American University Business Law Review

Volume 2 | Issue 2 Article 2

2013

Reliance on Experts from a Corporate Law Perspective

Alexandros N. Rokas

Recommended Citation

Rokas, Alexandros N. "Reliance on Experts from a Corporate Law Perspective." American University Business Law Review 2, no. 2 (2013): 323-352. American University Business Law Review 2, no. 2 (2013):

RELIANCE ON EXPERTS FROM A CORPORATE LAW PERSPECTIVE

ALEXANDROS N. ROKAS*

In discharging their duty of care, directors of corporations are not expected to independently investigate all parameters affecting a decision they are about to make. In fact, statutory provisions encourage or sometimes require directors to seek the advice of experts, such as auditors, lawyers, investment bankers, and tax specialists. In this Article, emphasis is placed on Section 141(e) of the Delaware General Corporation Law, according to which directors are entitled to rely on the advice of such experts as long as they believe that the advice was within the expert's professional competence, the expert was selected with reasonable care, and reliance is in good faith. Apart from systematizing the elements of this rule, as they were interpreted by a significant number of court decisions, this Article sheds light on the interaction of the reliance defense with basic concepts of Delaware corporate law, mainly the business judgment rule, as well as good faith, after Caremark. *This Article does not examine whether directors will be eventually held liable (which, besides, is rarely the case in Delaware due to the business judgment presumption, exculpatory clauses, and insurance and indemnification provisions), but solely whether the additional defense of Section 141(e) should apply or not.*

* LL.M., *Harvard Law School*, *Fulbright* and *Onassis Scholar*, 2011–12; Ph.D., *Humboldt University of Berlin*; LL.B., *University of Athens*, admitted in Athens, Greece. The author would like to thank Professor Reinier H. Kraakman and the participants of the Comparative Corporate Governance Seminar for their constructive feedback and comments.

TABLE OF CONTENTS

INTRODUCTION: PSYCHOLOGY OF DECISION-MAKERS AND CORPORATE LAW

Decision-making is often a painful process. Decision-makers face various challenges, ranging from lack of factual data or incapacity to critically assess the available data to an unwillingness to undertake responsibility or personal conflicts of interest. Many challenges appear in periods of uncertainty, such as during financial and other crises. In such periods, decision-makers would feel extremely relieved if somebody else could bear the burden and offer an answer to whatever dilemma they are facing. They would feel even more comfortable if they knew that relying on this advice would remove the burden of responsibility, in case the advice proves to be wrong.[1]

To be sure, feeling more secure is not per se harmful. However, turning the decision-making process into a process of uncritical adoption of a third-party's view could seriously distort the intellectual element involved in this process. Even if the advice is sound, decision-makers may not be able to oversee the implementation of their decision in the future and will fail to adjust their strategy in the absence of the advisor. In fact, a relatively recent empirical experiment examined the neurobiological processes of making financial decisions with and without expert advice, especially under conditions of enhanced uncertainty.[2] It showed that areas of the brain responsible for making value judgments, accessible through Magnetic Resonance Imaging ("MRI") technology, were clearly less active when such advice was received. This result was not affected by the fact that the financial advisor's suggestions were very conservative and, thus, could not lead to maximum earnings.[3] The researchers did not examine what caused this behavior; however, one could speculate that the feeling of safety, created by the presence of the (perceived) authority, coupled with the surrounding conditions of uncertainty, and sometimes the laziness of decision-makers, led them to offload the responsibility for making financial decisions. A similar experiment, concentrating on brain activities when choosing and changing financial advisors, concluded that detecting errors of advisors is more likely when the recipients of the advice consider changing their advisors.[4] According to the researchers, in the absence of such circumstances, recipients observe more the personal characteristics of the advisors, and less the numerical realities.

The most prominent personal characteristic of the advisors is their ability to convey trust. This seemed to be the case, for instance, with the relationship of members of various Wisconsin school boards and David W. Noack, who, in 2006, convinced them to borrow more than $160 million

---

1. Of course, in most cases the latter is not possible because the one suffering the consequences of incorrect advice is the decision-maker himself. A patient trusting his doctor would damage his health if the medication the doctor provided is improper. In the case of fiduciaries, though, decisions affect third persons. Corporations form the most prominent example because directors administrate "other people's money," an expression introduced in LUIS BRANDEIS, OTHER PEOPLE'S MONEY AND HOW BANKERS USE IT (1914).

