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How Juries and Judges Are Reexamining Directors', Officers' Duties in the Wake of Corporate Scandals

BY ED ARO, DAN SHEA, AND AMY NAFZIGER

Although widely publicized corporate scandals have precipitated much new legislation and regulation, those scandals have fostered two even more fundamental changes in the regulation of corporate decisionmaking.

First, the public—from which juries are drawn—is fed up with the real and perceived abuses that stained corporate decisionmaking during the Internet bubble. Second, judges are more willing than ever to probe deeply into corporate decisions. Given these changes, many corporations are adopting a radically different view of the guiding principles of corporate governance and regulatory compliance.

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Public's Disdain

Recent survey data reflect a fundamental shift in how people perceive companies and corporate insiders. Things were bad enough in 2000, when the 2000 Annual Juror Outlook Survey conducted by DecisionQuest and The National Law Journal revealed that three out of four members of the public agreed that ''[e]xecutives in big companies often try to cover up the harm they do,'' and more than one in four doubted their ability to serve impartially on a jury in a case in which a corporate executive was a defendant.

That skepticism exploded in the past two years. For example, DecisionQuest's 2003 juror survey revealed that 63 percent of the respondents felt that their opinion of large corporations had changed for the worse during 2002. Likewise, 78 percent of respondents agreed that ''[m]any companies destroy documents hoping to avoid taking responsibility for things that they have done.''

People are more willing than ever to believe charges of corporate misconduct.

In response to the question, ''In a lawsuit where a large corporation is a defendant, which of its witnesses is most likely to lie or withhold the truth on the witness stand?,'' 52 percent of respondents answered, ''senior executives.''

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Data such as this form a critical backdrop for corporate decisionmaking. In particular, they reveal that the current environment is a risky one in which to be a corporate defendant, because people (jurors, judges, etc.) doubt the honesty of companies and their executives and thus are more willing than ever to believe allegations of corporate misconduct. They also confirm that this is not a good time for companies to defend their actions based on a narrow or technical reading of the law.

Because judges are people, the information that has degraded the public's perception of corporate America cannot help but influence judicial decisionmaking. It thus is no surprise that in 2002 and 2003 courts exhibited a shocking willingness to revisit established legal principles and to closely scrutinize corporate decisions, especially in the areas of fiduciary duties, corporate opportunities, and corporate waste.

Breach of Fiduciary Duty

Four recent Delaware cases have caused corporations, their officers, and their counsel to reexamine the contours of the tenet that corporate fiduciaries must act in the best interests of shareholders.

The most widely publicized of these cases is *In re The Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) (18 CCW 169, 6/4/03), which arose from the severance package of former Disney executive Michael Ovitz. The plaintiffs claimed that Disney's directors breached their fiduciary duties by failing to properly oversee CEO Michael Eisner's employment contract and severance negotiations with his friend Ovitz.

Brushing aside the defendants' invocation of the business judgment rule, the court suggested that the directors may be liable for simply failing to involve themselves meaningfully in the severance arrangement.

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Likewise, in *Omnicare Inc. v. NCS Healthcare Inc.*, 818 A.2d 914 (Del. 2003) (18 CCW 113, 4/9/03; 18 CCW 176, 6/4/03), the Delaware Supreme Court halted a merger because the subject company's board had approved deal terms that assured shareholder approval of the transaction, despite a later competing merger proposal that was more favorable to shareholders. Such terms, the court concluded, were ''preclusive and coercive'' and thus violated the directors' fiduciary duties.

Delaware courts applied a similarly probing fiduciary duty analysis in *Levco Alternative Fund Ltd. v. The Reader's Digest Ass'n Inc.*, 803 A.2d 428 (Table), 2002 WL 1859064 (Del. 2002), which blocked a corporate transaction because the board failed to consider the transaction's effect on a discrete group of shareholders, and *MM Companies Inc. v. Liquid Audio Inc.*, 813 A.2d 1118 (Del. 2003) (18 CCW 56, 2/12/03; 18 CCW 19, 1/15/03), which rejected an effort to expand a corporate board in response to a proxy contest.

Some observers have questioned whether these decisions gutted the business judgment rule in Delaware. In response, E. Norman Veasey, Chief Justice of the Delaware Supreme Court, recently stated in ''Stock Responses, Shareholders Ask for Changes in Corporate Governance, and the Courts are Starting to See It Their Way,'' an article by John Gibeaut published in the September 2003 *ABA Journal*, that the business judgment rule survives, but added, ''Directors need to do their homework and realize that they're the boss.''

