

## Avoiding the courtroom: Application of the business judgment rule

Remarks by the Honorable Randy J. Holland  
Delaware Supreme Court Justice  
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# Directors' College 2008

Directors' College 2008, hosted by PricewaterhouseCoopers and the John L. Weinberg Center for Corporate Governance, University of Delaware, provided a forum where board members of major public companies examined current governance issues and shared insights and board practices. This year, the program focused on how to effectively deal with activist shareholders, discussing the multiple dimensions of this issue, including proxy access, ways to prepare and position a company, and shareholders' power in executive compensation decisions.

The Honorable Randy J. Holland, Delaware Supreme Court Justice, also addressed directors' legal concerns and clarified the application of the business judgment rule. His remarks are attached.

Highlights of the full Directors' College program will be available soon at [www.pwc.com/directorscollege](http://www.pwc.com/directorscollege).

# Avoiding the courtroom: Application of the business judgment rule

Remarks by the Honorable Randy J. Holland  
Delaware Supreme Court Justice

*The Honorable Randy J. Holland serves on the Delaware Supreme Court. He is the youngest person to serve on the Delaware Supreme Court, having been recommended to the state's governor by a bipartisan merit selection committee. Prior to his appointment and confirmation in 1986, Justice Holland was in private practice as a partner at Morris, Nichols, Arshat & Tunnell. In 1999, he was reappointed and confirmed unanimously for a second twelve-year term.*

I'm going to talk to you about shareholder activists from the perspective of the courts. I know that all of you probably never want to see or hear from me again, at least not in a courtroom. So that will be the focus of my remarks: how not to see me again.

I thought I would review a little bit of how we got to where we are and the role of litigation with regard to shareholders who want to take an active part in things that you would prefer they not be active in. I think it all starts with the idea that in Delaware we recognize there's a separation of ownership and control. It has been said in many Delaware opinions that one of the cardinal precepts of Delaware law is that the corporation is being managed by you, the directors, not by the shareholders. The Delaware corporate statute clearly provides, in section 141(a), that the directors manage the corporation.

## Fiduciary obligations

The statutory power that you have carries with it what have been called fundamental fiduciary obligations. You have these fiduciary obligations because of the recognition that there's a separation of control and ownership. It is because of those obligations that the shareholders—who do not manage the company—are able to hold directors accountable for taking care of things on their behalf. Directors' fiduciary duties go not only to the shareholders, but also to the corporation. They have been described colloquially as a triad of duties: care, loyalty, and good faith. The two duties are care and loyalty; and you have an obligation to conduct yourself in good faith. Your fiduciary obligations operate in a variety of contexts. What the Delaware Court of Chancery tries to do, and what the Delaware Supreme Court attempts to do in its opinions, is to give you a little guidance. You'll see opinions stating your fiduciary duties are unremitting, and yet you'll see other language that says we're going to try to give you the channel markers, tell you where the safe harbors are. So the statutory powers and the fiduciary obligations really operate in tandem.

With respect to shareholder activism, what we see in cases that go back as far as 1984, such as in *Aronson*, is that if shareholders are concerned about the way directors are managing corporations they have two methods of redress. One is corporate democracy—the shareholder's right to vote. You find that in the statutes; it is limited, by in large. The two primary areas a shareholder votes on are director elections and mergers. The second method is a derivative lawsuit, also identified in *Aronson*, and that's really what I'm going to talk about today.

In a derivative lawsuit the shareholder brings an action against a corporation nominally to bring an action against a third party. So it's really the corporation's lawsuit. Normally directors are the people who bring lawsuits. However, in a derivative lawsuit the directors are dealing with shareholders who want to do the directors' job with regard to deciding whom to sue.

## The business judgment rule

In discussing derivative lawsuits we start with the business judgment rule. This rule is a judicial acknowledgement that directors manage the company. It's a presumption that in making a business decision the directors acted on an informed basis, in good faith, and in the honest belief their action was taken in the best interest of the company. Directors have this powerful presumption in their favor when they come into a Delaware court. The burden is on the shareholders to rebut the presumption. They do that by alleging that you, the director, did not act with care or that you did not act with loyalty or that you did not act in good faith.