2. *See* Jan B. Engelmann et al., *Expert Financial Advice Neurobiologically "Offloads" Financial Decision-Making under Risk*, PLOS ONE (Mar. 24, 2009), http://www.plosone.org/article/info:doi%2F10.1371%2Fjournal.pone.0004957.

3. *See id.*

4. Russell N. James III, *Choosing and Changing Financial Advisors: An fMRI Study of Associated Brain Activations* 1 (Working Paper, Feb. 27, 2012), *available at* http://www.researchgate.net/publication/228293349_Choosing_and_Changing_Financial_Advisors_An_fMRI_Study_of_Associated_Brain_Activations.

and contribute $35 million of their own money to purchase synthetic collateralized debt obligations ("CDOs") sold by the Royal Bank of Canada ("RBC").[5] Noack, apart from being an investment banker who provided decades-worth of services to the schools, was also the son of a teacher who taught at a local school for forty-seven years, while all of his children attended local schools. With regard to the investment, Noack stated that "[t]here would need to be 15 Enrons" for the schools to lose money.[6]

At the same time, some of the challenges mentioned at the beginning of this Article were present. First, due to the complexity of the proposed investment, the board members lacked sufficient knowledge to independently assess its details. One of the members, who was a financial advisor himself, admitted he never read the thick packets of documents he received, claiming that he was not worried because the board had its questions satisfactorily answered by Noack. Second, Noack's company, Stifel, Nicolaus & Company ("Stifel"), had close ties with RBC. Finally, board members never examined the advisor's qualifications relating to such investments, which were in fact limited. This confirms the trust element of the board's relationship to Noack.[7] The rest of the story is more or less predictable: the CDOs lost most of their value, and the Securities and Exchange Commission ("SEC") charged Stifel and RBC with fraudulent misconduct.[8]

Corporate boards, like school boards, consist of fiduciaries entrusted with the administration of an estate. However, they more often have to reach investment decisions or decisions on other complicated issues that require an expert's advice. On the other hand, corporate board members tend to be more qualified than school board members for such purposes, and a substantial body of statutory provisions facilitates the decision-making process. In this Article, emphasis is given to corporate law provisions enabling corporate board members under certain conditions to trust their advisors and escape liability should the advice prove to be mistaken. After explaining the reasoning behind the relevant rules in Delaware law (Section I), this Article unfolds all elements included in the relevant provision (Section II), as well as further requirements set by case law and recommended by scholars (Section III). Final conclusions are

5. *See* Charles Duhigg & Carter Dougherty, *The Reckoning: From Midwest to M.T.A., Pain From Global Gamble*, N.Y. TIMES (Nov. 1, 2008), http://www.nytimes.com/2008/11/02/business/02global.html?pagewanted=all.

6. *Id.*

7. *Id.* Of course, it was not only trust that led to the board's decision. CDOs were quite popular at that time, and the particular CDOs received satisfactory ratings.

8. *See* Press Release, SEC, SEC Charges RBC Capital Markets in Sale of Unsuitable CDO Investments to Wisconsin School Districts (Sept. 27, 2011), *available at* http://www.sec.gov/news/press/2011/2011-191.htm.

offered at the end of this Article.

I. THE RULE AND ITS JUSTIFICATION

In Delaware, the key provision enabling boards to rely on their advisors is Section 141(e) of the Delaware General Corporation Law ("DGCL"), which states:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by 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.[9]

The legislative history of Section 141(e) shows that its initial version, as adopted in 1943, did not encompass all categories of outside experts, but only public accountants and appraisers.[10] In fact, it took some decades for the state legislators to broaden the language of the provision: in 1974, Section 35 of the Model Corporation Act was amended to include all sorts of experts.[11] Subsequently, many states (including Delaware in 1987) adopted similar provisions.[12]

Even before 1974, directors throughout the United States relied on outside advisors, and courts recognized this reliance as a factor that must be considered in assessing good faith. For example, in 1936, the Michigan Supreme Court (applying Delaware law) dealt with the case of a director who, based on advice provided by his counsel, approved certain dividends, rendering the company insolvent.[13] The legality of the dividends was questionable because they were declared from monies received from the

---

9. DEL CODE ANN. tit. 8, § 141(e) (2010). There is a similar provision in Section 172, regulating the reliance on experts with regard to "facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid." *See id.* § 172.

10. *See* 44 Del. Laws 423 (1943) (stating that a director "shall in the performance of his duties be fully protected in relying in good faith upon . . . reports made to the corporation by any of its officials, or by an independent certified public accountant, or by an appraiser selected with reasonable care by the Board of Directors").

