Guest Column

# Delaware's Emerging Definition Of Bad Faith: Not As Bad As You Think

By Peter B. Ladig and Stephen B. Brauerman

In the Delaware Court of Chancery's recent decision in Ryan v. Lyondell Chemical Co., Vice Chancellor John W. Noble denied a motion for summary judgment filed by the independent directors because he could not find that directors who did "nothing or virtually nothing" to maximize shareholder value in a sale of control were protected by the company's 102(b)(7) exculpatory provision. Court watchers decried the Chancery Court's "conflation" of a duty of care violation with the bad faith component of the duty of loyalty. This criticism focused primarily on the apparent conversion of grossly negligent conduct traditionally governed by the duty of care and protected by a Section 102(b)(7) exculpatory charter provision into a nonexculpable, bad-faith, intentional dereliction of duty, potentially exposing independent directors to broad-based personal liability. But subsequent Chancery decisions (including one from Noble himself) make clear that it would take an extreme and unlikely set of facts for exculpatory duty of care claims to implicate the duty of loyalty.

One month to the day after he issued Ryan, Noble clarified the issue in a letter opinion denying the Ryan defendants' motion for certification of interlocutory appeal. Expressing surprise at the director defendants' overreaction to what he perceived as a routine denial of summary judgment on a paltry record, Noble emphasized that "the reports of the death of Section 102(b)(7) (and the consequent possibility for the 'resuscitation' of a Van Gorkom-esque liability crisis) in Delaware law are greatly exaggerated both...in this case, and certainly with regard to the application of a Section 102(b)(7) provision defense in any other case." The liability crisis to which Noble referred followed the Delaware Supreme Court's 1985 opinion in Smith v. Van Gorkom that directors could face substantial personal liability for their failure to exercise due care in making reasonably informed decisions. That opinion ultimately led to the adoption of Section 102(b)(7) by the Delaware General Assembly.

Noble also noted that while the Ryan defendants may ultimately prove that their sale process, which he characterized as "do nothing, hope for an impressive-enough premium, and buy a fairness opinion," was reasonable, their failure to engage in the sale process did not squarely fit within the duty of care to justify per se protection from liability under the company's 102(b)(7) provision. By emphasizing the procedural posture of his decision and narrowing the scope of its impact, Noble attempted to quell the uncertainty that followed Ryan.

Two subsequent Court of Chancery decisions, McPadden v. Sidhu and In re Lear Corporation Shareholders Litigation, should further allay any liability fears caused by Ryan. These cases make clear that Delaware's definition of bad faith, including the conscious disregard of a known duty, does not eviscerate the exculpation protections provided by Section 102(b)(7) provisions. In McPadden v. Sidhu, Chancellor William B. Chandler III explained that "a board of directors may act 'badly' without acting in bad faith." The McPadden decision found that directors who unreasonably delegated responsibility for a sale of their company's wholly owned subsidiary to an officer the board knew was interested in purchasing that subsidiary "were not careful enough in the discharge of their duties" but were, nevertheless, entitled to rely on the company's 102(b)(7) provision. McPadden's reluctance to lump all "bad conduct" into Delaware's conception of bad faith demonstrates the breadth of Section 102(b)(7)'s reach and provides comfort to anxious directors that the duty of care survives Ryan.

If McPadden was not sufficient to calm the outcry that followed Ryan, Vice Chancellor Leo E. Strine Jr.'s decision in Lear should provide serious comfort. Lear teaches that plaintiffs must meet a high burden to state a claim against an independent director protected by an exculpatory provision: "[s]uch a claim cannot rest on facts that simply support the notion that the directors made an unreasonable or even grossly unreasonable judgment. Rather, it must rest on facts that support a fair inference that the directors consciously acted in a manner contrary to the interests of [the company] and its stockholders."

Lear's articulation of the facts necessary to state a claim of bad faith is consistent with traditional conceptions of bad faith and demonstrates that any unintended expansion of liability after Ryan is unlikely to find traction in Delaware. Indeed, Strine emphasized, "[i]n the transactional context, a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties." Although the class of conduct that may fall within the definition of bad faith may appear to have expanded somewhat in recent years, Delaware courts will still review decisions of independent directors with deference and find independent directors are not entitled to the protections of a Section 102(b)(7) provision only in the most egregious factual circumstances.

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## FASB...

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The numbers have gotten so huge - $27 billion at giant insurer MetLife Inc. in late November - that many investors are worried insurers are failing to recognize reality. And a battle could erupt at year end as auditors potentially demand write-downs of at least some of the securities.

The possible rule revision falls far short of what banking and insurance executives were seeking because they wanted relief that would give them greater leeway in valuing a wider range of securities. But it illustrates how aggressive they have become in trying to stave off paper losses. Analysts are still trying to figure out which companies might own the particular securities at issue.

FASB staff's proposed easing pertains to certain structured securities that were rated lower than double-A at the time of origination. Most pieces of a securitization are more highly rated when created, many at triple-A.

The rub is that there isn't a clear rule on when losses have to be recognized on any type of debt security. Many banks and insurers continue to maintain, even after some securities have shown market losses for more than a year, that they will eventually be money good. The insurers add that they match investments with policy obligations, and they have cash hoards to ensure they won't be forced sellers.

At MetLife, the nation's biggest life insurer by assets, unrealized losses more than doubled between Sept. 30 and late November, the company told analysts Dec. 8. The company says the "temporarily impaired" securities all are performing well and are overwhelmingly highly rated. It attributed many securities' declines to "supply/demand imbalances" as "deleveraging" continues in much of the financial world. The company expects $200 million to $300 million in realized losses for the fourth quarter.

he FASB staff said the goal is to make the rule more consistent with a broader impairment standard that permits "the use of reasonable management judgment" of the probability of collecting all amounts due. Its change isn't assured; some board members expressed serious reservations about the move. Year-end conversations between auditors and insurance executives likely "will be substantial and somewhat heated," says Andrew Edelsberg, an analyst with ratings firm A.M. Best Co.

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Read together and in context, Ryan, McPadden and Lear suggest that the independent directors have no reason to question the protection afforded by exculpatory 102(b)(7) provisions in the transactional context. Just three months since the decision, the outrage that followed the Ryan decision seems entirely misplaced. As Delaware courts continue to identify precisely what action (or inaction in the face of a known duty to act) falls within nonexculpable, bad faith, violations of the duty of loyalty, independent directors can manage their companies securely, knowing that only an extreme set of facts will suffice to impose liability in the face of a Section 102(b)(7) provision. Such extreme facts will, as Lear suggests, often provide separate and independent bases for liability. While Delaware's definition of bad faith has received more attention in recent years, an exculpatory Section 102(b)(7) provision remains a viable, meaningful way for directors to insulate themselves from liability.

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*Peter B. Ladig is a director and Stephen B. Brauerman is an associate at the law firm of Bayard P.A. in Wilmington, Del. The views expressed herein are the authors' own and do not represent the views of Bayard P.A. or its clients. Ladig and Brauerman can be reached at (302) 655-5000.*

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