Reining in Directors and Officers in Corporate America

In Delaware, the Answer Is Not to Expand Their Personal Liability

By Dominick T. Gattuso and Vernon R. Proctor

The recent corporate and financial scandals and the ensuing economic turmoil have led some people to question whether directors and officers of public corporations should be exposed to greater risk of personal liability as a means of curbing what they perceive as excessive risk-taking by these corporate managers. Indeed, some have even called for the federalization of this and other related aspects of state corporate law, arguing that the states, and Delaware in particular, have not acted aggressively to hold corporate managers accountable.

In point of fact, Delaware's legislature and its courts have responded to the call to rein in directors and officers, albeit in a balanced, pragmatic manner that embodies a deep understanding of both the practical limitations facing directors and officers of publicly held corporations and the need to encourage investor confidence.

Gattuso is special counsel and Proctor is a partner with Proctor Heyman LLP, Wilmington, Delaware. The authors practice in the areas of corporate, alternative entity, and commercial litigation. Their views expressed herein do not necessarily represent the views of Proctor Heyman LLP or the firm's clients. Their respective e-mails are vproctor@proctorheyman.com and dgattuso@proctorheyman.com.

The General Assembly's Response

The Delaware General Assembly did not expand the personal liability of directors and officers for fiduciary violations by narrowing the robust statutory protections afforded to directors under section 102(b)(7) of the Delaware General Corporation Law (the DGCL), which protects directors from personal liability for money damages for violations of their duty of care; section 141(e), which protects directors' good faith reliance on the reports of experts and management; or section 145, which provides directors (and officers) with statutory indemnification and advancement rights.

However, in 2009, the general assembly amended the DGCL in several material respects to provide shareholders with additional checks on the power of directors and officers. Newly added sections 112 and 113 provide shareholders of Delaware corporations with greater access to the ballot box. For example, under section 112, the company's bylaws may be amended to require shareholder nominees for board seats to be included in the company's proxy materials. The bylaws also may be amended to permit shareholders to seek reimbursement for proxy solicitation expenses, pursuant to section 113. Next, the general assembly addressed "empty voting" by revising several sections of the DGCL, including section 213(a). As amended, section 213(a) allows a board to establish a record date for determining those shareholders entitled to notice of a meeting and a later record date for ascertaining those shareholders entitled to vote at the meeting. Finally, and perhaps most interestingly, newly added section 225(c) authorizes the Court of Chancery to remove a director who failed to act in good faith, if his or her removal is necessary to avoid irreparable injury to the company. A section 225(c) claim may be brought derivatively or directly. These amendments, coupled with existing provisions of the DGCL, potentially provide shareholders with substantial power to remove corporate directors and officers who cause the company to act in a manner that the shareholders deem excessively risky.

The Delaware Court's Response

Like the general assembly, in recent years the Delaware courts have made a conscious decision not to alter the

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standards of conduct for directors and officers and, thereby, expose them to greater risk of personal liability. Instead, the courts have clarified the standards for evaluating director and officer conduct, while reaffirming that the business judgment rule remains an integral component of the state's corporate jurisprudence. For example, in *In re Emerging Communications Shareholders Litigation*, 2004 WL 1305745 (Del. Ch. May 3, 2004, revised June 4, 2004), Justice Jacobs, sitting on the Delaware Court of Chancery by designation, ruled that a director had violated his fiduciary duty of "loyalty and/or good faith" by voting to approve a merger transaction because he possessed special financial expertise and knowledge of the industry and, therefore, knew, or should have known, that the merger price was unfair. The director's refusal to speak out against the fairness of the merger was explainable by one of two mindsets: either the director made a deliberate judgment to further his own personal business interests by voting in favor of the deal, or he "'consciously and intentionally disregarded' his responsibility to safeguard the minority stockholders from the risk, of which he had unique knowledge, that the transaction was unfair." Several scholars and practitioners read the decision in *Emerging Communications* as providing for a heightened standard of conduct for directors with special expertise in a particular area (e.g., finance, accounting, law), thereby exposing this subgroup of directors to greater personal liability for a fiduciary violation. However, a more nuanced reading of *Emerging Communications*, and one that is supported by dicta in *In re Citigroup, Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009), is that directors possessing specialized knowledge or expertise will be held to the same standard of conduct as any other director, though they may lose the protection afforded by section 141(e) of the DGCL if they are unable to rely in good faith on the report of an expert or management. Thus, it is not the director's special expertise that gives rise to a greater risk of personal liability, but the inability to take advantage of the section 141(e) safe harbor.

