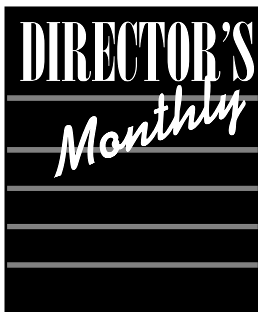
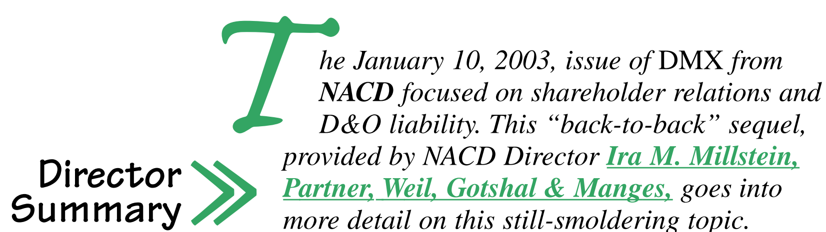


DM Extra!

January 14, 2003

Timely Commentary on Critical Events and Regulatory Developments

The Heat Is Still On: Director Liability Warnings from Delaware



Director Summary

The January 10, 2003, issue of DMX *from* ***NACD*** *focused on shareholder relations and D&O liability. This "back-to-back" sequel, provided by NACD Director* ***Ira M. Millstein, Partner, Weil, Gotshal & Manges,*** *goes into more detail on this still-smoldering topic.*

In recent days, *The Wall Street Journal* and *Fortune* have published provocatively titled articles—"Delaware Justice Warns Boards of Liability for Executive Pay and Overpaid CEOs?" "Try Suing the Paymasters: Delaware Judge, in Warning Signal to Boards, Opens Door to Courtroom Remedy"—reporting recent comments by **E. Norman Veasey**, the Chief Justice of the **Delaware Supreme Court,** in a roundtable discussion that appears in the January 2003 issue of the *Harvard Business Review.* Chief Justice Veasey's observations, together with recent actions by the Delaware Supreme Court, signal that court's—and almost certainly other courts'—heightened sensitivity and focus upon corporate governance issues and the increased exposure to liability directors face in the post-Enron and post-Sarbanes-Oxley Act of 2002 world.

Chief Justice Veasey's observations, together with recent decisions and articles by other Delaware judges, suggest a perceptible shift in the rigor with which the courts will review director conduct. Although it is too early to predict the precise doctrinal contours that will be applied by the courts, *now* is the time for directors and their advisors to review and, where appropriate, strengthen—and follow—their procedures to meet the evolving demands and heightened judicial scrutiny that is sure to come. Now, more than ever, it is critical for directors to establish and follow procedures designed to assure independent, informed decision-making.

Discussion

Chief Justice Veasey observes in the *Harvard Business Review* that "the changes in corporate governance that we're seeing through the voluntary best practices codes, for example, or through the **New York Stock Exchange** listing requirements have created a new set of expectations for directors" and states that "that is changing how the courts look at these issues."[1] Courts—including the Delaware Supreme Court—long have held that "in making business decisions, directors must consider all material information reasonably available."[2] The "new set of expectations for directors" created by best practices codes, Sarbanes-Oxley, and new listing requirements—as well as common knowledge of the **Enron** and **WorldCom** experiences (to name just two)—may well play a role in a court's assessment with respect to whether "material information" that directors did not obtain nevertheless was "reasonably available" to directors.

The "new set of expectations for directors" may also create the backdrop for claims that directors who do not act in accordance with the "new set of expectations" have not acted in "good faith." Such a finding would be particularly significant in light of charter provisions adopted by shareholders of most corporations pursuant to statutes modeled upon Section 102(b)(7) of the Delaware General Corporation Law, which permit shareholders to protect directors from liability for money damages for breaches of the duty of care but not "acts or omissions not in good faith."

The meaning—and possibly new meanings—of "good faith" in light of the "new set of expectations for directors" likely will play an important role in litigation regarding the conduct of outside directors. As Delaware Vice

A publication of the
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1 "What's Wrong with Executive Compensation?" A roundtable moderated by Charles Elson, Harvard Business Review, Jan. 2003, at 68 and 76.
2 See, e.g., Brehm v. Eisner, 746 A.2d 244, 259 (Del. 2000); Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
3 "Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle," 57 Bus. Law. 1371, 1385 (2002).
4 Id. at 1386.
5 Harvard Business Review at 76.
6 Id.
7 Id.