11. *Report of Committee on Corporate Laws: Changes in the Model Business Corporation Act*, 30 BUS. LAW. 501 (1974–75).

12. *See* 66 Del. Laws 335 (1987); MODEL BUS. CORP. ACT ANN., § 8.30, at 8-207 (2011).

13. *See* Stratton v. Anderson, 270 N.W. 764, 764 (Mich. 1936).

sale of certain territorial franchise rights.[14] The court did not hesitate to adopt a broad exception to liability, stating that evidence proving advice "not only . . . negat[es] any bad faith upon the part of defendant in voting for the dividend following the receipt of this advice, but it [also] sanctions a finding by us that such vote was made in good faith and without negligence."[15] Facts indicating reliance were taken into account by courts in numerous cases outside corporate law—ranging from criminal to tax cases—as elements supporting good faith.[16]

Behind this finding lies a basic justification of the reliance doctrine, namely that it is in accordance with the principles of prudent decision-making. The above-mentioned decisions support the view that even in the absence of a reliance provision, reliance is a fact to be taken into account to determine whether directors acted with due care and in good faith.[17] Generally, seeking advice indicates a reasonable effort of the director to become informed and gain the necessary familiarity with complicated facts in the course of the decision-making process. Reliance does not contradict the business judgment rule. One of the requirements of this rule is to reach *informed* decisions. This is generally deemed to be satisfied when the director consults and relies on outside professionals.[18]

The argument for reliance provisions invites us to admit that directors are not capable of independently assessing all relevant and available facts or personally contacting every officer and employee in order to become informed. Solely reading written reports of the various divisions of the corporation would require an enormous amount of time, especially in large

14. *See id.* at 766–67.

15. *Id.* at 767; *see also* Smith v. Van Gorkom, 488 A.2d 858, 881 (Del. 1985). *See generally* Thomas L. Preston, *Advice of Counsel as a Defense*, 28 VA. L. REV. 26 (1941).

16. *See* Douglas W. Hawes & Thomas J. Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, 9–11 (1976).

17. One would expect that common law countries would not include reliance provisions, leaving the interpretation of duty of care issues to the courts. While the United States, Australia (see *infra* note 63), and New Zealand have such provisions, Germany and other civil law countries do not. Recently, the German Federal Court of Justice ("BGH") set the conditions under which boards can rely on legal advisors based on the general duty of care provision. Bundesgerichtshof [BGH] [Federal Court of Justice] Sept. 20, 2011, II ZR 234/09. These conditions are quite similar to the ones detailed in this Article, while the legal literature (before the decision was issued) regularly refer to relevant U.S. concepts. *See, e.g.*, Holger Fleischer, *Vertrauen von Geschäftsleitern und Aufsichtsratsmitgliedern auf Informationen Dritter*, 30 ZEITSCHRIFT FÜR WIRTSCHAFTSRECHT 1397 (2009).

18. *See* A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE, § 4.01(c) cmt. b, 171 (1994); *see also Van Gorkom*, 488 A.2d at 873 (noting that "gross negligence" is the appropriate standard to apply when evaluating whether directors were adequately informed in reaching a business judgment).

corporations. "Directors would be snowed under with paper," as one commentator puts it, while directorship would become an extremely hazardous job.[19] In such corporations, the hierarchy structure and the distinct roles assigned are crucial factors affecting the efficiency and the pace of decision-making. Roles are usually assigned in accordance with the significance of decisions, which brings to mind again certain duty of care interpretations, according to which the importance of the business judgment to be made is a factor affecting the reasonable investigation directors are required to perform.[20] Therefore, by providing a safe harbor, directors and officers are encouraged to introduce such organizational structures that expedite and rationalize the decision-making process, while at the same time honoring their duty of care.[21]

On the other hand, critics could allege that reliance provisions encourage wrongful conduct, motivating directors to shield themselves behind the advice given without actually familiarizing themselves with the decision to be made or, even worse, knowing its negative aspects. Reliance provisions may even incentivize directors to shop for favorable advice.[22] However, as Section 141(e) implies, and as will be explained below, courts should consider all factors calling into question the good faith of the decision-makers. Thus, rejecting unfavorable advice could indicate bad faith, excluding the application of the rule. The mere fact that the board hired an advisor and adopted his views does not constitute an absolute defense when good faith is questioned. To the extent that Section 141(e) excuses negligent behavior, as will be explained below, criticism is justified.[23]

