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Chancery Reaffirms Safe Harbor for Directors' Reasonable Reliance on Expert Advice

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Longstanding Delaware law not only entitles but encourages directors to rely in good faith on corporate officers and expert advisers for advice, information, and specialized expertise. Pursuant to Section 141(e) of the Delaware General Corporation Law, a member of a board of directors is "fully protected" from personal liability for duty of care violations "in relying in good faith upon … 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." The Delaware Court of Chancery recently continued this long line of Delaware authority in *The Cirillo Family Trust v. Moezinia*, in which the court dismissed breach of fiduciary duty claims against directors who had relied on legal advice, even when that legal advice was later challenged in litigation.

Brian M. Lutz and Mark H. Mixon Jr. of Gibson, Dunn & Cructcher. Courtesy photo

Precedent Cases

In *Graham v. Allis-Chalmers Manufacturing*, Section 141(f) (the predecessor to Section 141(e)) protected directors from charges that they were liable to their company for losses arising from the unlawful acts of a few employees. Given the "magnitude of the enterprise," the Court of Chancery found and the Supreme Court affirmed, Section 141(f) permitted the directors to rely on "summaries, reports and corporate records" in considering and deciding whether to "rely on the honesty and integrity of their subordinates" or "put into effect a system of watchfulness." Similarly, in *Cheff v. Mathes*, the Supreme Court held that Section 141(f) permitted directors to rely upon "direct investigation, receipt of professional advice, and personal observations" in concluding that a stockholder's accumulation of stock in the company created a reasonable threat to corporate policy and effectiveness, and in deciding in good faith that the corporate interest was best served by using corporate funds to purchase all of his shares.

In *In re Walt Disney Co. Derivative Litigation*, derivative plaintiffs sued Disney directors for breaching their fiduciary duties when the company fired Michael Ovitz, its president who had served in that position for only 14 months, without cause and paid him $130 million in severance. The plaintiffs alleged that members of Disney's compensation committee breached their duty of care in approving Ovitz's compensation package, and the other board members breached their duty of care in electing Ovitz as president. Rejecting the plaintiffs' theory that the committee failed to inform itself of the magnitude of Ovitz's potential severance when it approved his employment agreement, the Supreme Court affirmed the trial court's conclusions that Section 141(e) protected both the compensation committee's approval of the agreement's terms and the whole board's election of Ovitz. In particular, the court found that, under Section 141(e), the committee reasonably relied on an executive compensation expert and members directly involved in the negotiations with Ovitz, and the board reasonably relied on the committee's report and approval of the agreement.

In *Versata Enterprises v. Selectica*, a target's competitor, who was also a stockholder, challenged the target's adoption of a poison pill equipped with a 5 percent trigger to protect about $160 million in net operating loss carryforwards (NOLs) from impairment due to an "ownership change" under Section 382 of the Internal Revenue Code. The Supreme Court affirmed the Court of Chancery's holding that, under enhanced scrutiny, the target's board of directors reasonably concluded both that the competitor's efforts to impair the NOLs by causing an "ownership change" was a threat to the company, and that the poison pill's 5 percent trigger was a proportionate response in relation to the threat posed. Importantly, the board's conclusions were found to satisfy enhanced scrutiny because, consistent with Section 141(e), it had relied in good faith both on an outside accountant's expert valuation of the NOLs and assessment of their risk of impairment, and on an investment banker's advice that the NOLs were worth protecting given the possibility of a sale of the target or its assets.

'The Cirillo Family Trust v. Moezinia'

Recently, the Court of Chancery held that Section 141(e) protected disinterested, independent directors from monetary liability arising from breaches of their duty of care in connection with a notice of appraisal rights prepared by the company's longtime corporate counsel that the court found to be deficient, *The Cirillo Family Trust v. Moezinia*. In this case, the defendant company had effectuated its sale by near-unanimous written consent, and notices were provided to the lone holdout informing it of its right to seek appraisal of its shares within 20 days. The notice was defective, however, as it provided, "if not zero, [then] as close to zero as you could get by way of information that would be relevant to allow somebody to make a determination as to whether or not to seek appraisal." Nonetheless, the Court of Chancery granted the defendant directors' motion for summary judgment because it was unrebutted that each defendant's reliance on outside counsel "reached a level of essentially complete dependence with respect to the legal aspects of the merger," and that they had selected their counsel with "reasonable care" and "relied in good faith on [its] advice with respect to subject matters they believed fell within its professional judgment."

Conclusion

Cirillo Family Trust, as the latest in a long line of cases protecting directors who reasonably rely on expert advice, should give corporate directors and their advisers comfort that Delaware law will continue to protect directors when rendering decisions on the basis of information and advice from legal and financial experts.

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