Chancellor **Leo E. Strine, Jr.,** recently observed, corporate failures such as Enron "generate increased pressure on courts to examine carefully the plausibility of director claims that they were able to devote sufficient time to their duties to have carried them out in good faith."[3] Vice Chancellor Strine notes that "one can envision plaintiffs' lawyers who will try to take apart a board of directors based on the simple argument that the board simply could not have carried out its duties in the time devoted to them."[4]

By way of example only, plaintiffs pursuing arguments such as these may ask courts to decide questions such as:

- Could directors have had a good faith belief that they devoted enough board and/or committee time to oversight in light of the size and scope of the corporation's activities and—with 20-20 hindsight—what went wrong?
- Could directors have had a good faith belief that an audit committee of a multi-billion dollar multi-national corporation that meets for an hour or two quarterly (and possibly with some members participating by phone) devoted enough time and attention to oversight?
- Could directors have had a good faith belief that a chief executive officer would have left the corporation or not performed up to his or her potential if he or she were offered less money than the millions or tens of millions of dollars the compensation committee agreed to pay? and
- Could directors who have full time jobs and/or serve on multiple boards (and/or multiple audit committees) have had a good faith belief that their multiple obligations provided them enough time to exercise sufficient oversight over the affairs of each corporation they serve?

Key Questions

Chief Justice Veasey comments to the *Harvard Business Review* also urge that "[c]ompensation committees should have their own advisors and lawyers."[5] This statement raises numerous questions relating to both compensation and other matters:

- To what extent can compensation committees rely upon the corporation's advisors and lawyers?
- To what extent can other committees—such as audit committees, which under the Sarbanes-Oxley Act have "authority to engage independent counsel and other advisors, as it determines necessary to carry out its duties"—rely upon the corporation's advisors and lawyers?
- Should the board as a whole have its own advisors and lawyers?
- Can the board and/or more than one committee utilize the same advisors and counsel?
- To what extent will a compensation or audit committee determination not to retain their own advisors and lawyers—based upon cost considerations and/or their confidence in the board's advisors—face allegations that the failure to do so reflected something less than good faith?
- Are all committees obligated to at least consider whether they need their own advisor and counsel?
- If so, can reliance upon the company's advisors and counsel on that subject possibly be deemed to reflect something less than good faith?

Chief Justice Veasey's comments to the *Harvard Business Review* also urge directors "to demonstrate their independence, hold executive sessions, and follow governance procedures sincerely and effectively" in order to "guard against anything that might happen to them in court."[6] In Chief Justice Veasey's words, "[d]irectors who are supposed to be independent should have the guts to be a pain in the neck and act independently."[7] The implications of this statement obviously are substantial.

Cases Send Signal

Finally, we note that from June 2002 through today, the Delaware Supreme Court has issued written decisions in five cases involving the performance by directors of their fiduciary duties. *In every one of these five decisions, the Supreme Court held for the shareholders and against directors* (and reversed Court of Chancery decisions that had rejected the shareholder claims). (See chart on next page.)

And, in a sixth case, involving a limited partnership agreement creating fiduciary duties "substantially mirroring traditional fiduciary duties that apply in the corporation law," the Supreme Court affirmed the Court of Chancery's finding that a general partner

breached its fiduciary duty to limited partners and affirmed the Court of Chancery's finding that rescission was not required, but held that the Court of Chancery erred by failing to "fashion a remedy that is an appropriate substitute for rescission under the circumstances" of the case.[8]

No one, obviously, should reach broad conclusions based upon a small population of cases arising in disparate factual and procedural contexts. This unusual string of Supreme Court decisions siding with shareholders, however, certainly suggests a heightened sensitivity by the Delaware Supreme Court to shareholder claims and certainly should stand as a warning to directors and their counsel.

Bottom Line Lesson

The bottom line lesson from Chief Justice Veasey: Corporations should "genuinely and in good faith" have "good corporate practices in place," and independent directors should "have the guts to make sure those practices are followed, without being adversarial."[9] Following this advice will offer a strong defense to the heightened threat of shareholder litigation.

For further information on these corporate governance developments, please feel free to call **Thomas A. Roberts**, **Greg A. Danilow**, or **Stephen A. Radin** at **Weil, Gotshal & Manges** (212) 310-8000.

8 See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 2002 WL 31303135 (Del. Aug. 29, 2002).

9 Harvard Business Review at 77.

Cases Where the Delaware Supreme Court Held for the Shareholders and Against Directors
(Reversing Court of Chancery Decisions)

Case	Date	Holding
Telxon Corp. v. Meyerson, 802 A.2d 257	Del. June 7, 2002	Reversing grant of summary judgment
Saito v. McKesson HBOC, Inc., 806 A.2d 113	Del. June 11, 2002	Reversing decision limiting access to corporate books and records by shareholder investigating alleged wrongdoing
Levco Alternative Fund Ltd. v. Reader's Digest Association, Inc., 2002 WL 1859064	Del. Aug. 13, 2002	Reversing denial of motion for preliminary injunction
OmniCare, Inc. v. NCS Healthcare, Inc., 2002 WL 31767892	Del. Dec. 10, 2002	Reversing denial of preliminary injunction
MM Cos. v. Liquid Audio, Inc., No. 606, 2002	Del. Jan. 7, 2003	Reversing final judgment dismissing challenge to board decision to adopt defensive measures that changed the size and composition of the board during a proxy contest

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