**Director and Officer Liability**

### A Brief Review of 2006 and Preview of 2007

Here are some developments since the last issue was distributed in early 2006 that might deserve your attention:

**Disney, Again**

If you are receiving this newsletter you must already know that last summer the Delaware Supreme Court unanimously affirmed the Court of Chancery's August 9, 2005 judgment in *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27 (Del.Supr. 2006) dismissing all claims in a plaintiffs' derivative action against Michael Eisner and other current or former directors of The Walt Disney Company. The 91-page opinion by Justice Jacobs found that the record supported the determination that the defendants met their fiduciary obligations. The Court took the opportunity to expound on the duty of good faith and the opinion is required reading for that reason, among others. Much ink has been spilled on this topic already, so we shall not belabor it here. Other cases noted below, however, also seem in one way or another to address the duty of director good faith, so it seems to be in the minds of the justices.

**Two Options Cases Raise Issues for Directors**

In February 2007, Chancellor Chandler delivered two opinions declining to dismiss complaints alleging inappropriate manipulation of options. In *Ryan v. Gifford*, 2007 WL 416162 (Case No. 2213-N), the corporation allegedly backdated options for top executives. Citing Delaware's interest in deciding important new issues of corporate law, the Chancellor refused to put the Delaware case on hold even though there are pending federal cases dealing with the same matter in California. In denying the motion to dismiss, the Chancellor noted that the case has serious implications for the duty of good faith. In pointed words, Chancellor Chandler said: "I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith." As Delaware continues to add gloss to the concept of the "duty of good faith," this opinion provides another example of the idea.

*In re Tyson Foods*, 2007 WL 416132 (Case No. 1106-N), the Chancellor addressed so-called "spring-loading" options in the context of a complicated multi-faceted lawsuit alleging self-dealing and challenging several components of an executive compensation plan. The allegations of "spring-loading" options involve options that were issued in anticipation of news the directors believed would push up Tyson's stock price. Chancellor Chandler did not grant the motion to dismiss the action against the director members of the compensation committee that granted the spring loading options. Again, in pointed words Chancellor Chandler indicated the Court's deep concern with the Board's actions. The opinion notes that it would be "difficult to conceive of an instance, consistent with the concept of loyalty and good faith, in which a fiduciary may declare that an option is granted at 'market rate' and simultaneously withhold that both the fiduciary
and the recipient knew at the time that those options would quickly be worth much more." (emphasis in original). The opinion also provided guidance for what the plaintiff would have to prove at trial and covered other topics relating to the overall action.

**Director Oversight Duties After Caremark**

In late 2006, the Delaware Supreme Court issued an en banc decision in *Stone v. Ritter*, 911 A.2d 362 (Del.Supr. 2006), a derivative action implicating directors’ duty to oversee corporate compliance. Specifically, the derivative plaintiff stockholders alleged that the defendant directors of AmSouth failed to implement effective reporting systems and internal compliance monitoring and thereby failed to detect fraudulent activity within the organization which ultimately led to about $50 million in liability for the corporation.

The Supreme Court affirmed the Court of Chancery’s decision to dismiss the action and in its opinion provided some additional guidance on the evolving duty of good faith and its relation to the more familiar duty of loyalty. The en banc decision was based on principles articulated in both *Caremark* and the *Disney* decision handed down earlier in the year. The Court pointed out that a "sustained or systematic failure of the board to exercise oversight -- such as an utter failure to attempt to assure [that] a reasonable information and reporting system exists" could be sufficient to show that a board lacked good faith and could give rise to a finding of director liability.

Having recognized the possibility of liability in the abstract, the Supreme Court went on to explain why the case before it was not one where liability should be imposed. The opinion helpfully clarified the role of the "duty of good faith" by saying that "although good faith may be described colloquially as part of a 'triad of fiduciary duties that includes the duties of care and loyalty,' the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly." The Court went on to say as a matter of Delaware corporate doctrine "the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith."

The Court made quite clear that Caremark continues to be good law in Delaware, saying "[w]e hold that Caremark articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations."