II. STATUTORY ELEMENTS OF THE RULE

A. Stricto Sensu *Reliance*

The first element of the reliance doctrine is self-explanatory: there is no reliance and the directors will not enjoy the protection of Section 141(e) if they do not follow the advice provided in all its material aspects.[24]

19. Robert W. Hamilton, *Reliance and Liability Standard for Outside Directors*, 24 WAKE FOREST L. REV. 5, 19 (1989).

20. *Id.*

21. R. Franklin Balotti & Megan W. Shaner, *Safe Harbor for Officer Reliance: Comparing the Approaches of the Model Business Corporation Act and Delaware's General Corporation Law*, 74 J. L. & CONTEMP. PROBS. 161, 170 (2011) (referring to officers).

22. *See* Hawes & Sherrard, *supra* note 16, at 8.

23. *See infra* Section III.A.

24. *See* Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000); Ash v. McCall, No. Civ. A. 17132, 2000 WL 1370341, at *9 (Del. Ch. Sept. 15, 2000); Hawes & Sherrard, *supra* note 16, at 35; Thomas A. Uebler, *Reinterpreting Section 141(e) of Delaware's General Corporation Law: Why Interested Directors Should Be Fully Protected in*

Directors are not required to accept the recommendations of the experts; however, if they do not follow the advice, they will not be able to invoke the protection of Section 141(e). Regardless, unless gross negligence is proven, directors are still shielded by the business judgment presumption, since the latter is a broader shield for directors and applies even when Section 141(e) is inapplicable.[25] Consequently, not following the advice does not necessarily indicate bad faith or negligence, but merely excludes the applicability of the reliance doctrine.[26] Seen from this perspective, the Delaware Court of Chancery in *In re Walt Disney Co. Derivative Litigation* misinterprets Section 141(e) in saying that:

> [a]n interpretation of Section 141(e) that would require boards to follow the advice of experts (substantially? completely? in part?) before being able to claim reliance on those experts would be in conflict with the mandate in Section 141(a) that the corporation is to be managed 'by or under the direction of a board of directors.'[27]

There are cases, where, for various reasons, following the advice of experts is not a simple task. Such cases occur when a legal opinion concludes that a particular course of action is "more likely permissible than not,"[28] when it provides for more than one option, or when the recipient of the advice fails to understand the means of its implementation. In these instances, what matters is the director's effort to make sure his actions comply with the advice and, if necessary, ask for further explanation. If he fails to do so, reliance will not be granted.

B. Reliance in Good Faith

Without the requirement of good faith, reliance provisions would be a shelter for incompetent or even dishonest directors to hide behind the advice of an outside advisor. Good faith is a broad concept that refers mainly to the state of mind of the directors who claim reliance. Therefore, by definition, it covers most cases of dishonest directors. The violation of the good faith requirement does not lead to director liability, but only to the inapplicability of the reliance doctrine.

The general notion applies that a conscious (or intentional) disregard of

---

Relying on Expert Advice, 65 BUS. LAW. 1023, 1045 (2010).

25. *Ash*, 2000 WL 1370341, at *9 ("[A board of directors] is entitled to the presumption that it exercised proper business judgment, including proper reliance on experts."); *see also infra* Section III.A.4.ii.

26. *Contra* Hawes & Sherrard, *supra* note 16, at 35.

27. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 770 n.550 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

28. *See* Hawes & Sherrard, *supra* note 16, at 33.

the director's duties constitutes bad faith. The Model Business Corporation Act ("MBCA") entitles a director who does not have "knowledge that makes reliance unwarranted" to rely on experts.[29] Even though there is no reference to the concept of good faith, the MBCA's requirement is largely equivalent to the good faith requirement, perhaps with a stronger emphasis on the subjective elements of the director's behavior.[30] An example of knowledge that would make reliance unwarranted is being aware of facts that contradict the findings of the expert.[31] For example, there is a lack of good faith if the director knows—due to his personal expertise or due to a tip provided by an employee—that the advice is shoddy, or if he adopts only favorable advice and rejects other experts' opinions.[32] In such cases, the director should disclose these facts to the rest of the board according to MBCA Section 8.30(c).[33] Other instances of bad faith will be discussed later in this Article.[34]

---

29. MODEL BUS. CORP. ACT § 8.30(e). *But see* N.Y. BUS. CORP. LAW § 717(a) (McKinney 2003 & Supp. 2013) ("[A director] shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted.").

