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Reliance by Directors: What's a Conscientious Director to Do? © [¶14.1]

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An Issue Needing Attention

In its decision in *In Re Rural Metro Corporation Stockholders Litigation*,[1] the Delaware Court of Chancery, in a footnote, touches on what it means for directors to be "fully protected" by §141(e) of the Delaware General Corporation Law when they rely on information, opinions, reports or statements provided to them by officers, employees, board committees or experts. While not central to the *Rural Metro* decision, this is an issue that should be of interest to conscientious public company directors. Below I suggest that, as currently applied, §141(e) does not sufficiently protect conscientious directors, examine why that may be so, highlight the need for alternative approaches to provide truly full protection without undermining other important conduct imperatives Delaware law imposes on directors and others, and offer some suggestions toward that end.

Life as a Public Company Director

Serving as a director of a public company these days is serious business. Directors are supposed to act in a disinterested and independent manner, know their fiduciary duties of loyalty, care and disclosure, and abide by them in the myriad factual circumstances that can arise. Moreover, they are increasingly subject to adequacy and accountability assessments through, among other means, shareholder litigation, activist shareholder campaigns (including election contests), corporate governance initiatives, proxy advisory firm policies and recommendations,

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government oversight and media commentary. Reputations as well as pocket books are at stake. So it should be no surprise to a public company director these days that he or she needs to be demonstrably conscientious in performing the job of a director.

Happily, there are a great many directors who understand and subscribe to this basic point — and not simply because it is drilled into them repeatedly by their lawyers. They are willing to serve in the belief that, notwithstanding the enhanced reputational and monetary risk, conscientiously trying to do the right thing will protect them in the end.

Reliance on Others

Key to that judgment is the ability to rely responsibly on others. This commonsensical point is embedded in U.S. corporate law. A prime example is §141(e), which provides, in part:

> A member of the board of directors . . . shall, in the performance of such members' duties, be fully protected in relying in good faith upon . . . such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

This seemingly straightforward statutory protection provides important and appropriate comfort for conscientious directors, who cannot be expected to be able to affirm the existence, accuracy or completeness of much of the important information involved in board decision-making, including the opinions of management and outside experts and the bases for them. So, for example, it would seem that a conscientious director — that is, one who acts in good-faith reliance on the advice received from a financial advisor reasonably believed to be a competent expert and selected with reasonable care — would be "fully protected" from a claim of breach of the director's fiduciary duty in relying on that advice, both against harm to reputation and monetary liability.

The Meaning of "Fully Protected" — *Rural Metro* Footnote 13

Not so fast. As usual, the devil is in the details — and the details here involve the meaning of "fully protected." In its recent decision in *Rural Metro*, the Delaware Court of Chancery describes the protection afforded by §141(e) and, in so doing, highlights a zone of inadequate protection for conscientious directors.

Section 141(e) was not at issue in the case. However, in presenting its analysis the Court thought §141(e) supportive of the proposition that directors could be found to have breached their fiduciary duty even if exculpated from monetary liability by a charter provision adopted under DGCL §102(b)(7). Accordingly, the Court referred to §141(e) in footnote 13, as follows:

> Along similar lines, if the directors followed a process or reached a result falling outside the range of reasonableness, but did so in reliance on the advice of experts, they could be found to have breached their fiduciary duties under the applicable standard of review and yet be "fully protected" against liability under Section 141 of the DGCL. 8 *Del. C.* §141(e) [citations omitted]

A Clash of Legitimate Interests

This is a troubling proposition. The Court defines ''fully protected'' uncomfortably narrowly. Notwithstanding that the conscientious director adheres to the statutory standards for selection of and reliance on an expert, and presumably takes no decision that falls outside the range of reasonableness except in reliance on the expert's advice, the director is ''fully protected'' only from liability but not from a finding of a breach of fiduciary duty when it follows such advice. To put the point as a question: If conscientious directors properly engage an expert financial advisor to run a sale process for their company and properly follow its advice, why should they be said to have breached their fiduciary duty based on following the advice from the advisor (whether just poor advice or motivated by the interests of the advisor) that later is found by a court to fall outside the range of reasonableness? The question seems particularly apt in light of the Court's own observation in *Rural Metro*: ''Directors are not expected to have the expertise to determine a corporation's value for themselves, or to have the time or ability to design and carry out a sale process. Financial advisors provide these expert services.''[2]

