

Chapter 63

Director and Officer Liability

by The Honorable Paul S. Diamond and Mathieu J. Shapiro

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I. INTRODUCTION

§ 63:1 Scope note

This chapter includes an examination of corporate director and officer liability. Historically, this was a matter of state law; the courts gave officers and directors broad discretion to make business decisions. More recently, purported corporate excess and abuse in some high-profile bankruptcies have generated considerable concern. In response, Congress passed the Sarbanes-Oxley Act of 2002. This incursion into an area traditionally regulated by state law will almost certainly have significant consequences.

The first and largest division of the chapter includes a discussion of the substance of director and officer claims, including:

- (1) the duties of care, loyalty, and disclosure;
- (2) the business judgment rule;
- (3) the effect bankruptcy or impending bankruptcy has on an officer or director's duties; and
- (4) the effect Sarbanes-Oxley likely will have on director and officer litigation, and the interplay of state and federal law.

The chapter also includes an analysis of the three types of actions typically brought against directors and officers: direct actions, class actions, and derivative actions. There follows a short discussion of the special attorney-client privilege considerations that may arise in the context of director and officer litigation. In addition, the chapter includes an examination of statutory or contractual indemnity provisions and director and officer insurance policies—matters that usually determine who will bear the cost of director and officer litigation and who will fund the settlement or pay the verdict.

§ 63:2 Legal issues outside the scope of the chapter

As this volume goes to print, those deemed responsible for corporate scandals dominate the news. Directors and officers may be held liable for crimes they actually commit, and for crimes they fail to prevent if they were committed by someone under their control. In addition, statutes such as the Racketeer Influenced and Corrupt Organizations Act and the Occupational Safety and Health Administration Act, as well as various environmental statutes, impose criminal liability. The securities laws, such as § 15 of the Securities Act of 1933 and § 20(a) of the Securities Exchange Act of 1934, create personal liability for directors and officers who “control” others within the corporation and have “culpable participation” in the other person's violation of the federal securities laws.¹ A full discussion of criminal liability is well beyond the scope of this chapter.

In some circumstances, officers and directors may be “persons” within the definitions under the Resource Conservation and Recovery Act or the Comprehensive Environmental Response, Compensation and Liability Act.² Much litigation involves the degree of involvement a director or officer must have to be subject to liability under those statutes.

Directors and officers generally are not individually liable under federal civil rights laws, such as Title VII, the Americans with Disabilities Act, or the Age Discrimination in Employment

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¹See Chapter 62 “Securities” (§§ 62:1 et. seq.).

²See Chapter 95 “Environmental Claims” (§§ 95:1 et. seq.).

Act. Most states have their own nondiscrimination laws, and some impose personal liability on directors and officers.

Directors and officers are subject to individual liability under the Fair Labor Standards Act and the Family and Medical Leave Act, but, as a general matter, only if they have “operational control” over the “employer.”

Directors and officers may be liable for their personal involvement in other common law tort claims, if the liability arises from their own conduct, rather than from their status as directors or officers.³ For instance, directors and officers have been sued for fraud, deceit or conversion, where they personally participated in the alleged wrong-doing.⁴

§ 63:3 Preliminary considerations

Too often, lawyers are compelled to defend or justify actions their clients have already taken. The fortunate attorney will be consulted by his officer or director client long before civil litigation begins. The officer or director client will have asked counsel for advice on both how best to perform his or her fiduciary duties and how best to document the performance of those duties. As an example, officers and directors in the midst of hostile takeover attempts frequently employ teams of lawyers to vet all their actions in advance. Of course, even officers and directors in the normal course of their duties are well-advised to discuss general corporate governance issues with counsel. Advising directors and officers on how to avoid litigation is a subject well beyond the scope of this chapter.

When officer and director litigation is on the horizon, the attorney—whether consulted by potential plaintiffs or potential defendants—should begin with a thorough review of the evidence. By the nature of the litigation, shareholder plaintiffs are less likely to have extensive evidence available to them. When the plaintiff is the company, however, the opposite is true.

For defense counsel, understanding the evidence usually means conducting an internal investigation—a subject to which an entire book could easily be devoted. Briefly, counsel representing the corporation first must review all relevant material documents and interview appropriate officers and employees. The corporate client will usually ask counsel to prepare an internal investigation report, which will often be presented to the corporate board. The results of the internal investigation will often determine litigation and settlement strategies.

One of the first questions presented to plaintiff’s counsel will be whether injunctive relief is appropriate. Are the directors and of-

³*Donsco, Inc. v. Casper Corp.*, 587 F.2d 602, 606, 199 U.S.P.Q. (BNA) 705 (3d Cir. 1978).

⁴*In re Rodriguez*, 895 F.2d 725, 22 Collier Bankr. Cas. 2d (MB) 633, Bankr. L. Rep. (CCH) P 73282 (11th Cir. 1990).

ficers prepared to take some action with regard to the company that will cause irreparable harm? This will most often be the case in the takeover/merger context.

Plaintiffs' counsel will next have to determine whether suit should be filed in state or federal court. What types of claims are being asserted? A simple breach of fiduciary duty allegation is a state law claim. Is there diversity? Are any federal claims also being asserted? Are there benefits to being in federal court? Alternatively, even if there is federal jurisdiction, in what state court would the action be filed? Are the Delaware Courts, with their greater familiarity with corporate litigation, an option? Or, is the case necessarily in federal court because it is an adverse proceeding related to a bankruptcy?

Discovery in officer and director litigation must be carefully considered. Which party or parties possess documents to be produced, and how extensive is the potential production? What will the cost be of compiling, producing, or reviewing the extensive documents that may be available? The costs of electronic discovery are increasingly important, given the prominence of e-mail communication in today's corporate environment. How much money is available to spend on electronic discovery experts, and how likely is it that a "smoking gun" e-mail will be found? Is it possible that the costs of electronic discovery will be shifted to the producing party?

Litigators must consider not only discovery available on the merits of the particular case, but also, on topics and issues sufficiently related to the merits of the case to be discoverable under the Federal Rules of Civil Procedure. Discovery disputes sometimes focus on documents or testimony that are sufficiently related to an allegation in the case to be discoverable, but are of greater significance because one side or the other simply does not want the documents or testimony to become public. Such discoverable material might be evidence of criminal behavior, might harm someone's marketplace position, might lead to other civil litigation, or might simply be embarrassing. The litigator may be required to consider whether a protective or confidentiality order helps or harms the client's strategic goals, not to mention whether it is warranted under the law.

Director and officer litigation is frequently influenced by factors other than the merits of the litigation. Thus, litigators entering into a director and officer case should consider the following questions.

Is the case of public interest? Are the defendant officers and directors being publicly portrayed in the media as criminals? Or, is the case "merely" one where the officers and directors are being "second-guessed"? Public perception—particularly if the officers and directors remain in office and the company is either a going business concern or one trying to fend off bankruptcy—frequently can be as important to the client as the results of the litigation.

Is there a criminal investigation also under way? Although plaintiffs in civil litigation may attempt to portray directors and officers as criminals, an actual criminal investigation is quite another matter. First, companies are under ever-increasing pressure to investigate themselves in the manner described above. Moreover, prosecutors increasingly insist that corporations waive any attorney-client privilege and disclose any internal investigation report. Second, officers and directors under criminal investigation usually should give first priority to the criminal defense. Indeed, courts will—often at the request of the government—stay civil litigation pending the outcome of a criminal investigation.

Finally, and perhaps most importantly, counsel must ask, what are the economics of the litigation? Is the plaintiff's case self-funded? When the plaintiff is the company or the plaintiff is represented by a well-known law firm, there will be abundant resources available for motion practice and discovery. This may not be the case if the company is the plaintiff but is in bankruptcy. Are the officers and directors paying for their own defense, or is the company indemnifying them; or, is there D & O insurance? Will the insurer fund a settlement? The availability of insurance coverage is often a function not only of the nature of the settlement, but, more importantly, the nature of the claims being settled. Accordingly, all counsel must consider carefully—within the strictures of Rule 11 and related provisions—how to frame the allegations and the issues in the litigation. Typically, allegations regarding a breach of the duty of care allow for the greatest amount of indemnification or insurance, but are hardest prove. In effect, they require “second-guessing” the business decisions of the directors or officers. Breaches of the duty of loyalty are easier to prove, but may preclude access to insurance or indemnification.

II. SUBSTANCE OF DIRECTOR AND OFFICER ACTIONS

§ 63:4 Overview

Directors and officers owe the company and its shareholders the basic fiduciary duties of care and loyalty.¹ They may not engage in conduct that will either harm the company or take advantage of the company's trust.

Purported violations of fiduciary duty drew vast public attention in 2001 and 2002. The Rigas family was accused of using Adelphia Corporation as a personal bank and so causing the company to collapse. Enron Corporation's senior management was accused of using Ponzi-like accounting schemes to bolster returns. Executives at Worldcom were accused of outright fraud

[Section 63:4]

¹For a comprehensive treatise on director and officer liability, see Knepper and Bailey, *Liability of Corporate Officers and Directors* (7th ed.).

in the preparation and reporting of its financial condition. These scandals provoked increased attention to what constitutes proper—and improper—officer and director conduct.

§ 63:5 Duty of care

Officers and directors represent the financial interests of the corporation and the corporation's shareholders. Accordingly, they are required to act diligently and prudently in managing the corporation's affairs, to pay attention and to inform themselves, actively to participate in board discussions, and to use reasonable and independent judgment.

Whether an officer or director's conduct satisfies the duty of care is a factual question that must be decided on a case-by-case basis.¹ Accordingly, the practitioner's task is establishing what the director did or did not do, and why that conduct did or did not satisfy the director's "unyielding fiduciary duty to the corporation and its shareholders."²

The duty of care is defined both statutorily and through common law. Under the "internal affairs doctrine," the law of the state of incorporation governs the liability of directors and officers to the corporation and its shareholders.³ Thus, prior to Sarbanes-Oxley,⁴ the duty of care owed by directors and officers was specific to each state. Most state statutes are based on the former version of the Revised Model Business Corporation Act. These provisions require, in one form or another, "good faith" discharge of one's duty with the level of care an "ordinarily prudent person in a like position would exercise under similar circumstances," and a reasonable belief that one's conduct is in the "best interests" of the corporation.⁵

The leading duty of care case is *Smith v. Van Gorkom*,⁶ or the *Trans Union* case, in which the Delaware Supreme Court established gross negligence as the standard for individual director liability. *Trans Union* was a publicly-traded, diversified hold-

[Section 63:5]

¹McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000).

²Loft, Inc. v. Guth, 23 Del. Ch. 138, 2 A.2d 225 (1938), determination sustained, 23 Del. Ch. 255, 5 A.2d 503 (1939).

³Shaffer v. Heitner, 433 U.S. 186, 215 n.44, 97 S. Ct. 2569, 2585, 53 L. Ed. 2d 683 (1977); In re Sagent Technology, Inc., Derivative Litigation, 278 F. Supp. 2d 1079, 1086 (N.D. Cal. 2003); Polar Intern. Brokerage Corp. v. Reeve, 187 F.R.D. 108, 116, Fed. Sec. L. Rep. (CCH) P 90488 (S.D. N.Y. 1999).

⁴§ 63:10.

⁵See § 8.20(a) of the Revised Model Business Corporation Act, former version.

⁶Smith v. Van Gorkom, 488 A.2d 858, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

ing company.⁷ It experienced federal tax problems because it had generated excessive tax credits and insufficient taxable income to offset the credits.⁸ After exploring various potential solutions to the problem, company Chairman and CEO Jerome Van Gorkom met with Jay Pritzker, a well-known corporate takeover specialist. Without consulting either his board or any member of senior management save one individual, Van Gorkom proposed a cash-out merger at a price of \$55 per share and a financial structure for the deal.⁹ Within two days, Pritzker advised Van Gorkom he was interested in the deal, but required the board to act within three days.¹⁰

Van Gorkom called a special meeting of the board, to be preceded by a meeting of the company's senior management. At the senior management meeting, Van Gorkom disclosed the offer and its terms, but had no copies of the proposed merger agreement.¹¹ Although senior management's reaction was "completely negative," and one person objected to the price as being too low, Van Gorkom proceeded immediately to the full board meeting.¹² There, Van Gorkom made a "twenty-minute oral presentation."¹³ He did not provide copies of the proposed merger agreement in time for it to be studied. He did not disclose either the methodology for the \$55/share price or that the price had been his idea.¹⁴ After a two-hour meeting, the board approved the proposed merger. The board members relied on Van Gorkom's oral presentation, a supporting presentation by the company's President, an oral statement of the CFO (who admitted having learned of the transaction only that day), a lawyer's statement on the legal aspects of the merger, and their general knowledge of the company's market history. Van Gorkom executed the agreement that evening, during "a formal social event that he hosted for the opening of the Chicago Lyric Opera. Neither he nor any other director read the agreement prior to its signing and delivery

⁷Smith v. Van Gorkom, 488 A.2d 858, 864, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

⁸Smith v. Van Gorkom, 488 A.2d 858, 864, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

⁹Smith v. Van Gorkom, 488 A.2d 858, 866, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹⁰Smith v. Van Gorkom, 488 A.2d 858, 867, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹¹Smith v. Van Gorkom, 488 A.2d 858, 867, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹²Smith v. Van Gorkom, 488 A.2d 858, 867–868, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹³Smith v. Van Gorkom, 488 A.2d 858, 868, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹⁴Smith v. Van Gorkom, 488 A.2d 858, 868, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

to Pritzker.”¹⁵

The Delaware Supreme Court held that Trans Union’s board was “grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to” the merger.¹⁶ The Court explained that directors have a duty to protect the financial interests of others by proceeding “with a critical eye in assessing information of the type and in the circumstances present here.”¹⁷ Thus, the Trans Union directors were required to “act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders.”¹⁸ By acting rashly, with insufficient documentation, and without taking the time properly to inform itself, the Trans Union board breached its fiduciary duty to the company and its shareholders.¹⁹

Although the *Van Gorkom* Court deemed the directors liable, it established a very high standard for proving individual director liability. Thus, *Van Gorkom* established judicial tolerance of ordinary negligence from corporate fiduciaries.²⁰ Indeed, the case demonstrates courts’ willingness to defer to corporate managers, and their reluctance to second-guess business decisions. *Van Gorkom* also began the trend away from the “vocabulary of negligence,” which is “not well-suited to judicial review of board attentiveness.”²¹ Instead, courts have focused on the process by which boards reach decisions: as long as the directors were informed, rational, and acted in good faith, the courts will likely defer to their judgment.²² As the Delaware Chancery court has explained:

[c]ompliance with a director’s duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed. That is, whether a

¹⁵Smith v. Van Gorkom, 488 A.2d 858, 869, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹⁶Smith v. Van Gorkom, 488 A.2d 858, 881, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹⁷Smith v. Van Gorkom, 488 A.2d 858, 872, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹⁸Smith v. Van Gorkom, 488 A.2d 858, 873, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

¹⁹Smith v. Van Gorkom, 488 A.2d 858, 874, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

²⁰United Artists Theatre Co. v. Walton, 315 F.3d 217, 231, 40 Bankr. Ct. Dec. (CRR) 182, 49 Collier Bankr. Cas. 2d (MB) 1434, Bankr. L. Rep. (CCH) P 78777 (3d Cir. 2003).