30. The content of good faith, in particular whether it encompasses only subjective or also objective components is a disputed issue. *See* E. Norman Veasey & Christine T. DiGuglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1452–53 (2005).

31. *See* Hamilton, *supra* note 19, at 21.

32. *See In re* Emerging Commc'ns, Inc. S'holders Litig., No. 16415, 2004 WL 1305745, at *38–43 (Del. Ch. June 4, 2004) (holding—without citing Section 141(e)—that a director possessing special financial expertise did not reasonably rely on a fairness opinion, because he had very strong reasons to suspect that the price was unfair and that he should not vote in favor of the proposed transaction). Corporations hire skilled directors to take advantage of their expertise. In another decision, the same court concludes that even "board members who are experts are fully protected under § 141(e) in relying in good faith on the opinions and statements of the corporation's officers and employees who were responsible for preparing the company's financial statements," adding that plaintiffs should "plead with particularity facts that would lead to the reasonable inference that the director defendants made or allowed to be made any false statements or material omissions with knowledge or in bad faith." *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 135 (Del. Ch. 2009). This concept is rather confusing; one should conclude, however, that even after *Citigroup*, courts should examine the good faith of skilled directors and take into account their particular qualifications and exposure.

33. *See* MODEL BUS. CORP. ACT § 8.30(c) ("In discharging board or committee duties a director shall disclose . . . to the other board or committee members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions . . . .").

34. *See infra* Section III.A.

C. Reasonable Belief That the Advice Was Within the Expert's Professional Competence

The language of Section 141(e) shows that the rule applies even if the expert opines on a subject not within his area of competence as long as the director reasonably believes the opposite (and the rest of the provision's requirements apply). This will occur only in extreme cases because reasonableness must be assessed in an objective manner—that is, based on material information that was reasonably available about the expert.[35]

In assessing whether there is a reasonable belief that an expert acts within his professional competence, all factors should be taken into consideration. For instance, a lawyer would be suitable to opine on technical issues of environmental compliance if he specializes in environmental law or if he is member of a legal organization with access to relevant information and it is not the first time he deals with compliance.[36] In the case of *Selectica, Inc. v. Versata Enterprises*, the Delaware Court of Chancery considered an investment banker suitable to assess the value of net operating losses ("NOLs") and to explain the consequences of a potential sale.[37] The court placed emphasis on the fact that the Board had "ample cause to consider him an expert qualified to speak on Selectica's NOLs and on the threat of their impairment," taking into account inter alia his work history as a tax attorney and partner at several accounting firms.[38] On the other hand, a lawyer is generally not the appropriate person to opine on questions of fact, such as valuation and fairness issues.[39] In such cases, there should be two opinions, one for the facts, and one for the legal issues based on the facts presented in the first opinion.

D. Selection with Reasonable Care

The requirement of reasonably believing that the advice is within the expert's professional competence and the requirement of selecting the expert with reasonable care are partially interchangeable as a careful selection excludes experts that the director believes are incompetent. Apart from that, a careful selection process should eliminate experts that are not

35. *See* Uebler, *supra* note 24, at 1042 ("objective reasonableness").

36. *See* MODEL BUS. CORP. ACT ANN. § 8.30, at 8-204.

37. *See* Selectica, Inc. v. Versata Enters., No. 4241-VCN, 2010 Del. Ch. LEXIS, at *50 (Mar. 1, 2010).

38. *Id.*

39. *See* Glassberg v. Boyd, 116 A.2d 711, 719 (Del. Ch. 1955); *see also* Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 751 (Del. Ch. 2007) (acknowledging that outside legal advisors can opine on whether a proposed transaction will be subject to the entire fairness test and on the possible outcomes of the test, but not on the actual substantive fairness of the proposal); Bevis Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 BUS. LAW. 1185, 1194 (1982).

reliable due to factors of personal nature. Such factors relate to the bias of the advisors, and, secondarily, to instances of frivolous or unprofessional behavior on the part of the expert. This Section will mainly cover conflict of interest issues as competence issues are discussed above.[40]

