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IN THE SUPREME COURT OF THE STATE OF DELAWARE

IN RE THE WALT DISNEY COMPANY DERIVATIVE LITIGATION, -------------------------------------	:	No. 411, 2005
William Brehm and Geraldine Brehm, as Trustees and Custodians; Michael Grening; Richard Kaplan and David Kaplan, as Trustees; Thomas M. Malloy; Richard J. Kager and Carol R. Kager, as Joint Tenants; Michael Caesar, as Trustee for Howard Gunty, Inc. Profit Sharing Plan; Robert S. Goldberg, I.R.A.; Michael Shore; Michele DeBendictis; Peter Lawrence, I.R.A.; Melvin Zupnick; Judith B. Wohl, I.R.A.; James C. Hays; and Barnett Stepak, Plaintiffs Below, Appellants,	:	Court Below: Court of Chancery of the State of Delaware in and for New Castle County Cons. C.A. No. 15452-N Chancellor William B. Chandler III
vs.	:	
Michael D. Eisner, Michael S. Ovitz, Stephen F. Bollenbach, Sanford M. Litvack, Irwin Russell, Roy E. Disney, Stanley P. Gold, Richard A. Nunis, Sidney Poitier, Robert A.M. Stern, E. Cardon Walker, Raymond L. Watson, Gary L. Wilson, Reveta F. Bowers, Ignacio E. Lozano Jr., George J. Mitchell, Leo J. O'Donovan, Thomas S. Murphy and The Walt Disney Company, Defendants Below, Appellees.	:	

APPELLANTS' OPENING BRIEF

PART 8 of 11

D. Expert Witnesses

Six expert witnesses testified over the course of the trial.[363] In general, their reports and testimony, while meeting the minimum standards for admissibility, were not of as much help to the Court as they could have been because of the polarized nature of their opinions, especially their interpretations of the factual questions that are of central importance in this trial. I shall discuss each expert *seriatim*. To the extent that my conclusions about an expert are decidedly negative, that characterization is based upon an objective evaluation of the witness and the strength and relevance of the evidence presented both in the report and at trial.

1. Professor Deborah DeMott

Plaintiffs offered Professor DeMott, the David F. Cavers Professor of Law at Duke Law School, as an expert on "the custom and practice with regard to corporate governance in Delaware public companies in the time period relevant to this case."[364] Professor DeMott was subject to an earlier motion *in limine*, whereby defendants sought to exclude her testimony. That motion was granted on the grounds that her report and proposed testimony

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[363] A seventh expert, Alan Johnson, prepared a report on behalf of the defendants and was deposed, but he did not testify at trial. *See* Tr. 771:24-772:16. His amended report dated August 6, 2004, is part of the trial record. DTE 181. Professor Murphy spent a significant amount of time at trial disputing certain elements of Johnson's report. Tr. 833:21-857:19.

[364] Tr. 23:20-24.

did not comply with D.R.E. 702 and improperly opined on the application of Delaware law to the facts of this case.[365] Professor DeMott rewrote her report,[366] and her testimony was received at trial over defendants' objections.[367]

Professor DeMott opined on the "custom and practice of corporate governance in publicly traded Delaware corporations as of the times relevant to the transactions in this case," and also on "whether the conduct of the board of directors of [the Company] complied with or departed from those customs and those practices."[368] Despite plaintiffs' and Professor DeMott's efforts to couch her opinion in terms of custom and practice of Delaware corporations, it was clear to all that her report and testimony were still directed to the core issues in this case—whether the defendants breached their fiduciary duties as they exist under Delaware law.[369]

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[365] *See In re The Walt Disney Co. Derivative Litig.*, 2004 WL 550750 (Del. Ch. Mar. 9, 2004).

[366] PTE 462.

[367] Tr. 24:1-38:6.

[368] Tr. 40:9-18.

[369] For example, instead of using the term "custom and practice" in her report, Professor DeMott states that good corporate goverance "requires," "includes" and "envisions" certain actions. Tr. 98:24-101:10; *see also* Tr. 161:22-166:3 (plaintiffs' counsel objects to a question on cross-examination on the grounds that defense counsel was "just inserting the phrase 'custom and practice,'" and that these questions were "not going to what is the custom and practice in the particular time frame with respect to public Delaware companies, but what are the legal requirements [imposed upon fiduciaries of Delaware corporations]").