²¹In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 967 (Del. Ch. 1996).

²²United Artists Theatre Co. v. Walton, 315 F.3d 217, 231, 40 Bankr. Ct. Dec. (CRR) 182, 49 Collier Bankr. Cas. 2d (MB) 1434, Bankr. L. Rep. (CCH) P 78777 (3d Cir. 2003), citing In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational,” provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests. To employ a different rule—one that permitted an “objective” evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests.²³

Board members usually have the ability to make rational, informed decisions. Board members always have a right to inspect the corporation’s books and records, and to receive copies of all minutes of board meetings. They are obligated to acquire at least a rudimentary understanding of the business of the corporation, and to keep informed about the activities of the corporation. And, there is no incentive for intentional ignorance: failing to remain abreast of the company’s affairs does not shield directors from liability.²⁴

Significantly, directors usually are entitled to rely on information, reports, and statements prepared or presented by management, counsel, or other experts, so long as the directors reasonably believe the data to be reliable and have no knowledge that would render the reliance unwarranted. When presented with reliable information, directors’ obligation to remain informed is limited:

[T]he standard for judging the informational component of the directors’ decision making does not mean that the Board must be informed of *every* fact. The Board is responsible for considering only material facts that are reasonably available, not those that are immaterial or out of the Board’s reasonable reach.²⁵

Francis v. United Jersey Bank, like *Van Gorkom*, demonstrates the difficulty in proving breach of the duty of care. The court found a director liable where she did not make “the slightest effort to discharge any of her responsibilities.”²⁶ The director in question and her two sons served as the corporation’s only directors. The sons siphoned substantial corporate funds to themselves in the guise of unrepaid loans. The corporate minute books reflected only “perfunctory activities.” The “loans” were not discussed in the minutes or authorized by any resolution. The value of the “loans” far exceeded the sons’ salaries and financial reserves. And, the financial treatment of the “loans” in the corporate books was part of a “woefully inadequate and highly

²³In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 967 (Del. Ch. 1996) (emphasis in the original).

²⁴E.g., *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814, 823 (1981) (“A director is not an ornament, but an essential component of corporate governance.”).

²⁵*Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000).

²⁶*Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814, 820 (1981).

dangerous bookkeeping system.” Funding of the “loans” left the corporation insufficient money to operate. The mother knew nothing of her sons’ conduct.²⁷ She made “no effort to assure that the policies and practices of the corporation, particularly to withdrawal of funds, complied with industry custom or relevant law.”²⁸

Where the operations of a large corporation are delegated to officers and other subordinates, directors should exercise ordinary care and prudence in supervision and oversight.²⁹ Again, proving a breach of these duties is difficult. In *In re Caremark Intern Inc. Derivative Litig.*, plaintiffs claimed that “the directors allowed a situation to develop and continue which exposed the corporation to enormous legal liability and that in so doing they violated a duty to be active monitors of corporate performance.”³⁰ The Delaware Chancery court characterized such a claim as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”³¹ The court required a “sustained or systematic failure of the board to exercise oversight” to impose liability for failure to supervise.³² To prove such a case, plaintiff would likely be required to show a sustained failure to act, over a long period, in the face of a paper trail demonstrating the directors ought to have been aware of the problem.³³ In other words, a successful plaintiff would show that the directors were “conscious of the fact that they were not doing their jobs.”³⁴ The magnitude and duration of the alleged wrongdoing would likely be relevant in determining whether the directors’ failure to act was sufficient to impose liability.³⁵

Finally, even when a director or officer breaches the duty of care, the court still must determine whether the conduct proximately caused the alleged harm or loss to the stockholders or corporation. If the director’s or officer’s behavior did not proximately cause the injury, the director or officer is not liable.³⁶ Thus, if a director’s self-dealing and fraud caused the corporation

²⁷Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814, 816–819 (1981).

²⁸Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814, 819 (1981).

²⁹Briggs v. Spaulding, 141 U.S. 132, 147, 11 S. Ct. 924, 929, 35 L. Ed. 662 (1891) (directors have a duty to supervise and manage corporate affairs).

³⁰In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 967 (Del. Ch. 1996).

³¹In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 967 (Del. Ch. 1996).

³²In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, 970 (Del. Ch. 1996).

³³In re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795, 809, 55 Fed. R. Serv. 3d 1005 (7th Cir. 2003).

³⁴Landy v. D’Alessandro, 316 F. Supp. 2d 49, 74 (D. Mass. 2004).

³⁵In re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795, 809, 55 Fed. R. Serv. 3d 1005 (7th Cir. 2003).

³⁶Bellis v. Thal, 373 F. Supp. 120, 124 (E.D. Pa. 1974), aff’d, 510 F.2d 969 (3d Cir. 1975).

to lose value over a certain period, but market conditions also caused a loss of value of the same period, the director would be liable only for the loss properly attributable to his wrongdoing.³⁷

§ 63:6 Duty of loyalty

Directors must put the corporation's interest before their own, avoid self-dealing, and maintain confidentiality. This duty of loyalty is especially important whenever a director has a personal stake in any board action. Thus, directors must promote the interests of the corporation, and may not benefit personally from any corporate transaction.¹ If a director engages in outside business activity that competes with or otherwise threatens harm to the corporation, the director violates the duty of loyalty.²

Directors may not "usurp" corporate business opportunities.³ An opportunity properly belongs to the corporation "when a proposed activity is reasonably incident to the corporation's present or prospective business and is one in which the corporation has the capacity to engage."⁴ Whether or not a corporate opportunity exists is primarily a factual question, to be determined from the specific circumstances of the opportunity.⁵ In determining whether an opportunity existed and whether it belonged to the corporation, the courts typically afford the corporation broad protection.⁶ When a director learns of a corporate opportunity, he or she has a duty to disclose all the material details of the opportunity to the shareholders so they can decide whether the corporation should take advantage of the opportunity.⁷

A director who usurps a corporate opportunity is liable for all

³⁷*Bellis v. Thal*, 373 F. Supp. 120, 124 (E.D. Pa. 1974), *aff'd*, 510 F.2d 969 (3d Cir. 1975).

[Section 63:6]

¹*U. S. v. Byrum*, 1972-2 C.B. 518, 408 U.S. 125, 137-138, 92 S. Ct. 2382, 2391, 33 L. Ed. 2d 238, 72-2 U.S. Tax Cas. (CCH) P 12859, 30 A.F.T.R.2d 72-5811 (1972).

²*Morton v. Rank America, Inc.*, 812 F. Supp. 1062, 27 U.S.P.Q.2d (BNA) 1344, 1993-1 Trade Cas. (CCH) P 70269 (C.D. Cal. 1993).

³See Chapter 85 "Theft or Loss of Business Opportunities" (§§ 85:1 et. seq.).

⁴*Robinson, Leatham & Nelson, Inc. v. Nelson*, 109 F.3d 1388, 1392 (9th Cir. 1997).

⁵*Robinson, Leatham & Nelson, Inc. v. Nelson*, 109 F.3d 1388, 1392 (9th Cir. 1997).

⁶*In re Cumberland Farms, Inc.*, 284 F.3d 216, 228, 39 Bankr. Ct. Dec. (CRR) 87, 52 Fed. R. Serv. 3d 820 (1st Cir. 2002), citing *Brudney and Clark, A New Look at Corporate Opportunities*, 94 Harv. L.Rev. 997, 1032 n.108 (1981) (stating that the definition of "corporate opportunity" should leave little room for the director to appropriate any opportunity conceivably advantageous to the corporation, without its consent).

⁷*In re Cumberland Farms, Inc.*, 284 F.3d 216, 221, 39 Bankr. Ct. Dec. (CRR) 87, 52 Fed. R. Serv. 3d 820 (1st Cir. 2002).

damages caused by the self-dealing.⁸ Similarly, if the director hid transaction details (and so prevented the corporation from evaluating the opportunity knowledgably), the director breached the duty of loyalty.⁹ Of course, a director plainly violates the duty of loyalty if the disclosure of the corporate opportunity is “misleading, inaccurate, and materially incomplete.”¹⁰

It may be a defense that the corporation was unable to take advantage of the opportunity in question.¹¹ If the corporation was insolvent or otherwise unable financially to undertake a transaction, then a director who took advantage of an opportunity usurped nothing.¹² Similarly, after a corporation sought without success to obtain an opportunity, a director may then be free to pursue it.¹³ If a director can establish that a third party was interested in working with the director, individually, and not the corporation, then no corporate opportunity existed.¹⁴ No corporate opportunity existed if the corporation declined the opportunity, or if it was settled policy of the corporation not to engage in a particular line of business.¹⁵

Many state statutes govern conflict of interest transactions. These “safe harbor” statutes provide procedures that, if followed, allow the transaction to take place. For instance, Georgia’s safe harbor statute requires directors with conflicts of interest to advise disinterested directors of their interest in the transaction, and then not to participate in the decision-making process.¹⁶ Delaware’s safe harbor provision protects conflicted directors if they make full disclosure and a majority of the disinterested directors approve the transaction, or if the transaction was fair to the corporation at the time it was authorized, approved or ratified by the board.¹⁷

Recent takeover litigation has centered on the duty of loyalty.

⁸Foy v. Klapmeier, 992 F.2d 774, 780 (8th Cir. 1993).

⁹In re Mi-Lor Corp., 348 F.3d 294, 303, 42 Bankr. Ct. Dec. (CRR) 23 (1st Cir. 2003); In re Cumberland Farms, Inc., 284 F.3d 216, 229, 39 Bankr. Ct. Dec. (CRR) 87, 52 Fed. R. Serv. 3d 820 (1st Cir. 2002).

¹⁰In re Cumberland Farms, Inc., 284 F.3d 216, 229, 39 Bankr. Ct. Dec. (CRR) 87, 52 Fed. R. Serv. 3d 820 (1st Cir. 2002).

¹¹In re McCalla Interiors, Inc., 228 B.R. 657, 661, 33 Bankr. Ct. Dec. (CRR) 775 (Bankr. N.D. Ohio 1998).

¹²In re McCalla Interiors, Inc., 228 B.R. 657, 662–663, 33 Bankr. Ct. Dec. (CRR) 775 (Bankr. N.D. Ohio 1998); In re Viscount Air Services, Inc., 232 B.R. 416, 451 (Bankr. D. Ariz. 1998).

¹³Northwestern Terra Cotta Corp. v. Wilson, 74 Ill. App. 2d 38, 219 N.E.2d 860, 864 (1st Dist. 1966).

¹⁴Bob Davidson & Associates, Inc. v. Norm Webster & Associates, Inc., 251 Ga. App. 56, 553 S.E.2d 365, 370 (2001).

¹⁵Diedrick v. Helm, 217 Minn. 483, 14 N.W.2d 913, 920, 153 A.L.R. 649 (1944).

¹⁶Ga. Code Ann. § 14-2-862; Fisher v. State Mut. Ins. Co., 290 F.3d 1256, 1261 (11th Cir. 2002).

¹⁷Del. Code Ann. Tit. 8, § 144; Pentz v. Truserv Corp., 2001 WL 417776

When control of the corporation is at stake, there is “an omnipresent specter that the board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.”¹⁸ Thus, whenever large or controlling blocks of a company’s stock are sold—either by or to the corporation or its directors—the transaction is likely to receive heightened judicial scrutiny to ensure that the directors acted in the corporation’s interest, not in their own. Similarly, when directors defend against a potential acquirer’s unwanted overtures, those actions are subject to increased scrutiny.