Conflicts of interest arise primarily when the independence and objectivity of the expert are questionable. An obvious example: in the context of leveraged buy-outs ("LBOs"), allowing the acquirer to select an appraiser for a solvency opinion can easily render the selection process flawed.[41] Similarly, if Company X is about to acquire substantial assets of Company Y, the director of Y, who also owns X, is not suited to appoint the advisor to this transaction.[42] The mere fact that management selected the advisor, though, is insufficient to prove a conflict of interest.[43] If management had a conflicting interest in the transaction that is known to the board, directors should avoid trusting their advisors. For example, in *Valeant Pharmaceuticals International v. Jerney*, the Delaware Court of Chancery examined the fairness of bonuses paid to former directors and officers after a spin-off of a division of the company.[44] The board of directors instructed the compensation committee to select a particular advisor, who had already issued an opinion favoring the award of bonuses, instead of selecting its own independent compensation consultant.[45] The court decided to deny the application of reliance provisions.[46]

---

40. *See supra* Section II.C.

41. *See, e.g.*, Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 307 (Bankr. D. Mass. 1997) (adding that the opinion was based on the data provided by the acquirer and thus some losses were understated).

42. Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 910 (Del. Ch. 1999) (finding that Section 141(e) is not a defense).

43. *Cf.* James D. Cox, *Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel*, 48 VILL. L. REV. 1077, 1086–87 (2003) (citing cases showing that, in the absence of signs of self-dealing, plaintiffs' claims alleging that advisors were not independent from senior management usually get dismissed).

44. 921 A.2d 732 (Del. Ch. 2007).

45. Further flaws in the procedure included the fact that the advisor based his opinion on misleading information provided by management, that his report addressed a different transaction from the one actually adopted, and that some of the committee's members were interested in the transaction. *Id.* at 748, 751.

46. *Id.* at 751. Interestingly, the court did not just hold Section 141(e) inapplicable, but added that in entire fairness cases, the existence of reasonable reliance, while being a factor in evaluating whether directors have met the standard of fairness, is not "outcome determinative of entire fairness" because this would replace the court's role in determining entire fairness under Section 144 and would create a conflict between Sections 141(e) and 144. In response to this view, Thomas A. Uebler notes that a court should first assess the entire fairness of the transaction (and, in doing so, consider various factors, among which is the use of advisors). Then, if the transaction has been found to be unfair, the court should consider the Section 141(e) defense. Applying this theory to the *Valeant* facts, and assuming that the transaction was found to be unfair,

Delaware courts have assessed transactions in which advisors had a personal stake in a business transaction. In *In re Del Monte Foods Co. Shareholders Litigation*, the court found that a financial advisor misled the board of a company that private equity buyers were in the process of acquiring.[47] The advisor did not disclose to the board that the advisor would participate in the buy-side financing and that the advisor actually encouraged potential buyers even before its appointment as advisor.[48] The board was unaware of the advisor's interactions with the potential buyers. The court examined the breach of fiduciary duties for the purpose of granting injunctive relief to delay the shareholder vote and did not examine monetary liability, admitting that Sections 102(b)(7)[49] and 141(e) make the chances of a judgment for money damages "vanishingly small."[50] In other words, the Court implied that Section 141(e) applies despite the advisor's interest in the transaction. This makes sense because undisclosed facts the board could not have known do not undermine the reasonableness of the Section 141(e) selection process.[51] To require that boards ask advisors to disclose any conflicts of interest would exceed the reasonable inquiry a board must make and render the Section 141(e) selection process highly unpredictable. Requiring that boards ask advisors to disclose conflicts of interest could eliminate, of course, the risk of injunctive relief.[52] Finally,

---

but Section 141(e) applied, the directors would have been required to disgorge the unfair portion of the compensation, but, on the other hand, they would not have been held liable for additional monetary damages flowing from breach of fiduciary duty. *See* Uebler, *supra* note 24, at 1049, 1053. Furthermore, Professor Bainbridge, adopting a somewhat different approach, concludes that the court's view in this case serves to eviscerate Section 141(e), noting that a Section 141(e) report should indeed be "outcome determinative." *See* Stephen Bainbridge, *Eviscerating DGCL 141(e)*, PROFESSORBAINBRIDGE.COM (Apr. 2, 2007), http://www.professorbainbridge.com/professorbainbridgecom/2007/04/eviscerating-dgcl-141e.html.

47. *In re* Del Monte Foods Co. S'holders Litig., 25 A.3d 813 (Del. Ch. 2011).

48. *See id.* at 823 (noting that the board had previously called off the process of a potential sale, and its investment bankers maintained contact with the potential buyers, despite the confidentiality agreement).