In addition to opining on the core issues in this case,[370] another key area of Professor DeMott's report (and the corresponding testimony) that is of no value to the Court is her interpretation of the Company's certificate of incorporation, bylaws, and board committee charters.[371] Interpretation of the Company's internal governing documents is a matter exclusively for the Court.[372] Thus, there is very little, if any, of Professor DeMott's report that is of benefit to the Court, especially because the relevant question is not whether the defendants complied with the custom and practice of other Delaware corporations during the relevant time frame, but whether they complied with their fiduciary duties.[373]

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[370] *See* PTE 462 at ¶ 14 ("Neither Disney's Board nor its Compensation Committee gave careful consideration to the implications of the terms of Disney's employment agreement with Mr. [Ovitz]."); *see also id.* at ¶ 17 ("The record leaves no doubt that both the decision to terminate Mr. Ovitz's employment and the decision to characterize the termination as a non-fault termination were made by Mr. Eisner without consideration by Disney's Board.").

[371] PTE 462 at ¶¶ 9, 12, 17; Tr. 172:6-175:5.

[372] *See Itek Corp. v. Chicago Aerial Indus., Inc.*, 274 A.2d 141, 143 (Del. 1971).

[373] Professor DeMott's testimony was useful, however, in the sense that it drew in stark relief the contrast between ideal corporate governance practices and the unwholesome boardroom culture at Disney—that is, her testimony clarified how ornamental, passive directors contribute to sycophantic tendencies among directors and how imperial CEOs can exploit this condition for their own benefit, especially in the executive compensation and severance area. *See* Tr. 43:4-46:15 (individualized one-on-one discussions between management and directors can lead to directors who are "unequally or unevenly informed with regard to significant matters" and "have the effect of vitiating, sapping the board's ability as an institution to function together collectively and collegially and deliberatively"); 83:12-84:6.

2. Professor John Donohue

Professor Donohue, the William H. Neukom Professor of Law at Stanford Law School, came to the witness stand on behalf of plaintiffs three different times during the course of the trial. His report and testimony were directed to the issue of whether Ovitz could (and should) have been terminated for cause as opposed to the NFT he received. The fatal flaw in Donohue's opinion is that it is based upon his factual determinations— determinations with which I, after weighing all of the evidence, do not agree.[374] For example, in the summary of his conclusions, Donohue states that Ovitz committed gross negligence or malfeasance because of his dishonesty, and because of eight other categories of bad acts.[375] As demonstrated above, in the lengthy and detailed recitation of the facts, I conclude that those determinations are simply not supported by a fair and neutral evaluation of the record.

Donohue's opinion outlined an array of legal standards that might cover Ovitz's termination.[376] In his zeal to crucify Ovitz, Donohue concluded that Ovitz's conduct would meet any of the multiplicity of standards he discusses for gross negligence or malfeasance, and his report

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[374] *See* Tr. 636:16-637:6; 702:4-7.
[375] PTE 404 at 4.
[376] *Id.* at 7-34.

contains very little guidance in terms of which standard might be the most appropriate or most likely to be applied by a California court.[377] As a result, Donohue's report and testimony are of little value to the Court in evaluating defendants' conduct as it relates to Ovitz's termination.

Donohue was permitted to file a supplemental report based upon his review of certain documents, which were produced by defendants shortly before trial.[378] The supplemental report made no substantive changes to Donohue's opinions and conclusions.[379]

3. Professor Kevin Murphy

Professor Murphy (to whom I will refer as "Professor Murphy" in order to avoid any potential confusion with defendant Thomas Murphy), the E. Morgan Stanley Chair in Business Administration at the Marshall School of Business at the University of Southern California, presented expert testimony for plaintiffs on the issue of damages together with an economic and reasonableness evaluation of Ovitz's compensation package.[380] Professor Murphy concluded that Ovitz's compensation package was unreasonably excessive and orders of magnitude larger than the