The answer from a legal analysis standpoint is tied to the enhanced scrutiny judicial standards of review developed by the Delaware courts and applied in certain circumstances — the *Revlon* standard, applied in change of control transactions; the *Unocal/Unitrin* standard, applied to defensive responses to threatened changes of control; and the *Blasius* standard, applied to actions impairing shareholder voting rights. Each involves judicial application of a test beyond the informed, honest belief by directors that they are acting in the best interests of shareholders — ''reasonableness'' in *Revlon* and *Unocal/Unitrin* situations and ''compelling justification'' in *Blasius* situations. By introducing this judicial second-guessing, directors who act with loyalty and care are, nonetheless, exposed to the risk of breaching their fiduciary duty by taking actions that do not measure up under the judicial application of an enhanced scrutiny standard. As ''unfair'' as that might seem to some, it has become an integral part of the directorial landscape in Delaware. Moreover, it is probably the case that in almost all situations where enhanced scrutiny applies the directors have some ''responsibility'' for the claimed unreasonable or not compellingly justified act.[3]

However, footnote 13 of *Rural Metro* starkly spotlights the visceral trouble spot in the enhanced scrutiny paradigm — that even the conscientious director, who does everything right that he or she can, *including relying on the statutorily sanctioned use of necessary third-party expertise to satisfy the duty of care (or, perhaps, loyalty)*, may still be branded as breaching her or his fiduciary duty by following advice received from the expert.[4] This is particularly troubling in the context of §141(e)'s promise that directors will be ''fully protected'' if they conscientiously comply.

One might ask: So what's the big deal? Section 141(e) protects the conscientious director's pocket book. And narrowly interpreting ''fully protected'' permits judicial monitoring of director decision-making regarding certain important corporate circumstances, where a higher standard of review than the less stringent traditional business judgment standard should apply because those circumstances place inherent pressures on director motivations and conduct. If accomplishing this

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requires burdening conscientious directors with the risk, and on occasion the reality, of "no fault fiduciary duty breach," it's a price worth paying, isn't it?

Make "Fully Protected" Real

I, for one, do not think so. In any event, it is a question worth debating. Directors have a genuine interest in their reputations — as do the companies they serve. And Delaware also has an important interest in not having directors who have acted conscientiously, in reliance on advice and information on which they are statutorily permitted to rely, be found to have committed the ultimate directorial bad act — a breach of fiduciary duty — based on the misconduct of experts on which the directors were entitled to rely. Delaware should encourage the service of conscientious directors. The best way to do so is by really "fully protecting" them — including from a finding of fiduciary duty breach when they act conscientiously in accordance with the requirements of §141(e), and from the reputational stain such a finding would represent.

Close One Gap, Create Another? A Possible Resolution

Admittedly, by closing the gap in what it means for directors to be "fully protected" under §141(e), a loophole arguably could be opened for the misbehaving advisor and in other remedial circumstances. In the advisor case, as noted in *Rural Metro*, a key element of an aiding and abetting finding is that there is a primary breach of fiduciary duty by directors. If applying §141(e) to conscientious directors exonerates them from a breach of fiduciary duty, will this provide an opportunity for the faithless advisor to escape aiding and abetting liability? One would hope not — or at least not without an alternate theory of liability applying. More broadly, if in those enhanced scrutiny cases where the only "outside the range of reasonableness" circumstances involved §141(e)-permitted reliance by conscientious directors on experts (or on management, employees or a board committee), would the exoneration of the directors from any fiduciary duty breach by virtue of §141(e) leave the Court without a predicate breach for an injunction or other appropriate remedy relating to the transaction? Again, one would hope not.

Clearly those problems should be solved, whether legislatively or judicially. As creative as Delaware has been over the years, one would hope that a solution would be fashioned to get the actual bad actor or to order appropriate equitable relief without the need to have conscientious directors, acting in reliance on §141(e), declared in breach of their fiduciary duty.