In two prominent cases, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* and *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware courts have created heightened standards that are applied specifically in the mergers and acquisitions context, and require courts to examine more closely the board’s conduct.¹⁹ In *Condec Corp. v. Lunkenheimer Co.*, the Delaware Chancery Court set aside a stock sale to a friendly purchaser because the sale followed a threat to management and was intended solely to allow present management to maintain its control of the corporation.²⁰ Examples of attempted “entrenchment” courts have frowned upon include the use of corporate machinery, such as changing bylaws or voting rights, to encumber dissident shareholder contests against management.²¹ Similarly, courts disfavor reducing or increasing the number of board positions to obstruct minority power.²² Other attempts at “entrenchment” include “poison pill” contract provisions that require onerous expenditures in the event of a change of control. In its recent attempt to defend against Oracle’s takeover attempt, PeopleSoft is reported to have included language in its customer contracts that would have triggered payments to customers if PeopleSoft was acquired.²³ Put simply, directors are not permitted to “entrench” themselves to

(N.D. Ill. 2001), at *7.

¹⁸*Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954, Fed. Sec. L. Rep. (CCH) P 92046, Fed. Sec. L. Rep. (CCH) P 92077 (Del. 1985).

¹⁹*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, Fed. Sec. L. Rep. (CCH) P 92525, 66 A.L.R.4th 157 (Del. 1985), found that, subsequent to the directors’ decision to sell a company, the court may review whether the directors took adequate steps to maximize the share price. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, Fed. Sec. L. Rep. (CCH) P 92046, Fed. Sec. L. Rep. (CCH) P 92077 (Del. 1985), required directors who took defensive actions to protect the corporation to prove that they had reasonable grounds to believe a threat existed, and that they took reasonable action in response to the specific threat posed.

²⁰*Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 230 A.2d 769, 775 (1967).

²¹*Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971).

²²*IBS Financial Corp. v. Seidman & Associates, L.L.C.*, 136 F.3d 940, Fed. Sec. L. Rep. (CCH) P 90139 (3d Cir. 1998); *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651, Fed. Sec. L. Rep. (CCH) P 93965 (Del. Ch. 1988), rearg. denied, *Blasius Industries, Inc. v. Atlas Corp.*, 1988 WL 909333 (Del. Ch. 1988).

²³Beck, “Extreme Takeover,” *The American Lawyer*, May 2005, p. 86. The

the shareholders' detriment, by using the corporation's procedures, programs, or business mechanics to perpetuate their own control of the corporation.

A director may defend against a duty of loyalty claim by establishing both that he acted in good faith and that the decision in question was ratified by a fully informed and disinterested board.²⁴ Good faith typically requires full disclosure to the board. In addition, the decision in question must have been fair to the corporation. Assuming the director made full disclosure, the burden of proving the "unfairness" of a transaction may shift to the plaintiff, depending on the jurisdiction and the controlling statute.

There is a duty to disclose that is usually considered a part of the duty of loyalty. Under this duty, managing directors are presumed to have superior knowledge, or access to knowledge, than do nonmanaging directors or shareholders to whom the managing directors make recommendations.²⁵ Accordingly, the managing directors are required to disclose to the full board all material information in their possession.²⁶ The disclosure must be "full."²⁷ As the Delaware Supreme Court explained, "[t]he duty of disclosure is a specific formulation of these general duties [of care, good faith and loyalty] that applies when the corporation is seeking stockholder action. It requires that directors disclose fully and fairly all material information within the board's control"²⁸

There is an important difference between failing to make a required disclosure and disclosing the wrong information. An erroneous but good faith judgment as to the proper scope or content of a required disclosure implicates the director's duty of care—

propriety of such a contract provision was not resolved by court decision.

²⁴In re Wheelabrator Technologies, Inc. Shareholders Litigation, 663 A.2d 1194, 1201, Fed. Sec. L. Rep. (CCH) P 98805 (Del. Ch. 1995).

²⁵Hamermesh, Calling off the lynch mob: the corporate director's fiduciary disclosure duty, 49 Vand. L. Rev. 1087, 1101 (1996).

²⁶In re Allegheny Intern., Inc., 954 F.2d 167, 178–181, 26 Collier Bankr. Cas. 2d (MB) 663, Bankr. L. Rep. (CCH) P 74447 (3d Cir. 1992); Waddell & Reed Financial, Inc. v. Torchmark Corp., 337 F. Supp. 2d 1243, 1250 (D. Kan. 2004).

²⁷In re Cumberland Farms, Inc., 284 F.3d 216, 229, 39 Bankr. Ct. Dec. (CRR) 87, 52 Fed. R. Serv. 3d 820 (1st Cir. 2002).

²⁸Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1172 (Del. 2000) (internal citations and quotations omitted); see also Innes v. Howell Corp., 76 F.3d 702, 715, 1996 FED App. 0050P (6th Cir. 1996) (fiduciary owes the duty of good faith and full disclosure and must "lay bare the truth, without ambiguity or reservation, in all of its stark significance."). At least one commentator has suggested that *Smith v. Van Gorkom* ought to be analyzed as a duty to disclose case, where liability was imposed on the directors because they failed to disclose all material information to the shareholders who were voting on the merger proposal. Hamermesh, Calling off the lynch mob: the corporate director's fiduciary disclosure duty, 49 Vand. L. Rev. 1087, 1125 (1996).

not the duty of loyalty.²⁹ Thus, if a director without a personal interest inadvertently provided inaccurate or incomplete information to the board when the board was considering whether or not to approve the transaction, the director would have potential liability only for a breach of the duty of care. This difference can be significant because duty of care allegations are both more likely to be insured and indemnifiable, and substantially harder to prove.

To prove a breach of the duty to disclose, a plaintiff must show a substantial likelihood that “the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the total mix of information made available.”³⁰

§ 63:7 Duty of disclosure

Directors and officers of public corporations are frequently sued for inadequate or inaccurate public disclosure of material corporate information. As the Delaware Chancery Court recently noted, “[t]he basic legal standard applicable . . . is well-established and deceptively easy to state: the defendant directors have the duty to disclose in a non-misleading manner all material facts bearing on the decision [in question]. The defendants must also avoid partial disclosures that create a materially misleading impression.”¹

Possession of material nonpublic information does not create an absolute duty to disclose the information.² For instance, directors and officers are not required to disclose the corporation’s plans or its strategic thinking. Business matters, such as a company’s plans to expand, to enter a new market, or to develop a new product, are considered proprietary and confidential. “An issuer of securities owes no absolute duty to disclose all material information.”³ Rather, as the Second Circuit held in an important 1968 decision, the “timing of disclosure” of most business matters

²⁹Waddell & Reed Financial, Inc. v. Torchmark Corp., 337 F. Supp. 2d 1243, 1251 (D. Kan. 2004).

³⁰Minzer v. Keegan, 218 F.3d 144, 149, Fed. Sec. L. Rep. (CCH) P 91009, Fed. Sec. L. Rep. (CCH) P 91053 (2d Cir. 2000); Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1172 (Del. 2000); Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 143 (Del. 1997), citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449, 96 S. Ct. 2126, 2132, 48 L. Ed. 2d 757, Fed. Sec. L. Rep. (CCH) P 95615 (1976).

[Section 63:7]

¹In re Staples, Inc. Shareholders Litigation, 792 A.2d 934, 953 (Del. Ch. 2001).

²Cooperman v. Individual, Inc., 171 F.3d 43, 50, Fed. Sec. L. Rep. (CCH) P 90450 (1st Cir. 1999).

³Cooperman v. Individual, Inc., 171 F.3d 43, 50, Fed. Sec. L. Rep. (CCH) P 90450 (1st Cir. 1999).

is “entrusted with the management of the corporation.”⁴

Because the duty to disclose is not absolute, it arises in particular contexts, most often related to sale of the corporation’s stock. For example, during a public offering, Section 11 of the Securities Act of 1933 imposes liability if a registration statement: (1) contains an untrue statement of material fact; (2) omits a material fact required to be stated; or (3) omits a material fact necessary to make the statement not misleading.⁵ Section 10(b) of the Securities Exchange Act of 1934 imposes a duty to disclose in three circumstances: (1) when the corporation has made a statement of material fact that becomes false or misleading if the undisclosed information is omitted; (2) when insiders trade stock or a corporation issues stock on the basis of the undisclosed information; and (3) when a statute or regulation requires the information to be disclosed.⁶

“The duties to update and correct are two . . . avenues of finding a duty to disclose that ‘have been kicked around by courts, litigants and academics alike.’ ”⁷ If a corporation provides opinions or projections that have “become misleading as the result of intervening events,” a duty to disclose updated information may arise.⁸ If a corporation provides statements that, although reasonable at the time, become misleading in the context of subsequent events, a duty to correct arises.⁹

In general, “hard” or “factual” information is more likely to give rise to a duty to disclose. Indefinite or “soft” public statements that “suggest only the hope of any company,” are less likely to create a duty to disclose.¹⁰ Thus, merger negotiations are unlikely to create a duty to disclose. “Such negotiations are inher-

⁴Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12, 2 A.L.R. Fed. 190 (2d Cir. 1968).

⁵Shaw v. Digital Equipment Corp., 82 F.3d 1194, 1204, Fed. Sec. L. Rep. (CCH) P 99217, 35 Fed. R. Serv. 3d 55 (1st Cir. 1996); see Chapter 62 “Securities” (§§ 62:1 et. seq.).

⁶In re Tyco Intern., Ltd., Fed. Sec. L. Rep. (CCH) P 93002, 2004 DNH 154, 2004 WL 2348315 (D.N.H. 2004), at *6; see Chapter 62 “Securities” (§§ 62:1 et. seq.).

⁷In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1430, Fed. Sec. L. Rep. (CCH) P 99485, 38 Fed. R. Serv. 3d 557 (3d Cir. 1997), citing Stransky v. Cummins Engine Co., Inc., 51 F.3d 1329, 1331, Fed. Sec. L. Rep. (CCH) P 98,668 (7th Cir. 1995), as amended, (Apr. 7, 1995).

⁸In re Time Warner Inc. Securities Litigation, 9 F.3d 259, 267, Fed. Sec. L. Rep. (CCH) P 97824, 27 Fed. R. Serv. 3d 1005 (2d Cir. 1993); In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1431, Fed. Sec. L. Rep. (CCH) P 99485, 38 Fed. R. Serv. 3d 557 (3d Cir. 1997).

⁹Stransky v. Cummins Engine Co., Inc., 51 F.3d 1329, 1331–1332, Fed. Sec. L. Rep. (CCH) P 98,668 (7th Cir. 1995), as amended, (Apr. 7, 1995) (“when a company makes a historical statement that, at the time made, the company believed to be true, but as revealed by subsequently discovered information actually was not,” the company must correct the prior statement within a reasonable time).

¹⁰In re Time Warner Inc. Securities Litigation, 9 F.3d 259, 267, Fed. Sec. L.

ently fluid and the eventual outcome is shrouded in uncertainty. Disclosure may in fact be more misleading than secrecy so far as investment decisions are concerned.”¹¹ Similarly, there is rarely a duty to disclose internal forecasts.¹² Failing to disclose negotiations or forecasts is not akin to a failure to disclose “hard facts which definitely affect a company’s financial prospects.”¹³

Lawsuits for failure to disclose “soft” information are likely to be successful only if the information is of the type considered important by investors. Of course, the most common director and officer lawsuits involving failures to disclose involve the misuse of insider information to engage in “insider trading.”¹⁴

A director does not have a duty to disclose information where the complaining party already knows such information.¹⁵

§ 63:8 Business judgment rule

The business judgment rule is a defense to breach of fiduciary duty claims. It begins with the presumption that a corporate director’s decisions are made on an informed basis, in good faith, and in the company’s best interests.¹ Unless the presumption established by the rule is rebutted, directors are not personally liable for their managerial conduct.²

For the rule to apply, the decision in question must have been a business decision made by the director or officer, the director or officer must not have stood to gain personally from the decision, and the director or officer must have exercised informed judgment in making the decision. To make an informed decision, the director or officer must make a reasonable investigation into the corporation’s business and affairs. The director or officer may rely upon information provided by others. The rule does not provide

Rep. (CCH) P 97824, 27 Fed. R. Serv. 3d 1005 (2d Cir. 1993).

¹¹Reiss v. Pan American World Airways, Inc., 711 F.2d 11, 14, Fed. Sec. L. Rep. (CCH) P 99266 (2d Cir. 1983).

¹²In re Burlington Coat Factory Securities Litigation, 114 F.3d 1410, 1427, Fed. Sec. L. Rep. (CCH) P 99485, 38 Fed. R. Serv. 3d 557 (3d Cir. 1997).

¹³Reiss v. Pan American World Airways, Inc., 711 F.2d 11, 14, Fed. Sec. L. Rep. (CCH) P 99266 (2d Cir. 1983).

¹⁴Insider trading is discussed in more detail in Chapter 62 “Securities” (§§ 62:1 et. seq.).

¹⁵Waddell & Reed Financial, Inc. v. Torchmark Corp., 337 F. Supp. 2d 1243, 1252 (D. Kan. 2004).

[Section 63:8]

¹Aronson v. Lewis, 473 A.2d 805 (Del. 1984) (rejected by, Kamen v. Kemper Financial Services, Inc., 908 F.2d 1338, Fed. Sec. L. Rep. (CCH) P 95363, 17 Fed. R. Serv. 3d 224 (7th Cir. 1990)) and (overruled on other grounds by, Brehm v. Eisner, 746 A.2d 244 (Del. 2000)). The business judgment rule is discussed more extensively in Chapter 17 “Derivative Actions by Stockholders” (§§ 17:1 et. seq.).