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[377] *See id.* at 4.
[378] PTE 826.
[379] *Id.*
[380] *See* PTE 426 (Professor Murphy report).

compensation awarded to executives with arguably equivalent responsibilities.[381] In determining the reasonableness of Ovitz's compensation, Professor Murphy chose not to consider Ovitz's past income at CAA and the effect that income would have on the remuneration he would expect from any future employment.[382] As would be expected, Professor Murphy concluded that the most reasonable and appropriate assumptions are those that would maximize the value of the OEA and corresponding cost of the NFT.[383] Perhaps Professor Murphy's most pointed criticism of the OEA is that the Company was unable to reduce its potential financial exposure because the OEA did not contain any provisions for mitigation or non-compete restrictions,[384] but that criticism is not supported by the language of the OEA.[385]

Professor Murphy's report did not include an event study, but at trial Professor Murphy gave a very brief and unpersuasive critique of Dunbar's event study, which as discussed below, concluded that the Company's

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[381] *See, e.g.*, Tr. 748:22-749:13.

[382] Tr. 868:17-870:16; 1061:5-19; *see also* Tr. 1010:21-1020:18; 1036:12-1037:9; 1043:1-21.

[383] *See* Tr. 901:6-919:14; 925:2-939:4; 980:4-989:7; 1072:11-1077:13; 1081:19-1085:17; PTE 426 at 24-31 (Professor Murphy's discussion of the cost to the Company of Ovitz's severance where he concludes that the Black-Scholes value (as opposed to intrinsic or realized cost) of Ovitz's options (by far the highest of the three) is the appropriate way to measure that cost).

[384] Tr. 803:3-805:5.

[385] *See* PTE 7 ¶ 9 at WD00209-10.

market capitalization increased by more than $1 billion as a result of the announcement of Ovitz's hiring. The record does not reflect that Professor Murphy's qualifications as an expert extend to performing and interpreting event studies, and I therefore reject Professor Murphy's critique of Dunbar's conclusion with respect to the market's reaction to the announcement of Ovitz's hiring.[386] The remainder of his report, however, is of use to the Court in determining the economic consequences facing the defendants when the decisions at issue in this case were made.

4. Larry R. Feldman

Ovitz's expert with respect to whether he could have been terminated for cause was Larry Feldman. Feldman is a renowned litigator in southern California and is currently employed at Kaye Scholer LLP.[387] Feldman opined that the Company had no grounds upon which to terminate Ovitz for cause, and that had the Company done so, that Ovitz would have been able

[386] Notwithstanding the statements in the text above, Professor Murphy does make a very good point that the press release announcing Ovitz's hiring (PTE 3) does not disclose any economic terms of Ovitz's employment with the Company, and therefore, as a matter of common sense, the market cannot be said to have "approved" the economic terms of the OEA. *See* 859:7-860:3. One might intuit, however, that the $1 billion increase in the Company's market capitalization as a result of Ovitz's hiring would reflect the assumptions of the market as to the potential cost of Ovitz's employment contract, even if the market was unaware of the actual cost. Dunbar testified to this effect, outlining the public reports of Ovitz's compensation before the text of the OEA was filed publicly in December 1995 and concluding that the lack of statistically significant market reaction at that time was due to the market's correct assumptions of the size of the compensation package on August 14, 1995. Tr. 7296:8-7297:20; 7414:19-7416:3; DTE 428 at 3-9.

[387] *See* DTE 408 at 1-2.

to pursue meritorious claims for breach of contract, fraud and defamation, with damages far in excess of the value of the NFT.[388]

Upon comparing Feldman's report to the factual determinations I have made, I conclude that the evidence presented at trial is generally consistent with Feldman's view of the relevant facts. Feldman's legal analysis, however, is more troublesome. For example, I am not persuaded in the least that the legal standard used by Feldman in his report to define gross negligence or malfeasance—criminal misconduct or its equivalent—is the correct standard.[389] Additionally, his opinion with respect to potential claims for defamation and fraud in the inducement is thinly supported and fails to adequately address potentially meritorious defenses that the Company could have asserted to such causes of action.[390] In sum, therefore, Feldman's report and testimony are of some value to the Court, but not substantial value.