The business judgment rule can be invoked only by disinterested directors, and that's why you see a lot of debate in the literature and in litigation about who is independent, who is interested. Shareholders don't have to worry about the business judgment rule if they can show a majority of the board was "interested" or not independent.

## Restraints on derivative lawsuits

The United States Supreme Court has held that by its nature a derivative suit impinges on the power of directors to run the corporation, including their power to decide whom to sue. The United States Supreme Court also has said that if derivative suits go on unrestrained they will undermine what boards of directors should be doing. As a result, in Delaware you see what I would characterize as appropriate restraints on derivative suits—such as restraints described in the *Aronson* decision and particularly in the Court of Chancery rule 23.1.

The restraints operate like this: If you are a shareholder who wants to bring a suit on behalf of the corporation, because you contend it is a suit that should be brought, but the directors are not doing their job, you have two options. You can make a demand on the board to bring the suit. If you don't make a demand on the board, you have to demonstrate with particularity that the business decision you object to was not a product of a valid business judgment. To do that, you need to show that a majority of the board is interested or that the business judgment rule does not apply. You do this by alleging facts in your complaint with sufficient particularity that they raise a reasonable doubt.

## Disney: A case study

Shareholder activist concerns run along a couple of major themes. One is executive compensation and severance packages. In that vein, I thought it might be helpful to talk about the Walt Disney Company case and the lessons we all could learn from it. The Disney case eventually led to a 37-day trial in the Court of Chancery, and over 1,000 exhibits were introduced. Two events were being challenged by the shareholders in that derivative suit. The first board action in contention was the decision to hire Michael Ovitz as president and to give him his compensation package. The second action at issue was the decision to let him go on a nonfault basis, with a severance package that was substantial by anyone's standards, in excess of \$100 million.

The Court of Chancery held that approving Ovitz's employment agreement, hiring him as president, and terminating him on a nonfault basis were all protected by the business judgment rule. This was affirmed by the Delaware Supreme Court. Both courts also found that the severance package didn't constitute waste. You're probably thinking to yourself, that's some good news for directors. You're also

probably thinking to yourself, all things considered, I'll bet those directors would have preferred not to have a 37-day trial and not to have their depositions taken, and they would have preferred not to be on pins and needles for so many years during the protracted litigation.

The Disney directors filed a motion to dismiss the derivative complaint. The Court of Chancery denied the motion. The court said, the way we read this complaint, these directors are alleged to have breached their duty to act in good faith, and if those facts are true, their actions fall outside the protection of the business judgment rule. That was the key point in this motion to dismiss, and the Court of Chancery made that point in its opinion. In denying the motion to dismiss, the court wasn't saying anybody did anything wrong, or that the business judgment rule doesn't apply. It was saying that the complaint alleged facts that, if true, fell outside the protection of the business judgment rule.

There was a corollary motion to the Disney board's motion to dismiss the complaint. On this motion the Court of Chancery said the shareholders had alleged particularized facts, which if true, raised a reasonable doubt about the application of the business judgment rule. Well, as you can imagine, the Disney board had good lawyers, and those lawyers had an alternative position. They said, the shareholders have raised this reasonable doubt about the application of the business judgment rule, but our charter has a 102(b)(7) provision protecting us from any allegation of gross negligence; therefore, we are exculpated from having to pay monetary damages and thus the complaint should be dismissed. The Court of Chancery denied that motion too. In doing so, the Court of Chancery said that if directors have not acted in good faith or if they have intentionally engaged in misconduct, they don't fall within the protection of 102(b)(7).