²Stepak v. Addison, 20 F.3d 398, 403, 28 Fed. R. Serv. 3d 1274 (11th Cir. 1994).

“protection for directors who have made an unintelligent or unadvised judgment.”³

When the rule applies, it provides a powerful defense. Unless the presumption established by the rule is rebutted, courts generally will not substitute their judgment for the judgment of the board, so long as the board’s decision can be attributed to a rational business purpose.

To rebut the presumption, a plaintiff must make a showing that casts doubt as to whether an action was taken on an informed basis or whether the directors honestly and in good faith believed the decision was in the corporation’s best interest.⁴ At the pleading stage, particularized facts are required to make this showing.⁵ If the rule is rebutted, the burden shifts to the defendant directors to prove the entire fairness of the questioned transaction.⁶ The concept of fairness has two parts: fair dealing and fair price.⁷

§ 63:9 Change in duties in the zone of insolvency

A solvent corporation’s creditors typically may not sue the directors and officers for breach of fiduciary duty. If the creditors are not paid, they are expected to protect themselves through contractual rights, fraudulent conveyance statutes, the Federal Bankruptcy Code, and other bodies of law.¹ The directors owe the creditors no fiduciary duty.

Once a corporation becomes insolvent, however, the directors owe fiduciary duties to the corporation’s creditors. These new duties arise because “[t]he directors of a Chapter 11 debtor are not fiduciaries of the corporation; rather, they are fiduciaries of the estate, which the debtor-in-possession holds as trustee for the creditors.”² Thus, the directors of an insolvent corporation no longer act in the best interest of the company’s equity-holders.

³Smith v. Van Gorkom, 488 A.2d 858, 872, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

⁴Stanziale v. Nachtomi, 2004 WL 878469 (D. Del. 2004), aff’d in part, rev’d in part, 2005 WL 1813272 (3d Cir. 2005), at *7.

⁵Blasband v. Rales, 971 F.2d 1034, 1048–1049, Fed. Sec. L. Rep. (CCH) P 96918, 23 Fed. R. Serv. 3d 560 (3d Cir. 1992); In re Walt Disney Co. Derivative Litigation, 825 A.2d 275, 286, 30 Employee Benefits Cas. (BNA) 2288 (Del. Ch. 2003).

⁶Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361, Fed. Sec. L. Rep. (CCH) P 97811 (Del. 1993), decision modified on reargument, 636 A.2d 956 (Del. 1994).

⁷King v. Douglass, 973 F. Supp. 707, 722 n.21, Fed. Sec. L. Rep. (CCH) P 99528 (S.D. Tex. 1996).

[Section 63:9]

¹See Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 787–788 (Del. Ch. 2004).

²Matter of Baldwin-United Corp., 43 B.R. 443, 459, 11 Collier Bankr. Cas. 2d (MB) 1391 (S.D. Ohio 1984); see also Commodity Futures Trading Com’n v.

Rather, because the company's assets will be used first to pay the company's debts, the creditors' claims against the company are superior to the interests of shareholders. A creditors committee has standing to bring a derivative suit against the directors and officers, individually, exactly as the shareholders could have sued the directors and officers when the corporation was solvent.³

Director and officer duties when the corporation is in the "zone of insolvency" are not as clear, and potentially run to both the shareholders and the creditors.⁴ One court explained that a company close to insolvency is more likely to gamble on a high-risk strategy that might be extremely beneficial to the equity holders, but is more likely to waste assets, to the detriment of the creditors. A Massachusetts Bankruptcy Court recently noted "when a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of the creditors become paramount."⁵

Some bankruptcy courts have gone so far as to suspend the business judgment rule or to deprive directors of other defenses if their corporations are in the "zone of insolvency." These courts reason that the directors and officers already have become trustees for the creditors.⁶ Recently, the Delaware Court of Chancery challenged this federal trend, however.

The Delaware Chancery Court, in its well-known *Credit Lyonnais* decision, had held that directors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy because they believed a more risky strategy might render the company unable to meet its obligations to its creditors.⁷ In *Production Resources*, the Vice Chancellor explained that other courts have misinterpreted this "creative language."⁸ According to the Vice Chancellor, *Credit Lyonnais* was not

Weintraub, 471 U.S. 343, 354–356, 105 S. Ct. 1986, 1994–1995, 85 L. Ed. 2d 372, 12 Bankr. Ct. Dec. (CRR) 1247, 12 Collier Bankr. Cas. 2d (MB) 651, Bankr. L. Rep. (CCH) P 70360, 17 Fed. R. Evid. Serv. 529, 1 Fed. R. Serv. 3d 417 (1985).

³In re Healthco Intern., Inc., 208 B.R. 288, 300, 30 Bankr. Ct. Dec. (CRR) 858, 37 Collier Bankr. Cas. 2d (MB) 1445 (Bankr. D. Mass. 1997).

⁴E.g., Bank Leumi-Le-Israel, B. M., Philadelphia Branch v. Sunbelt Industries, Inc., 485 F. Supp. 556 (S.D. Ga. 1980); In re Healthco Intern., Inc., 208 B.R. 288, 30 Bankr. Ct. Dec. (CRR) 858, 37 Collier Bankr. Cas. 2d (MB) 1445 (Bankr. D. Mass. 1997).

⁵In re Healthco Intern., Inc., 208 B.R. 288, 296, 30 Bankr. Ct. Dec. (CRR) 858, 37 Collier Bankr. Cas. 2d (MB) 1445 (Bankr. D. Mass. 1997).

⁶Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 354 (N.D. Tex. 1996) (when a corporation becomes insolvent, the assets become a trust for the corporation's creditors and the directors hold a fiduciary duty as trustees to protect the assets).

⁷Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 17 Del. J. Corp. L. 1099, 1991 WL 277613 (Del. Ch. 1991), at *34 n.55.

⁸Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 789 (Del. Ch. 2004).

intended to create extended or expanded duties to creditors. Rather, it was intended to create an additional shield for directors against shareholders claiming the company should have taken increased risks.⁹ Thus, *Production Resources* holds that both the business judgment rule and the benefits of Delaware's exculpation provisions remain fully available to the directors of a corporation in insolvency, and that insolvency does not expand any duties owed by the directors to the creditors.¹⁰

Production Resources may be an attempt to allow directors of corporations within the "zone of insolvency" to make tough business decisions without fearing for their own liability—so long as the directors do not engage in self-dealing or other bad faith actions. Whether or not federal courts will follow Delaware's lead remains to be seen. Until then, the "zone of insolvency" will likely be a focus of litigation.

Finally, practitioners litigating insolvency claims must carefully examine the applicable requirements for both pleading and proving insolvency. Courts have used both the "balance sheet" test and various versions of the "cash flow" test to determine whether a corporation actually is or was insolvent.¹¹ Of course, in litigation, plaintiff's counsel will use a "snapshot" test to determine, on a specific day in the past, the corporation was insolvent. Directors and officers will best be able to defend themselves: (1) if they regularly evaluated and reviewed the corporation's financial statements, business projections and assumptions, and historical performance; (2) if they regularly investigated and analyzed the corporation's then-current condition and its external competitive factors; (3) and if they regularly evaluated the corporation's cash flow, its liquidity and its safety margin.

§ 63:10 Sarbanes-Oxley and the federal incursion on state law

The Sarbanes-Oxley Act of 2002 ("Sarbanes")¹ is Congress' response to recent well-publicized allegations of wrongdoing in publicly-held corporations. Sarbanes generated much academic comment and criticism regarding its likely effectiveness and how it might have been strengthened. For purposes of this chapter,

⁹*Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 788–790 (Del. Ch. 2004).

¹⁰*Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 791–792 (Del. Ch. 2004). Creditors claims, according to Vice Chancellor Strine are derivative, not direct.

¹¹See *Pereira v. Cogan*, 294 B.R. 449, 520–521 (S.D. N.Y. 2003), vacated and remanded, 413 F.3d 330 (2d Cir. 2005).

[Section 63:10]

¹Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, codified in various sections of 11 U.S.C.A., 15 U.S.C.A., 18 U.S.C.A., 28 U.S.C.A. and 29 U.S.C.A.

however, we focus on the ways in which it confirms and extends both recent case law and other articulations of the fiduciary duty, thus embracing enhanced standards for directors and officers.²

Sarbanes's greatest effect may be on corporate audit procedures. The Act requires all companies listed on a national exchange to have an independent audit committee made up of independent members of the board of directors.³ The audit committee is directly responsible for appointing, compensating, and overseeing the outside auditor. The audit committee has extremely limited ability to engage an outside accounting firm for nonaudit activities.⁴ Further, the audit committee is required to establish procedures to receive, retain, and treat complaints regarding accounting, internal controls, and auditing matters, including procedures to facilitate confidential and anonymous employee reports of questionable procedures.

Sarbanes also requires companies to file reports with the SEC that disclose and demonstrate management's establishment and maintenance of adequate internal controls and procedures for financial reporting. Significantly, top executives must certify the company's financial statements.

These provisions effectively heighten the obligation of members of the audit committee to remain informed and active in the auditing process.⁵ Before Sarbanes, the Delaware Supreme Court held, in *Graham v. Allis-Chalmers Manufacturing Co.*, that, absent knowledge of facts to put them on notice of possible wrongdoing, directors had no duty to implement a system of watchfulness.⁶ The court reasoned that it knew of "no rule of law" that required directors to create such a monitoring system.⁷ Sarbanes has created exactly such a requirement.⁸ Moreover, because many of the obligations in Sarbanes are not clearly defined, it has made civil litigation against audit committee members more likely.

Sarbanes also requires that corporations adopt a code of ethics for senior financial officers, or else disclose that no such code ex-

²See Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 *St. John's L. Rev.* 953 (2002). Some have suggested that Sarbanes does "little more than marginally change old rules, codify existing best practice, or regulate a limited bit of behavior." McDonnell, *Sox Appeals*, 2004 *Mich. St. L. Rev.* 505.

³Sarbanes-Oxley Act § 301, 15 U.S.C.A. § 78f(m).

⁴Sarbanes-Oxley Act § 301, 15 U.S.C.A. § 78f(m).

⁵Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 *St. John's L. Rev.* 953, 962 (2002).

⁶*Graham v. Allis-Chalmers Mfg. Co.*, 41 *Del. Ch.* 78, 188 A.2d 125 (1963).

⁷*Graham v. Allis-Chalmers Mfg. Co.*, 41 *Del. Ch.* 78, 188 A.2d 125, 130 (1963).

⁸Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 *St. John's L. Rev.* 953, 969 (2002).

ists and explain why not.⁹ Sarbanes does not, however, prescribe the source of the ethics code. It requires only that the code promote “honest and ethical conduct,” including the treatment of conflicts of interest, “full, fair, accurate, timely, and understandable disclosure” in required public reports, and “compliance” with applicable government rules and regulations.¹⁰ Plainly, proof that a company’s code of ethics has been breached could have serious consequences in director and officer litigation.

Sarbanes directly conflicts with state corporate law. For instance, many states expressly permit corporations to make loans to employees and officers.¹¹ Sarbanes prohibits corporations from extending “credit” or making any personal loan to any officer or director.¹² In thus effectively nullifying state laws, Sarbanes represents a major federal limitation on the discretion and authority of state-chartered corporations.¹³ Companies will likely continue to seek ways to provide additional compensation to valued top executives. These efforts will likely generate considerable litigation.

Sarbanes also requires a majority of the board to be composed of independent directors. A nominating/corporate governance committee must be comprised entirely of independent directors. There must be policies regarding consideration and evaluation of nominations. Attendance at meetings must be publicly disclosed.

Blackout periods are set when directors and officers may not purchase, sell or otherwise acquire or transfer shares of the company. Violation of the blackout provision gives rise to a new derivative action against officers and directors.

These and other Sarbanes provisions set federal standards in areas traditionally regulated by state law. As the Delaware Chancery Court Chancellor and Vice Chancellor have noted, Sarbanes may well have created “a shadow corporation law that requires public company boards to comply with a very specific set of procedural prescriptions.”¹⁴ Sarbanes “can be viewed as adding content to, and buttressing, the overall monitoring role of corporate directors and officers.”¹⁵ In effect, Sarbanes may have defined a national “reasonable prudent person” standard of care. Accordingly, the Delaware Chancellor and Vice Chancellor expect

⁹Sarbanes-Oxley Act § 406, 15 U.S.C.A. § 7264.

¹⁰Sarbanes-Oxley Act § 103(a)(1), 15 U.S.C.A. § 7213.

¹¹See, e.g., Del. Code Ann. Tit. 8, § 143.

¹²Sarbanes-Oxley Act § 402, 15 U.S.C.A. § 78m(k).

¹³Chandler and Strine, *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U.Pa.L.Rev. 953, 971–972 (2003).

¹⁴Chandler and Strine, *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953, 973 (2003).

¹⁵Fairfax, *The Sarbanes-Oxley Act as Confirmation of Recent Trends in Director and Officer Fiduciary Obligations*, 76 St. John’s L. Rev. 953, 961 (2002).

“the active corporate plaintiffs’ bar [to be] creative and aggressive in deploying [Sarbanes and its regulation] as a tool in shareholder litigation under state law.”¹⁶

§ 63:11 Defenses

A director can best defend himself by showing that he fulfilled his duties to the corporation. Defense counsel’s task will be aided immeasurably if the corporation maintained proper records—including board minutes that are accurate and complete. In *Smith v. Van Gorkom*, the court criticized repeatedly the company’s incomplete and unenlightening records.