Two years after *Emerging Communications*, in *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del. 2006), the Delaware Supreme Court reaffirmed the significant protections afforded to Delaware directors by the business judgment rule and offered "conceptual guidance" on the duty to act in good faith, explaining that "fiduciary action taken solely by reason of gross negligence and without any malevolent intent" does not constitute bad faith. Rather, to establish that a director failed to act in good faith, a plaintiff must show something more, such as "fiduciary conduct motivated by an actual intent to do harm [i.e., subjective bad faith]" or "a conscious disregard for one's responsibilities . . ." Importantly, these are but two examples of bad faith. As the court explained, "[t]here may be other examples of bad faith yet to be proven or alleged . . ." A few months later, in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006), the Delaware Supreme Court explained that, where an independent director is accused of failing to satisfy his or her oversight duties, fiduciary liability will not result ipso facto from a failure to act in good faith, and that there is no separate fiduciary duty of good faith. Rather, liability will attach only upon a showing that the director breached his or her duty of loyalty by "intentionally fail[ing] to act in the face of a known duty to act, demonstrating a conscious disregard for his [or her] duties." *Stone*, like *Disney*, reaffirmed Delaware's commitment to retaining the robust protections afforded to directors and officers under the business judgment rule.

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Nor has the recent meltdown in the capital markets altered Delaware's view on oversight duties, the application of the business judgment rule, or the expansion of personal liability, as evidenced by three key decisions from the Delaware courts in the first three months of 2009. In *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009), the Delaware Supreme Court reversed the trial court's decision, finding that imperfection of process in a sale transaction was not synonymous with bad faith. The class plaintiffs alleged that Lyondell's independent directors breached their fiduciary duty by failing to be actively involved in the process of selling the company to Basell AF. Lyondell's directors moved for summary judgment, arguing that their inaction amounted to a breach of the duty of care, at most, and that they were exculpated from liability under the section 102(b)(7) provision in the company's charter. The chancery court denied the summary judgment motion, even though the directors had no conflicts, were independent, had met several times to consider options, received a fairness opinion, relied on the advice of financial and legal advisors, and obtained a 45 percent premium over the market price. The court reasoned that a more developed record was necessary to determine whether the directors intentionally disregarded a known duty to act in accordance with the sale process envisioned by *Revlon* and its progeny, characterizing the directors' approach as one of "slothful indifference" and "do nothing, hope for an impressive-enough premium, and buy a fairness opinion . . ." However, in a sharply worded decision, the Delaware Supreme Court reversed, holding that a flawed effort to satisfy one's fiduciary duties is not bad faith conduct sufficient to breach the duty of loyalty. Such a breach exists only where directors "knowingly and completely fail[] to undertake their responsibilities . . ."

The Court of Chancery has been forthright in determining when the allegations of a complaint are sufficient to deprive defendant directors of a limited liability shield. Consider

the recent decision of Vice Chancellor Strine in *American International Group, Inc. Consolidated Derivative Litigation*, 965 A.2d 763 (Del. Ch. 2009). In *AIG*, the court addressed a complaint containing a detailed description of an integrated and multifaceted financial fraud that, in its view, amounted virtually to a "criminal enterprise." Specifically, the court determined that allegations of fiduciary misconduct against the chief executive officer of AIG (Greenberg) and members of his "inner circle" were sufficiently detailed to survive the "plaintiff-friendly" pleading threshold imposed by Rule 12(b)(6). The court's opinion was focused principally upon the allegations concerning two members of the "inner circle," Matthews and Tizzio, who were at top levels of AIG management and intimate colleagues of Greenberg. In a nutshell, the pervasive scheme described by the plaintiffs included "transactions designed 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 harms allegedly incurred by AIG included the payment of $1.6 billion in fines and penalties, $440 million in settlement payments, $800 million in disgorged profits and penalties, and the restatement of financial statements to the tune of a $3.5 billion "hit" to shareholders' equity.

