DELAWARE COURT OF CHANCERY REDEFINES “GOOD FAITH” DUTIES OF BOARDS OF DIRECTORS

The recent decision of the Delaware Court of Chancery in In re The Walt Disney Company Derivative Litigation should have directors thinking about the manner in which they approach decision-making for the corporations that they govern.\(^1\) The court in Disney found that the process followed by Disney's board of directors in approving an executive compensation package was so deficient as not to have been undertaken in “good faith” and thus denied the defendants' motion to dismiss. Although the concept of a duty of “good faith,” either as a separate fiduciary duty of directors or as a subpart of the traditional duties of care and loyalty, has recently received significant attention, particularly in articles and speeches by members of the Delaware judiciary, the Disney case is among the most sweeping articulations of this concept in a judicial decision to date. For most directors, Disney is a reaffirmation that they need to be deliberate and appropriately attentive in their decision-making process.

This advisory summarizes the Disney decision and the development of the concept of a duty of good faith preceding it. This advisory also suggests some best practices that directors should consider implementing in order to increase the chances that they will be viewed as having acted in good faith.

WHAT IS THE SIGNIFICANCE OF THE DISNEY DECISION?

The most serious ramification of Disney is that a finding that a director did not act in good faith may make unavailable to the director the benefit of director liability exculpation provisions commonly adopted by most corporations and may also preclude indemnification of the director by the corporation for the director’s liability for the challenged acts.

In the late 1980s, following several court decisions imposing personal liability on directors for breaches of the duty of care, Delaware adopted Section 102(b)(7) to its General Corporate Law. DGCL Section 102(b)(7) allows a corporation to exculpate a director from monetary liability for breaches of fiduciary duty except in certain specific instances. One exception is for acts or omissions “not in good faith.” Most states followed suit and adopted similar director liability exculpation statutes, many of which also contained similar exceptions for acts or omissions not in good faith.

Similarly, Delaware’s director indemnification statute, like those of many other states, permits a corporation to indemnify a person for liability incurred by reason of being a director “…if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation.”\(^2\)

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\(^1\) In re The Walt Disney Company Derivate Litigation, Memorandum Opinion, Case No. 15452 (May 28, 2003).

\(^2\) DGCL §145(a).
With this as background, one can readily see the significance of the *Disney* case. However, it is important to note that, while Delaware courts are extremely influential in matters of corporate governance, courts in other jurisdictions may not follow the reasoning in *Disney*, and the corporate statutes of other jurisdictions may have exculpation and indemnification provisions that do not except conduct considered not in good faith.³

**HIGHLIGHTS OF THE DISNEY DECISION**

**Background of the Case**

*Disney* involved a challenge by Disney stockholders to the decisions of the Disney board of directors approving an executive compensation package for Michael Ovitz and approving a non-fault termination that resulted in an award to Ovitz allegedly exceeding $140,000,000. The plaintiffs argued that Disney’s Chief Executive Officer, Michael Eisner, unilaterally made the decision to hire Ovitz, over the initial objection of certain Disney directors and despite internal documents warning of potential problems with Ovitz’s proposed compensation package. Additionally, the plaintiffs alleged serious defects in the process followed by the board of directors in approving Ovitz’s employment, including:

- The compensation committee and board of directors did not review drafts of the employment agreement, but rather only summaries. Although substantive changes were later made to the employment agreement, neither the compensation committee nor the Board received updated drafts or summaries of the final employment agreement.

- Neither the board of directors nor the compensation committee sought expert advice about the size of Ovitz’s compensation package compared to compensation agreements of similarly situated executives in the entertainment industry.

- Neither the board of directors nor the compensation committee received any analysis showing the potential total costs of Ovitz’s compensation package in different scenarios, including upon early termination of Ovitz’s employment.

- The compensation committee meeting where Ovitz’s hiring and compensation package were considered lasted less than one hour. According to the minutes of that meeting, more discussion was devoted to the payment of a fee to a compensation committee member for assisting in Ovitz’s hiring than to consideration of the hiring itself.

- The board of directors delegated final negotiation of the employment agreement to Eisner, who had been friends with Ovitz for over twenty-five years.

Ovitz’s tenure as president of Disney was short-lived. After Eisner and Ovitz mutually agreed that Ovitz’s resignation would be beneficial to Disney, Eisner, Ovitz and a Disney director worked together to arrange Ovitz’s termination in a manner that would provide him with the optimum severance package under his employment agreement. This required treating his termination as a “non-fault” termination. Neither the compensation committee nor the full board reviewed the treatment of Ovitz’s termination as “non-fault” or approved it. However, Disney’s bylaws allegedly required board approval for this “non-fault” termination.

