

# Delaware Corporate

COMMENTARY

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## Delaware Decision in *Disney* Sets Forth Parameters for Duty of Good Faith

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On June 8 the Delaware Supreme Court issued its long anticipated decision in *In re Walt Disney Co. Derivative Litigation*<sup>1</sup> and for the first time defined the parameters of the duty of good faith. The Supreme Court affirmed in all respects the trial court's decision holding that, *inter alia*, the Disney directors did not breach their fiduciary duties in connection with their approval in 1995 of an employment agreement between the company and Michael Ovitz.

That agreement permitted Ovitz to receive a \$140 million severance payment just 14 months after he joined Disney. Despite finding that the directors' conduct in reviewing and approving the employment agreement with Ovitz fell short of the "best practices of ideal corporate governance,"<sup>2</sup> the trial court nonetheless concluded that the Disney directors "did not act in bad faith and were at most ordinarily negligent," which is insufficient to support a claim under Delaware law.<sup>3</sup>

The Supreme Court also held that the lower court's "factual findings and legal rulings were correct and not erroneous in any respect."<sup>4</sup>

The aspect of the high court's decision that is most notable, though, is not the court's analysis of the trial court's ruling. Rather, it is the Supreme Court's digression into an area of Delaware law that had been plagued in recent years by some uncertainty and controversy. Historically, the fiduciary duties owed by officers and directors to the corporations they serve were understood to be the dual duties of loyalty and due care.<sup>5</sup> The Delaware Supreme Court has long defined the fiduciary duty of loyalty in "these strict and unyielding terms":

Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. ... A public policy,

existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest.<sup>6</sup>

Delaware courts have held that misconduct that rises to the level of gross negligence constitutes a breach of the duty of care.<sup>7</sup> "The fiduciary duty of due care requires that directors of a Delaware corporation 'use that amount of care which ordinarily careful and prudent men would use in similar circumstances,' and 'consider all material information reasonably available' in making business decisions."<sup>8</sup>

In its 1993 decision in *Cede & Co. v. Technicolor Inc.*,<sup>9</sup> however, the Delaware Supreme Court began to refer to a "triad" of fiduciary duties governing the conduct of officers and directors: the duty of loyalty, the duty of care and the duty of good faith.<sup>10</sup> Despite referring in this and subsequent cases to the existence of a duty of good faith separate and apart from the duty of loyalty and duty of care, the court never discussed the distinct parameters of that duty of good faith.<sup>11</sup>

Over the past several years lower courts and commentators have questioned whether the duty of good faith is a

stand-alone duty or whether it is a subsidiary duty encompassed within the two other duties of loyalty and care. For example, a director who acts disloyally clearly also is acting in bad faith. But is a director who acts with gross negligence — in other words, in breach of the duty of care — necessarily also in breach of the duty of good faith? As one court observed:

There might be situations when a director acts in subjective good faith and is yet not loyal (e.g., if the director is interested in a transaction subject to the entire-fairness standard and cannot prove financial fairness), but there is no case in which a director can act in subjective bad faith towards the corporation and act loyally. ... For example, one cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey.<sup>12</sup>

The trial court in *Disney* thus recognized that “[d]ecisions from the Delaware Supreme Court and the Court of Chancery are far from clear with respect to whether there is a separate fiduciary duty of good faith,” candidly describing those decisions as creating a “fog” of “hazy jurisprudence.”<sup>13</sup> After review of this “hazy jurisprudence,” the trial judge applied the following standard for a breach of the duty of good faith:

[T]he concept of *intentional dereliction of duty*, a *conscious disregard for one’s responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.<sup>14</sup>

The Delaware Supreme Court upheld the trial court’s definition “as a legally appropriate, although not the exclusive, definition of fiduciary bad faith.”<sup>15</sup> Nonetheless, recognizing that “the duty to act in good faith ... to date is not a well-developed area of our corporate fiduciary law,” the Supreme Court in *Disney* decided to provide “some conceptual guidance to the corporate community” on the subject.<sup>16</sup>