One important lesson from the case seems to be that a plaintiff must do more than just "equate a bad outcome with bad faith." That strategy alone will fall short of the obligation to allege "particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities." The successful plaintiff's pleadings will have to show "red flags" that establish the board is aware that the corporation's compliance mechanisms and reporting structure are inadequate, that those inadequacies have resulted in illegal
activity, and that the board chose to do nothing about problems it never knew existed. The court noted that claims of this type are "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win judgment."

Majority Shareholder's Conduct Creates Liability for Directors

Although many of us tend to focus on statutory and decisional law that creates liability for directors and officers, it is important to remember that in heavily regulated industries like banking liability may be imposed by regulatory action as well. In ATR-Kim Eng Financial Corp. v. Araneta, 2006 WL 3783520 (Del.Ch. 2006), the Delaware Court of Chancery characterized the directors as "mere tools" of the majority shareholder and imposed liability on them for failing to carry out their duty to protect minority shareholders from the actions of the majority shareholder. The opinion details how the majority shareholder, Araneta, essentially looted the company while the other directors stood idly by. In Vice Chancellor Strine's words, "[a]lthough it was Araneta who ran amok by emptying the Delaware Holding Company of its major assets, the other directors did nothing to make themselves aware of this blatant misconduct or to stop it. Put in plain terms, it is no safe harbor to claim that one was a paid stooge for a controlling stockholder." The abuse was so blatant the Vice Chancellor even allowed the shifting of attorneys' fees.

Federal Reserve Issues Lifetime Ban to Missouri Bank Director

Although many readers of this newsletter focus their attention on legislative actions and judicial opinions that can affect director and office liability, it is important to remember that in highly regulated industries such as banking there exists the possibility of regulatory liability as well. As a case in point, consider the matter of Perry D. Lake, the former president, CEO and director (i.e. a former "Institution-Affiliated Party" in the language of bank regulators) of Exchange Bank of Missouri, Fayette, Missouri. On February 1, 2007, the Federal Reserve Board announced that it had issued an Order of Prohibition against Mr. Lane. The Order is available on the Federal Reserve Board's website at: http://www.federalreserve.gov/boarddocs/press/enforcement/2007/20070201/attachment.pdf

Although specifics were lacking, the Order was based on allegations that Lane violated the law, engaged in unsafe and unsound banking practices, and breached his fiduciary duty in connection with reports to "the bank's management and board of directors of the delinquency status and other information concerning borrower's loans, and other actions related to loan documentation, property appraisals, and loan purpose statements." Mr. Lane, without admitting to any allegations, consented to the issuance of the Order, which prohibits him from participating in any manner in the conduct of the affairs any insured depository institution, bank holding company, or any other institution specified in the Federal Deposit Insurance Act Section 8(e)(7)(A) (12 U.S.C. § 1818(e)(7)(A). The Order also prohibits him from soliciting or transferring voting rights or voting by proxy in any federal banking institution. In late 2006 he signed a similar prohibition order with the Missouri Division of Finance.

Friendly Committee Found Not Independent

A case out of Massachusetts, *Blake v. Friendly Ice Cream Corp.*, 21 Mass.L.Rptr. 131, Not Reported in N.E.2d, 2006 WL 1579596,
Mass. Super., 2006, examined the question of whether a Special Litigation Committee formed by the board of directors of Friendly Ice Cream Corp. to respond to a derivative suit instituted by a founder and major shareholder of the company was sufficiently independent to meet the requirements of state law. Friendly had a small board – only five members – and two of them were named to the SLC. While the plaintiff conceded the independence of one of the SLC members, the independence of the second member, Mr. Daly, was challenged. The court noted that although Daly on first blush seemed to meet the traditional tests for independence, when other factors were taken into account he failed to measure up. The court looked into Mr. Daly’s knowledge of many details beyond the usual expectation of director knowledge, such as the portfolio holdings of the CEO, in deciding whether Daly met the standard of independence. Ultimately the court found Daly was not independent, which meant the SLC was improperly formed.

The case seems to be out of step with other jurisdictions around the country that have considered the question of when a director on an SLC is independent.