EMERGING COMMUNICATIONS AND THE RÉSUMÉ APPROACH TO BAD FAITH CLAIMS

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In *In re* Emerging Communications,[1] a case decided last year by the Delaware Court of Chancery, the court was very interested in a Defendant director's experience and expertise as a securities analyst and investment banker. In fact, because of his "specialized expertise and knowledge,"[2] the court determined that he "knew or should have known"[3] that the merger price agreed upon by the company he represented was too low. For the first time ever, the Chancery Court inferred a breach of good faith or loyalty based partly on a director's résumé, while letting the other "dummy" directors off the hook. This decision has stunned the corporate law community and left many directors in the business world worried about personal liability.[4]

Emerging Communications is the most recent case to interpret Delaware's nebulous new fiduciary duty: the duty to act in good faith. This note will briefly summarize the developments and the confusion surrounding this duty under Delaware law. Prior to this decision, Delaware courts rarely, if ever, used a director's expertise as evidence to infer bad faith. This practice, which could be referred to as the "résumé approach," actually runs directly against federal policy. Under the Sarbanes-Oxley Act of 2002, corporate directors are held to the same standard regardless of their background and alleged experience. This note urges Delaware courts to consider the economic and moral implications of inferring bad faith based on

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1. *In re* Emerging Commun's, Inc. S'holders Litig., 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) [*hereinafter* "Emerging Communications"].

2. *Id.* at *144.

3. *Id.* at *149.

4. Kara Scannel, *Judge Decides Some Directors Are More Liable*, WALL ST. J., October 12, 2004, at C1.

a director's expertise. After reviewing the pertinent case law, I conclude that Delaware would be wise to adopt the SEC's position that a higher standard for expert directors is counter-productive and contrary to the public interest.

I.
DELAWARE'S DUTY TO ACT IN GOOD FAITH

Many have questioned why Delaware courts point to an examination of directors' résumés, rather than focusing on each individual director's actions. The impetus of this seemingly odd practice is Delaware's evolving duty of good faith. While "good faith" was once a minor-league responsibility that received a short mention in *dictum*, it has now arguably evolved into a full-fledged fiduciary duty on par with the duties of care and loyalty. Thus before we examine *Emerging Communications*, we must briefly review the major and recent developments of Delaware's new duty.

The Confusing Effect of DGCL § 102(b)(7)

In the landmark case *Smith v. Van Gorkom*, a Delaware court for the first time ever held a board liable for breaching their duty of care in a situation where the board made a "business decision."[5] In response to wide criticism of the case,[6] and a significant increase in director's' and officer's' insurance premiums,[7] the Delaware legislature enacted § 102(b)(7) of the Delaware General Corporation Law. This provision authorizes corporations to include a provision in their charters that exculpates directors from liability for breaches of the duty of care.[8] Section 102(b)(7) does not authorize exculpatory provisions for "any breach of the director's duty of loyalty to the corporation or its stockholders . . . [or] for acts or omissions *not in good faith* or which involve intentional misconduct or a knowing violation of law."[9] Section 102(b)(7) can be seen as

5. 488 A.2d 858 (Del. 1985).

6. *See* Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985) (criticizing *Van Gorkom* as "one of the worst decisions in the history of corporate law.").

7. *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L. J. 1155, 1155-59 (1990).

8. 8 Del. C. § 102(b)(7) (2005).

9. *Id.* (emphasis added).

the midwife to the modern duty of good faith; the section separates the duty of good faith from the duty of loyalty, and in so doing, it seems to have brought it to the attention of the courts and litigants as a separate tool of corporate governance.[10]

The arguably sloppy language of § 102(b)(7) ignited a debate that is unsettled today: what does "good faith" mean? Is there an independent *duty* to act in good faith, or is it a subsidiary requirement of the duty of loyalty? The Delaware Supreme Court has generally, but timidly, encouraged an independent duty of good faith.[11] The Chancery Court at times has been vocally resistant.[12]

The recent executive compensation case, *In re* Walt Disney Co. Derivative Litigation,[13] Kristi Hinner[14] After *Disney*, we know that a bad faith claim alone—without any allegations of self-interest—can be sufficient to rebut the business judgment rule. Yet in many ways, *Disney* raises many more questions than it answers. What exactly is the "we don't care about

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10. Emerald Partners v. Berlin, No. 9700, 2003 Del. Ch. LEXIS 42, at *138 n.133 (Del. Ch. Apr. 28, 2003) (criticizing the drafting of § 102(b)(7) because its structure "balkanizes the fiduciary duty of loyalty into various fragments, thereby creating unnecessary conceptual confusion"). *See also* David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 496-504 (2004) (reviewing the confusion surrounding the language of 102(b)(7)); John L. Reed & Matt Niederman, "*Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111, 119-124 (2004) (reviewing the meaning of good faith for purposes of 102(b)(7)).

11. In 1993, the Delaware Supreme Court defined the duty to act in good faith as "one of the *triads* of their fiduciary duty—good faith, loyalty or due care." Cede v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). *See also* Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998) (citations omitted) (reiterating the Delaware Supreme Court's view of the "triad" conception of fiduciary duties).

12. As late as 2000, the Chancery Court defined the duty of good faith as a subsidiary requirement of the duty of loyalty "within which traditional duty would logically rest the subsidiary requirement to act in good, rather than bad, faith toward the company and its stockholders." *In re* Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000).

13. *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 286 (Del. Ch. 2003).

14. *Id.* at 291 (finding that the plaintiff shareholders survived a motion to dismiss based *solely* on a duty of good faith claim against an admittedly disinterested and independent board of directors).

the risks attitude" that may breach the duty of good faith?[15] *Disney* lets us know that a bad faith claim need not involve allegations of financial self-interest. This may cause further separation of the duty of good faith from the duty of loyalty.

However, *Disney* does not present a coherent framework for differentiating the duty of good faith from the duty of care.[16] After *Disney*, the line between the duty of care and the "duty" of good faith has been blurred dramatically. Compare the acts of the *Disney* board and those of the *Van Gorkom* board.[17] Which board acted "grossly negligent" (behavior exculpated by 102(b)(7)) and which board exhibited the supposedly more egregious "we don't care about the risks attitude?" It is even possible that if *Van Gorkom* were decided today, the directors would *still* be found liable on a duty of good faith claim, notwithstanding the purpose of §102(b)(7) to exculpate such behavior.[18]

The academic debate surrounding the boundaries of the duty of good faith has also begun. Some academics are enamored with an independent and robust duty of good faith.[19]

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15. *Id.* at 289-90 ("[t]hese facts, if true, do more than portray directors who, in a negligent or grossly negligent manner, merely failed to inform themselves or to deliberate adequately about an issue of material importance to their corporation. Instead, the facts alleged in the new complaint suggest that the defendant directors *consciously and intentionally disregarded their responsibilities,* adopting a we don't care about the risks attitude concerning a material corporate decision.") (emphasis added).

