

Directors' Fiduciary Duties: Back to Delaware Law Basics

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The dawn of a new decade brings with it the certainty of ongoing challenges to the conduct of public company directors based on alleged breaches of fiduciary duty.

This note is a brief reminder for directors of Delaware corporations (and of corporations organized in states that generally follow Delaware law in this area) of the basic fiduciary duty rules that govern their conduct. If these rules are understood and followed, directors should be able to avoid fiduciary duty breaches and protect themselves from exposure to potential liability. These rules and available protections, discussed below, encompass:

- the basic fiduciary duties (care and loyalty, including good faith, oversight and disclosure),
- key director attributes (independence and disinterestedness, and appreciation of “red flags”),
- the importance of process (including asking the right questions and keeping a good record),
- the core standard for judging director conduct (the business judgment rule), and
- key Delaware law protections (including good faith reliance on others and exculpatory charter provisions).

Director ‘Rules of the Road’ for Satisfying Fiduciary Duties

- Be well-advised, including as to all of the rules of the road.
- Be satisfied as to the disinterestedness and independence of each director (including yourself) as well as management and advisers, and how to respond appropriately to identified issues.
- Be comfortable with the process, including timing, board involvement and record-keeping.
- Be properly informed — ask questions, examine assumptions, and gather and review all material information reasonably available.
- Understand and follow the rules permitting reliance on management and third parties.
- Examine the premises of proposed action, including the benefits and risks, and understand and weigh the alternatives.
- Act in good faith to do what you honestly believe is in the best interests of the corporation and its stockholders collectively.
- Keep up with evolving external demands and expectations regarding board conduct — *e.g.*, whether and how to address ESG (environmental, social and governance) and other non-stockholder constituency interests; director performance of their “oversight” duty (implementing reasonable company risk monitoring systems and sensitivity to “red flags” signaling noncompliance).
- Keep confidential information confidential.

A Practical Suggestion for Maintaining Director Focus

In order to assist directors in maintaining a focus on their fiduciary duties as they address the myriad matters that come before the board, we suggest they ask themselves

Directors' Fiduciary Duties: Back to Delaware Law Basics

(and others on whom they rely) the following question, from the outset and on a continuing basis, in situations where board attention to a matter is appropriate:

To make an independent, disinterested, informed, good faith decision about the matter before us, what information do we need (including about ourselves, our advisers and our experts), how do we get that information and what should be our board process?

The Delaware Model

Basic Fiduciary Duties

Directors of Delaware corporations are subject to the fiduciary duties of *care* and *loyalty* (which include the subsidiary duties of *good faith*, *oversight* and *disclosure*).

- **Duty of care.** *Care* requires informed, deliberative decision-making based on all material information reasonably available.
- **Duty of loyalty.** *Loyalty* requires acting (including deciding not to act) on a disinterested and independent basis, in good faith, with an honest belief that the action is in the best interests of the company and its stockholders.
 - This focus does not preclude directors from considering the interests of other constituencies in determining what is in the company's and stockholders' best interest.¹

Disinterested and Independent Directors

Ideally, directors should be *disinterested* (that is, free of any material financial or other benefit derived from the matter under consideration, except as a stockholder) **and** *independent* (that is, not having a relationship with an interested party that reasonably could influence the director's decision-making).

- **Court deference to disinterested, independent board majority.** If a board decision is approved by a majority of independent (for Delaware law purposes) and disinterested directors, Delaware courts will give deference to that decision.
- **Disclosure.** Directors should disclose promptly to the board facts that could raise a question about their disinterestedness or independence in considering a matter. Directors must also disclose all material facts in a non-misleading way when seeking stockholder approval.

¹ See Peter A. Atkins, Marc S. Gerber and Edward B. Micheletti, "Putting To Rest the Debate Between Corporate Social Responsibility and Current Corporate Law" (Aug. 27, 2019); Peter A. Atkins, Marc S. Gerber and Edward B. Micheletti, "Social Responsibility and Enlightened Shareholder Primacy: Views From the Courtroom and Boardroom" (Feb. 4, 2019).

Oversight Duty and 'Red Flags'

The *oversight* aspect of the directors' duty of loyalty includes board-level attention to the company's risk management. Particular attention has been focused on oversight of compliance with law and related company protocols in highly regulated mission-critical aspects of a company's business. As applied there, this duty will be breached if directors (a) consciously fail to implement a board-level system to monitor reasonably company compliance with applicable law and related company protocols, or (b) having implemented such a system, consciously ignore *red flags* signaling material company noncompliance with such law and protocols.

- While the standard for finding such an oversight breach is quite high, recent Delaware court decisions suggest some willingness, based on factual allegations, to refuse to dismiss these cases before discovery.

Board Process

Board process is important, and may be critical, for several reasons. A good process (1) provides a situation-appropriate framework for addressing the matter at hand, (2) creates a record of how the matter was handled and (3) serves as credible evidence of the directors' satisfaction of their fiduciary duties.

Business Judgment Rule

In general, courts applying Delaware law and evaluating board decisions will, in the first instance, apply the *business judgment rule*² (BJR).

- **Rebuttable presumption.** The BJR is a rebuttable presumption that in making decisions directors act in accord with their fiduciary duties.
- **Burden on plaintiff.** To rebut the presumption, a plaintiff has the burden of presenting evidence that directors were at least grossly negligent in not becoming adequately informed or were motivated by interests other than those of the company's stockholders as a whole (or acted in bad faith by consciously disregarding a known duty).

² In certain types of circumstances, more rigorous standards may have to be satisfied by directors to avoid a breach of duty or liability: *enhanced scrutiny* variations (defensive response to change of control threat; sale of control); *compelling justification* (manipulation of corporate voting rights); *entire fairness* (initial BJR application rebutted; related party transactions; majority of directors approving a board decision, or a director under review, not independent and disinterested).

Directors' Fiduciary Duties: Back to Delaware Law Basics

- **Effect of failure to rebut.** If the BJR is not rebutted, Delaware courts will not second-guess a board judgment unless found to be not rational.
- **Nonrational decisions.** To make that finding, a court must conclude that the board's decision cannot be attributed to any rational business purpose related to the company.

Certain Delaware Protections Permitted for Directors

Delaware law contains provisions that assist directors in satisfying their fiduciary duties, in defending against claims of breach of duty and in avoiding certain consequences of a breach.

- **Reliance on company records and others.** A director is entitled to rely in good faith on company records and on information, opinions, reports or statements presented to the board by the company's officers, employees or board committees, or by other parties as to matters the director reasonably believes are within the parties' professional or expert competence and who have been selected for the company with reasonable care.
- **Exculpation of certain personal liability for monetary damages.** Delaware corporations may include in their certificates of incorporation (COI) an exculpation provision for the benefit of directors. In short, a maximum strength provision eliminates the personal liability of a director to the corporation or its stockholders for monetary damages for breaches of the duty of care (but not, among other things, breaches of the duty of loyalty).
- **Indemnification and expense advancement.** Delaware corporations may indemnify directors and advance their expenses (pursuant to COI, bylaw or agreement), when directors are or are threatened to be made parties to a range of proceedings, subject to specified limitations.
- **D&O liability insurance.** Delaware permits its corporations to purchase directors' and officers' liability insurance, whether or not the corporation would have the power to indemnify the directors against the liability under Delaware's statutory indemnification authorization provision.

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