5. John C. Fox

John Fox, a partner of Fenwick & West LLP, testified on behalf of all defendants but Ovitz as an expert with respect to whether Ovitz could have

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[388] DTE 408 at 47.

[389] DTE 408 at 10-16. *But see* PTE 404 at 17-18 (Donohue's opinion that gross negligence is not exclusively a criminal standard); DTE 430 at 8-11 (Fox concurring with Donohue); *cf.* Tr. 8333:24-8334:10 (Feldman) (stating at trial that gross negligence does not require actual criminal misconduct).

[390] *See* DTE 408 at 36-44; Tr. 8403:19-8411:3; 8455:21-8467:3; 8552:18-8577:21.

been terminated for cause. Fox's report and testimony were very thorough, well reasoned and informed by Fox's extensive practical experience as an employment law litigator and advisor.[391]

The overwhelming majority of Fox's factual determinations are consonant with the conclusions I have reached above based upon the evidence presented at trial. His legal conclusions based upon those facts, therefore, are of far greater weight and persuasive value than the conclusions reached by Donohue. Similar to Feldman, Fox gives short shrift in his report to analyzing Ovitz's potential claims for fraud in the inducement and defamation.[392] Unlike Feldman, however, Fox was able to clearly articulate at trial the reasoning behind his conclusion with respect to the viability of these tort claims, bolstering the value of his report in those areas.[393] Fox also testified in great detail regarding the definition of gross negligence and malfeasance.[394] He also opined that, regardless of how gross negligence and malfeasance might be defined in a hypothetical *Ovitz v. The Walt Disney Company* suit had Ovitz been terminated for cause, after reviewing the evidence, Ovitz's conduct (or misconduct) did not even come close to that

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[391] *See* DTE 430 (Fox report); DTE 248 (Fox's supplemental report).

[392] DTE 430 at 27-28; *see* DTE 430 at 28; DTE 408 at 36-43.

[393] *See* Tr. 8838:1-19; 8866:3-17; 8905:20-8908:1; 8948:20-8951:13; 8956:6-8960:9; 9207:14-9213:23; 9222:23-9231:19; 9244:21-9246:8.

[394] Tr. 8739:15-8748:4; 8999:20-9039:22; 9084:5-20.

high standard.[395] In summary, Fox's report is of significant value to the Court, and I will weigh his conclusions accordingly in making my determinations regarding the ultimate issues in this case.

6. Frederick C. Dunbar

The remaining expert was Frederick Dunbar, Senior Vice President of National Economic Research Associates, Inc., who testified on behalf of the defendants as to the market reaction to the hiring of Ovitz and also critiqued Professor Murphy's report as it related to the valuation of Ovitz's options and the present value calculation of the cash portion of the NFT payment.[396] Dunbar's conclusion with respect to the market's overwhelmingly positive reaction to Ovitz's hiring is not unassailable, but is nonetheless well-

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[395] Tr. 8758:1-8837:3; 8844:10-8860:6; 8922:3-8925:18; 8947:5-8951:13; 8955:10-8961:24; 9025:22-9026:15; 9039:23-9040:12; 9048:3-9195:7.

[396] *See* DTE 428 (Dunbar report). I have omitted any discussion regarding Professor Murphy's opinion regarding the appropriate discount rate (together with Dunbar's response thereto) because there is no evidence in the record that would indicate that any of the defendants in this action exercised any discretion whatsoever in determining the discount rate applied to the cash payment received by Ovitz as a result of the NFT. Without that evidence connecting a defendant to that decision, I fail to see the current relevance of why other discount rates might have been appropriate. Whichever Disney employees made the decision as to which discount rate to use, were they before the Court, would receive the protections of the business judgment rule. There is no evidence in the record that would impugn in any way the presumptions of care, loyalty, or good faith used by those employees in the business judgment of determining the appropriate discount rate. For that reason, an analysis of why a particular discount rate might have been more appropriate than the one selected is not germane to the issues to be decided herein. *See* Santaniello 149:16-154:14 (stating that he was unaware of how the discount rate was determined); PTE 130 (memo from the Company's Controller's office to Santaniello enclosing present value calculations at 6.5% and 6.75%); PTE 131 (demonstrating that the 6.5% discount rate was actually used in paying Ovitz).

supported by the evidence and based upon accepted methods of analysis.[397] With respect to his opinion that a reduced or discounted option expiration date is appropriate when performing a Black-Scholes valuation of the options, Dunbar's testimony at trial was thorough and convincing.[398] Accordingly, Dunbar's Black-Scholes calculations are more valuable and persuasive than those performed by Professor Murphy and will be useful in evaluating the defendants' actions.