The business judgment rule provides a substantial defense to directors and officers who operated on an informed basis and with an honest belief that they were acting in the best interests of the corporation.

Establishing that conduct was proper will be easier if the board was familiar with and followed some model formulation of duties, such as the *Corporate Director’s Guidebook Third Edition*,¹ published by the Section of Business Law of the American Bar Association. In addition, the corporation may have performed legal audits, and may have taken action to prevent the types of conduct on which the lawsuit is based. Many programs are available to ensure compliance with Sarbanes and other statutory and regulatory requirements. Having control and compliance programs in place will benefit directors and officers who are required by litigation to prove they met the applicable standard of care.

Many states allow a defense for directors who dissented to the decision in question.² Many states also have statutes that either limit or provide relief from director and officer liability.³ For instance, Delaware authorizes the shareholders of its corporations either to eliminate or to limit the personal liability of directors for money damages for breach of certain fiduciary duties.⁴ The shareholders may—and frequently do—exculpate directors from breaches of the duty of care. The shareholders may not, however, eliminate or limit liability for:

- (1) breach of the director’s duty of loyalty;
- (2) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

¹⁶Chandler and Strine, *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. Pa. L. Rev. 953, 984 (2003).

[Section 63:11]

¹Corporate Director’s Guidebook Third Edition, 56 Bus. Law. 1571 (2001).

²See, e.g., Del. Code Ann. Tit. 8, § 174; Revised Model Bus. Corp. Act § 8.24(d).

³Statutes limiting director liability are listed in Appendix B to Knepper and Bailey, *Liability of Corporate Officers and Directors* (7th ed.).

⁴Del. Code Ann. Tit. 8, § 102(b)(7).

- (3) payment of unlawful dividends or stock purchases or redemptions; or
- (4) any transaction from which the director derived an improper personal benefit.⁵

Virginia, on the other hand, limits damages available against a director to an amount specified in the corporation's governing documents or the greater of \$100,000 or the amount of cash compensation the director received over the prior twelve months.⁶ Ohio eliminates corporate director liability unless the plaintiff is able to prove by clear and convincing evidence that the director's action or failure to act was undertaken with deliberate intent to cause injury to the corporation, or else in reckless disregard of the corporation's best interests. Ohio's elimination of liability applies unless a corporation's articles explicitly provide that the statute is inapplicable.⁷

In short, and as in many other aspects of director and officer litigation, counsel must review the law of the corporation's domicile state to determine the best defenses available to directors and officers.

§ 63:12 Attorney-client privilege in director and officer litigation

Director and officer litigation often gives rise to the fiduciary exception to the attorney-client privilege.¹

In *Garner v. Wolfinbarger*, corporate stockholders sued their company for acting against their interests; they argued that the attorney-client privilege did not protect communications between the corporation and its attorneys.² The Fifth Circuit recognized "it is difficult to rationally defend the assertion of the privilege if all, or substantially all, stockholders desire to inquire into the attorney's communications with corporate representatives who have only nominal ownership interests, or even none at all."³ Accordingly, the court allowed the shareholders to discover otherwise privileged communication upon a showing of good cause.⁴ The court noted that "management does not manage for itself"; as such, "management judgment must stand on its merits, not

⁵Del. Code Ann. Tit. 8, § 102(b)(7).

⁶Va. Code Ann. § 13.1-692.1.

⁷Ohio Rev. Code Ann. § 1701.59(D).

[Section 63:12]

¹See Chapter 19 "Discovery Strategy and Privileges" (§§ 19:1 et. seq.).

²*Garner v. Wolfinbarger*, 430 F.2d 1093, Fed. Sec. L. Rep. (CCH) P 92759, Fed. Sec. L. Rep. (CCH) P 92819, 14 Fed. R. Serv. 2d 490 (5th Cir. 1970).

³*Garner v. Wolfinbarger*, 430 F.2d 1093, 1101, Fed. Sec. L. Rep. (CCH) P 92759, Fed. Sec. L. Rep. (CCH) P 92819, 14 Fed. R. Serv. 2d 490 (5th Cir. 1970).

⁴*Garner v. Wolfinbarger*, 430 F.2d 1093, 1103-1104, Fed. Sec. L. Rep. (CCH) P 92759, Fed. Sec. L. Rep. (CCH) P 92819, 14 Fed. R. Serv. 2d 490 (5th Cir. 1970).

behind an iron clad veil of secrecy which under all circumstances preserves it from being questioned by those for whom it is, at least in part, exercised.”⁵ Accordingly, the court held that, when corporate stockholders claim that the corporation acted inimically to their interests, the privilege is “subject to the right of the stockholders to show cause why it should not be invoked in the particular instance.”⁶ The *Garner* court offered criteria to be employed in the “cause” determination:

[T]he number of shareholders and the percentage of stock they represent; the bona fides of the shareholders; the nature of the shareholders’ claim and whether it is obviously colorable; the apparent necessity or desirability of the shareholders having the information and the availability of it from other sources; whether, if the shareholders’ claim is of wrongful action by the corporation, it is of action criminal, or illegal but not criminal, or of doubtful legality; whether the communication related to past or to prospective action; whether the communication is of advice concerning the litigation itself; the extent to which the communication is identified versus the extent to which the shareholders are blindly fishing; the risk of revelation of trade secrets or other information in whose confidentiality the corporation has an interest for independent reasons.⁷

Other courts have adopted *Garner* and applied it to other fiduciary areas, including ERISA cases.⁸ Once again, the reasoning is compelling: a corporation’s lawyers represent the *company*, not just its officers or directors. Accordingly, the company’s owners—the shareholders—are the lawyers’ clients. The shareholders may well be entitled to learn from the corporation’s attorneys all their thoughts and advice.

§ 63:13 Remedies

Breach of fiduciary duty is an equitable cause of action. Accordingly, the remedies available are broad. Injunctive relief is often the remedy sought for a breach of that duty. Plaintiffs may ask the court to void, reverse, or stop a transaction.

Breach of fiduciary duty is also a tort, so that the tortfeasor

⁵*Garner v. Wolfinbarger*, 430 F.2d 1093, 1101, Fed. Sec. L. Rep. (CCH) P 92759, Fed. Sec. L. Rep. (CCH) P 92819, 14 Fed. R. Serv. 2d 490 (5th Cir. 1970).

⁶*Garner v. Wolfinbarger*, 430 F.2d 1093, 1103–1104, Fed. Sec. L. Rep. (CCH) P 92759, Fed. Sec. L. Rep. (CCH) P 92819, 14 Fed. R. Serv. 2d 490 (5th Cir. 1970).

⁷*Garner v. Wolfinbarger*, 430 F.2d 1093, 1104, Fed. Sec. L. Rep. (CCH) P 92759, Fed. Sec. L. Rep. (CCH) P 92819, 14 Fed. R. Serv. 2d 490 (5th Cir. 1970).

⁸*In re Occidental Petroleum Corp.*, 217 F.3d 293, 47 Fed. R. Serv. 3d 196 (5th Cir. 2000); *Helt v. Metropolitan Dist. Com’n*, 113 F.R.D. 7, 7 Employee Benefits Cas. (BNA) 2617, 42 Fair Empl. Prac. Cas. (BNA) 1561, 7 Fed. R. Serv. 3d 476 (D. Conn. 1986); *Deutsch v. Cogan*, 580 A.2d 100 (Del. Ch. 1990); Rice, *The Corporate Attorney-Client Privilege: Loss of Predictability Does Not Justify Crying Wolf*, 55 Bus.Law. 735 (2000); Kummer, *The Garner Exception to Attorney-Client Privilege: A New Approach to “Good Cause,”* 13 *Cardozo L. Rev.* 2141 (1992); see Chapter 79 “ERISA” (§§ 79:1 et. seq.).

may be liable for any loss suffered by the corporation or its shareholders.¹ Thus, shareholders may seek to recover as a form of restitution assets improperly taken from the corporation. In that instance, the damages may be either the amount of corporate loss or the amount of wrongful director profit. Often, when a court orders restitution, it also imposes a constructive trust. The court simply declares that the defendant is a “constructive” trustee, and orders him or her to transfer the property in question to the beneficiary of the trust.² Significantly, punitive damages and attorney’s fees are sometimes available.³

The damages available for a breach of fiduciary duty are joint and several.

III. TYPES OF DIRECTOR AND OFFICER ACTIONS

§ 63:14 Direct actions

Among the first questions counsel must answer is whether the director and officer suit he or she intends to file should be a direct action, a derivative action, or a class action. Generally, an action for an injury to a corporation must be pursued in the name of the corporation. That an individual shareholder sustained harm incidental to the corporate injury does not confer upon the shareholder standing to sue in his own right.¹ An individual shareholder may sue in his own right—file a “direct action”—only where he is able to plead an injury separate and distinct from the injury suffered by the corporation. Under Delaware law, the plaintiff is required to plead a “special injury”:

Special injury has been defined as an injury that is suffered by the plaintiff either ‘directly’ or ‘independently’ of the corporation. Typically, a plaintiff has been found to have alleged a ‘special injury and may maintain an individual action’ if he: i) ‘complains of an injury distinct from that suffered by other shareholders;’ or ii) ‘a wrong involving one of his contractual rights as a shareholder.’²

When a corporation tortiously conspires with others to harm

[Section 63:13]

¹See Chapter 85 “Theft or Loss of Business Opportunities” (§§ 85:1 et. seq.).

²See, e.g., *Graham v. Mimms*, 111 Ill. App. 3d 751, 67 Ill. Dec. 313, 444 N.E.2d 549, 556 (1st Dist. 1982).

³*Ansin v. River Oaks Furniture, Inc.*, 105 F.3d 745, Fed. Sec. L. Rep. (CCH) P 99417 (1st Cir. 1997); *In re Rose Marine, Inc.*, 1993 WL 13004542 (S.D. Ga. 1993); *In re H. King & Associates*, 295 B.R. 246 (Bankr. N.D. Ill. 2003); *In re Insulfoams, Inc.*, 184 B.R. 694 (Bankr. W.D. Pa. 1995), subsequently aff’d, 104 F.3d 547, 30 Bankr. Ct. Dec. (CRR) 242, Bankr. L. Rep. (CCH) P 77288 (3d Cir. 1997).

[Section 63:14]

¹*Combs v. PriceWaterhouse Coopers LLP*, 382 F.3d 1196 (10th Cir. 2004); *Amoco Oil Co. v. Gomez*, 379 F.3d 1266 (11th Cir. 2004), cert. denied, 125 S. Ct. 1693, 161 L. Ed. 2d 539 (U.S. 2005).

²*In re Gaylord Container Corp. Shareholders Litigation*, 747 A.2d 71, 75

an individual shareholder, a cause of action arises that belongs to the individual.³ More complicated cases arise when minority shareholders file *Unocal* actions—actions alleging that the directors took improper defensive actions against a potential acquirer. An entrenchment claim may be individual if the entrenching activity impaired the plaintiff’s rights as a minority shareholder, as distinguished from impairing a right that belongs to the corporation.⁴ For instance, in *In re Gaylord Container Corp. Shareholders Litigation*, the board’s defensive takeover tactics “markedly diminish[ed]” the ability of the nonmanagement stockholders to elect a new slate of directors, to entertain sales proposals, and to amend the corporation’s charter and bylaws. Because the non-management stockholders’ rights were diminished in comparison to the management stockholders’ rights, the court found that the non-management stockholders suffered an injury separate from the injury to the corporation.⁵

§ 63:15 Class actions

A class action is a procedural mechanism that allows one or more plaintiffs to sue on behalf of others who have similar interests. Class actions are common in corporate litigation, where it may be either impossible or impractical to join all the shareholders of a publicly held corporation.¹

§ 63:16 Derivative actions

Derivative actions are brought by shareholders on behalf of the corporation to enforce a claim belonging to the corporation. Because the law entrusts corporate management to the directors, shareholder derivative suits typically require that an aggrieved shareholder first make a demand on the corporation. Alternatively, the shareholder may plead the futility of making a demand.¹

(Del. Ch. 1999).

³*Moffatt Enterprises, Inc. v. Borden Inc.*, 807 F.2d 1169 (3d Cir. 1986).

⁴*In re Gaylord Container Corp. Shareholders Litigation*, 747 A.2d 71, 83 (Del. Ch. 1999) (“Where the entrenching actions of a corporate board have the purpose and effect of reducing the voting power of stockholders the affected stockholders may bring an individual action.”).

⁵*In re Gaylord Container Corp. Shareholders Litigation*, 747 A.2d 71, 83–84 (Del. Ch. 1999).

[Section 63:15]

¹Class actions are covered extensively in Chapter 16 “Class Actions” (§§ 16:1 et. seq.).

[Section 63:16]

¹The procedure required to bring a derivative action is covered extensively in Chapter 17 “Derivative Actions by Stockholders” (§§ 17:1 et. seq.).

§ 63:17 Type of action considerations

It is important to understand the ramifications of the type of action brought. As described more fully elsewhere in this treatise,¹ a derivative action requires compliance with the demand requirement. Class actions require certifying the class, and protecting the due process rights of absent class members, particularly at settlement. The type of action will affect discovery, allotment of resources, and the battlefield on which many of the litigation skirmishes may take place.

