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The Business Judgment Rule is Alive and Well

Two widely reported recent cases from influential courts have refocused attention on the question of whether an independent director who is not alleged to have engaged in self-dealing may face personal liability because of his failure to prevent harm to the corporation. Walt Disney Co. Derivative Litigation, No. 15452 (Del. Ch. May 28, 2003); Abbott Laboratories Derivative Litigation, 325 F.3d 795 (7^{th} Cir. Mar. 28, 2003). In fact, while these two decisions are examples of the heightened scrutiny that all board conduct is subject to in the post-Enron climate, the fundamental principles governing independent director liability have not changed. Each of these cases involve allegations that the directors failed to engage even in normal everyday levels of deliberation and decision-making, and there is no reason to think that directors who do use common sense and appropriate diligence are any more exposed to personal liability today than previously. The Business Judgment Rule is alive and well.

In shareholder litigation arising out of Disney's $140 million severance payment to its former President, Michael Ovitz, the Delaware Court of Chancery addressed allegations that Disney's outside directors first failed to obtain basic information about the Ovitz contract (i.e., its potential cost in the event of termination), and then, after the directors knew Ovitz was leaving, allowed Eisner, who was alleged to be Ovitz' long-time personal friend, to single-handedly arrange for Ovitz to receive termination benefits beyond those he was entitled to.

The Court found simply that these allegations, if proved, stated a claim on which plaintiffs could recover. The complaint described a company where board process on this issue had completely broken down, in that the Disney directors did not "exercise any business judgment or make any good faith attempt to fulfill the[ir] fiduciary duties." The Court noted that "[i]f the board had taken the time or effort to review [the company's] options [with respect to Ovitz' termination], perhaps with the assistance of expert legal advisors, the business judgment rule might well protect its decision." The problem at Disney was that there was (at least as alleged) simply no process, no inquiry and no decision.

> [T]he facts alleged in the new complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities*, adopting a "we don't care about the risks" attitude concerning a material corporate decision. . . .[T]he alleged facts, if true, imply that the defendant directors *knew* that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury to loss.

In the Abbott opinion, the Seventh Circuit dealt with allegations that the independent directors on the board of Abbott stood by and did nothing during a six year period in which the FDA repeatedly served notice of safety violations at one of Abbott's major divisions. The Seventh Circuit found that shareholder plaintiffs stated a claim by alleging "that the board knew of the problems and decided no action was required." The key to the Court's decision was its view that the allegations, if proved, showed that the directors failed to act "in conscious disregard of a known risk" and that a "systematic failure of the board to exercise oversight" had occurred:

> We find that six years of noncompliance, inspections, [FDA] warning letters, and notice in the press, all of which then resulted in the largest civil fine ever imposed by the FDA and the destruction and suspension of products which accounted for approximately $250 million in corporate assets, indicate that the directors' decisions to not act were not made in good faith. . .

The lessons of Disney and Abbott are plain, but they do not include a change in the legal standards governing director conduct. In both cases, the courts were required by the procedural posture of the case to assume all of the plaintiffs' allegations would be proved at trial. And both cases do indicate that what might in the past have been characterized as a breach of the duty of care may now be considered a breach of the duty of good faith, with potential negative consequences for indemnity and insurance. But the following bed-rock principles remain true:

— **Independent board members remain fully protected by the business judgment rule when they make corporate decisions with the exercise of due care.** Due care means that directors have acted to assure themselves that they have the information required to take, or refrain from taking, action; that they devote sufficient time to the consideration of such information; and that they obtain, where useful, advice from experts and counsel. Neither Disney nor Abbott suggests that the advisors usually employed to assist the board need to be supplemented with new ones simply because the board is reviewing conduct of the company's senior management. Nor is there any implication that a special committee of independent directors is necessary, or for that matter even desirable, where there is no conflict involved.

— **Neither Disney, Abbott or any other decision imposes liability on directors who were unaware of issues which subsequently resulted in losses.** Both cases involve clearly apparent "red flags" and problems that were reported in the media..

— **Neither case contemplates director liability where a well-functioning oversight function was in place.** In Abbott, the Court inferred that after six years of repeated notices of regulatory non-compliance, the board should have concluded that internal controls were insufficient.

— **Cases like Disney and Abbott highlight the importance of the board-level record of events.** Minutes that accurately convey the time and effort directors devote to decision-making, even where the outcome is to take no action, are essential to responding to claims that the board has not been doing its duty.

In sum, there is no doubt that the courts are applying a high level of scrutiny to allegations of board misconduct, including failure to exercise oversight where there was clear indication of need for it. **But the courts also continue to recognize that, if large public companies are to attract experienced persons who will not be petrified into excessive risk-aversion by the possibility of personal liability, independent directors must be given adequate judicial protection for their decisions where the record shows that they took the time to deliberate and to exercise oversight.**

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