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A legal update from Dechert's White Collar and Securities Litigation Group

Delaware Supreme Court Clarifies "Bad Faith" in *Brehm v. Eisner*

The Delaware Supreme Court recently reaffirmed the right of a media giant to make—and correct—a major personnel mistake, and in so doing helped to clarify the burden of potential liability facing members of boards of directors. In the future, the burden on dissident shareholders seeking to prove that corporate fiduciaries have acted in bad faith will be to show that the fiduciaries crossed the line between gross negligence and recklessness.

In *Brehm v. Eisner*, decided on June 8, 2006, the Supreme Court upheld the holdings of the Chancery Court below that neither the Board of Directors of The Walt Disney Company nor Michael Ovitz violated any fiduciary duty in connection with the negotiation of Ovitz' employment contract (especially its generous severance terms) or the termination of his employment in accordance with those terms. Much of the court's opinion turned on specific findings of fact made by the court below, such as that the members of Disney's Board had, in fact, familiarized themselves with the essential terms of Ovitz' contract before voting to approve it, and that Michael Eisner, then Disney's CEO, had acted reasonably in determining that, under Ovitz' contract, there did not exist "cause" to terminate his employment.

According to the opinion of the Supreme Court, the Chancellor had been correct in his decision that the actions of the directors, while falling short of optimal practices, had not been so deficient as to constitute less than "due care." The court also held that the payments to Ovitz did not constitute waste.

The opinion's rulings on the conduct of the directors that was deemed less than optimal should serve as a reminder to corporate fiduciaries and their legal advisors that, even if such conduct will not necessarily subject directors to liability for breach of the duty of due care, it may still bring them under unpleasant public scrutiny and result in a scathing tongue-lashing from the courts.

One issue of law was decided by the court in a manner both novel and significant. Plaintiffs in the derivative action against Disney and Ovitz had sought to overcome the presumptions of the business judgment rule by alleging that the directors had acted without due care and in bad faith. After determining that the directors had acted with due care, based largely on specific findings of fact (as described above), the Chancellor assessed the directors' good faith under a standard of "bad faith equals 'conscious disregard for one's responsibilities,'" and concluded that no bad faith had been shown.

Plaintiffs objected, insisting that the Chancellor had measured bad faith by looking for a "subjective bad motive or intent," while the proper test of bad faith was "making material decisions without adequate information and without adequate deliberation." The Supreme Court noted that the plaintiffs' formulation of the standard for bad faith would conflate a breach of the duty of due care with a breach of the duty of good faith, and then noted that, since the Chancellor had correctly determined that the directors had not breached their duty of due care, it did not matter whether the standard for finding a breach of the duty of good faith was the same or more stringent—in either case, the plaintiffs had failed to satisfy the standard.

That would ordinarily have been the end of the discussion, but the Supreme Court went on to explain that "the duty to act in good faith is, up to this point relatively uncharted," and therefore proceeded to offer "some conceptual guidance to the corporate community."

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The court examined three kinds of misconduct by directors that could conceivably be labeled "bad faith," in order from most to least culpable:

- Subjective bad faith—conduct motivated by an actual intent to do harm
- Conscious disregard of responsibilities—conduct constituting an intentional dereliction of duty without any intent to do harm
- A lack of due care—action taken solely by reason of gross negligence, again without any malevolent intent

After a ten-page analysis, the court held that the first two levels of misconduct, but not the third, constituted bad faith.

The standard adopted by the court is the rough equivalent of a recklessness standard, requiring more than ignorance of the facts, however culpably negligent such ignorance might be, but less than intentional wrongdoing. The risk in the face of which directors acted (or failed to act) must be one of which they were actually aware, but it need not be shown that they subjectively desired an impermissible result.

The ruling by the court will have implications in many areas. Section 102(b)(7) of the Delaware General Corporate Law ("DGCL") permits a company in its certificate of incorporation to relieve its directors of monetary liability for a breach of their duty of care, but not if they act "not in good faith." Similarly, DGCL Section 145 permits indemnification of a director by a corporation, but, again, only if the director acts in good faith. And many D&O insurance policies have exclusions for "bad faith" conduct. In all of these contexts, Delaware courts can be expected to apply the rules laid down by this case in determining who did and who did not act in bad faith.

Another issue raised by the *Brehm* decision is whether corporate fiduciaries other than directors will be treated differently. Senior officers of a corporation who are not also directors are treated as fiduciaries for many purposes, but they do not receive the protection of either the business judgment rule or the exculpatory provisions of DGCL Section 102. Future plaintiffs may well conclude that it is easier to hold non-director officers (or perhaps director/officers in their capacity as officers) liable for breaches of the duty of good faith than directors.

It will be worthwhile to continue to monitor the Delaware courts as they deal with these and other issues of fiduciary duty. In the meantime, corporate directors and their legal advisors should be encouraged to learn that the business judgment rule is alive and well in Delaware, that "due care" does not necessarily require "best practices," and that negligence—even gross negligence—does not equate to "bad faith."

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work or one of the attorneys listed. Visit us at www.dechert.com/financialserviceslit or www.dechert.com/whitecollar.

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