II. LEGAL STANDARDS

The outcome of this case is determined by whether the defendants complied with their fiduciary duties in connection with the hiring and termination of Michael Ovitz. At the outset, the Court emphasizes that the best practices of corporate governance include compliance with fiduciary duties.[399] Compliance with fiduciary duties, however, is not always enough

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[397] DTE 428 at 3-9; Tr. 7287:6-7300:3; 7365:6-7448:16.

[398] Tr. 7306:11-7333:16; 7448:17-7506:6. In contrast, Professor Murphy's explanation for using the latest possible termination date when valuing the options upon termination, based upon the fact that the exercisability of those options was extended, (in exchange for dropping the $50 million guarantee), and based upon an array of possible hedges, is not nearly as persuasive. *See* Tr. 823:18-830:20; 964:19-972:20.

[399] All good corporate governance practices include compliance with statutory law and case law establishing fiduciary duties. But the law of corporate fiduciary duties and remedies for violation of those duties are distinct from the aspirational goals of ideal corporate governance practices. Aspirational ideals of good corporate governance practices for boards of directors that go beyond the minimal legal requirements of the corporation law are highly desirable, often tend to benefit stockholders, sometimes reduce litigation and can usually help directors

to meet or to satisfy what is expected by the best practices of corporate governance.

The fiduciary duties owed by directors of a Delaware corporation are the duties of due care and loyalty.[400] Of late, much discussion among the bench, bar, and academics alike, has surrounded a so-called third fiduciary duty, that of good faith. Of primary importance in this case are the fiduciary duty of due care and the duty of a director to act in good faith. Other than to the extent that the duty of loyalty is implicated by a lack of good faith, the only remaining issues to be decided herein with respect to the duty of loyalty are those relating to Ovitz's actions in connection with his own termination.[401] These considerations will be addressed *seriatim*, although issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty, as well as a principal reason

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> avoid liability. But they are not required by the corporation law and do not define standards of liability.

Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

[400] The Delaware Supreme Court has been clear that outside the recognized fiduciary duties of care and loyalty (and perhaps good faith), there are no other fiduciary duties. In certain circumstances, however, specific applications of the duties of care and loyalty are called for, such as so-called "*Revlon*" duties and the duty of candor or disclosure. *See Malpiede v. Townson*, 780 A.2d 1075, 1083, 1086 (Del. 2001); *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1994) ("The directors' fiduciary duties in a sale of control context are those which generally attach. In short, 'the directors must act in accordance with their fundamental duties of care and loyalty.'") (citation omitted)).

[401] *See In re The Walt Disney Co. Derivative Litig.* (*"Disney III"*), 2004 WL 2050138, at *7 (Del. Ch. Sept. 10, 2004); *Brehm*, 746 A.2d at 257-58.

the distinctness of these duties make a difference—namely § 102(b)(7) of the Delaware General Corporation Law.[402]

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[402] Perhaps these categories of care and loyalty, so rigidly defined and categorized in Delaware for many years, are really just different ways of analyzing the same issue. Professor Sean Griffith said it best when he recently wrote:

At first glance, the duties of care and loyalty appear quite distinctive. . . .