The court did so primarily by exploring different scenarios to illustrate directorial conduct on both sides of the good-faith/bad-faith divide. First, the court observed that “conduct motivated by an actual intent to do harm” is a “quintessential” breach of the duty of good faith.<sup>17</sup> Conduct “at the opposite end of the spectrum,” *i.e.*, “action taken solely by reason of gross negligence and without any malevolent intent,” is not a breach of the duty of good faith.<sup>18</sup>

Next, the court noted that while “issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty,” in the “pragmatic, conduct-regulating legal realm which calls for more precise conceptual line-drawing, the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith.”<sup>19</sup>

This, the court explained, is significant because Delaware law distinguishes between good- and bad-faith breaches of the duty of care in applying the exculpation provisions of Section 102(b)(7)<sup>20</sup> limiting the personal liability of the director and the indemnification provisions of Section 145<sup>21</sup> of the Delaware General Corporation Law. Thus, exculpation and indemnification may be available if a director has committed grossly negligent misconduct, but it was not done in bad faith.

Finally, the court confirmed that a conscious disregard of directorial duties — the formulation applied by the trial court — clearly is an act of bad faith, not just a breach of the duty of care, and thus outside the scope of protection offered by Section 102(b)(7) and, potentially, Section 145.<sup>22</sup>

The Supreme Court’s central point is thus:

[T]he universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (*i.e.*, preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. *A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.*<sup>23</sup>

The Supreme Court’s decision in *Disney* puts to rest any doubt regarding the existence of the separate duty of good faith in Delaware corporate-governance jurisprudence. It is safe to assume that shareholder plaintiffs will redouble their efforts to expand liability under this element in order to, among other things, avoid the potentially dispositive effect of exculpation from liability under Section 102(b)(7).

## Notes

- <sup>1</sup> *In re Walt Disney Co. Derivative Litig.*, \_\_\_ A.2d \_\_\_, 2006 WL 1562466 (Del. June 8, 2006).
- <sup>2</sup> *In re Walt Disney Co. Derivative Litig.*, No. Civ. A. 15452, 2005 WL 2056651, at \*1 (Del. Ch. Aug. 9, 2005).
- <sup>3</sup> *Id.* at \*39.
- <sup>4</sup> *Disney*, 2006 WL 1562466, at \*1.
- <sup>5</sup> See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).
- <sup>6</sup> *Disney*, 2005 WL 2056651, at \*33 (quoting *Guth*, 5 A.2d at 510).
- <sup>7</sup> *Id.* at \*32.
- <sup>8</sup> See *id.* (citing *Brehm v. Eisner*, 746 A.2d 244, 259 [Del. 2000]; *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 [Del. 1963]).
- <sup>9</sup> *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345 (Del. 1993).
- <sup>10</sup> See *id.* at 361.
- <sup>11</sup> See, e.g., *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998); *Cinerama Inc. v. Technicolor Inc.*, 663 A.2d 1156, 1179 (Del. 1995).
- <sup>12</sup> *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).
- <sup>13</sup> *Id.* at \*35.
- <sup>14</sup> *Id.* at \*36 (footnotes omitted).
- <sup>15</sup> *Disney*, 2006 WL 1562466, at \*27.
- <sup>16</sup> *Id.* at \*24.
- <sup>17</sup> *Id.* at \*25.
- <sup>18</sup> *Id.*
- <sup>19</sup> *Id.*

<sup>20</sup> Del. Code Ann. tit. 8, § 102(b)(7). Section 102(b)(7) of the Delaware General Corporation Law provides, in pertinent part: "(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters: ... (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law; ... or (iv) for any transaction from which the director derived an improper personal benefit" (emphasis added).

<sup>21</sup> Del. Code Ann. tit. 8, § 145. Section 145 of the Delaware General Corporation Law permits a corporation to indemnify officers and directors who are parties to litigation arising from their conduct on behalf of the corporation for damages, settlements and defense costs "actually and reasonably incurred by the person in connection with such action, suit or proceeding if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation." *Id.* § 145(a) (emphasis added); accord *id.* § 145(b).

<sup>22</sup> *Disney*, 2006 WL 1562466, at \*26.

<sup>23</sup> *Id.* (emphasis added).

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