16. Admittedly, as of the date of publication of this note, it is unknown whether the Disney directors will ultimately be found to have breached their fiduciary duty to act in good faith. Yet the fact that the business judgment rule was rebutted solely on the basis of a bad faith claim may reveal an evolution of this duty into independence. *Id.*

17. 488 A.2d 858 (Del. 1985).

18. This hypothetical exercise only addresses how the modern Delaware Chancery Court might address a claim of breach of fiduciary duty of good faith on the facts of *Van Gorkom.* However it is very possible that our hypothetical plaintiff today might not take the time to prove a duty of good faith breach when a breach of "Revlon duties" might be more easily established under the facts of *Van Gorkom. See generally* Revlon Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

19. Hillary A. Sale, *Delaware's Good Faith,* 89 CORNELL L. REV. 456 (2004). *See also* John L. Reed & Matt Niederman, *supra* note 10, at 142 (advocating increased use of the duty of good faith by courts because "[m]ore legislation may follow if there is a perception that courts have not created standards of conduct sufficient to ensure that directors will be accountable for willful ignorance or lack of oversight").

One commentator, Hillary Sale, has advocated the finding of good faith violations in situations where directors "fail to ask questions . . . fail to investigate . . . or when they make decisions without assuring themselves that they are deciding on sufficient information."[20] Sale's definition of good faith has been criticized by others such as David Rosenberg for failing to articulate a definition of the duty of faith that is independent from the fiduciary duties of loyalty and care.[21] Rosenberg advocates a "contractarian" definition of good faith: "Properly construed, good faith is not itself a fiduciary duty, nor is it a subset of a specific fiduciary duty. Rather, good faith is an interpretive device which can be used to determine whether directors have adhered to their traditional fiduciary duties of loyalty and care."[22]

Another commentator, Matthew Berry, acknowledges the existence of a separate duty of good faith, but advocates restricting its definition to exclude reckless acts.[23] Berry's definition of bad faith would only include acts committed with a dishonest purpose, ill will state of mind, or an illicit motive.[24]

The debate over the duty of good faith rolls on in the courts and academic journals, with much of the focus on its definition and relationship to other fiduciary duties. An independent duty seems to be in the works, and perhaps inevitable, considering the current political climate. But less attention has been paid to the evidentiary requirements of this new duty. If any of these commentator''s definitions of bad/good faith were accepted, questions would still remain regarding what evidence should be used by the court to infer bad faith. The Chancery Court confronts this issue in *Emerging Communications*, where it rather nonchalantly inferred bad faith on part of one director who (unlike several of his colleagues who were

20. Sale, *supra* note 20, at 492.

21. Rosenberg, *supra* note 10, at 509. *See also* Eric A. Chiappinelli, *The Life and Adventures of Unocal—Part 1: Moore the Marrier*, 23 DEL. J. CORP. L. 85, 86 (1998) (defining the duty of loyalty as "the duty to act in good faith and in the company's best interest").

22. *Id.* at 515.

23. Matthew R. Berry, *Does Delaware Section 102(b)(7) Protect Directors from Personal Liability? Only if Delaware Courts Act in Good Faith*, 79 WASH. L. REV. 1125 (2004).

24. *Id.* at 1149-51.

let off the hook) had the misfortune of being an expert in finance and securities evaluation.

II.
SUMMARY OF *EMERGING COMMUNICATIONS*

Facts and Court's Analysis

Emerging Communications ("ECM") is a Delaware Corporation whose main source of revenue (88%) comes from being the exclusive provider of local wired telephone services in the Virgin Islands. In early 1998, the controlling shareholder, Jeffrey J. Prosser , decided to pursue a transaction to cash out the public minority, which ultimately happened at $10.25 per share.[25] Minority shareholders, dissatisfied with their consideration and the conduct of the directors in the transaction, subsequently filed an appraisal action and a class action alleging breaches of the fiduciary duties of loyalty and good faith.[26]

Because this was an acquisition of a corporation''s minority stock by its majority stockholder, the standard underwhich the Court reviewed the validity of the transaction was "entire fairness."[27] Before the merger, the directors of ECM formed a special committee that negotiated and approved the share price, which was subsequently approved by the rest of the board and a majority of the minority shareholders. However, as the Delaware Chancery Court later found, Prosser withheld the most recent June financial projections from the special committee and its financial advisors—information which the court believed to be a "highly material fact."[28] Because Prosser withheld material information, the court ruled that the merger had not been approved by a committee of independent directors who were properly informed or independent of

25. *Emerging Communications,* 2004 Del. Ch. LEXIS at *2, *5.

26. *Id.* at *3.

27. *Id.* at *35-*36, citing Emerald Partners v. Berlin, 787 A.2d 85 (Del. 2001) (applying fairness review for mergers and buy-outs where controlling shareholder is self-interested). Under the reasoning of these cases, if the controlling shareholder is not on both sides of the transaction, fairness review is not automatic. *See id.*

28. *Id.* at *112. According to the court, "the June projections forecasted substantially higher growth than did the March projections." *Id.* at *25. Because this material fact was also undisclosed in the proxy statement sent to the minority shareholders, shareholder approval of the merger was also uninformed and therefore ineffective for burden shifting purposes. *Id.* at *113.

Prosser, and had not been approved by an informed vote of a majority of ECM''s minoritystockholders.[29] Thus at trial, the directors were held to bear the burden of proof at trial in establishing entire fairness.

Under the fairness analysis, the court found the fair value of ECM to be $416,996,000, or $38.05 per share. This was considerably larger than the original $10.25 per share that had been received by the minority stockholders.[30] The court also found that the merger price was not the result of fair dealing.[31] But because ECM's charter contained a § 102(b)(7) exculpatory provision, the directors could only be found liable for breaches of their fiduciary duties of loyalty and good faith.[32]

The Directors' Liability

The directors were then individually considered for liability.[33] The court found that the controlling shareholder, Prosser, breached his duty of loyalty "by eliminating ECM''s minority stockholders for an unfair price in an unfair transaction that afforded the minority no procedural protections."[34] Prosser's liability was predictable, since he was directly interested in the transaction and actively undermined the bargaining process.[35]

The court also found John P. Raynor, a director of ECM, to have breached his duties of loyalty and good faith. Raynor was a practicing attorney, a partner of an Omaha, Nebraska

29. *Id.* at *111-12.

30. *Id.* at *2.

31. *Id.* at *137.

32. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2003) (allowing corporations to include a provision in their charter which exculpates directors only for acts which breach their duty of care).

33. *Emerging Communications*, 2004 Del. Ch. LEXIS at *140 ("[t]he 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 exculpated from liability for that breach, can vary for each director.").

34. *Id.* at *139.

