of which could lead to a finding of personal liability. A surface reading of the Court's holding in In Re Walt Disney Co. Derivative Litigation,<sup>1</sup> might suggest broad immunity for directors of Delaware corporations, but to the extent that Disney failed to establish a bright-line test regarding good faith, the duty has certainly not been eviscerated.

### The Statute:

Section 102[b][7] of the Delaware General Corporation Law permits a corporation to provide its directors exemption from liability for certain breaches of fiduciary duties by including the following in its certificate of incorporation:

*“[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for*

*monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: [i] For any breach of the director's duty of loyalty to the corporation or its stockholder; [ii] for acts or omissions not in good faith or which involved the intentional misconduct or a knowing violation of law; [iii] under Section 174 of this title; or [iv] for any transaction from which the director derived an improper personal benefit.”<sup>2</sup>*



**What did Washington say when he crossed the Delaware? He probably asked about the exculpatory statute.**

The crux of the problem lies with interpretation of the second provision, “acts or omissions not in good faith.” As a legal principle, “good faith” is ill-defined, and any inquiry into whether a

<sup>1</sup> 2005 WL 205665 (Del. Ch. Aug. 9, 2005)

<sup>2</sup> 8 Del. Code Ann. s. 102[b][7] [2001].

director's acts or omissions were carried out in good faith will necessarily be subjective and fact-driven. This is not a dilemma unique to Delaware. Witness the following comment on the meaning of the term under New York law:

*“Good faith” is an intangible and abstract quality with no technical meaning or statutory definition. It encompasses, among other things, an honest belief, the absence of malice and the absence of a design to defraud or to seek an unconscionable advantage. An individual's personal good faith is a concept of his own mind and inner spirit and, therefore, may not conclusively be determined by his protestations alone.”*<sup>3</sup>

Even prior to Disney, Delaware courts had wrestled with the good faith standard. A 1996 decision, In re Caremark International, Inc., Derivative Litigation,<sup>4</sup> held that lack of good faith was “evidenced by sustained or systematic failure of a director to exercise reasonable oversight.” While acknowledging that this standard was “quite high,” Chancellor William T. Allen noted that “a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely while continuing to acts as a stimulus to good faith performance by directors.” Clearly, the Delaware courts are committed to interpreting the statute's exculpatory provision in a manner that ensures the interests of shareholders are capably represented in the corporate boardroom.

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<sup>3</sup> Doyle v. Gordon, 158 NYS2d 248 (1954).

<sup>4</sup> 698 A.2d 959, 971 (Del. Ch. 1996),

### **The Significance of Disney with Respect to the Duty of Good Faith:**

In a much anticipated decision, the Court of Chancery determined that, while the defendant directors' conduct in allowing the compensation package for Michael Ovitz to go through “fell significantly short of the best practices of ideal corporate governance,” they “did not breach their fiduciary duties or commit waste” with respect to the decisions to hire Ovitz in 1995 and terminate him one year later.

The decision appears to confer relatively wide latitude under Delaware law for directors in discharging their fiduciary duties on behalf of the shareholders they represent. It would seem that the Court believed that the members of the Compensation Committee thought they were advancing the interests of the corporation. Perhaps if the impact of the decision was more obvious at the time it was made (say, for example, a decision to sell the company), then the Court might have viewed the standard of care employed differently. Still, there was no duty of loyalty implicated, and no hint of an interested transaction, only what can be said in hindsight was not the greatest of business judgment. And the remedy for that, the Court seems to suggest, is for shareholders to vote the directors out of office, not to seek legal redress against them.

Even so, this is only one interpretation of good faith. Under Delaware law, directors enjoy a presumption that they have exercised sound business judgment in making their decisions. A strict application of the Business Judgment Rule, however, might have yielded a different result. Instead of asking

whether there was an absence of malice or self-dealing, perhaps a more appropriate inquiry (one we can expect plaintiffs to argue in the future), would be whether the defendant directors *knew or should have known* that they were making material decisions without adequate information and with little deliberation, and that they reached these decisions without any genuine regard for whether the corporation and its stockholders would suffer injury or loss as a result.

On appeal, the shareholders are seeking to rebut the presumption of sound business judgment by invoking *Emerald Partners v. Berlin*,<sup>5</sup> which held that directors are presumed to have made decisions *on an informed basis*, and that Section 102(b)(7) really deals with damages, and should only come into play once the directors potential liability has been established as a result of their breach of duty. This would have given the plaintiffs the opportunity to rebut the presumption that they acted in good faith under the Business Judgment Rule, without allowing the defendants to essentially circumvent that inquiry by citing the exculpatory statute.

### **Is there Life after Disney?**

The smoke has yet to clear with respect to the impact of Disney on cases involving D&O liability and the availability of Section 102(b)(7) as a protection for directors. In the aftermath of Disney, two cases have been decided in Delaware that hold independent directors liable for breaches of their fiduciary duties *and* personally responsible for monetary damages.

One of these cases, In re Emerging Communications, Inc., Shareholders Litigation,<sup>6</sup> found some directors liable for breaching their fiduciary duty, while exonerating other, arguably less sophisticated directors. The plaintiffs' case was based upon a vote to approve taking the company private at a price later alleged to be unfair. Interestingly, Emerging Communications calls for determination of liability on an individual basis, and takes into consideration a director's specialized knowledge. For example, one director who was found liable was a principal in an investment advisory firm, and had substantial experience with the financing of telecommunications enterprises. The Court found that this particular director should have recognized that the share price being offered for the company was on the low end, and breached his duty of loyalty *and/or* good faith by failing to advocate for a higher price.

In another case, decided by the U.S. District Court for the Southern District of New York,<sup>7</sup> the Court held that directors of Trace International Holdings, a Delaware Corporation, were not protected by a provision in their corporate charter when they failed to prevent a controlling shareholder from liquidating the company. Although this case involved a breach of duty of loyalty in addition to the breach of duty to exercise good faith, the should serve as a wake up call to directors and officers that exculpatory clauses will not always save them from being held liable for monetary damages.

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<sup>5</sup> 787 A.2d 85 (Del. 2001)

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<sup>6</sup> 2004 WL 1305745 (Del. Ch. May 3, 2004; Revised June 4, 2004)

<sup>7</sup> Pereira v. Cogan, 2003 WL 21039976 (2003)

**Best Practices:**

Sound articles of incorporation may help protect directors from liability, but the best by-laws and corporate structures will not absolve a director from his or her own fiduciary duties. A director's role is one of actual governance, not just to offer advice to the principals. In other words, directors are responsible for controlling the policy of the corporation, and this requires an investment of time, maintenance of reliable records, use of outside advisors where appropriate, and the use of reporting systems (including, but not necessarily limited to, those required by the Sarbanes-Oxley Act of 2002), to keep directors informed. For corporations formed outside of Delaware, directors should familiarize themselves with the applicability of exculpatory statutes (the retention of independent counsel may be in order here), and should review any indemnification agreements or bylaws governing liability for conduct that fails to meet the test of "good faith." Finally, directors should gain an understanding of what types of acts and omissions are subject to coverage under the entity's D&O liability policy.

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