IV. INDEMNITY**§ 63:18 Overview**

Corporate indemnification protects directors and officers from personal liability. Although litigation has become an “occupational hazard for corporate directors,” indemnification provisions ensure that litigation expense is often “shifted to the corporation.”¹ Indemnification statutes assure corporate officials “that they will not be hampered by financial constraints in mounting a full defense against unjustified suits.”² The primary focus of the following sections is on Delaware’s indemnification provisions, although similar provisions are common in almost all states.³

Broadly speaking, entitlement to indemnification may be categorized as either “mandatory” or “permissive.”

§ 63:19 Mandatory indemnification

Under § 145(c) of the Delaware Code, an officer or director is absolutely entitled to corporate indemnification if he or she is “successful on the merits or otherwise” in defending a lawsuit.¹ Mandatory indemnification is liberally allowed where directors and officers have successfully defended against a claim or action.²

To be successful, a defense must be final, and it must resolve

[Section 63:17]

¹See Chapter 17 “Derivative Actions by Stockholders” (§§ 17:1 et. seq.).

[Section 63:18]

¹*Heffernan v. Pacific Dunlop GNB Corp.*, 965 F.2d 369, 369, Fed. Sec. L. Rep. (CCH) P 96813 (7th Cir. 1992).

²*McLean v. International Harvester Co.*, 902 F.2d 372 (5th Cir. 1990).

³Del. Code Ann. Tit. 8, § 145.

[Section 63:19]

¹Del. Code Ann. Tit. 8, § 145(c).

²*Witco Corp. v. Beekhuis*, 38 F.3d 682, 692, 39 Env’t. Rep. Cas. (BNA) 1545, 25 Env’t. L. Rep. 20007 (3d Cir. 1994); *McLean v. International Harvester Co.*, 902 F.2d 372, 374 (5th Cir. 1990).

the case without any payment by the director or officer.³ Thus, a settlement “with prejudice” that results in dismissal of the case is final, and entitles the officer or director to indemnification.⁴ A settlement without prejudice to a plaintiff’s right to assert additional claims is not “successful.”⁵

Mandatory indemnification does not require success on all claims in a given lawsuit. Delaware allows mandatory indemnification “to the extent” that the officer or director is successful on the merits.⁶ Thus, under Delaware law, indemnification may be mandatory as to some claims even if the officer or director is unsuccessful in defending against others.⁷ In those instances, the expenses incurred must be allocated among the claims, and those expenses reasonably incurred in defense of the claims on which the officer or director is successful are subject to mandatory indemnification. In contrast, some states require officers and directors to be “wholly successful on the merits” to be entitled to mandatory indemnification.⁸ The practitioner must pay particular attention to the language of the applicable exculpatory statute.

Significantly, to receive mandatory indemnification, a director or officer need not act in good faith or with a reasonable belief that his or her actions were consistent with the corporation’s best interests.⁹ Rather, the director or officer need only prevail.

§ 63:20 Permissive indemnification

Indemnification under §§ 145(a) and (b) of the Delaware Code is permissive, allowing a corporation to indemnify its directors and officers, even if the directors or officers settle or lose a lawsuit.

Section 145(a) conveys broad indemnification powers for actions brought against a director or officer by a third party. The corporation may indemnify its directors and officers under § 145(a) so long as the officer or director acted in good faith and in a manner reasonably believed to be consistent with the best interests of the corporation. Section 145(a) allows indemnification

³Waltuch v. Conticommodity Services, Inc., 88 F.3d 87, 96, Comm. Fut. L. Rep. (CCH) P 26738 (2d Cir. 1996); Wisener v. Air Exp. Intern. Corp., 583 F.2d 579, 583 (2d Cir. 1978).

⁴Safeway Stores, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa., 64 F.3d 1282, 1290 n.24 (9th Cir. 1995); Wisener v. Air Exp. Intern. Corp., 583 F.2d 579, 583 (2d Cir. 1978).

⁵Galdi v. Berg, 359 F. Supp. 698 (D. Del. 1973).

⁶Del. Code Ann. Tit. 8, § 145(c).

⁷Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138 (Del. Super. Ct. 1974).

⁸N.C. Gen. Stat. § 55-8-52; see also In re Adelphia Communications Corp., 323 B.R. 345 (Bankr. S.D. N.Y. 2005).

⁹Green v. Westcap Corp. of Delaware, 492 A.2d 260, 264 (Del. Super. Ct. 1985). Other states and other statutes require otherwise. Diamond v. Diamond, 307 N.Y. 263, 120 N.E.2d 819, 821 (1954).

of all expenses—including attorney’s fees—judgments, and settlements.

Section 145(b) limits the corporation’s authority to indemnify directors against actions brought in the name of the corporation. Unlike § 145(a), § 145(b) does not permit indemnification for amounts paid in settlement or under judgments. It limits indemnification to counsel fees and other expenses. Thus, if the officer or director is found liable in a derivative action, his indemnification rights will not extend to the judgment amount.

§ 63:21 Expenses available

A director or officer may be indemnified for expenses and other liabilities incurred in any “action, suit or proceeding, whether civil, criminal, administrative or investigative.”¹ Under Delaware’s broadest provisions, the officer may be indemnified against all expenses—including attorney’s fees—as well as judgments, fines, and amounts paid in settlement actually and reasonably incurred.² Accordingly, before settling, an officer or director who expects to be indemnified should take care that the amounts for which he or she will seek indemnification are not unreasonable or excessive.³ Generally, the standards used in determining whether amounts are “reasonable” are the same as those used when courts award attorney’s fees.⁴ Whenever possible, the officer or director should seek court approval in advance for any expenditures. Alternatively, the officer or director should seek advance approval from the corporation. At a bare minimum, all such expenditures should be carefully documented, with the intention of justifying each expense to a court, the company, or both.

Generally, the obligation to indemnify does not accrue until the indemnitee suffers an actual loss. Historically, corporations have nonetheless advanced expenses before litigation has concluded.⁵ Courts have ruled that advancing expenses does not require that the indemnitee first show a probability that he will succeed on the merits.⁶

In *Tafeen v. Homestore, Inc.*,⁷ the Delaware Chancery Court noted in dicta that Sarbanes has created uncertainty as to whether corporations may continue to advance costs. The court

[Section 63:21]

¹Del. Code Ann. Tit. 8, § 145(a).

²Del. Code Ann. Tit. 8, § 145(a).

³Macmillan, Inc. v. Federal Ins. Co., 741 F. Supp. 1079 (S.D. N.Y. 1990).

⁴Merritt-Chapman & Scott Corp. v. Wolfson, 321 A.2d 138, 143 (Del. Super. Ct. 1974).

⁵Del. Code Ann. Tit. 8, § 145(e).

⁶Ridder v. CityFed Financial Corp., 47 F.3d 85 (3d Cir. 1995).

⁷Tafeen v. Homestore, Inc., 2004 WL 556733 (Del. Ch. 2004).

questioned whether Sarbanes' prohibition of personal loans preempts the Delaware Code's provisions that expressly allow corporations to advance attorney's fees.⁸ The implications here are significant. Should courts ultimately determine that corporations may not advance costs of litigation, affected directors and officers will have to pay out perhaps millions of dollars in defense costs—monies they may never recoup. In these circumstances, the law may well discourage people from serving as corporate directors or officers.

§ 63:22 Bankruptcy and indemnification

Bankruptcy also raises questions with respect to indemnification. Section 502(e)(1)(B) of the Bankruptcy Code requires the court to disallow any claim where: (1) the claim is for reimbursement or contribution; (2) the entity asserting the claim is "liable with the debtor"; and (3) the claim is contingent at the time of its allowance or disallowance.¹ The first and third elements are likely to be present where a defendant director seeks indemnification from a bankrupt corporation. The second element requires the court to examine whether the cause of action against the director or officer includes claims for which the corporation would be liable but for the bankruptcy.² If the underlying lawsuit includes claims that would give rise to liability against the debtor, but for the automatic stay, then "co-liability" is present and the director's claim may be disallowed.³

In *In re Mid-American Waste Systems, Inc.*, directors and officers asked the court to classify their indemnification claims as administrative expenses—so they would receive higher priority in the bankruptcy.⁴ The court refused, primarily because the indemnification claim arose from pre-petition conduct.⁵

Because their claims are likely to be disallowed, and will be given low priority even if they are allowed, directors or officers of bankrupt corporations would be wise not to rely on the likelihood of corporation indemnification.

⁸Tafeen v. Homestore, Inc., 2004 WL 556733 (Del. Ch. 2004), at *9.

[Section 63:22]

¹*In re Pinnacle Brands, Inc.*, 259 B.R. 46, 37 Bankr. Ct. Dec. (CRR) 127, 45 Collier Bankr. Cas. 2d (MB) 1037 (Bankr. D. Del. 2001); *In re Wedtech Corp.*, 85 B.R. 285, 289 (Bankr. S.D. N.Y. 1988).

²*In re Wedtech Corp.*, 85 B.R. 285, 290 (Bankr. S.D. N.Y. 1988).

³*In re Wedtech Corp.*, 85 B.R. 285, 290 (Bankr. S.D. N.Y. 1988).

⁴*In re Mid-American Waste Systems, Inc.*, 228 B.R. 816, 821, 33 Bankr. Ct. Dec. (CRR) 958 (Bankr. D. Del. 1999).

⁵*In re Mid-American Waste Systems, Inc.*, 228 B.R. 816, 829, 33 Bankr. Ct. Dec. (CRR) 958 (Bankr. D. Del. 1999), discussing § 510(b) of the Bankruptcy Code.

V. INSURANCE

§ 63:23 Director and officer insurance policies

Litigation involving Enron, Adelphia, and other well-known companies continues to have a profound impact on director and officer insurance. As directors and officers seek increasing coverage (with increasing premiums), insurers seek to eliminate coverage entirely. Throughout, bankruptcy courts struggle to determine whether the policies are assets of the estate, and who has access to the policies while the corporations are in bankruptcy proceedings.

Director and officer insurance policies generally include three kinds of coverage: (1) Coverage A indemnifies directors and officers for any “loss” they become legally obligated to pay as a result of a “wrongful act” arising from their activities as directors or officers; (2) Coverage B reimburses the corporation for the amount it is required to pay in indemnifying its directors or officers; and (3) Coverage C indemnifies the corporation itself for certain types of claims filed against the corporation. Coverage B pays the corporation where the corporation is statutorily required to indemnify the officers and directors. Coverage A usually covers losses incurred by directors and officers that are not subject to mandatory indemnification and that the corporation chooses not to indemnify. By choosing not to exercise its ability “permissively” to indemnify its directors and officers, the corporation is in essence determining that the insurance company, as distinguished from the corporation, will pay the loss. Coverage C is of more recent vintage, and developed in response to securities claims that were in part against the directors and officers and in part against the corporation itself.¹ It is the only coverage for claims made directly against the corporation.

Unlike traditional Comprehensive General Liability coverage, director and officer policies typically do not impose a duty to defend. Rather, they require the insurer either to advance or to reimburse defense costs incurred by the insured as part of the limits of the policy coverage. This allows senior management to select its own counsel. Much litigation has involved whether director and officer policies require contemporaneous payment, or whether they permit the insurer to defer payment until after conclusion of the claim. Some courts hold that the insurer has a contemporaneous duty to advance defense costs until after a court

[Section 63:23]

¹By adding coverage C, both the insurer and the insured avoided disputes over how to allocate the costs of defense or settlement resulting when shareholders filed complaints including both insured claims against individual directors and uninsured claims against the corporation. See, e.g., *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, Fed. Sec. L. Rep. (CCH) P 98,678, 32 Fed. R. Serv. 3d 217 (9th Cir. 1995), as amended on denial of reh’g, (Aug. 1, 1995).

has resolved any coverage questions in the insurer's favor.² Others have concluded that the insurer has no obligation to pay defense expenses as they are incurred.³ Ideally, the director or officer and the insurer will cooperate—perhaps even pursuant to a “duty of cooperation” clause—in the defense.

When the policy has a single aggregate coverage limit, a conflict may arise among the individual insureds, or between the individual insureds and the corporation, regarding the order in which the insurer pays out claims. Depending on the scope of the litigation, some insureds may seek an early settlement—while the insurer is still below the limit and obligated to make the full payment—to the detriment of other insureds. In some instances, director and officer policies address how the limits will be paid among competing insureds. For instance, some policies provide that the policy will first pay a loss for which Coverage A is provided, followed by a loss for which Coverage B is provided. In other instances, the question will create satellite litigation to enjoin or allow specific payments.⁴ If the corporation is in bankruptcy, the court must determine whether or not to lift the bankruptcy stay to allow payments under the policy.⁵ How priority of payment questions are resolved can dramatically affect the underlying director and officer litigation by pressuring immediate settlements or limiting defense costs that may ultimately be recovered.

Insurers often seek to delay payment, or avoid it altogether. If the insured made a material misrepresentation in the policy application, the insurer may typically deny coverage, or reform or rescind the policy—depending on specific policy language and applicable state statutes.⁶ Standards for insurance policy rescission are fairly well—settled in most jurisdictions, and require a material misrepresentation upon which the insurer relied. Litigation frequently involves the extent to which public statements or filings were part of the insurance application. Many insurers require that the application include financial statements, information relating to the company's operations, information relating to other claims, and information relating to other insurance. If the insurer relied on a company's financial statements to evalu-

²*Little v. MGIC Indem. Corp.*, 836 F.2d 789 (3d Cir. 1987); *Federal Insurance Company v. Tyco Intern. Ltd.*, 2 Misc. 3d 1006(A), 784 N.Y.S.2d 920, 32 Employee Benefits Cas. (BNA) 1799 (Sup 2004), appeal dismissed, 18 A.D.3d 33, 792 N.Y.S.2d 397, 34 Employee Benefits Cas. (BNA) 2678 (App. Div. 1st Dep't 2005).