35. The court found that Prosser committed several nefarious acts which violated fair dealing, including: his initial decision to "flip" the transaction for his personal benefit to take advantage of the temporarily and artificially depressed stock price, co-opting the corporation's investment advisors to work for him rather than the corporation, and withholding valuable financial projections. See *id.* at *116-*130.

law firm, and served as Prosser''s personal attorney as well as ECM''s counsel. Raynor was also a business associate of Prosser, had been a director of another Prosser owned entity, and acted as Prosser''s advisor in formulating the terms of the privatization transaction.[36] Although Raynor did not benefit directly from the transactions, the court found that "his loyalties ran solely to Prosser because Raynor''s economic interests were tied solely to Prosser and he acted to further those economic interests."[37] In other words, Raynor was on Prosser's payroll, and he actively assisted Prosser in undermining the bargaining process to the detriment of the shareholder class.[38] This amounted to a breach of Raynor's duties of loyalty and/or good faith.[39]

The Surprising Liability of Mr. Muoio

Prosser directly benefited from the transaction, and Raynor, as Prosser's personal attorney, actively assisted Prosser to the detriment of the minority shareholders. These directors' liability is unsurprising. However the court, "albeit with reluctance,"[40] found another director to be liable. Salvatore Muoio did not directly benefit from the transaction, nor did he do anything affirmatively to assist Prosser in breaching his fiduciary duties. Without being financially interested or having knowingly participated in the transaction, most lawyers would never have expected Muoio to be on the radar screen of this court. It is this director's problematic liability that is the subject of this note.

36. *Id.* at *10.

37. *Id.* at *142.

38. *Id.* at *140, *141.

39. *Id.* at *142, n.184 (explaining that "the Court employs the 'and/or' phraseology because the Delaware Supreme Court has yet to articulate the precise differentiation between the duties of loyalty and of good faith. If a loyalty breach requires that the fiduciary have a self-dealing conflict of interest in the transaction itself . . . then only Prosser is liable on that basis. Raynor would be liable for violating his duty of good faith for consciously disregarding his duty to the minority stockholders. On the other hand, if a loyalty breach, does not require a self-dealing conflict of interest or receipt of an improper benefit, then Raynor would be liable for breaching his duties of loyalty *and* good faith.") (emphasis added) (citations omitted).

40. *Id.* at *143.

Muoio had significant experience in finance and the telecommunications sector.[41] It was this experience that apparently got Muoio in trouble, while four other directors who also approved the transaction were let off the hook:

> Muoio was in a unique position to know that [the merger price was unfair.] He was a principal and general partner in an investment advising firm, with significant experience in finance . . . Hence, Muoio possessed a specialized financial expertise, and an ability to understand ECM's intrinsic value, that was unique to the ECM board members . . .[42]

This language stunned the business and legal community,[43] as no Delaware court has ever used a defendant's expertise as a basis from which to infer bad faith.[44]

The court did admit the possibility that Muoio actually believed the price to be fair; however in this particular case,

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41. Mr. Muoio's background included employment as a securities analyst and vice president at Lazard Freres & Co., from 1995 to 1996 in the telecommunications and media sector, and then for Gabelli & Co., Inc., from 1985 to 1995, serving both as a generalist and in the communications sector. During his career, Mr. Muoio has been quoted in many well-regarded financial newspapers and periodicals. *Id.* at *9.

42. *Id.* at *143-44. Interestingly, the plaintiff's pre-trial brief does not argue that Muoio's expertise should be used as a basis for a finding of bad faith. The brief describes Muoio's expertise only to make the point that Muoio should have been appointed to the special committee that negotiated the merger, which, partly as a result of his absence, was ineffective: "The *only* director who was an expert in financial valuation of telecommunications companies, Muoio, did not serve on the Special Committee . . . Muoio's extensive practical experience in corporate valuation in the telecom industry was plainly superior to that of the three directors who did serve . . . " Petitioner's Pretrial Brief at 38, *Emerging Communications*, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004), *available at* http://corporate-law.widener.edu.

43. *See, e.g.*, Scannel, *supra* note 4, at C1.

44. The court does not exactly specify whether Muoio violated his duty of loyalty or that of good faith: "Muoio's conduct is explainable in terms of only one of two possible mindsets. The first is that Muoio made a deliberate judgment that to further his personal business interests, it was of paramount importance for him to exhibit his primary loyalty to Prosser. The second was that Muoio, for whatever reason, consciously and intentionally disregarded his responsibility to safeguard the minority stockholders from the risk, of which he had unique knowledge, that the transaction was unfair. If motivated by either of those mindsets, Muoio's conduct would have amounted to a violation of his duty of loyalty and/or good faith." *Emerging Communications*, 2004 Del. Ch. LEXIS at *147.

Muoio carried the burden of proof, and in such a situation "the burden falls upon the director to show that '[his] failure to withstand an entire fairness analysis is *exclusively* attributable to a violation of the duty of care." The court declared that "Muoio has not carried that burden."[45]

There is an additional troubling fact with Muoio's liability: Muoio was expected to know the fair value of the firm, even though Prosser withheld the June projections[46] that showed "substantially higher growth."[47] This information was considered important enough by the court to render the director and shareholder ratifications uninformed (and therefore ineffective as a burden-shifting device).[48] Justice Jacobs does not address this issue.[49] That a director can act in bad faith when material information has been deliberately withheld from him in making the decision is a controversial proposition.

Admittedly, Muoio did not do much to help his own cause at his deposition, testifying that the $10.25 merger price was "at the low end of any kind of fair value you would put."[50] He also expressed to another director his view that the Special Committee might be able to get up to $20 per share from Prosser.[51] There is also evidence that Muoio, as a shareholder, felt

45. *Id.* at * 146, citing Emerald Partners v. Berlin, 787 A.2d at 98 (emphasis added) (citations ommited).

46. Although Prosser made the June projections available to his legal advisor, financial advisor, and lender, the June projections were never provided to the Special Committee, Houlihan, or the ECM board. Instead, Prosser directed Heying to send Houlihan the *March* projections, even though the June projections were available by that point. As a result, the Committee and its advisors believed—mistakenly—that the March projections were the most recent projections available. *Id.* at *27. *See also* Petitioner's Pretrial Brief at 27, *Emerging Communications*, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004), *available at* http://corporate-law.widener.edu ("In making his valuation, Muoio did not have the benefit of the June Projections, which would have increased his value").

47. *Id.* at *25.

48. *Id.* at *111-115.

49. Perhaps Justice Jacobs believed that Muoio should have asked for the information. But this at most amounts to negligence exculpable by §102(b)(7), and does not likely amount to a bad faith abdication. The likely explanation is that Justice Jacobs believed that with the limited information that Muoio had, he made a decision in bad faith.