You may remember what 102(b)(7) is about. In 1985, the Delaware Supreme Court decided *Smith v. Van Gorkom*, holding directors personally liable for being grossly negligent. There was a seismic wave across the country. It was thought no one would want to be a director of a Delaware corporation. In a balanced response, the Delaware General Assembly said, we'll leave it up to the shareholders—if they don't think they can get good directors unless they exculpate them from gross negligence, we will allow them to adopt a 102(b)(7) provision, and then the directors won't have to worry about it. As you know, virtually every Delaware Corporation has one of those provisions.

If shareholders file a complaint but only have allegations of gross negligence, and the corporation has a 102(b)(7) provision, we're not going to waste everybody's time. We're going to dismiss the suit, because even if there ultimately was a problem and it's attributable to gross negligence, the directors are exculpated from damages—meaning no discovery, no trial, end of case. That's why the Chancellor's ruling in Disney was really significant. In denying the motion to dismiss, the Chancellor said that if the allegations made in the complaint are true, they raise questions about good faith. There's no exculpation if your actions are intentionally wrong or if you do not act in good faith.

Going into the trial, the Disney directors were wondering whether they would ultimately face personal liability. Needless to say they got focused as the litigation went forward. I mentioned that at the end of the trial, the directors were all found not to have breached their fiduciary duties. They were found to have been protected by the business judgment rule, which was affirmed.

Let me talk about what happened at the trial. What the Court of Chancery concluded is that the Disney board of directors created a perception that it was serving an imperial CEO. Michael Eisner had stacked the board with friends and acquaintances who, although not legally beholden to him, were supporting what he wanted to do almost unconditionally, functioning essentially as passive, ornamental directors in what had become an unwholesome boardroom culture. The directors really didn't appear to be acting as independent directors.

One of the lessons all boards can learn from Disney is not to conduct themselves in a way that an opinion can be written like the one issued by the Court of Chancery or that such a suit can be brought in the first place. However, there is a lot of good news for board directors if you look at the Court of Chancery decision in the Disney case and the Delaware Supreme Court affirmation of that decision. First, both courts acknowledged that the conduct in the Disney case preceded Enron and WorldCom by many years. It was a different time, with a different mindset in the boardroom.

The other thing the courts made clear is that there is a big difference between fiduciary duties and best practices. Although as directors you have to fulfill your fiduciary duties, you're not necessarily going to be faulted if you haven't acted in accordance with best practices. That doesn't mean best practices aren't important, because clearly the better your practices the less likely you're going to create an aura of an unwholesome culture.

Most importantly for directors, the Disney case is a reaffirmation of the strength of the business judgment rule. The Delaware Supreme Court and the Court of Chancery are going to defer to directors who make informed business decisions, as long as the directors are independent and act in good faith. A significant point we made in the Disney case is that there's a qualitative difference between care, gross negligence, and good faith. We pointed out three examples of conduct that would not be in good faith. First, if you act intentionally in a way that's not in the best interest of the corporation, you're not acting in good faith. Second, if you act with the intent to violate the positive law, you are not acting in good faith. And third, if you fail to act in the face of a known duty to act, and you consciously disregard your duty, you are not acting in good faith. So if you are in a situation where everybody says, well you know we have to do that, and then a motion to adjourn passes and you all leave, there is going to be a problem, because you're disregarding a known duty to act.

Another point we emphasized in the Disney case is your ability to rely on the advice of experts. You can rely on expert advice even if the advice isn't right, as long as you rely on it in good faith. The other thing we pointed out is there is no requirement that you follow the expert's advice, in whole, in part, or at all. You simply have to engage an expert and consider the expert's advice in good faith. The point of the expert is to assist you, not to do your job.

I want to move to another subject that's in the news quite a bit and certainly in court: oversight responsibility. This was addressed by the Delaware Supreme Court in a case called *Stone v. Ritter*. As you know, if shareholders are concerned about what you're doing as far as compensating executives and giving them severance packages, they also are concerned about whether you are exercising

## Oversight responsibility and red flags

your oversight responsibility. For years everyone had been operating under the assumption that oversight responsibility had been defined by the Court of Chancery in a case known as *Caremark*, and it turned out to be true. However, the *Caremark* case, like many Chancery cases, was never appealed to the Delaware Supreme Court, and in *Stone v. Ritter* the Delaware Supreme Court could say definitively that *Caremark* articulated the standard of fiduciary duties for directors in an oversight context.