³*Zaborac v. American Cas. Co. of Reading, Pa.*, 663 F. Supp. 330 (C.D. Ill. 1987); *In re Kenai Corp.*, 136 B.R. 59 (S.D. N.Y. 1992).

⁴See, e.g., *In re Enron Corp.*, 2002 WL 1008240 (Bankr. S.D. N.Y. 2002).

⁵*In re Adelphia Communications Corp.*, 298 B.R. 49 (S.D. N.Y. 2003).

⁶*Republic Ins. Co. v. Masters, Mates & Pilots Pension Plan*, 77 F.3d 48, 19 Employee Benefits Cas. (BNA) 2825 (2d Cir. 1996); *Shapiro v. American Home Assur. Co.*, 584 F. Supp. 1245 (D. Mass. 1984).

ate the company and to determine the policy premium, a restatement of the company's earnings may place the director and officer policy at risk of rescission—at precisely the time when shareholders are likely to sue.⁷

Frequently, a single director or officer makes a misrepresentation in the application process.⁸ If the insurance company discovers the misrepresentation after suit is filed against both the individual who made the misrepresentation and other “innocent” insureds, may the insurance company still rescind the policy? Most courts hold that the “innocent” insureds retain coverage under the insurance contract.⁹ Resolution of this issue often depends on the severability clause in the insurance contract, which may explicitly state that statement of one or more officers shall, or shall not, be imputed to the rest of the officers.¹⁰ A rescinded policy is deemed never to have existed. Thus, rescission may require directors and officers to themselves fund defense costs and settlement or judgment.

Counsel for corporate insureds would be well-advised to familiarize themselves with the applicable state law penalizing bad faith denials of insurance coverage.¹¹ Because such penalties can be severe, the insurance company that denies coverage acts at its peril if the denial is unwarranted.¹²

§ 63:24 Exclusions

Typical director and officer policies exclude claims for liability that arise from a director's fraud, self-dealing, or other intentional

⁷National Union Fire Ins. Co. of Pittsburgh, Pa. v. Sahlen, 999 F.2d 1532 (11th Cir. 1993); *In re HealthSouth Corp.*, 308 F. Supp. 2d 1253 (N.D. Ala. 2004).

⁸*Bird v. Penn Cent. Co.*, 334 F. Supp. 255 (E.D. Pa. 1971), on reargument, 341 F. Supp. 291 (E.D. Pa. 1972) (corporate officer who signed application for D & O insurance was agent for the corporate entity and all other directors and officers).

⁹*Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D. Del. 2002); *S.E.C. v. Credit Bancorp, Ltd.*, 147 F. Supp. 2d 238 (S.D. N.Y. 2001).

¹⁰Compare *In re HealthSouth Corp.*, 308 F. Supp. 2d 1253 (N.D. Ala. 2004) (“no statement in the application or knowledge possessed by any insured person shall be imputed to any other insured person for the purpose of determining if coverage is available”) with *Cutter & Buck, Inc. v. Genesis Ins. Co.*, 306 F. Supp. 2d 988 (W.D. Wash. 2004), judgment aff'd, 2005 WL 1799397 (9th Cir. 2005) (“no knowledge possessed by any director or officer shall be imputed to any other director or officer except for material information known to the person or persons who signed the application”).

¹¹E.g., Colo. Rev. Stat. § 10-3-1113; 42 Pa. Cons. Stat. § 8371; *Casson v. Nationwide Ins. Co.*, 455 A.2d 361 (Del. Super. Ct. 1982); *Pickett v. Lloyd's*, 131 N.J. 457, 621 A.2d 445 (1993).

¹²See Richmond, *Bad Insurance Bad Faith Law*, 39 *Tort Trial & Ins. Practice L.J.* 1 (2003), pp. 1–2 n. 3–10, and examples cited therein.

wrongful conduct.¹ Usually, such claims require a judicial determination of wrongdoing before the exclusion is operative.²

Policies also typically exclude “*insured v. insured*” claims.³ This exclusion bars coverage when one insured, such as the corporation, sues another insured, such as the directors and officers. This issue frequently arises when a bankruptcy trustee brings suit, and the insurance company asserts that the trustee is an “insured.”⁴

§ 63:25 Bankruptcy and insurance

When a corporation files for bankruptcy, it is important to determine whether the insurance policy, and its proceeds, constitute part of the bankruptcy estate.

The policy itself is typically considered part of the estate, even if the debtor is not an insured under the policy, because “the debtor retains certain contract rights under the policy itself.”¹ This is particularly true if the policy includes Coverage C, or “entity” coverage.² In these circumstances, the Bankruptcy Code’s stay of any act intended to obtain possession of the estate’s property requires directors and officers to obtain the court’s permission to receive any benefits otherwise due them under an insurance policy.³ The Code also may stay litigation pending against the directors and officers if a covered claim is asserted.

[Section 63:24]

¹How these provisions should be interpreted is not clear. TIG Specialty Ins. Co. v. Pinkmonkey.com Inc., 375 F.3d 365 (5th Cir. 2004); Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376 (D. Del. 2002).

²National Union Fire Ins. Co. of Pittsburgh, Pa. v. Brown, 787 F. Supp. 1424, 1429 (S.D. Fla. 1991), aff’d, 963 F.2d 385 (11th Cir. 1992).

³Township of Center, Butler County, Pa. v. First Mercury Syndicate, Inc., 117 F.3d 115, 71 Empl. Prac. Dec. (CCH) P 43913 (3d Cir. 1997); Harris v. Gulf Ins. Co., 297 F. Supp. 2d 1220 (N.D. Cal. 2003).

⁴Reliance Ins. Co. of Illinois v. Weis, 148 B.R. 575, 583 (E.D. Mo. 1992), aff’d in part, 5 F.3d 532 (8th Cir. 1993) (“there is no significant legal distinction between [the company] and the bankruptcy estate”); In re Buckeye Country-mark, Inc., 251 B.R. 835, 36 Bankr. Ct. Dec. (CRR) 177, 44 Collier Bankr. Cas. 2d (MB) 1107 (Bankr. S.D. Ohio 2000) (“Trustee brings his claims on behalf of the Debtor’s creditors rather than on behalf of the debtor making the exclusionary language inapplicable to the Trustee’s claims”).

[Section 63:25]

¹Matter of Edgeworth, 993 F.2d 51, 55, 29 Collier Bankr. Cas. 2d (MB) 306, Bankr. L. Rep. (CCH) P 75291 (5th Cir. 1993); First Fidelity Bank v. McAteer, 985 F.2d 114, Bankr. L. Rep. (CCH) P 75117 (3d Cir. 1993).

²In re Titan Energy, Inc., 837 F.2d 325, 329, 18 Collier Bankr. Cas. 2d (MB) 717, Bankr. L. Rep. (CCH) P 72183 (8th Cir. 1988); In re Minoco Group of Companies, Ltd., 799 F.2d 517, 519, 14 Bankr. Ct. Dec. (CRR) 1399, 15 Collier Bankr. Cas. 2d (MB) 1277 (9th Cir. 1986).

³11 U.S.C.A. § 362(a)(3); In re Medex Regional Laboratories, LLC, 314 B.R. 716, 43 Bankr. Ct. Dec. (CRR) 178, 52 Collier Bankr. Cas. 2d (MB) 1591 (Bankr. E.D. Tenn. 2004); In re Enron Corp., 2002 WL 1008240 (Bankr. S.D.

If the company purchased only Coverages A and B, courts are split as to what is property of the estate.⁴ The proceeds of the policy may not be property of the estate.⁵ Some courts have concluded that the policy is property of the estate, but the proceeds of the policy are not.⁶ Most recently, courts seem inclined to analyze the question on a case-by-case basis, considering the types of coverage provided, whether there is a priority of payment provision, the likely outcome of the bankruptcy, and the directors or officers alleged wrongdoing, if any.⁷

When a company has filed for bankruptcy protection, parties to any litigation against directors and officers are well-advised to consider whether the jurisdiction where the bankruptcy is pending has addressed ownership of director and officer policies and proceeds. The automatic stay typically will not enjoin litigation against nonbankrupt officers and directors, but it may imperil their right or ability to receive defense costs. Neither the insurer nor the officers and directors should move forward with litigation without first obtaining either relief from the automatic stay or a declaration that the policy is not an asset of the bankruptcy estate.

VI. PRACTICE AIDS

A. CHECKLISTS

§ 63:26 Checklist: director and officer liability checklist

- The defendant has a fiduciary duty to the plaintiff (§ 63:4).
- The plaintiff:
 - Sustained a special injury (§ 63:14);
 - Is suing derivatively (§ 63:16); or,
 - Is a creditor of a corporation insolvent or in the zone of

N.Y. 2002).

⁴In re Pintlar Corp., 124 F.3d 1310, 1314–1315, 31 Bankr. Ct. Dec. (CRR) 632, Bankr. L. Rep. (CCH) P 77530 (9th Cir. 1997) (not part of the estate); In re CyberMedica, Inc., 280 B.R. 12, 39 Bankr. Ct. Dec. (CRR) 215, 48 Collier Bankr. Cas. 2d (MB) 734 (Bankr. D. Mass. 2002) (policy is part of the estate).

⁵In re First Cent. Financial Corp., 238 B.R. 9, 34 Bankr. Ct. Dec. (CRR) 1210, 42 Collier Bankr. Cas. 2d (MB) 1410, Bankr. L. Rep. (CCH) P 77996 (Bankr. E.D. N.Y. 1999).

⁶In re Louisiana World Exposition, Inc., 832 F.2d 1391, 1399–1401, 17 Collier Bankr. Cas. 2d (MB) 1291, Bankr. L. Rep. (CCH) P 72124 (5th Cir. 1987); In re First Cent. Financial Corp., 238 B.R. 9, 16, 34 Bankr. Ct. Dec. (CRR) 1210, 42 Collier Bankr. Cas. 2d (MB) 1410, Bankr. L. Rep. (CCH) P 77996 (Bankr. E.D. N.Y. 1999).

⁷In re Adelphia Communications Corp., 285 B.R. 580, 591–592, 40 Bankr. Ct. Dec. (CRR) 123 (Bankr. S.D. N.Y. 2002), order vacated, 298 B.R. 49 (S.D. N.Y. 2003); In re Youngstown Osteopathic Hosp. Ass'n, 271 B.R. 544, 47 Collier Bankr. Cas. 2d (MB) 971 (Bankr. N.D. Ohio 2002); In re First Cent. Financial Corp., 238 B.R. 9, 34 Bankr. Ct. Dec. (CRR) 1210, 42 Collier Bankr. Cas. 2d (MB) 1410, Bankr. L. Rep. (CCH) P 77996 (Bankr. E.D. N.Y. 1999); In re Leslie Fay Companies, Inc., 207 B.R. 764 (Bankr. S.D. N.Y. 1997).

- insolvency (§ 63:9).
- The defendant breached his fiduciary duty by:
 - Failing to act diligently and prudently in managing the corporation's affairs (§ 63:5);
 - Failing to pay attention and to inform himself about the corporation's affairs (§ 63:5);
 - Failing to exercise reasonable and independent judgment in conducting the corporation's affairs (§ 63:5);
 - Self-dealing (§ 63:6);
 - Appropriating for personal benefit a business opportunity belonging to the corporation (§ 63:6);
 - Entrenching himself within the corporation's management structure (§ 63:6); or,
 - Failing to disclose material information (§ 63:7).
 - The business judgment rule does not apply (§ 63:8).
 - The defendant did not:
 - Disclose his conduct to the corporation for authorization and ratification, if appropriate (§ 63:11); or,
 - Otherwise comply with an applicable statute governing such situations (§ 63:11).
 - The defendant's breach of fiduciary duty caused harm to the corporation or the plaintiff.

B. SAMPLE COMPLAINTS

§ 63:27 Generally

The Delaware Corporate Law Clearinghouse (<http://corporate-law.widener.edu>) offers free access to selected filings and opinions in the Delaware Court of Chancery. On that website, one can search and review a database of complaints and briefs. Complaints and other filings in various high-profile corporate scandals are available for free at other sites on the web, such as www.findlaw.com.

Following are two sample complaints prepared for this volume by the authors. They are based on imaginary, but typical, factual scenarios.

§ 63:28 Form: defalcation complaint

[Insert caption]

COMPLAINT

Plaintiff, Corporation, Inc., by its undersigned counsel, for its complaint against Defendant Director, makes the following allegations, upon information and belief:

1. Plaintiff Corporation, Inc., is a Pennsylvania corporation, with its principal place of business at 300 Main Street, Philadelphia, Pennsylvania.
2. Defendant Director is a citizen and resident of Florida.
3. The Court has jurisdiction over this action based on diversity of citizenship pursuant to 28 U.S.C.A. § 1332.

4. Venue is proper in this District because Corporation regularly conducts business in this District and Director regularly attended meetings in this District.

5. In September 1990, Director became Chairman and Chief Executive Officer of Corporation.

6. Director's level of compensation increased each year thereafter, ultimately rising to over \$1 million per year. In addition, Director received over \$20 million in stock grants.