50. *Id.* at *144

51. *Id.*

coerced by Prosser into approving the deal. Muoio testified that he felt Prosser "squeezing" shareholders, and commented that he did not "actually want to be his shareholder three years from now so if this is someone you don't trust, do you want to commit to being a long-term shareholder if the company is not very liquid . . . [W]e're going to end up getting low end of low end now or low end of some other low end some other time."[52] While this testimony may not amount to bad faith, it certainly does not paint a picture of a diligent, valiant director. In an interview with the Wall Street Journal, Muoio stated in his defense, "I feel like I did the right thing, 100%, for the shareholders, and I was a shareholder."[53]

There were four remaining directors of Emerging Communications who engaged in the same actions as Muoio. Like Muoio, they were not personally interested in the transaction, but were not independent of the controlling shareholder either. Fortunately for them, however, they lacked Muoio's expertise and knowledge. Thus the court found there to be no evidence that any of those directors "knew or had reason to believe, that the merger price was unfair."[54] It is this mind-reading that represents a new use of Delaware's duty of good faith to find certain directors liable, even though they were not interested nor assisted in an unfair transaction. This note will explore the development and ramifications of this practice, as well as examining recent developments in Delaware's duty to act in good faith.

III.
INFERRING BAD FAITH

The duty of good faith has inherent evidentiary difficulties. The fiduciary duties of care and loyalty can most often be established with objective evidence. The duty of care is satisfied by evidence of deliberation and other procedural aspects

52. Petitioner's Pretrial Brief at 45, n. 44, *Emerging Communications, 2004* Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004), *available at* http://corporate-law.widener.edu.

53. Kara Scannel, *Judge Decides Some Directors Are More Liable,* WALL ST. J., October 12, 2004, at C1.

54. *Emerging Communications,* 2004 Del. Ch. LEXIS at *148.

of the decision making process. If carelessness amounts to "gross negligence," the duty is breached.[55]

The duty of loyalty is also more easily measured by objective evidence.[56] First, the defendant may produce evidence that she was not on both sides of the transaction. If she did personally gain from the transaction, she must demonstrate that the transaction meets the standards of "entire fairness."[57] The court determines fairness by evaluating the dealings between the parties, and may engage in financial analysis to determine fair price. If the financial interest was fully disclosed and approved by independent directors or shareholders, the burden of proof may shift to the plaintiff in the fairness proceeding. With most duty of loyalty claims (where the defendant gains personally from the transaction), a court need not trouble itself with the murky waters of a director's state of mind.

Neither the duty of care nor loyalty necessitates inquiries into the state of mind of the director.[58] The duty to act in good faith is different. As *Emerging Communications* demonstrates, it is possible for the same physical acts to be carried out in good faith by one director, and in bad faith by another. This was allegedly the case when Mr. Muoio supposedly approved the merger "informed by his specialized expertise and knowledge,"[59] while four other directors approved the merger in ignorance, honestly believing in good faith that the buy-out consideration was fair. The difference is a matter of scienter;

55. *Van Gorkom*, 488 A.2d at 884.

56. Here I am speaking of the duty of loyalty as if it were separate from the duty to act in good faith, an issue which Delaware has yet to resolve. *See supra* note 39 and accompanying text.

57. Emerald Partners v. Berlin, 787 A.2d at 96 (explaining the standard of review for transactions with divided loyalties).

58. Scienter is normally not an issue with duty of loyalty claims, assuming that the duty to act in good faith is separate from the duty of loyalty (an issue left unresolved by Delaware courts). *See supra* note 39 and accompanying text. If the duty of good faith were to be included under the umbrella of the duty of loyalty, the state of mind of defendants would naturally be considered an issue under the duty of loyalty. I separate the duties of loyalty and good faith in this discussion only as a conceptual exercise to understand the evidence normally used to prove/rebut such claims, not to advocate their separation as a matter of law.

59. *Emerging Communications*, 2004 Del. Ch. LEXIS at *144.

acting knowingly (bad faith) versus acting negligently (a breach of care).

The Presumption of Good Faith

Good faith and bad faith are both states of mind, and it is precisely for this reason that we encounter evidentiary difficulties. Reading a "subjective state of mind"[60] can be a very difficult task.[61] As a result, Delaware courts have traditionally been very reluctant to undertake the task of mind reading. This deference is part of the basic presumption of the business judgment rule, articulated in several Delaware cases such as *Aaronson v. Lewis*: "[the business judgment rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[62] The business judgment rule presumes good faith motives on the part of directors.

Overcoming the Presumption of Good Faith

How does a litigant go about rebutting this presumption of good faith? There is no precise formula. Several recent cases involving takeover defenses are revealing. In *Citron v. Fairchild*, Chancellor William Allen suggested a few options:

> While the absence of significant financial adverse interest creates a presumption of good faith, or a prima facie showing of it, the question of *bona fides* may not

60. *See Citron v. Fairchild*, 14 DEL. J. CORP. L. 273, 300 (1989).

61. *Emerging Communications*, 2004 Del. Ch. LEXIS at *145 ("Admittedly, divining the operations of a person's mind is an inherently elusive endeavor"). *See also Blasius Industries v. Atlas Corp.* 564 A.2d 651, 658 (Del. Ch. 1988) (holding that even if a court determines a board is acting in good faith, the decision "will typically, if not always, be a contestable or debatable judicial conclusion").

62. 473 A.2d at 812 (Del. 1984). *See also* Citron v. Fairchild Camera & Instrument Corp., 1988 Del. Ch. LEXIS 67 (Del. Ch. 1988) ("As a presumption, the rule provides that the acts of independent directors will be *presumed* to be taken in good faith and with appropriate care. Thus, one who seeks to visit liability . . . must prove that the action was grossly negligent or was not taken in an honest attempt to foster the corporation's welfare."). *See also* Warshaw v. Calhoun, 221 A.2d 487, 492-493 (Del. 1966) ("in the absence of a showing of bad faith on the part of the directors or of a gross abuse of discretion the business judgment of the directors will not be interfered with by the courts"); Polk v. Good, 507 A.2d 531, 536 (Del. 1986).

> be finally determined on that basis alone. Rather, that question calls for an *ad hoc* determination of the board''s motives in this particular instance. As in other contexts, however, this inquiry into a subjective state of mind necessarily will require inferences to be drawn from overt conduct—the quality of the decision made being one notable possible source of such an inference.[63]

According to *Citron*, the court can look at the overt conduct and the substance of a decision to determine if the decision has been made in good faith.[64] Although this review is in some sense "substantive," it is extremely limited: "[t]here may be instances in which an apparently disinterested board makes a judgment that is essentially inexplicable except on the basis of an otherwise unproven inappropriate motive—such as personal favoritism or antipathy."[65] In *Citron*, the court ultimately declined to infer that the board acted in good faith. In the matter of *J.P. Stevens & Co. Shareholders Litigation*,[66] the court stated that "[a] court may, however, review the *substance* of a business decision made by an apparently well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[67] Both *Citron* and *J.P. Stevens* use the word "inexplicable" when articulating the standard for substantive judgment of a business decision as a basis to infer bad faith.[68] This demonstrates

63. *Citron*, 1988 Del. Ch. LEXIS at *46-7.