49. DEL. CODE ANN. tit. 8, § 102(b)(7) (2011); *see* Ryan *ex rel.* Maxim Integrated Prods. v. Gifford, 2009 Del. Ch. LEXIS 1, at *23–24 n.27 (Del. Ch. Jan 2, 2009) ("Section 102(b)(7) allows companies to adopt a provision in their certificate that eliminates the personal liability of directors for monetary damages for breach of fiduciary duty as a director, except for, among other things, breaches of the duty of loyalty and acts or omissions not in good faith or which involve intentional misconduct.").

50. *See In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d at 818.

51. *See* Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000) ("[T]he faulty selection process was attributable to the directors."); *see also* Hawes & Sherrard, *supra* note 16, at 25 ("[I]f reasonable inquiry would not have disclosed the interest.").

52. *See* David A. Katz, Del Monte *and the Responsibility of a Board in a Sales Process*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 14, 2011), http://blogs.law.harvard.edu/corpgov/2011/04/14/del-monte-and-the-responsibility-of-

the court noted that, even if monetary liability is not an option, disgorgement of transaction-related profits may be available as an alternative remedy.[53] This concept agrees with Uebler's above-mentioned concept, according to which the applicability of Section 141(e) does not undermine alternative remedies, such as the disgorgement of amounts received as a result of an unfair transaction.[54]

Another variation of having interest in the transaction arises when a substantial part of the advisor's fee depends on the success of the transaction (contingent fees). Delaware courts hold that the sole presence of such a fee structure does not itself destroy the advisor's perceived independence and that additional factors should be considered.[55] As a practical matter, prominent financial advisors normally would not risk their reputation issuing inaccurate or incomplete advice.[56]

Finally, while courts have sporadically demonstrated a prejudice against the independence of in-house counsels,[57] the reputations of in-house legal departments are rapidly improving.[58] The general rule is that particularized facts indicating bad faith or a flawed selection process are required to rebut the presumption of disinterestedness.[59]

III. FURTHER REQUIREMENTS

Beyond the expressly stated elements of Section 141(e), courts and scholars set additional requirements for the application of the reliance doctrine. Most notably, in *Brehm v. Eisner*,[60] the Delaware Supreme Court tried to systematize all basic requirements, stating that to reject reliance, a complaint must:

> allege particularized facts . . . that, if proved, would show, for example, that: (a) the directors did not in fact rely on the expert; (b) their reliance

a-board-in-a-sales-process.

53. *See In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d at 838.

54. *See* Uebler, *supra* note 24.

55. *See In re* General Motors (Hughes) S'holders Litig., No. Civ. A. 20269, 2005 WL 1089021, at *14 n.143 (Del. Ch. May 4, 2005), *aff'd*, 897 A.2d 162 (Del. 2006) (noting that the fee arrangement was unremarkable in terms of the overall value of the transaction).

56. *See* Winters v. First Union Corp., No. 01-CVS-5362, 2001 WL 34000144, at *4 (N.C. Super. Ct. July 12, 2001) (noting further that contingent fee arrangements are standard within the investment banking industry).

57. *See In re* Oracle Secs. Litig., 829 F. Supp. 1176, 1189 (N.D. Cal. 1993) ("inherently biased counsel").

58. Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, 33 J. CORP. L. 497, 510 (2008).

59. *See* Hawes & Sherrard, *supra* note 16, at 26.

60. 746 A.2d 244, 262 (Del. 2000).

> was not in good faith; (c) they did not reasonably believe that the expert's advice was within the expert's professional competence; (d) the expert was not selected with reasonable care by or on behalf of the corporation, and the faulty selection process was attributable to the directors; (e) the subject matter . . . that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice; or (f) that the decision of the Board was so unconscionable as to constitute waste or fraud.[61]

Requirements (a) through (d) rephrase Section 141(e). The most crucial requirement is (e) because it is the only one directly aimed at preventing the blind adoption of experts' views, which, as noted at the beginning of this Article, poses a significant problem for the reliance doctrine, due to the psychological safety decision-makers seek. This Section will explore further requirements that are thought to rationalize the reliance process. As the wording of the above court decision implies, there is a presumption that these requirements are met, meaning the plaintiff must present contrary evidence.[62]

A. *No Blind Reliance*

According to the first requirement, the board should not blindly adopt the advice given, i.e. without even trying to understand its basic logic. This concept, though, is somewhat vague. A broad interpretation of this requirement renders the reliance doctrine useless. Requiring, for example, that directors familiarize themselves with all technical aspects of the advice given would doubtlessly deviate from current business practices. Similarly, requiring that they obtain all necessary information to be able to independently assess the substance of the advice would severely undermine the reliance doctrine and impose less than cost-effective duties. Besides, under Delaware law, the sole ground deterring blind reliance can be found in the (somewhat abstract) good-faith limitation incorporated in Section 141(e). Unlike the wording adopted in New York or, more explicitly, in Australian law, there is no further limitation in the discussed statute.[63]

---

61. *Id.*; *see* Ash v. McCall, No. Civ. A. 17132, 2000 WL 1370341, at *9 (Del. Ch. Sept. 15, 2000).

