# Directors and Officers: The Role of Motive in Defining the Line Between Good Faith and Bad

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A collateral effect of the downturn in the economy and the credit crisis of the last two years has been a heightened focus by the courts on activities of corporate directors and officers. Increasingly, in such cases, the courts have sought to discern the often opaque line between good faith activities necessitated by circumstances and excessive and self-serving conduct. In doing so, they have upheld board actions compelled by sudden cataclysmic financial circumstances where the courts have found the challenged activity made in the heat of the moment need not be perfect, as long as the course taken was one of several reasonable alternatives. However, they have also responded critically where board members have acted with a motive that appears self-interested or inconsistent with the objectives of the corporation and its shareholders.

*Fiduciary Duty Standard*

Under well-developed bodies of law in New York and Delaware, members of a corporate board of directors are fiduciaries and, as such, are held to an elevated standard of care. In New York, the duty has been famously been described as requiring a level of behavior that is “stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive . . ."[1] A “special duty” arises from a relationship that imposes an obligation to “protect the interests of another.”[2] In the corporate context, an officer’s fiduciary duty includes discharging corporate responsibilities “in good faith and with conscientious fairness, morality and honesty in purpose and displaying ‘good and prudent management of the corporation.’”[3] The “core duties” are those of “loyalty and due care.”[4]

*The Business Judgment Rule*

Despite the heightened standards to which directors and officers are held, their activity is, under most circumstances, insulated from personal liability by the “business judgment rule.” The business judgment rule presumes that a business decision has been made on an “informed basis,” in “good faith” and with an “honest belief that the action taken was in the best interests of the company.”[5] The rule “bars inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance or corporate purposes.”[6] The central premise behind the rule is to prevent a court from “second-guessing corporate decision-making in the event the corporate decision was made in good faith and after reasonable investigation.”[7] Where a director’s decision can be attributed to “any rational business purpose,” it will remain undisturbed.[8]

To rebut the presumption of good faith requires evidence that the directors engaged in acts constituting a "[breach of] their duty of care or of loyalty or acted in bad faith."[9] Where such evidence compels the conclusion that "no person of ordinary sound business judgment would say that the corporation received fair benefit," the presumption of the business judgment rule is overcome.[10] In such circumstances, the burden shifts to the directors "to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."[11] Where the directors establish that they have acted in the best interest of the corporation, liability will not be imposed, even where hindsight reflects that the action fell short of the goal intended.[12]

*Recent Examples*

In the *Bear Stearns Litigation*,[13] a consolidated class of shareholders brought suit challenging the shocking stock-for-stock acquisition of Bear Stearns by JP Morgan Chase. As the decision recounts, Bear Stearns faced a grave "liquidity crisis" in March 2008 arising from its exposure to subprime mortgage debt that had been dramatically downgraded by rating agencies. Large numbers of customers expressed a desire to withdraw funds from Bear Stearns, and counterparties that extended credit to the firm expressed concern over maintaining their ordinary course exposure.[14] The class members alleged, among other things, that the sale consideration paid by JP Morgan was inadequate, that more beneficial alternatives to the sale were available, including bankruptcy, and that the Bear Stearns directors violated their fiduciary duties in recommending the sale.[15]

The court reviewed extensive evidence offered by experts for each side regarding other options available to the directors, including the sale of assets in bankruptcy or governmental intervention. In considering the viability of the options and the circumstances surrounding the decision-making process, the court found that:

[P]laintiffs' arguments rest largely on expert affidavits speculating about Bear Stearns' alleged true value and the claimed superiority of various bankruptcy options. These opinions, however, do not take into sufficient consideration the very real emergency which the company faced, and the real time pressure under which Bear Stearns' officers and directors were operating. The company could simply not continue to carry on its major operations . . . unless it had put some major financing, or a major transaction which would carry with it major financing, into place. No options appeared to be available other than the merger transaction with JP Morgan.

The various alternatives, suggested by plaintiffs and their experts, could not reasonably have been consummated by the opening of business on Monday [March 17, 2008] morning. In their absence, and in view of the market pressure and the pressure exerted by the Treasury Department, the company would have been driven into bankruptcy. To expect greater assistance than was offered from the various governmental entities including the Treasury Department, was apparently not considered prudent by the board of directors, which was ultimately charged with the responsibility of making the decision.

In response to a sudden and rapidly-escalating liquidity crisis, Bear Stearns' directors acted expeditiously to consider the company's limited options. They attempted to salvage some $1.5 billion in shareholder value and averted a bankruptcy that may have returned nothing to the Bear Stearns shareholders, while wreaking havoc on the financial markets. The Court should not, and will not, second guess their decision.[16]

Essential is the court's determination that the directors' selection from among the limited options available was not influenced by self-interest. Indeed, among other things, the court noted that the terms of the merger agreement required the directors to resign immediately.[17] Such a finding is in contrast with other decisions arising out of the same troubled period in which evidence of self-interest compelled the court to reach a different conclusion.