64. *Id.*

65. *Id.* at *49.

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

67. *Id.* at 780-81.

68. *Citron*, 1988 Del. Ch. LEXIS at *49; *In re* J.P. Stevens, 542 A.2d at 780-81. *See also* Gelfman v. Weeden Investors, LP, 859 A.2d 89 (Del. Ch. 2004) (partnership agreement insulated the general partner and the board from all acts unless they acted with gross negligence or with an illicit state of mind). Judge Strine's reasoning sheds light on when a court will infer bad faith: "[t]he inference of bad faith is especially strong here for another reason: The defendants cannot point to *any rational justification* for the extremely punitive course of action they took." *Id.* at 124-25 (emphasis added). Though "any rational justification" is not meant to be a judicial standard for measuring good faith, the language articulates the deference normally given to business decisions.). *Id.*

the court's traditional propensity to infer bad faith only in the most extreme of circumstances.

A case in the abdication context, *In re Caremark International Inc. Derivative Litigation*, reiterates this standard.[69] Chancellor Allen's formulation of the duty to act in good faith makes liability very difficult: "only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability. Such a test of liability . . . is quite high."[70] In summary, Delaware courts have traditionally looked at the overt conduct of the director and the substance of the decision as a basis to infer bad faith. The latter is questioned in only the most extreme of circumstances.

EMERGING COMMUNICATIONS AND THE DELAWARE STANDARD

If *Emerging Communications* is deemed to represent Delaware law, one must wonder if that standard has been lowered, or at least altered.[71] The court inferred bad faith for Muoio based on three things: the substance of the merger decision,

69. 698 A.2d 959 (Del. Ch. 1996). In *Caremark*, shareholders attempted to hold the board liable for damages resulting from the illegal conduct of several employees, alleging that the directors knew that such conduct was occurring or would occur but looked the other way. *Id.*

70. *Id.* at 971. Though the Chancery Court was only in the position of approving the settlement, the Chancellor noted that, "[t]he record at this stage does not support the conclusion that the defendants either lacked good faith in the exercise of their monitoring responsibilities or conscientiously permitted a known violation of law by the corporation to occur." *Id.* A 2000 Chancery Court decision, *McMillan v. Intercargo*, 768 A.2d 492 (Del. Ch. 2000), also demonstrates this reluctance. The case involved facts similar to *Emerging Communications*. Intercargo Corp. was acquired by XL America, Inc. for $12 a share. The plaintiffs alleged the board breached its fiduciary duty of care by failing to inform themselves of the true value of the company, and accused one director of violating his duty of loyalty by approving a subpar deal with XL because XL promised him future employment. Yet the Chancery Court declined to infer bad faith: "the complaint alleges no facts from which a reasonable inference can be drawn that any conflicting self-interest or bad faith motive caused the defendant directors to fail to meet their obligations to seek the highest attainable value . . . " *Id.* at 496.

71. Peter D. Lyons et al., Emerging Communications: Directors Found Liable for $148 Million in Squeeze-Out Transaction, M&A LAWYER (June 2004).

his past personal business dealings with Prosser,[72] and Muoio's résumé. It should be observed at the outset that the directors, including Muoio, had the burden of proof.[73] This was not the case in any of the precedent considered.[74]

Even though Muoio had the burden of proof, *Emerging Communications* certainly stretches the precedent in regards to the court's propensity to infer bad faith.[75] But what is truly unique about *Emerging Communications* is the court's use of Muoio's expertise and experience as a securities analyst and portfolio manager.[76] Often, the court will review the background of the directors to introduce the defendants.[77] Using

72. *See Emerging Communications,* 2004 Del. Ch. LEXIS at *125.

73. *Id.* at *147. The directors bore the burden of proof because this was a controlling shareholder transaction which was not approved by a fully informed board or shareholders. Thus the burden fell upon Muoio to show that "[his] failure to withstand an entire fairness analysis is *exclusively* attributable to a violation of the duty of care . . . Because Muoio has not established to the satisfaction of the Court, after careful scrutiny of the record, that his motivation was of a benign character, he is not exculpated from liability . . . " *Id.* at *146, citing Emerald Partners v. Berlin, 787 A.2d at 98.

74. According to my research, no director has yet faced Delaware's modern duty to act in good faith while also bearing the burden of proof, and also being disinterested in the transaction.

75. Muoio was found liable despite the fact that he "did nothing affirmatively to assist Prosser in breaching his fiduciary duties of loyalty and good faith." This might be a different standard than in *Citron,* where Chancellor Allen stated that "this inquiry into a subjective state of mind necessarily will require inferences to be drawn from overt conduct . . . " No "overt conduct" was required by this court to infer liability. In the matter of *J.P. Stevens & Co. Shareholders Litigation,* we learned that a "court may, however, review the substance of a business decision made by an apparently well motivated board for the limited purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." 542 A.2d 770, 781 (Del. Ch., 1988). Perhaps because the *Emerging Communications* court did not trust Muoio's motivations, they did not apply the "beyond the bounds of reasonable judgment" standard. In any event, *Emerging Communications* cites only *Disney* as authority for Muoio's liability. *Emerging Communications,* 2004 Del. Ch. LEXIS at *147, citing *Disney,* 825 A.2d at 289. In any event, this is an unprecedented propensity to infer bad faith.

76. *Emerging Communications,* 2004 Del. Ch. LEXIS at *143.

77. For example, in *Citron,* the court referred to the board as "experienced businessmen" and listed their accomplishments, yet these were simply not considered in determining compliance with fiduciary duties. *Citron,* 1988 Del. Ch. LEXIS at *4-5. In *Van Gorkom,* the court observed that Van Gorkom "had participated in many acquisitions as a manager and director of Trans Union and as a director of other companies. He was familiar with

experience as a basis to infer bad faith is simply an unprecedented development in Delaware law. Before we evaluate this practice, it is helpful to see how federal securities laws have recently treated the issue of increased liability for financial experts.

IV.
THE SARBANES-OXLEY ACT REJECTS HIGHER STANDARDS FOR FINANCIAL EXPERTS

Recent federal securities legislation has specifically rejected higher standards for financial experts on policy grounds. *Emerging Communications* and the Sarbanes-Oxley Act of 2002[78] have both emerged in a time of decreasing confidence in director oversight, and a time of increasing regulation and scrutiny of corporate directors and management.[79] Sarbanes-Oxley and the duty of good faith are very closely linked in a common effort to discourage fraud and abdication at the highest levels of the corporation. Several commentators have advocated the use of state fiduciary bad faith claims for failure to comply with Sarbanes-Oxley and other federal regulations.[80] Several Justices of the Delaware Chancery Court

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acquisition procedures, valuation methods, and negotiations. . ." *Van Gorkom*, 488 A.2d at 866. However this experience was not used as a basis to determine any breach of fiduciary duties. *Id.*

78. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in various sections of 15 U.S.C. and 18 U.S.C.).