³ See e.g., Georgia Business Corporation Code §14-2-202(b)(4), which permits exculpation for breaches of the duty of care or other duties as a director and contains no exception for acts or omissions not in good faith. However, GBCC §14-2-851(a) authorizes a corporation to indemnify a director against liability if the director “…acted in a manner he believed in good faith to be in or not opposed to the best interests of the corporation.” Note that, unlike DGCL §145(a) in which “good faith” modifies “acted,” in GBCC §14-2-851(a) “good faith” modifies the director’s belief concerning the nature of his actions.
The Positions of the Parties

The plaintiff stockholders filed a derivative suit alleging that Disney’s board of directors breached their fiduciary duties to the corporation in approving the Ovitz employment agreement and subsequent termination. The defendant directors brought a motion to dismiss the suit based on two grounds: (1) the board of directors’ decision was entitled to the protection of the business judgment rule, and (2) the exculpatory provision in Disney’s certificate of incorporation eliminated the monetary liability of directors to the corporation for breaches of fiduciary duty, except for, among other things, breaches of the duty of loyalty and acts or omissions not in good faith.

The Decision of the Court of Chancery

The court found that the facts as alleged raised sufficient doubt that the actions of the board were taken in good faith, finding that the Disney directors “consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude.” The court also found that they displayed a knowing and deliberate indifference to their duty to act faithfully and with appropriate care, and “where a director consciously ignores his or her duties to the corporation, thereby causing injury to its stockholders, the director’s actions are either ‘not in good faith’ or ‘involve intentional misconduct.’” The Delaware Court of Chancery noted that a breach of a director’s duty to act honestly and in good faith may lead a court to conclude that the director’s conduct falls outside the protection of the business judgment rule as well. Accordingly, the court denied the motion to dismiss.

The Good Faith Defense Beyond Disney

Although Disney is among the most sweeping judicial articulations to date of a director’s duty to act in good faith, the decision in many respects is a logical extension of other Delaware cases, recent public commentary by members of the Delaware judiciary and case law from other jurisdictions. In In re Caremark International, Inc. Derivative Litigation, the Delaware Court of Chancery stated that where a director makes a good faith effort to be informed and to exercise appropriate judgment, he or she will be deemed to have upheld his or her duty of attention and care to the corporation, regardless of the outcome of his or her decision. The court found that the board of directors was required to (and did) exercise good faith judgment that the corporation’s information reporting system was adequately designed to assure the board that relevant information will come to the board’s attention in a timely manner. The Caremark court noted, however, that a sustained or systematic failure of the board to exercise its oversight responsibilities will establish a lack of good faith and could lead to director liability.

By contrast, the Sixth Circuit Court of Appeals, applying Delaware law in McCall v. Scott, found that the plaintiffs properly alleged that the defendant directors had acted with “sustained inattention” and

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4 Ovitz was also named as a defendant based on the assertion that he was an officer, and thus a fiduciary, of Disney during the final negotiations of his employment agreement and his subsequent termination. The plaintiffs alleged he therefore had a fiduciary duty to Disney to ensure his compensation was fair.

5 Generally speaking, the business judgment rule provides that a court will not examine an informed decision of the board of directors of a corporation that was made in a disinterested manner and in good faith.

6 Ovitz’s request for dismissal of the claims against him were denied, because as a fiduciary he owed a duty to the corporation to negotiate his employment agreement in an adversarial and arms-length manner, a duty violated when he made no efforts to negotiate with anyone but his long-time friend Eisner.


8 239 F.3d 808 (6th Cir. 2001), amended by 250 F.3d 997 (6th Cir. 2001).
"willful blindness" to signs of illegal activity. The court noted that a breach of the duty of good faith could result from "reckless or intentional misconduct," citing this portion of a prominent treatise on Delaware corporate law:

> Whether [DGCL § 102(b)(7)] would protect a director against reckless acts is not altogether clear. To the extent that recklessness involves a conscious disregard of a known risk, it could be argued that such an approach is not one taken in good faith.\(^8\)

The court thus rejected the defendants’ arguments that the case should be dismissed because of the corporation’s liability exculpation provision.