A useful expression of this dilemma is contained, in the entire fairness context, in *Valeant Pharm. Int'l v. Jerney*,[5] as follows:

> Jerney argues that his good faith reliance on the advice of experts provides a defense, citing 8 *Del. C.* §141(e). Although "reasonable reliance on expert counsel is a *pertinent factor* in evaluating whether corporate directors have met a standard of fairness in their dealings with respect to corporate powers," its existence is not outcome determinative of entire fairness. [Footnote omitted] To hold otherwise would be to replace this court's role in determining entire fairness under 8 *Del. C.* §144 with that of various experts hired to give advice to the directors in connection with challenged transactions, creating a conflict between sections 141(e) and 144 of the [DGCL].

However, the choice should not and need not be between protecting shareholders (the ultimate beneficiaries of enhanced scrutiny reviews) and protecting conscientious directors. One approach that comes to mind for solving this dilemma is to think of the enhanced scrutiny review not as (or not just as) a review of director conduct, but as (or also separately as) applying more rigorous standards to certain types of transactions/circumstances that must be satisfied even if directors act with loyalty and care. This conceptual shift would permit continued application of enhanced scrutiny standards to special circumstance situations (where directors are under heightened pressure to respond to interests other than solely those of shareholders) without the need to find a breach of duty by directors to conclude that the standard was not met. At the same time, it would provide full scope for testing the directors' loyalty and care, including in light of the type of transaction and applicable enhanced scrutiny standard, and whether claimed reliance on experts (or on officers, employees or board committees) satisfied the requirements of §141(e). In short, if both the directors' conduct and the enhanced scrutiny circumstance itself were separately tested under the applicable enhanced scrutiny review standard, there would be no need to choose between innocent shareholders and conscientious directors.

As to the aiding and abetting situation, a further fix would be needed, to provide a substitute for the lack of a predicate breach of fiduciary duty that might result from the offered solution. Perhaps this could be achieved by declaring as the basis for a cognizable claim an act taken in furtherance of material, undisclosed self-interest and knowingly in contravention of the applicable enhanced scrutiny standard of review that causes a failure to satisfy such standard of review. I have no doubt the Delaware Bench and Bar can figure this one out.

An Added Bonus

Adopting a complete "fully protected" approach to §141(e) is consistent with incentivizing directors to do their best, and to be especially attentive to key information providers (officers, employees, board committees and experts) in situations where enhanced scrutiny applies — and where the role of those information providers often is critical. If directors were aware that, although protected from liability, relying on those information providers would not necessarily protect the directors from being found to have engaged in a breach of fiduciary duty due to circumstances relating to or conduct by any such information provider, to which the directors should have been more attentive, *but that they could gain such protection if they stayed active and alert*, presumably they would be optimally motivated to do so. In short, directors interested in protecting their reputations as well as their pocket books would focus carefully on their duties in the particular situation as they relate to what they should be asking about and of their information providers.

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1. C.A. No. 6350-VCL (Del. Ch. March 7, 2014). In *Rural Metro*, the Court found that Rural Metro's directors (who had settled before trial and were no longer in the case) breached their fiduciary duty because their conduct in selling control of the company fell outside the range of reasonableness required by the enhanced scrutiny standard applied under *Revlon*, and that their financial advisor (the only remaining defendant) knowingly aided and abetted that breach. (To find an aiding and abetting violation, the Court necessarily needed to find a breach of duty by the directors.)

2. *Id* at 47.

3. In *Rural Metro*, for example, the Court's analysis was based on its view that, among other

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things, separate and apart from what the financial advisor advised, the board (a) failed to become reasonably informed about alternatives available to the company by not receiving information about its value with adequate time to consider the information and (b) failed to "act reasonably to identify and consider the implications of the investment banker's compensation, relationships and potential conflicts" — and, as a result, effectively took decisions that were not adequately informed, and in light of the missing information and the lack of consideration of it, judged to be outside the range of reasonableness.

4. As indicated in the preceding footnote, *Rural Metro* is not a case where the Court concluded the directors had done everything right, but were directed off course solely by their financial advisors.

5. 2007 WL 2813789, at *14 (Del. Ch. Mar. 1, 2007).