79. *See* John Waggoner & Thomas A. Fogarty, *Scandals Shred Investors' Faith: Because of Enron, Andersen and Rising Gas Prices, the Public Is More Wary Than Ever of Corporate America*, USA TODAY, May 2, 2002, at C1; Louis Aguilar, *Scandals Jolting Faith of Investors*, DENVER POST, June 27, 2002, at 3.

80. Hillary A. Sale, *Delaware's Good Faith*, 89 CORNELL L. REV. 456, 495 (supporting state fiduciary duty of good faith claims for violations of federal law: "[s]hareholders, of course, are harmed by all kinds of fiduciary failures, but those arising from failures to comply with the common law, the Sarbanes-Oxley Act, the other federal securities laws, and the requirements of the New York Stock Exchange and other self-regulatory organizations—regardless of whether the failure to comply carries with it a private right of action—may fall into the category of good faith"). *See also* John L. Reed & Matt Niederman, *"Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111, 142 (2004) (observing the increased federal regulation of corporate governance under Sarbanes-Oxley as a means of preventing corporate scandals involving abdication, oversight, and other bad faith claims).

have noted that future cases may involve bad faith claims that directors breached their fiduciary duties by failing to comply with Sarbanes-Oxley and other recent NYSE and NASDAQ regulations.[81] However a careful look at Sarbanes-Oxley reveals that even the heavy-handed federal government has rejected the résumé approach found in *Emerging Communications.*

Sarbanes-Oxley ushered in a plethora of accounting and corporate governance reforms, among which is a provision mandating that audit committees of public corporations disclose whether or not they have a "financial expert" on the committee, and if not, to explain why not.[82] The Securities and Exchange Commission was authorized to promulgate the rules and qualifications regarding these financial experts.[83] The qualifications of a "financial expert" under Sarbanes-Oxley are quite stringent, and many experienced businesspersons were surprised to find that they would not qualify.[84]

Before the SEC passed its rules on the subject, the business community was very concerned that the designation of financial experts might create a new standard of liability that would deter experts from serving.[85] In response to these fears, the SEC promulgated a rule which contains a "safe harbor" provision which specifically prohibits any increased liability under the securities laws for these experts: "[t]he designation or identification of a person as an audit committee financial expert pursuant to this Item 401 does not impose on such person any duties, obligations or liability that are greater than the

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81. William B. Chandler III & Leo Strine, Jr., *Views from the Bench: The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State,* 152 U. PA. L. REV. 953 (2003).

82. 15 U.S.C. § 7265(a)-(b).

83. 17 C.F.R. § 229.401.

84. *See* Andrew R. Sorkin, *Back to School, but This One Is for Top Corporate Officials,* N.Y.T., Sept. 3, 2002, at A1; Cassell Bryan-Low, *Defining Moment for SEC: Who is a Financial Expert,* WALL ST. J., Dec. 9, 2002, at C1. *See also* Geoffrey Colvin, *Sarbanes & Co. Can't Want This: Under Reform Law, Alan Greenspan Would Not Qualify as a Board's Financial Expert,* FORTUNE, Dec. 30, 2002, at 66.

85. *Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002,* Releases Nos. 33-8177, 34-47235, (January 23, 2003), *available at* http://www.sec.gov/rules/final/33-8177.htm ("the opposition stemmed from a fear that the designation of an audit committee financial expert may inappropriately suggest that the expert bears greater responsibility, and therefore is subject to a higher degree of liability . . . and discourage qualified persons from serving as such experts.").

duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification."[86] In adopting the rule, the SEC clearly agreed with the business community that any heightened liability for experts would have an adverse impact:

> We continue to believe that it would adversely affect the operation of the audit committee . . . and systems of corporate governance more generally, if courts were to conclude that the designation and public identification of an audit committee financial expert affected such person's duties, obligations or liability as an audit committee member or board member. We find that it would be adverse to the interests of investors and to the operation of markets and therefore would not be in the public interest, if the designation and identification affected the duties, obligations or liabilities to which any member of the company''s audit committee or board is subject.[87]

The SEC recognized that holding financial experts of audit committees to a higher standard would not only discourage the service of those experts, but it would adversely affect the committee's purpose and general corporate governance of the firm.[88] This in turn would adversely affect investors, markets, and the public interest.

It is clear that Sarbanes-Oxley does not allow increased liability for financial experts of audit committees under federal securities laws. But what about *state* fiduciary duty claims and the Sarbanes-Oxley safe harbor for financial experts?

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86. 17 C.F.R. § 229.401(4)(ii) (2003).

87. *Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*, Releases Nos. 33-8177, 34-47235 (January 23, 2003), *available at* http://www.sec.gov/rules/final/33-8177.htm.

88. *Id.* The securities laws don't always fail to impose different standards of liability for directors. *See, e.g., Escott v. BarChris Construction Corp.*, 283 F.Supp. 643 (S.D.N.Y. 1968) (finding higher standards applicable to expert directors in carrying out their due diligence defense to § 11 claims under the Securities Act of 1933). However, the SEC's rule in implementing Sarbanes-Oxley is the closest comparison to Delaware's approach because it is the most recent treatment of the issue (and the most analogous because this SEC rule directly addresses the possibility of state claims of fiduciary duty).

Could a litigant attempt to hold a Sarbanes-Oxley "financial expert" to a higher standard by bringing a state fiduciary duty claim of bad faith? The SEC, in anticipating this situation, stated:

> In adopting this safe harbor, we wish to emphasize that all directors bear significant responsibility. State law generally imposes a fiduciary duty upon directors to protect the interests of a company''s shareholders . . . Our new rule provides that whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations or liabilities. We believe this should be the case under federal and state law.[89]

This statement makes it plain that the SEC does not want state fiduciary duty claims to hold Sarbanes-Oxley "financial experts" to any higher standard. The SEC clearly wants the financial experts of audit committees to be held to the same standards as other directors, even under state fiduciary duty claims. Nonetheless, lawyers have expressed worry that *Emerging Communications* may have this effect.[90]

While the holding of *Emerging Communications* does not violate the express provisions of Sarbanes-Oxley, parts of the decision—namely holding Muoio to a higher standard than his peers—runs directly against the policy reasoning behind Sarbanes-Oxley.[91]

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89. *Id.*

90. Bradley P. Cost & Daniel M. Miller, *Emerging Communications: Enhanced Director Liability for Experts?* METROPOLITAN CORPORATE COUNSEL (2005), *available at* http://www.torys.com/publications/pdf/AR2005-1N.pdf ("Although the safe harbor may protect a director from liability under federal securities law, once he or she is identified as a financial expert in a company's public filings, it may prove to be difficult to avoid the results under state corporate law that the Court reached in *Emerging Communications.*").