> A bit of digging beneath these surface differences, however, reveals the richly interconnected roots of the two doctrinal paradigms. Start with the duty of care: directors must conduct themselves as ordinarily prudent persons managing their own affairs. So far so good, but a moment's reflection reveals that an ordinarily prudent person becomes an ordinarily prudent director only once we assume an element of loyalty. How do ordinarily prudent directors conduct their affairs? A decision is taken with due care, when from an array of alternatives, the directors employ a procedure to pick the one that best advances *the interests of the corporation*. Now pause for a moment to consider what a funny way this is of conceiving what an ordinarily prudent person would do *in the conduct of her own affairs*. We might typically assume that an ordinarily prudent person, in evaluating a set of alternatives, picks the one that provides the most benefit and least cost to *herself*. A director's decision-making process, however, can be evaluated only by changing the referent from herself to the corporation. The question of prudence, in other words, is framed with a tacit element of loyalty.
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> . . . [Shareholders and courts] are worried about the directors' loyalty because we are concerned that their disloyalty will result in a poor bargain for the corporation. We are concerned, in other words, that conflicted directors will strike bargains for the corporation that an ordinarily prudent person would not strike for herself. This can be seen most clearly if the non-arms-length transactions that raise duty of loyalty concerns are imagined as arms-length transactions with third parties. Would an ordinarily prudent person lease a corporate asset to a third party on exceedingly generous terms? Would an ordinarily prudent person lavish compensation on a third party and permit the third party to divert investment opportunities that would otherwise come her way? These are duty of loyalty concerns framed as duty of care questions. The phrasing is natural because, at its core, the duty of loyalty is just a bet that some situations are likely to lead to careless or imprudent transactions for the corporation, which is to say that the duty of care is a motivating concern for the duty of loyalty. Here again the duties overlap.

A. The Business Judgment Rule

A comprehensive review of the history of the business judgment rule is not necessary here, but a brief discussion of its boundaries and proper use is appropriate. Delaware law is clear that the business and affairs of a corporation are managed by or under the direction of its board of directors.[403] The business judgment rule serves to protect and promote the role of the board as the ultimate manager of the corporation.[404] Because courts are ill equipped to engage in *post hoc* substantive review of business decisions, the business judgment rule "operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation."[405]

The business judgment rule is not actually a substantive rule of law,[406] but instead it is a presumption that "in making a business decision the directors of a corporation acted on an informed basis, . . . and in the honest belief that the action taken was in the best interests of the company [and its

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Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L. J. (forthcoming 2005) (manuscript of May 25, 2005 at 39-42 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=728431) (emphasis in original, citations omitted).

[403] 8 *Del. C.* § 141(a).

[404] *See Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. 1981).

[405] *Cede & Co. v. Technicolor, Inc.* ("*Cede III*"), 634 A.2d 345, 360 (Del. 1993) (citing *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1988)).

[406] *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995) (citing *Cede III*, 634 A.2d at 360); *see Emerald Partners v. Berlin*, 787 A.2d 85, 90-91 (Del. 2001); *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995).

shareholders]."[407] This presumption applies when there is no evidence of "fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment" on the part of the directors.[408] In the absence of this evidence, the board's decision will be upheld unless it cannot be "attributed to any

[407] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). In *Smith v. Van Gorkom*, the Delaware Supreme Court clarified that "the presumption that the directors acted in good faith [is] irrelevant in determining the threshold issue of whether the directors as a Board exercised an informed business judgment." 488 A.2d 858, 889 (Del. 1985). In *In re Holly Farms Corp. S'holders Litig.*, the Court of Chancery denied the protections of the business judgment rule to a board of directors' agreement to a lock up because it was "the product of a fundamentally flawed process and cannot be in the interests of the stockholders." 1988 WL 143010, at *6 (Del. Ch. Dec. 30, 1988).

[408] *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988); *Cede III*, 634 A.2d at 360. In *Gagliardi*, Chancellor Allen described the policy rationale for the business judgment rule in the paragraph quoted below. Although this statement, made in 1996, may at first appear to be undercut by the increased incentive compensation of the dot-com era, the rationale still applies because of the relatively small percentages of stock held by officers and directors of public companies.

