Message from the Chair

Dear Task Force Members:

We are pleased to provide you the second edition of our Task Force Newsletter. Special thanks to Professor Eric Gouvin for taking the lead on pulling together the materials for this edition. We look forward to seeing you at the Spring Meeting in Tampa. The Task Force will meet on Friday, April 7, 2006 at 4:30 pm and will be joined by John Keogh, President and CEO of National Union Fire Insurance Company of Pittsburgh, PA, who will be discussing D & O insurance coverage.

Amy L. Goodman,
Peter J. Walsh, Jr.
Co-Chairs
Task Force on Director and Officer Liability

Featured Articles

Disney Decided

In case you've been living in a cave since mid-summer, we report to you that the Delaware Chancery Court handed down the decision in the Disney (Michael Ovitz employment and termination) litigation in early August. In re Walt Disney Co. Derivative Litigation, Del. Ch. C.A. No. 15452, 8/9/05. As you probably know, the directors were found not to be liable for the transaction involving the hiring and subsequent termination of employment of Michael Ovitz. The court's opinion, however, is full of language excoriating the board of directors for failure to be vigilant. It is also interesting to note that the Chancellor observed that the directors' action must be evaluated in the context of the time in which they were acting -- the mid 1990s -- and that boards acting in the post-Enron, post-Sarbanes-Oxley era may likely be judged by the norms of behavior prevailing in this time. Nevertheless, the decision reaffirms the "wide latitude" that Delaware law affords to director decisions made in good faith even when the directors' degree of diligence and care falls "significantly short of the best practices of ideal corporate governance."

This is not to say that directors automatically get the protection of the business judgment rule in every case. The decision makes clear that directors must make good faith efforts to inform themselves of "all material information reasonably available to them" in order to retain the protections of the business judgment rule. The case is currently on appeal. An interesting blog providing quality commentary on this case can be found at: http://www.theconglomerate.org/conglomerate_forum_disney/index.html.

Black Day for Hollinger Directors

On December 15, 2005 the New York Times reported that the Securities and Exchange Commission has notified three current and former directors of Hollinger International Inc. that they may...
be sued personally by the SEC in an enforcement action for failing to spot fraud that Conrad Black and other senior executives of the newspaper company are suspected of committing. The directors made up the Audit Committee at the time Black and other parties are alleged to have fleeced the company. If the SEC does file a civil suit against the three directors, it would be an unusual attempt to hold independent directors to account for not being vigilant enough about a suspected fraud. None of the three directors who were put on notice by the SEC received any of the money from the fraudulent activities.

On a related note, Deputy Director of the SEC division of Enforcement, Peter Bresnan, was reported to have said on December 13, 2005 that the division is recommending that the agency bring actions against outside directors in cases pending on the agency's calendar. BNA Corporate Accountability Report, Vol. 3, No. 48, p. 1220 (Dec. 16, 2005). With regard to outside directors, Bresnan is quoted as saying that directors will be pursued when he or she "has taken no care in ensuring the accuracy of the statement [he or she] make[s]."

Delaware Case Extends Duty of Directors to Creditors to the LLC Context

A lawsuit by minority equityholders in an insolvent LLC against its directors was unsuccessful in imposing liability on the directors for failing to place equityholder interests first when the LLC eventually was sold to creditors. In Blackmore Partners L.P. v. Link Energy LLC, No. 454-n, 2005 WL 2709639 (Del. Ch. Oct. 14, 2005), the court ruled that the focus of the duty of the directors of Link Energy LLC shifted from owners to creditors when the company slipped into the "zone of insolvency." Therefore, the members of the LLC's board of directors were not liable to the LLC's equity holders for the company's sale in which the creditors got the entire company and the equityholders received nothing. Vice Chancellor Stephen Lamb said if Link truly was insolvent, the directors had no duty to balance the interests of creditors and owners.