What the Delaware Supreme Court held in *Stone v. Ritter* is that directors are not going to be held liable unless there is utter failure—utter failure to implement a reporting or information control system. In *Stone v. Ritter* there was a banking corporation, which had to comply with many banking regulations. Notwithstanding the many oversight provisions in place, some of the employees of the corporation engaged in criminal conduct and it cost the corporation a lot of money. The shareholder activists in this derivative suit alleged the directors were asleep at the switch. They claimed that if the directors had exercised oversight responsibility, criminal activity would not have occurred and the company wouldn't have been forced to spend a lot of money.

What the Delaware Supreme Court held in *Stone v. Ritter* is that, consistent with *Caremark*, directors are not going to be responsible as long as there isn't utter failure. A corollary to that is, if you put a system in place, you have an obligation to monitor it. In the absence of knowing something isn't working—in the absence of red flags—directors are not going to be liable.

What you see at the end of the Delaware Supreme Court's opinion in *Stone v. Ritter* is good news for directors. The complaint was dismissed, and we affirmed that dismissal, saying that the problem with the complaint was its correlation of a bad result with bad faith. The Delaware Supreme Court said a bad result doesn't equate with bad faith, and directors can't prevent criminal conduct—they can't be on the ground everywhere. The directors' job is to put a reasonable system in place, and they are allowed to assume it is working unless they see red flags. In *Stone v. Ritter*, the derivative complaint was dismissed—no discovery, no trial, end of the inquiry.

## Lessons learned

So let's look at the two cases together, Disney and Stone, and think about what you can take away from them in a way that will help you conduct yourself as a director.

The first point is that you want to resist being complacent. By that I mean you have to be active and attentive at board meetings, you have to be looking for red flags, you have to be engaged in discussions, you have to ask questions, you have to provide constructive criticism if needed, and you should think about embracing best practices. You can summarize these items as a focus on the board process.

If you go back to the Disney case, what you see is a board that let a process go forward that raised reasonable doubts about the directors' conduct, even though at the end of the day the doubts were found to be without merit. The way the board conducted itself permitted those doubts to be raised. Therefore, you don't want to operate in a manner that may give rise to a derivative complaint, which in

turn might withstand a motion to dismiss. You can avoid that situation by staying engaged and by relying on experts' advice in good faith.

Second, the good news for Delaware directors is if you're independent, and you're informed, and you act in good faith, the Delaware courts are not going to second-guess you. The Delaware courts are going to defer to your business judgment, and you're going to be protected by the business judgment rule. The whole philosophy behind the business judgment rule is that boards should be given the chance to make money for the shareholders, and that involves risks. There is no correlation between director liability and failing to hit a homerun.

The Delaware law by the Court of Chancery and the Delaware Supreme Court evolves, and it does so in a variety of contexts. Balance is important. I think whether you're talking to plaintiff's lawyers—I'm referring to lawyers for shareholder activists—or to directors, they are going to tell you that when they come to the Delaware courts, they believe they are going to be treated fairly and impartially. When complaints are not dismissed or matters go forward, frequently the court's perspective is, how in the world did anybody let this happen? We've been trying to provide guidance; we've been trying to put out channel markers and provide safe harbors. The answer is sometimes boards just become complacent.

So in conclusion, I think overall the good news for directors of Delaware corporations is if directors do what I'm sure all of you do on a regular basis, you're going to be protected by the business judgment rule. To the extent you stray, you will probably never wind up being personally liable but you may wind up being involved in litigation, having your deposition taken, and maybe even testifying at trial. If you were to talk to the Disney directors, they'd probably tell you they're happy with how things turned out. They would probably also say they would have preferred to avoid a firsthand experience with the Delaware courts, and that's what I wish for all of you.