7. At all times from 1980 through 2002 (when Director resigned), Director owed Corporation the fiduciary duties of honesty, good faith, care, and loyalty.

8. Director was obligated to pursue and to protect the interests of Corporation and its shareholders to the exclusion of his own interests. Director was also obligated to advise the Board promptly if his own interests ever conflicted with the interests of the Corporation.

9. Notwithstanding his duties and obligations to the Corporation, or his remuneration, Director engaged in a pattern of conduct replete with conflicts of interest, self-dealing and self-enrichment, taking advantage of Corporation's assets and harming both Corporation and its shareholders.

10. [provide details regarding defalcations, theft of corporate opportunities, self-dealing, etc.]

11. The conduct detailed above constituted a breach of the fiduciary duties that every corporate officer and director owes to the corporation.

12. By virtue of these breaches of the fiduciary duty of loyalty, Corporation has been damaged.

13. Corporation has no adequate remedy at law.

COUNT I BREACH OF FIDUCIARY DUTY

14. Plaintiff incorporates by reference the preceding paragraphs as if fully set forth herein.

15. As Chairman and Chief Executive Officer of Corporation, Director owed strict fiduciary duties to Corporation. He was required at all times to act honestly and in good faith, with a view towards the best interests of the Corporation. He was also required to exercise the care, diligence, and skill that a reasonably prudent person would exercise in the same or similar circumstances.

16. Director breached his duties to Corporation in many ways, including by:

- a. failing to disclose material facts;
- b. failing to inform the Board of actions he had taken;
- c. misappropriating funds and assets;

17. As a proximate result of Director's breaches of his fiduciary duties, Corporation suffered and continues to suffer substantial damages.

18. Director's conduct was willful, wanton, and intentional, and constituted a gross abuse of his position as fiduciary to Corporation.

WHEREFORE, Corporation respectfully requests that the Court enter judgment in its favor and against Director, and award compensatory, consequential, and punitive damages, and disgorgement of all compensation and benefits received during the course of his breaches, and such other and further relief, including interest, costs, and attorney's fees, as the Court deems just and proper.

COUNT II ACCOUNTING

19. Plaintiff incorporates by reference the preceding paragraphs as if fully set forth herein.

20. As Chairman and Chief Executive Officer of Corporation, Director owed strict fiduciary duties to Corporation. He was required at all times to act honestly and in good faith, with a view towards the best interests of the Corporation. He was also required to exercise the care, diligence, and skill that a reasonably prudent person would exercise in the same or similar circumstances.

21. Director breached his fiduciary duties to Corporation.

22. Director profited from his breach of duty.

23. Director commingled funds he received as a result of his breach of duty with his personal funds.

24. Because he is a fiduciary of Corporation, Director must account to Corporation for funds he received during the course of his employment.

WHEREFORE, Corporation respectfully requests that the Court enter judgment in its favor and against Director, and order Director to account for all amounts received from Corporation as compensation or otherwise, and such other and further relief as the Court deems just and proper.

COUNT III CONSTRUCTIVE TRUST

25. Plaintiff incorporates by reference the preceding paragraphs as if fully set forth herein.

26. As Chairman and Chief Executive Officer of Corporation, Director owed strict fiduciary duties to Corporation. He was required at all times to act honestly and in good faith, with a view towards the best interests of the Corporation. He was also required to exercise the care, diligence, and skill that a reasonably prudent person would exercise in the same or similar circumstances.

27. For the reasons set forth above, Director was a disloyal fiduciary, who used and abused his position of trust to his own substantial profit.

28. For the foregoing reasons, Director is deemed to hold the

funds he has wrongfully received in constructive trust for Corporation.

WHEREFORE, Corporation respectfully requests that the Court enter judgment in its favor and against Director, and impose a constructive trust on all funds received by Director, from Corporation, both authorized and unauthorized, proper and improper, during the course of Director's improper conduct, and such other and further relief as the Court deems just and proper.

§ 63:29 Form: entrenchment complaint

[Insert caption]

COMPLAINT

Plaintiff, Shareholder, by his undersigned counsel, for his complaint against Defendant Directors, makes the following allegations, upon information and belief:

1. Plaintiff Shareholder brings this action derivatively, on behalf of Corporation, against Directors.
2. Plaintiff owns, and owned at all relevant times, shares of Corporation.
3. Defendant Corporation is incorporated in Delaware.
4. Defendant Directors are directors of Corporation.
5. At all times, Directors acted as a collective entity.
6. Directors, as officers and/or directors of Corporation, owed fundamental fiduciary duties of care, loyalty, candor and good faith to Corporation and its shareholders.

JURISDICTION AND VENUE

7. [Describe basis for jurisdiction].
8. [Describe basis for venue].

DERIVATIVE ALLEGATIONS

9. Shareholder brings this action pursuant to Rule 23.1 of the Federal Rules of Civil Procedure on behalf of Corporation.
10. This action is appropriate as a derivative action because [see Chapter 17 "Derivative Actions by Stockholders" (§§ 17:1 et. seq.) for specific discussion of Rule 23.1 and the allegations necessary to maintain a derivative action].

FACTUAL BACKGROUND

11. On January 1, 2005, Corporation announced a \$50 million stock-for-stock merger agreement with Other Corporation. As part of the agreement Directors were guaranteed positions as directors of Other Corporation.
12. Shortly thereafter, Alternative Bidder Corporation announced its own superior \$100 million merger proposal, which would pay a significant premium to Corporation shareholders, but did not guarantee any positions for Directors.
13. Since the public announcement of the competing bids, the price of Alternative Bidder's stock has gone from \$10.00 per share to \$14.00 per share, while the price of Other Corporation's shares

has dropped from \$20.00 per share to \$16.00 per share, thereby making Alternative Bidder Corporation's proposal even more superior to Other Corporation's proposal.

14. In violation of their fiduciary obligations to act in the best interests of Corporation's shareholders, the directors of Corporation have placed formidable obstacles in the path of Alternative Bidder's proposal.

15. In the Fall of 2004, Corporation entered into a series of confidential negotiations and agreements in anticipation of the merger. Under the agreements, if the merger is terminated, Corporation will owe Other Corporation significant amounts of money as a termination fee and will lose intellectual property rights related to jointly-developed products. In addition, Corporation granted Other Corporation an option to acquire 20% of Corporation's common stock in the event the merger is terminated.

16. Directors knew when they entered into these agreements that Alternative Bidder was preparing a proposal to merge with Corporation.

17. Indeed, two Alternative Bidder directors had a specific and serious discussion with Directors about the imminent proposal.

18. Other Alternative Bidder representatives made repeated overtures and advances to Directors.

19. Directors went to great lengths not to inform themselves about Alternative Bidder's proposal.

20. Directors not only rebuffed Alternative Bidder's directors, they further expedited the agreements with Other Corporation. Directors also included in the agreements with Other Corporation the severe penalties that would take effect if Corporation failed to merge with Other Corporation.

21. The provisions are intended to coerce the shareholders of Corporation into approving the merger with Other Corporation.

22. These extreme and improper defensive mechanisms unlawfully prohibit Corporation's shareholders from giving full and fair consideration to Alternative Bidder's merger proposal.

23. Directors' motivation was to entrench themselves and to preserve the benefits of their position.

24. Indeed, during the discussions between Directors and the directors of Alternative Bidder, Directors specifically asked about the role they would have with Alternative Bidder, should Corporation merge with Alternative Bidder. When the directors of Alternative Bidder said their roles would be discussed "later," Directors made clear that they would only merge with another company if they were guaranteed significant roles in advance of the proposed merger.

25. Plaintiff seeks temporary, preliminary, and permanent injunctive relief preventing implementation of the merger.

26. Plaintiff has no adequate remedy at law.

27. If the merger is not enjoined Corporation's shareholders

will suffer irreparable harm.

COUNT I

Breach of Fiduciary Duty

28. Plaintiff incorporates the above as if fully set forth herein.

29. The actions set forth above constitute a breach of Directors' fiduciary duty to Corporation and its shareholders.

30. By not properly informing themselves of other bids, not seeking an auction, and taking improper defensive measures, defendants have breached their duty of loyalty.

31. Directors' plan to entrench themselves in office is a breach of their duty of loyalty.

32. By the plan, Directors have damaged and continue to damage Corporation and its shareholders.

33. Unless enjoined by this Court, Directors will continue their breach of fiduciary duty and will succeed in their plan.

34. Plaintiff has no adequate remedy at law.

WHEREFORE, Plaintiff respectfully requests judgment in his favor, against Directors and Corporation, as follows:

- a. Declaring Directors breached their fiduciary duty to Corporation;
- b. Awarding compensatory damages for the breach of fiduciary duty;
- c. Awarding any and all just and proper equitable relief, including temporarily, preliminarily and permanently enjoining Corporation from merging with Other Corporation;
- d. Awarding plaintiff his reasonable attorney's fees, expert fees, and other reasonable costs and expenses; and,
- e. Granting such other relief as the Court deems just and proper.

C. JURY INSTRUCTIONS

§ 63:30 Generally

Rule 39 of the Federal Rules of Civil Procedure allows a jury trial where the right exists under the Constitution or some other federal statute. The Seventh Amendment guarantees the right to a jury trial only for "suits at common law." It does not apply to cases in equity.¹

In federal court, whether a claim is legal or equitable is determined by federal law, even if the cause of action is created by state law.² "The general rule is that actions for breach of fiduciary duty, historically speaking, are almost uniformly actions in

[Section 63:30]

¹Gartenberg v. Merrill Lynch Asset Management, Inc., 487 F. Supp. 999, 1001 n.1, Fed. Sec. L. Rep. (CCH) P 97315, 29 Fed. R. Serv. 2d 439 (S.D. N.Y. 1980).

²Simler v. Conner, 372 U.S. 221, 222, 83 S. Ct. 609, 9 L. Ed. 2d 691, 6 Fed. R. Serv. 2d 803 (1963).

equity—carrying with them no right to trial by jury.”³ Further, the Delaware Court of Chancery handles enormous numbers of lawsuits related to Delaware corporations—including director and officer breach of fiduciary duty cases—without trial by jury.

Nonetheless, there are occasions when director and officer cases reach a jury. Following are sample instructions.

§ 63:31 Jury instruction: elements of breach of fiduciary duty

Plaintiff has alleged that the defendant breached his fiduciary duties. To recover on this claim, the plaintiffs must prove all of the following propositions:

- (1) a fiduciary duty existed between plaintiff and defendant;
- (2) defendant breached the fiduciary duty;
- (3) the breach of the fiduciary duty was a proximate cause of damage to the plaintiff; and
- (4) the amount of the damage.

If plaintiff fails to prove any of these propositions, the plaintiff cannot recover damages. If the plaintiff proves all of these propositions, the plaintiffs is entitled to recover damages in some amount.¹

§ 63:32 Jury instruction: duties of directors and officers

Directors and officers of a corporation are entrusted with the management of the corporation’s business and property for the benefit of all the shareholders. As such, they owe fiduciary duties of care, good faith, and loyalty to each other and to the corporation. This fiduciary duty constitutes an agreement to “honestly and diligently direct the business of the corporation.”

If you find that the directors breached any of these duties, you shall find for the plaintiff.¹

§ 63:33 Jury instruction: business judgment rule

A director, to fulfill the requisite duty of care under the business judgment rule, must:

³Pereira v. Cogan, 2002 WL 989460 (S.D. N.Y. 2002), at *3 (internal quotations omitted), citing, In re Evangelist, 760 F.2d (1st Cir. 1985) and In re Lands End Leasing Inc., 193 B.R. 426 (Bankr. D.N.J. 1996); see also In re Crowe Rope Industries, LLC, 307 B.R. 1, 5 (Bankr. D. Me. 2004).

[Section 63:31]

¹Hoselton v. Metz Baking Co., 48 F.3d 1056, 1063 n.10, 41 Fed. R. Evid. Serv. 987 (8th Cir. 1995); Shields v. Cape Fox Corp., 42 P.3d 1083, 1089 n.13 (Alaska 2002).

[Section 63:32]

¹Shields v. Cape Fox Corp., 42 P.3d 1083, 1089 n.13 (Alaska 2002); AMERCO v. Shoen, 184 Ariz. 150, 907 P.2d 536, 542–547 (Ct. App. Div. 1 1995), corrected, (Aug. 29, 1995); Long v. Lampton, 324 Ark. 511, 922 S.W.2d 692, 698 (1996).

(1) not have an undisclosed personal financial interest in the transaction that is the subject of the director's business judgment;

(2) be informed about the subject of the business judgment to the extent the director reasonably believes to be appropriate under the circumstances, and such belief must be rational; and

(3) rationally believe that the director's business judgment is in the best interest of the corporation.

The plaintiff, who is challenging the conduct of the director of a corporation, must prove that the director did not exercise the proper business judgment. And, consequently, you must find that defendants fulfilled their duty of care unless plaintiff proves:

(a) that the defendants have an undisclosed personal financial interest in the transaction that is the subject of their business judgment;

(b) that defendants were not informed about the subject of the business judgment to the extent that they reasonably believed to be appropriate under the circumstances;

(c) that they did not rationally believe that such business judgment was in the best interest of the corporation; or

(d) that no business judgment was, in fact, exercised.¹

[Section 63:33]

¹Navellier v. Sletten, 262 F.3d 923, 946, Fed. Sec. L. Rep. (CCH) P 91520, 50 Fed. R. Serv. 3d 559 (9th Cir. 2001).