The court found that this was one of the relatively rare pleadings that stated a claim for relief under the "duty of oversight" rubric: "[T]he complaint pleads details about the fraudulent schemes that, when taken with the pled facts regarding Matthews' and Tizzio's roles at AIG, support the inference that they knew of and approved much of the wrong-doing." Put differently, the allegations were more than sufficient to support an inference of "conscious disregard" and other bad faith conduct for purposes of *Stone* and related cases. The court also noted that "for present purposes, it is inferable that even when Matthews and Tizzio were not directly complicitous in the wrongful schemes, they were aware of the schemes and knowingly failed to stop them."

In the limited liability context, the Court of Chancery has expressly recognized the close interplay between the business judgment rule and managerial risk taking. In *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009), the shareholders of one of America's largest financial services companies filed a derivative action against the directors and officers of the company, alleging primarily that the defendants had breached their fiduciary duties by failing to provide oversight of management with respect to Citigroup's exposure to deteriorating conditions in the subprime mortgage market. Specifically, the plaintiffs alleged that the directors had ignored certain "red flags" that, in the plaintiffs' view, should have alerted the board to those problems and the attendant need to provide for adequate financial reporting and controls. The Court of Chancery dismissed almost all of the plaintiffs' claims for failure to comply with the demand requirements of Rule 23.1. The court noted that, in contrast to the usual corporate oversight claim, the Citigroup plaintiffs' "claims are based on defendants' alleged failure to properly monitor Citigroup's *business risk*, specifically its exposure to the subprime mortgage market."

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The Court of Chancery, in *Citigroup*, essentially found that, under the guise of such traditional oversight claims, the plaintiffs were actually attempting to hold the defendant directors liable "for making (or allowing to be made) business decisions that, in hindsight, turned out poorly for the Company." The plaintiffs' pleadings were fatally undercut by the lack of specific allegations raising a reasonable doubt that the director defendants had acted in good faith: the court noted that the plaintiff did not even allege such basic elements of bad faith conduct as "how the board's oversight mechanisms were inadequate or how the director defendants knew of these inadequacies and consciously ignored them." The court rejected the plaintiffs' invitation to accept their post hoc reasoning that the corporate losses were attributable to breaches of fiduciary duty. In the chancellor's view, a different result would have effectively straitjacketed the directors of Citigroup and other Delaware corporations in the proper and reasonable exercise of their business judgment: "Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor 'excessive' risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. 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." The court was evidently concerned that a stricter standard would have deterred board efforts to maximize shareholder value.

Delaware's reluctance to expand the personal liability of directors for fiduciary violations is an acknowledgment that directors are not omniscient. Nor can they be, given their role in the corporate enterprise, as the Delaware Supreme Court acknowledged in *Stone*: "the directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both . . ." Indeed, that oversight role is more suited to corporate officers who are responsible for managing the day-to-day affairs of the corporate enterprise. And, under Delaware law, it is those individuals that bear the greatest risk of personal liability for fiduciary violations.

Though corporate officers owe the same fiduciary obligations as directors, they do not benefit from the full spectrum of statutory and common law liability protections available to directors, as the Delaware Supreme Court recently acknowledged in *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009). This is not surprising, nor is it unwarranted, given that senior management typically have effective daily control of the company's operations and, thus, are in a much better position to monitor the activities of employees.

The Correct Response

Arguably, Delaware's measured response to the call for expanding the personal liability of directors and officers reflects a balancing of the need for good corporate governance with the realization that an appropriate level of risk is necessary for continued economic growth. Recognizing the bedrock principle of separation of ownership from management, Delaware's corporate law scheme, as construed by the courts, fosters investment in the corporate enterprise while allowing corporate directors and officers considerable flexibility to manage business risk and opportunity in order to maximize shareholder value. The limited liability protections for directors, officers, and stockholders are not absolute: normally, the business judgment rule is the "default rule," but stricter scrutiny will be applied by the courts if circumstances warrant. Even in these turbulent economic times, the process still works, and care should be taken to avoid stifling prudent risk taking in the name of enhancing investor protection.