> Corporate directors of public companies typically have a very small proportionate ownership interest in their corporations and little or no incentive compensation. Thus, they enjoy (as residual owners) only a very small proportion of any "upside" gains earned by the corporation on risky investment projects. If, however, corporate directors were to be found liable for a corporate loss from a risky project on the ground that the investment was too risky (foolishly risky! stupidly risky! egregiously risky!—you supply the adverb), their liability would be joint and several for the whole loss (with I suppose a right of contribution). Given the scale of operation of modern public corporations, this stupefying disjunction between risk and reward for corporate directors threatens undesirable effects. Given this disjunction, only a very small probability of director liability based on "negligence", "inattention", "waste", etc. could induce a board to avoid authorizing risky investment projects to any extent! Obviously, it is in the shareholders' economic interest to offer sufficient protection to directors from liability for negligence, etc., to allow directors to conclude that, as a practical matter, there is no risk that, if they act in good faith and meet minimalist proceduralist standards of attention, they can face liability as a result of a business loss.

Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996).

rational business purpose."[409] When a plaintiff fails to rebut the presumption of the business judgment rule, she is not entitled to any remedy, be it legal or equitable, unless the transaction constitutes waste.[410]

This presumption can be rebutted by a showing that the board violated one of its fiduciary duties in connection with the challenged transaction.[411] In that event, the burden shifts to the director defendants to demonstrate that the challenged transaction was "entirely fair" to the corporation and its shareholders.[412]

In *Van Gorkom*, the Delaware Supreme Court analyzed the Trans Union board of directors *as a whole* in determining whether the protections of the business judgment rule applied.[413] More recent cases understand that liability determinations must be on a director-by-director basis. In *Emerging Communications*, Justice Jacobs wrote (while sitting as a Vice Chancellor) that the "liability of the directors must be determined on an individual basis because the nature of their breach of duty (if any), and whether they are

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[409] *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); *see also Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

[410] *In re J.P. Stevens & Co., Inc. S'holders Litig.*, 542 A.2d 770, 780 (Del. Ch. 1988).

[411] *Emerald Partners*, 787 A.2d at 91.

[412] *Id.* In certain circumstances, the burden can shift back to the plaintiffs in the event of ratification by disinterested directors or shareholders. *See Solomon v. Armstrong*, 747 A.2d 1098, 1111, 1113-17 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000).

[413] *Van Gorkom*, 488 A.2d at 889.

exculpated from liability for that breach, can vary for each director."[414] There is a not insignificant degree of tension between these two positions, notwithstanding the procedural differences between the two cases.

Even if the directors have exercised their business judgment, the protections of the business judgment rule will not apply if the directors have made an "unintelligent or unadvised judgment."[415] Furthermore, in instances where directors have not exercised business judgment, that is, in the event of director inaction, the protections of the business judgment rule do not apply.[416] Under those circumstances, the appropriate standard for determining liability is widely believed to be gross negligence,[417] but a single Delaware case has held that ordinary negligence would be the appropriate standard.[418]

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[414] *In re Emerging Communications Inc. S'holders Litig.*, 2004 WL 1305745, at *38 (Del. Ch. Jun. 4, 2004).

[415] *Mitchell v. Highland-Western Glass*, 167 A. 831, 833 (Del. Ch. 1933); *Van Gorkom*, 488 A.2d at 872.

[416] *Aronson*, 473 A.2d at 813. This is not to say that all director inaction is not subject to the business judgment rule. As the *Aronson* Court noted, "*a conscious decision to refrain from acting* may nonetheless be a valid exercise of business judgment." *Id.* (emphasis added).

[417] *See Seminaris v. Landa*, 662 A.2d 1350 (Del. Ch. 1995); *In re Baxter Int'l, Inc. S'holders Litig.*, 654 A.2d 1268 (Del. Ch. 1995).

[418] *Rabkin v. Philip A. Hunt Chem. Corp.*, 1987 WL 28436, at *1-3 (Del. Ch. Dec. 17, 1987). *See Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963). I confess to being mystified why plaintiffs did not cite *Rabkin* and its lower standard of liability when they did cite *Aronson* for the proposition that the business judgment rule does not apply to director inaction, as well as a bankruptcy decision that heavily relied upon *Rabkin*. *See Pereira v. Cogan*, 294 B.R. 449 (S.D.N.Y. 2003), *vacated and*

B. Waste

Corporate waste is very rarely found in Delaware courts because the applicable test imposes such an onerous burden upon a plaintiff—proving "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration."[419] In other words, waste is a rare, "unconscionable case[] where directors irrationally squander or give away corporate assets."[420]