91. Sarbanes-Oxley was not on the books at the time of the Emerging Communications merger, and Muoio was not a "financial expert" on an audit committee for purposes of the Act. It is interesting to consider how the Delaware courts would have handled such a situation. It is likely that if a director were in a similar position as Muoio, yet was a Sarbanes-Oxley financial expert, the court would not infer bad faith to avoid entanglements with federal law. Perhaps ironically, Sarbanes-Oxley might have saved Mr. Muoio from liability had he been a financial expert under the statute.

V.
EVALUATING THE "RÉSUMÉ APPROACH" TO THE DUTY OF GOOD FAITH

Why Not Consider a Director's Background When Determining Good Faith?

Academic commentators have encouraged the prominence of the duty of good faith.[92] While the duty of good faith is probably here to stay, the courts have considerable work to do on its evidentiary standards.

From a policy standpoint, does it make sense to consider a director's background in determining his "subjective state of mind" during the transaction? After all, Doctors and lawyers are held liable according to their specialized knowledge, so why shouldn't corporate directors? There are several arguments to be made in support of using a higher standard for experts. One such argument is for responsibility/retributive reasons.

Scienter has long been used as a basis for determining culpability in both the criminal and civil law. The state of mind is a common and essential inquiry, and one cannot separate a person from her experience and expertise. To effectively determine scienter, the law must be allowed to at least consider all of the evidence available, including the director's conduct during the transaction (or evidence pertaining to omissions), the substantive outcome of the transaction, and finally the experience, expertise and background of the director. Why deny the court a valuable piece of evidence that may prove helpful in determining scienter? Courts should be allowed to use all the evidence available to hold directors accountable. Proponents of this argument might also argue that there is no reason to feel sorry for directors. Section 102(b)(7) already protects directors from "grossly negligent"

92. Sale, *supra* note 80, at 495 (advocating that "[s]trong enforcement of the duty of good faith creates an incentive to prompt fiduciaries to better behavior . . . That enforcement by the Delaware courts will, in turn, protect the shareholders . . . Such strong enforcement of good faith standards by the stewards of state corporate law contributes to good corporate governance norms. It also increases the good faith of shareholders in Delaware as the appropriate home for business and as the place for creating and enforcing those norms").

acts.[93] Delaware supports directors with a "three-legged stool" of limited liability, indemnification, and insurance.[94]

Lastly, an economic argument could be made on behalf of the résumé approach: strong enforcement of fiduciary duties is important to protect and increase shareholder wealth. This argument expresses dissatisfaction with the level of limited liability that directors have previously enjoyed. If directors are held to higher standards, they will be more vigilant and efficient agents of the shareholders, thereby increasing returns.

The Argument Against the "Résumé" Approach to Good Faith

There are several more convincing arguments against a court using a director's background in determining bad faith, or at least putting strict limitations on this practice. The first argument is pragmatic in nature, looking at the incentives and disincentives that such a legal rule creates on the propensity for a director to serve.

1. *Punishing the Experts; Encouraging the Dummies*

In *Emerging Communications*, Muoio was held liable while four other directors—Goodwin, Ramphal, Todman, and Vondras—were not. Like Muoio, none of these directors had "affirmatively colluded" with the controlling shareholder, Prosser, to effectuate the privatization.[95] However, unlike Muoio, they had little or no background in finance.[96] The effect of such a legal regime serves to punish expertise and reward ignorance. "Expert" directors such as Muoio will (very rationally) think twice before joining a board where one's expertise might come into play (and in the case of any expert in finance, it is hard to imagine when it would not). If one has experience in the oil industry, for example, better for her to join the board of an entertainment company. Muoio would have been

93. *Van Gorkom*, 488 A.2d at 883.

94. *See* Norman Veasey, *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance*, 42 BUS. LAW. 399, 415 (Feb. 1987).

95. *Emerging Communications*, 2004 Del. Ch. LEXIS at *148. However the four non-liable directors had significant accomplishments in areas of law, politics, and engineering. *Id.* at *7-*10

96. *Id.* at *148.

far better off sticking to his consulting business, which was very lucrative.[97] The effect is, ironically, that you discourage the service of exactly the type of director that you need the most.[98] In a time where more than ever we want directors to scrutinize management's decisions, we end up with a board of "dummies" that are far more likely to defer to management recommendations.

Many academics will scoff at the idea that significant numbers of experienced directors will decline to serve on boards. A lawyer interviewed on the subject of personal liability stated, "[i]t's a whole way of life. You think they're going to give that up?"[99] Who would turn down an annual six-figure salary just to sit through a few meetings without falling asleep? The obvious answer is that a large number of people would turn down such a relatively small amount of money when personal assets and reputation are at serious risk. The greater those assets or reputation, the less appealing a seat on the board becomes. As a result, the résumé approach discourages the most successful "experts" from serving on boards. There may continue to be a plentiful supply of businesspeople willing to serve on boards; it is more an issue of quality, rather than quantity.

The expert directors would be discouraged from serving at all, or if they did serve, they might seek out other smart directors with similar backgrounds to avoid sticking out. In a recent article on the case, several attorneys frankly observed that "it is better for a director to sit on a board of peers whose qualifications match or approximate one''s own, than to be the only director with a special set of skills that could ulti-

97. *Id.* at *121

98. Of course it is possible that a director with expertise and a low personal net worth might make the calculation that the risk of liability does not outweigh the benefits. However, I believe that such a person would be rare for several reasons. First, no matter how insignificant one's personal assets may be, the prospect of losing them is universally daunting. Secondly, a person with a résumé decorated with significant experience and expertise is likely to already have significant personal worth. Lastly, if one does not have significant personal assets, for example, as in the case of an academic expert, the potential tarnishing of their reputation acts as an equal deterrent as loss of personal wealth.

99. Joann S Lublin, Theo Francis, & Jonathan Weil, *Directors Are Getting the Jitters*, WALL ST. J., January 13, 2005, at B1.

mately lead to heightened liability."[100] The Tom Neff, Chairman of executive search firm Spencer Stuart's U.S. operations, commented that with liability on the rise, "legislation has produced as unintended consequence: some of the most experienced board members are unavailable."[101]

Directors appear to be seriously concerned with personal liability. One lawyer noted that the decision is "certainly a cautionary statement to directors that they have to be cognizant of the specialized skill that they have and the expectations that may be brought upon them as a result of the skills they bring to the board."[102] The Wall Street Journal carried an article entitled "Directors Are Getting the Jitters" in January, 2005,[103] where a director of both Electronic Data Systems Corp. and Morgan Stanley was quoted as saying, "I would view it as a tremendous injustice if I had to give up a percentage of my net worth [to settle investors' suits because] I don't sleep through board meetings . . . If that's the case, I'm going to resign."[104] A director of Reynolds American Inc. and three other public companies fretted, "[m]y life savings could be in jeopardy . . . It's very scary."[105] If *Emerging Communications* is followed, it could deter a significant number of the most qualified board members from serving.