Courts applying the laws of states other than Delaware have also noted the importance of director action being taken in good faith. For example, the Seventh Circuit Court of Appeals recently stated that where the directors of Abbot Laboratories repeatedly ignored (over the course of six years) FDA warnings about safety violations, which resulted in a large civil fine, the directors did not act in good faith.\(^10\) Applying Illinois law, but citing Caremark, the court found that the plaintiffs properly alleged that the directors acted "in conscious disregard of a known risk" and that there was a "systematic failure of the board to exercise oversight," which led the court to conclude that the directors’ decision to do nothing was not made in good faith.

Outside the courtroom, members of the Delaware judiciary also have increasingly mentioned the importance of directors acting in good faith. In a roundtable discussion sponsored by the Harvard Business Review, Chief Justice Veasey remarked that an action or omission can “be so egregiously lacking in due care or reckless that it evidences a lack of good faith.”\(^11\) Similarly, in a recent article in The Business Lawyer, Vice Chancellor Strine predicted the scenario raised in Disney, where a board of directors was alleged not to have devoted sufficient attention to its duties to have acted in good faith, and thus would not be protected by the exculpatory charter provision allowed by Section 102(b)(7) of the DGCL.\(^12\)

We believe allegations by plaintiffs of directors failing to act in good faith will increase in an effort to avoid the protection of director exculpation provisions similar to the provision permitted by Section 102(b)(7) of the DGCL. Provisions eliminating the liability of a director to the corporation or its stockholders for monetary damages for breaches of fiduciary duty are commonplace and are a significant protection against director liability, along with indemnification provisions and D&O insurance. Since Delaware law does not allow exculpation clauses to eliminate liability for acts or omissions not in good faith, the exculpation clause will not be grounds for dismissal of a lawsuit that alleges a failure to act in good faith. Accordingly, particularized allegations of acts or omissions not in good faith at a minimum will increase the time and expense associated with litigation.\(^13\)

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\(^10\) In re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795 (7th Cir. 2003).


\(^13\) Although the issue was not litigated in Disney, it is questionable as to whether indemnification would be available in such a case, and depending on the language of the policy, D&O insurance coverage may be unavailable as well.
BEST PRACTICES OF CORPORATE DIRECTORS IN LIGHT OF Disney

In addition to establishing good corporate governance practices generally, we recommend that directors consider the following in order to ensure that they will be viewed as having acted in good faith:

- The board should be engaged in actual governance – not just be an advisor to the principal executive officers (i.e., directors should control the policy of the corporation).

- Directors should have a number of face-to-face meetings throughout the year, and several of these should occur without the presence of management directors or other members of management.

- Directors should commit a significant amount of time to fulfilling their duties.¹⁴

- Maintain good minutes and other records to document the decision-making process of the board of directors.

- Use outside advisors for expert advice and where conflicts of interest involving management create a need for outside advisors (e.g., use outside counsel instead of internal counsel to negotiate employment agreements with management).

- Directors should ensure that there are controls and reporting systems in place that are designed to keep directors fully informed of any matters that are within their purview. The design of such controls and systems should be guided by the recent requirements imposed on public companies by the Sarbanes-Oxley Act of 2002 and related SEC regulations, which require that public companies have adequate internal controls and reporting systems to keep management and the audit committee informed of financial matters.¹⁵

Directors should also ensure that, from a liability perspective, they are protected to the full extent permissible under applicable law. In that regard, directors should:

- If the corporation is incorporated in a state other than Delaware, seek legal advice on how that state’s corporate code and judicial precedent treat acts or omissions not taken in good faith in both the exculpation and indemnification contexts. Directors should determine whether Disney has any impact under the state law of the corporation on whose board they sit.

- Review indemnification agreements or bylaw provisions to see if they preclude indemnification for conduct not in good faith.

- Review directors’ liability insurance policies to determine if conduct not in good faith is covered.

Of course, these are only general suggestions, and directors will need to consider how the concepts discussed in Disney apply to particular situations. As standards of director good faith continue to evolve in the courts and elsewhere, we will keep you updated about any significant developments.

¹⁴ Chief Justice Veasey has mentioned that directors should expect a minimum commitment of 100 hours per year, which includes reviews of all board and other relevant materials. See E. Norman Veasey, “Symposium Norms & Corporate Law: Should Corporation Law Inform Aspirations for Good Corporate Governance Practices – or Vice Versa,” 149 U. Pa. L. Rev. 2179, 2190 (2001). This necessarily leads to limits on the number of boards on which a director can serve.

¹⁵ For more information on the Sarbanes-Oxley Act and related corporate governance issues, see Alston & Bird’s Sarbanes-Oxley and Corporate Governance Resource Center, at www.alston.com, which contains all of A&B’s advisories and articles on related regulatory developments.
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