The Delaware Supreme Court has implicitly held that committing waste is an act of bad faith.[421] It is not necessarily true, however, that every act of bad faith by a director constitutes waste. For example, if a director acts in bad faith (for whatever reason), but the transaction is one in which a

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remanded sub nom. Pereira v. Farace, __ F.3d __, 2005 WL 1532318 (2d Cir. June 30, 2005). A similar mystery confronted then-Vice Chancellor Berger in *Rabkin*, where she wrote:

> Both parties agree that liability must be predicated upon a finding of gross negligence. As a result, the Court did not have the benefit of what it assumed would be plaintiffs' arguments in support of the Court's original ruling [that ordinary negligence was the appropriate standard] and the Court is left in the unenviable position of deciding against both parties.

1987 WL 28436, at *2. It also bears noting that no Delaware decision (until this one) has cited *Rabkin*, decided roughly eighteen years ago, and it would appear that *Seminaris*, *In re Baxter Int'l*, and *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996), have since eclipsed *Rabkin* by implicitly accepting that gross negligence is the appropriate standard even in cases of alleged director inaction and lack of oversight.

419 *Brehm*, 746 A.2d at 263; *In re The Walt Disney Co. Derivative Litig.* (*"Disney I"*), 731 A.2d 342, 362 (Del. Ch. 1998) (quoting *Glazer v. Zapata Corp.*, 658 A.2d 176, 183 (Del. Ch. 1993)).

420 *Brehm*, 746 A.2d at 263.

421 *See White v. Panic*, 783 A.2d 543, 553-55 (Del. 2001) (citing *J.P. Stevens*, 542 A.2d at 780-81).

businessperson of ordinary, sound judgment concludes that the corporation received adequate consideration, the transaction would not constitute waste.[422]

C. The Fiduciary Duty of Due Care

The fiduciary duty of due care requires that directors of a Delaware corporation "use that amount of care which ordinarily careful and prudent men would use in similar circumstances,"[423] and "consider all material information reasonably available" in making business decisions, and that deficiencies in the directors' process are actionable only if the directors' actions are grossly negligent.[424] Chancellor Allen described the two contexts in which liability for a breach of the duty of care can arise:

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[422] Nevertheless, if the director acted in bad faith, it would be extraordinarily difficult for the defendant directors to prove that the transaction was entirely fair to the corporation because it would be difficult to demonstrate fair process. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

[423] *Graham*, 188 A.2d at 130.

[424] *Brehm*, 746 A.2d at 259; *Official Comm. Of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, et al.* (*"IHS"*), 2004 WL 1949290, at *9 n.37 (Del. Ch. Aug. 24, 2004); *In re Nat'l Auto Credit, Inc. S'holders Litig.*, 2003 WL 139768, at *12 (Del. Ch. Jan. 10, 2003). In *Cede III*, the Supreme Court affirmed and adopted Chancellor Allen's "presumed findings" that the directors of Technicolor "were grossly negligent in failing to reach an informed decision when they approved the agreement of merger, and . . . thereby breached their duty of care." 634 A.2d at 366. By way of example, a board of directors need not read "*in haec verba* every contract or legal document that it approves, but if it is to successfully absolve itself from charges of [violations of the duty of care], there must be some credible evidence that the directors knew what they were doing, and ensured that their purported action was given effect." *Van Gorkom*, 488 A.2d 858, 883 n.25 (Del. 1985).

> First, such liability may be said to follow *from a board decision* that results in a loss because that decision was ill advised or "negligent". Second, liability to the corporation for a loss may be said to arise from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.[425]

Chancellor Allen then explained with respect to board decisions:

> . . . [These] cases will typically be subject to review under the director-protective business judgment rule, assuming the decision made was the product of *a process* that was *either* deliberately considered in good faith or was otherwise rational. What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in *a good faith* effort to advance corporate interests. To employ a different rule—one that permitted an "objective" evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.
>
> Indeed, one wonders on what moral basis might shareholders attack a *good faith* business decision of a director as "unreasonable" or "irrational". Where a director *in fact exercises a good faith effort to be informed and to exercise*

[425] *Caremark*, 698 A.2d at 967 (emphasis in original).