In *People v. Grasso*,[18] a challenge was brought by the New York Attorney General to compensation and benefits awarded to Richard Grasso, the former chief executive officer of the New York Stock Exchange. The decision affirmed a trial court denial of a motion for summary judgment by Kenneth Langone, a stock exchange director and the chair of its compensation committee, which had held that Langone breached his fiduciary duties by misleading the Exchange's board of directors concerning an award under a "Capital Accumulation Plan" that was part of Grasso's compensation as a senior executive. The court held that the ultimate issue of whether Langone breached his duties to the Board and the Exchange was "fact based" and therefore not appropriate for summary judgment. However, in doing so, it reviewed evidence in the record demonstrating that Langone "may not have effectively communicated Grasso's compensation to the Board." Notably, the court further found that seven Exchange board members had indicated during their depositions that "they did not understand the impact of their votes in favor of Grasso's compensation awards."[19] Other evidence had been presented that compensation worksheets circulated to members of the compensation committee that had been prepared at Langone's direction omitted a key component of Grasso's projected compensation.[20] Further, the evidence showed that Langone may have been motivated to hide the true amount of Grasso's compensation from the Exchange's members who, it was known, would "not be happy" had they been known of the full amount.[21] Thus, given this evidence, the court found that Langone had not established as a matter of law that he had fulfilled his fiduciary obligations to the Exchange.[22]

*Conclusion*

The proximity in time between the *Bear Stearns* and *Grasso* decisions by the New York courts and their contrasting conclusions present an opportunity to draw from them circumstances under which courts are more likely to impose personal liability against directors and officers. Although both cases involved decisions made by directors that were within the scope of their authority, liability was not imposed in *Bear Stearns* because the court was not confronted with evidence that the motives of the directors had been tainted by self-interest. Largely, the actions of the *Bear Stearns* board were justified by the dire circumstances presented. Indeed, its ability to salvage some shareholder value amid the wreckage appeared to validate its good faith. By contrast, the determining factor in the decision in *Grasso* was a nagging implication of deceit by Langone who, a jury might have concluded, manipulated the presentation of Grasso's compensation to those who might have objected to it had the full information been disclosed. While a trial might have yet shown that the board members were familiar with the omitted portion of Grasso's compensation, the fact that worksheets did not include (as they previously had) such information was simply too much for the court to eliminate the possibility of an ulterior motive. Accordingly, the *Bear Stearns* and *Grasso* cases illustrate the powerful — and even determinative — role that motive plays in defining the line between liability and non-liability of officers and directors.

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[1] *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 454 (1928) (Cardozo, C.J.).

[2] *Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 901 A.2d 106, 113 (Del. 2006) (citation omitted).

[3] *Alpert v. 28 Williams St. Corp.*, 63 N.Y.2d 557, 569, 483 N.Y.S.2d 667, 473 N.E.2d 19 (1984) (citations omitted).

[4] *Stone ex rel. AmSouth BancCorporation v. Ritter*, 911 A.2d 362 (Del. 2006).

[5] *Aronson v. Lewis*, 473 A.2d 805, 811 (Del 1984). *See Matter of Levandusky v. One Fifth Ave. Apt. Corp.*, 75 N.Y.2d 530, 554 N.Y.S.2d 807, 553 N.E.2d 1317 (1990).

[6] *Auerbach v. Bennett*, 47 N.Y.2d 619, 629, 419 N.Y.S.2d 920, 393 N.E.2d 944 (1979).

[7] *Lippman v. Shaffer*, 15 Misc. 3d 705, 836 N.Y.S.2d 766, 772 (Sup. Ct. Monroe Co. 2006). *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 360 (Del. 1993).

[8] *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

[9] *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006).

[10] *Aronoff v. Albanese*, 85 A.D.2d 3, 5, 446 N.Y.S.2d 368 (2d Dep't 1982).

[11] *In re Walt Disney Co.* at 52. *See K.C. McDaniel v. 162 Columbia Heights Housing Corp.*, 25 Misc. 3d 1024, 1042, 866 N.Y.S.2d 562, 578 (Sup. Ct. Kings Co. 2009).

[12] *Id*. at 1043. *See also Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45 (Del. 1994).

[13] 23 Misc. 3d 447, 870 N.Y.S.2d 709 (N.Y. Co. 2008).

[14] *Id.* at 450, 870 N.Y.S.2d at 720.

[15] *Id*. at 448, 870 N.Y.S.2d at 718.

[16] *Id*. at 465-66, 870 N.Y.S.2d at 730-31.

[17] *Id.*

[18] 50 A.D.3d 535, 858 N.Y.S.2d 23 (1st Dep't 2008).

[19] *Id.* at 547, 858 N.Y.S.2d at 34.

[20] *Id.* at 543, 858 N.Y.S.2d at 31.

[21] *Id.* at 547-48, 858 N.Y.S.2d at 34.

[22] *Id.* at 548, 858 N.Y.S.2d at 35.