2. *The Moral Argument Against the Résumé Approach*

Besides the economic arguments against the résumé approach to bad faith claims, there is also a normative argument against the practice. No one disputes the idea that a director who acts in bad faith should be held liable. The problem is that it is often very difficult, if not impossible, to determine the subjective state of mind of directors. The *Emerging Communications* court acknowledged this, observing that, "[c]oncededly,

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100. Bradley P. Cost and Daniel M. Miller, *Emerging Communications: Enhanced Director Liability for Experts?* METROPOLITAN CORP. COUNSEL, (2005), *available at* http://www.torys.com/publications/pdf/AR2005-1N.pdf.

101. Anita Raghavan, *More CEOs Say 'No Thanks' to Board Seats,* WALL ST. J., January 28, 2005, at B1.

102. Scannel, *supra* note 4, at C1.

103. Joann Lublin et al., *Directors Are Getting the Jitters: Recent Settlements Tapping Executives' Personal Assets Put Boardrooms on Edge,* WALL ST. J., Jan. 13, 2005, at B1.

104. *Id.*

105. *Id.*

the possibility exists that Muoio''s decision was driven not by his overriding loyalty to Prosser, but by a sincere belief that the $10.25 price was minimally fair, even if not the fairest or highest price attainable."[106] However in the end the court concludes, "albeit with reluctance,"[107] that Muoio is liable. The reluctance, the court explained, came from the fact that: "[a]dmittedly, divining the operations of a person's mind is an inherently elusive endeavor."[108]

Imposing liability primarily based on a director's résumé leaves a considerable margin of error that can have disastrous results on the personal lives of innocent people. During the trial of *Emerging Communications,* the valuation experts included University of Chicago Business School Professor Mark Zmijewski—the plaintiffs'' expert who valued ECM at over $41 per share; and Daniel Bayston, a consultant at Duff and Phelps and the defendants'' primary valuation expert—who valued ECM at $10.38 per share.[109] The defendants called two additional valuation experts: Princeton University Professor Burton Malkiel, who testified about issues relating to ECM''s market value, and Gilbert Matthews, an investment banker and former managing partner of Bear Stearns & Co.[110] The court ultimately picked $38.05[111] per share as the "intrinsic value" of the firm.[112] Experts with much longer résumés than Muoio believed the fair value to be even below the merger price. The point is that expertise is no guarantee that you will get something right. An investment banker is as equally prone to error as any other human being. It is similarly possible for a well-reputed securities analyst to underestimate the value of a company. Why do so many people place their personal wealth in passively managed index funds rather than fork it over to the "experts" on Wall Street? The answer is a matter of common sense. Experts often make mistakes. And when courts begin to infer bad faith based largely on expertise, there is a real and significant potential that courts will simply get it wrong.

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106. *Emerging Communications,* 2004 Del. Ch. LEXIS at *145.
107. *Id.* at *143.
108. *Id.* at *98.
109. *Id.* at *40.
110. *Id.*
111. *Id.* at *46.
112. *Id.* at *144.

VI.
CONCLUSION

The sky is not falling on Delaware corporate directors—yet. There are several reasons why an *Emerging Communications* situation is not likely to be repeated. The first is simply that the circumstances of the case were rare. This was a controlling shareholder cash-out of a public minority; therefore the transaction was subject to the demanding "entire fairness" review.[113] Most transactions do not involve self-dealing, and are therefore subject to the protections of the business judgment rule.[114] In addition, the "independent" committee that the board formed to negotiate the merger was not truly independent of Prosser, nor did they properly insulate their deliberations from him.[115] This compromised the committee and shifted the burden of proof to all of the directors at trial.[116] It may also be said that the price was obviously inadequate, and the entire bargaining process was blatantly ineffective.

Lastly, Muoio did have a history of financial ties to Prosser,[117] and the court was suspicious that he approved the merger to continue those ties.[118] The court had this suspicion despite the fact that the plaintiff's pre-trial brief pointed out that "[f]or his concerns, Muoio, alone among ECM's directors, was not appointed by Prosser as an ICC director following the closing of the Squeeze-Out."[119]

Suspicion of self-interest alone, however, would not have resulted in liability. Ramphal, another director who approved the merger and acted negligently on the special committee, also had significant ties to Prosser.[120] But Ramphal lacked the financial expertise that supposedly would have given him reason to believe the merger was unfair.[121] In summary, financial expertise should not be seen as a sufficient basis from which

113. *See, e. g.,* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
114. Aaronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)
115. *Emerging Communications,* 2004 Del. Ch. LEXIS at *112.
116. *Id.*
117. *Id.* at *125.
118. *Id.* at *146.
119. 115. Petitioner's Pretrial Brief at 45, n. 44, *Emerging Communications, 2004 Del. Ch. LEXIS 70 (Del. Ch.* May 3, 2004), *available at* http://corporate-law.widener.edu.
120. *Id.* at *123.
121. *Id.* at *149.

Delaware courts will infer liability. In *Emerging Communications*, it may have been merely the factor that tipped the scales of liability against Muoio.

The precedential effect of *Emerging Communications* is unknown. Justice Jacobs, who decided the case, has recently been nominated to the Delaware Supreme Court. In addition to the reasons explained above, there are also many practical issues that might arise with even a limited implementation of the résumé approach.[122] Yet it is difficult to imagine Delaware courts holding that the practice is not ever to be used, given that justices generally enjoy flexible legal regimes and eschew any absolute restrictions on their discretion.

The Delaware courts and legislature must strike a delicate balance between directors and litigants.[123] Some have warned that if Delaware courts don't "get tough" with corporate directors, more federal legislation will follow.[124] *Emerging Communications* may have demonstrated, however, that Delaware courts are beginning to go too far. The SEC has wisely observed the dangers of a higher standard for financial experts. The Delaware Supreme Court would be wise to reject the résumé approach to bad faith claims, and follow the SEC's policy of holding directors to a uniform standard.

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122. For example, what qualifies as expertise? Muoio was an analyst at Lazard Freres & Co., but what if he had been working at an unknown firm? Is an MBA from Wharton worth as much as one from the University of Wisconsin? It is difficult to imagine a judge willing to engage in this type of inquiry. However, even a limited practice of looking into a director's background would encourage litigants to make these types of arguments.

123. John L. Reed & Matt Niederman, *"Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 DEL. J. CORP. L. 111, 142 (2004) ("[c]entral to all of this is striking a balance to ensure that (1) directors are independent, yet not so detached from the company that they are not the best people to be governing the company, and (2) qualified people are encouraged to serve as directors and are not scared off by the threat of liability from standards that cannot reasonably be met.").

124. *Id.* ("More [federal] legislation may follow if there is a perception that courts have not created standards of conduct sufficient to ensure that directors will be accountable for willful ignorance or lack of oversight").