Indemnification of Expenses and the Clean Hands Defense

In December 2005, in an appeal from a final judgment entered by the Court of Chancery, the Supreme Court of Delaware recognized a novel "unclean hands" defense to an action for advancement of legal expenses, but also let stand the lower court's restriction on the scope of inquiry permitted to establish the defense. In Homestore, Inc. v. Tafeen, --- A.2d ----, 2005 WL 3091887 (Del.Supr.), Homestore, a Delaware corporation with a bylaw provision requiring mandatory advancement of costs for legal defense under Delaware General Corporation Law Section 145(e), balked at advancing legal and other costs in defense of Tafeen, an officer of the corporation. To justify its refusal, Homestore invoked the equitable defense of "unclean hands." Homestore grounded its unclean hands argument not on the conduct alleged in the underlying proceedings, but rather on what it claimed were Tafeen's attempts to shield his personal assets so he could avoid satisfying his obligation to repay advanced funds if called upon to do so. As evidence of Tafeen's plan to secret away his assets the company claimed Tafeen purchased millions of dollars worth of real property in Florida, where debtor-friendly "homestead" laws protect residential real estate from attachment by creditors.

In an earlier proceeding, the Court of Chancery acknowledged that Homestore's allegations, if proven, would support application of the unclean hands doctrine to deny advancement. Based on an
information and belief affidavit submitted by Homestore’s general
counsel, the Court of Chancery had concluded at that time that
"there [were] sufficient factual disputes surrounding [Homestore’s]
unclean hands defense . . . to warrant development of a more
complete record." In later proceedings the Court of Chancery
limited Homestore’s discovery in connection with the unclean
hands defense “to its allegation that Tafeen purchased his home
in Florida with the intent to shelter assets from Homestore”
because that was the only conduct that Homestore alleged in
connection with its defense.

During July 2004, the Court of Chancery conducted a trial. On
October 27, 2004, a post-trial opinion was issued. After reviewing
the evidence and the credibility of the witnesses, the Court of
Chancery rejected Homestore’s unclean hands defense, holding
that “[n]o credible proof adduced at trial . . . demonstrate[d] by a
preponderance of the evidence that Tafeen intended to shelter
assets from potential creditors, whether Homestore or others.”
More motions and disputes led to the appointment of a special
master to determine the appropriate amount of fees and expenses
to be awarded. The Special Master filed a Final Report in
February, 2005, Homestore filed its exceptions to that Report in
March and the Court of Chancery entered its Final Order and

In reviewing Homestore’s appeal, the Supreme Court upheld the
Court of Chancery’s handling of all the defenses raised, including
the unclean hands defense, in doing so laying out a strong policy
position in favor of indemnification and advancement provisions.
The Supreme Court found that the Court of Chancery’s rejection of
the unclean hands theory was not error and that the limitations
placed on the discovery were appropriate. And, it was probably a
good thing that Tafeen got indemnification. Earlier, the Ninth
Circuit had rescinded Homestore’s D&O policy "as to all insured"
because of material misrepresentations on the insurance
application by the former CFO who signed the application. Federal
Insurance Co. v. Homestore, Inc., F.3d (No. 03-55995), (9th Cir.,
August 12, 2005).

And In Case You Didn’t Get It In Disney, It’s Process, Process, Process

The Disney directors spent 37 days in trial basically because they
did not have a good set of minutes to prove what they had done
on the front end. Judge Chandler came back in December and
underscored the importance of process in In re Tele-
Communications, Inc., C.A. No. 16470 (Del. Ch., December 21,
2005). In TCI, a special committee was formed to consider a
proposed merger involving two series of common stock and a
premium to be received by the "high vote" stock relative to the
"low vote" stock. Invoking the "entire fairness" standard, the Court
concluded that the creation and operation of the special
committee failed to shift the burden of proof back to the plaintiffs
and that the standard was not met because, among other things:

- At lease one committee member was interested in the
  transaction and, therefore, was not independent.
- The special committee’s compensation was not set in
  advance and appeared to the Court to be "suspiciously
  contingent" on the outcome
- The special committee lacked a clear mandate
- The special committee did not retain separate legal and
  financial advisors
- The financial advisor failed to address the fairness of the
  premium paid the "high vote" shares relative to the "low
  vote" shares
There was a lack of arms’ length bargaining as a result of the foregoing factors.

While TCI is at this stage is still in pretrial proceedings, the decision is yet another wake up call of the importance of proactively designing and implementing effective processes for a special committee when one is warranted. The TCI directors now face the same fate as the Disney directors - a lengthy trial to demonstrate that they fulfilled their fiduciary obligations. That’s the purpose of board (and certainly special committee) processes. directors now face the same fate as the