Corporate Opportunity Doctrine

In *Telxon Corp. v. Meyerson*, 802 A.2d 257 (Del. 2002) (17 CCW 202, 7/3/02), the Delaware Supreme Court revisited the corporate opportunity doctrine in a way that has sent shockwaves through many corporate boardrooms. The case arose when a director developed intellectual property and sold it to the company on whose board he sat.

The court rejected a motion to dismiss a corporate opportunity-based challenge to the sale, relying primarily on the absence of any record that the director had presented the technology to the board (although there was testimony to that effect). The court also rejected the defendants' contention that the opportunity had been tendered to the company's CEO, holding that ''[r] ejection of a corporate opportunity by the CEO is not a

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valid substitute for consideration by the full board of directors.''

Telxon is important in several respects. First, it specifically notes the absence of *records* of corporate activities, thus implicitly rejecting mere testimony about what happened at a board meeting. Second, like *Disney*, it chides directors for failing to protect shareholders from the alleged predations of a corporate insider. Cases such as *Telxon* promise further debate over what constitutes a corporate opportunity and how insiders must handle such opportunities before exploiting them personally.

Conflicts of Interest

Corporate decisionmaking has long been dominated by people who travel in the same educational, social, and economic circles; contribute to the same causes; and do one another favors. Courts have not traditionally viewed such ties as compromising board members' independence. That may have changed, however, with the Delaware Court of Chancery's decision in *In re Oracle Corp. Derivative Litigation*, 824 A.2d 917 (Del. Ch. 2003) (18 CCW 193, 6/25/03).

In *Oracle*, shareholders alleged that Oracle's CEO, CFO, and two directors had engaged in insider trading. Oracle's special litigation committee moved to dismiss the lawsuit, relying on its independence and ability to manage the dispute on the company's behalf.

The court denied the motion based on the social, professional, and philanthropic connections between members of the SLC, including the CEO's donations to the university where two SLC members were professors. In so doing, the court noted the tension between its opinion and those in other cases, but nonetheless rejected any suggestion that it had redefined director independence. Rather, the court observed that it was merely ''recogniz[ing] the importance . . . [of] bias-creating factors other than fear that acting a certain way will invite economic retribution by the interested directors.''

Whether or not the *Oracle* court did indeed redefine ''independence,'' the case requires a rethinking of how corporate boards and committees should be constituted, and calls into question how personal ties affect the objectivity of corporate fiduciaries.

In yet another notable 2003 decision, the court in *In re National Auto Credit Inc. Shareholders Litigation*, 2003 WL 139768 (Del. Ch. 2003), considered a motion to dismiss a shareholder challenge to a CEO's compensation package, the board's approval of pricing for an acquisition, and an increase in directors' fees allegedly intended to induce directors to engage in a self-interested transaction.

Rejecting the contention that the plaintiffs were ''merely challenging, with the benefits of hindsight, three business judgments of the Board,'' the court denied the motion and permitted the lawsuit to proceed. Like *Disney*, *National Auto Credit* prescribes an active role for directors in matters involving executive compensation and related-party transactions. The case also places a premium on the ability of officers and directors to demonstrate a clear (and preferably documented) basis for decisions.

Conclusion

In March 1997, then-Vice President Al Gore raised eyebrows when he defended fundraising activities based on the alleged absence of ''controlling legal authority.'' In many ways, a claimed absence of ''controlling legal authority'' became an unspoken mantra in the roaring 1990s. For many businesses and professionals, loopholes were king and the paradigm seemed to be, ''So long as it's not clearly illegal, let's give it a shot.''

Recent social and legal developments have caused many officers and directors to reevaluate their core business practices. That course is appropriate, given rampant public skepticism and the judiciary's increasing willingness to second-guess corporate decisions.

These changes require that decisionmaking processes be fair and transparent, and that decisions be sensible and documented. More fundamentally, many companies have abandoned the dot com-era paradigm of exploiting any strategy not clearly prohibited by law, in favor of one centered on only those strategies that are explicitly permitted by law.

Perhaps the future will bring about a middle ground in which creativity and aggressiveness can coexist with fundamentally sound (and legal) decisionmaking models. One suspects, however, that that middle ground may be a long time in coming.