62. *See Ash*, 2000 WL 1370341, at *9 ("The . . . board is entitled to the presumption that it exercised proper business judgment, including proper reliance on experts.")

63. N.Y. BUS. CORP. LAW § 717(a) (McKinney 2003 & Supp. 2010) ("[I]n so relying he shall be acting in good faith *and with such degree of care* . . . .") (emphasis added); *see* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275 (2d Cir. 1986) (noting that directors have some oversight obligations to become reasonably familiar with an opinion, report, or other source of advice before becoming entitled to rely on it); *see also Corporations Act 2001*, § 189(b) (Austl.) ("[If] the reliance was

1. Smith v. Van Gorkom *on Reliance*

In the past, Delaware case law emphasized this element of the reliance doctrine, notably in the groundbreaking decision *Smith v. Van Gorkom.*[64] At the time, Section 141(e) encompassed only reliance on a corporation's own officials, accountants, and appraisers.[65] According to the court's holding, certain circumstances may give rise to the director's duty to make a "reasonable inquiry" into the reports submitted by officers.[66] In *Van Gorkom*, these circumstances included "hastily calling the meeting without prior notice of its subject matter, the proposed sale of the Company without any prior consideration of the issue or necessity therefor, the urgent time constraints imposed by [a takeover specialist], and the total absence of any documentation whatsoever . . . ."[67] Although the directors had no financial expertise, the court held that they could not reasonably have relied on the reports in good faith if they accounted for all reasonably available information.[68] The board is "entitled to good faith, not blind, reliance."[69]

2. Narrowing Good Faith As Well As Oversight and Risk Management Duties

After *Smith v. Van Gorkom*, Delaware courts severely narrowed oversight and monitoring duties. Following *Caremark*, the court briefly required a "sustained or systematic" failure to monitor.[70] *Stone v. Ritter* limited the scope of the duty to monitor, holding that liability is given only if "(a) the directors utterly failed to implement any reporting or information system or controls *or* (b) having implemented such system or controls,

made after making an independent assessment of the information or advice, having regard to the director's knowledge of the corporation and the complexity of the structure and operations of the corporation . . . ."); Mark Byrne, *Do Directors Need Better Statutory Protection when Acting on the Advice of Others?*, 21 AUSTL. J. CORP. L. 238, 253 (2008) (proposing the relaxation of the terms of this provision by means of requiring inquiry only "if the circumstances indicate the need for inquiry").

64. 488 A.2d 858 (Del. 1985).

65. *See* 44 Del. Laws 423 (1943).

66. *Van Gorkom*, 488 A.2d at 875.

67. *Id.* (holding that (a) the CEO's oral presentation did not constitute "reports" within the meaning of Section 141(e) (the current version of this provision includes, though, "information, opinions, reports or statements"); (b) the presentation lacked substance, since the CEO was "basically uninformed as to the essential provisions of the very document about which he was talking"; and (c) the CFO's report did not enjoy the status conferred by Section 141(e), since it was not pertinent as to the subject matter upon which the board is called to act (in fact, it did not purport to be a valuation study)).

68. *Id.* at 877.

69. *Id.* at 875.

70. *See In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 963, 971 (Del. Ch. 1996).

[directors] consciously failed to monitor or oversee its operations."[71] The court also required that directors knew that they were not discharging their fiduciary obligations.[72] In interpreting these holdings, subsequent court decisions adopted one of the following approaches.[73] In *Desimore v. Barrows* and *Wood v. Baum*, the courts required facts showing that the board actually *knew*—not *should have known*—that the internal controls of the corporation were inadequate.[74] In *American International Group v. Greenberg*, the court inferred such knowledge from the positions of the directors or officers in the company—which enabled the control of the relevant corporate divisions—as well as from the persistence and the magnitude of the fraudulent conduct.[75] However, in *In re Citigroup, Inc. Shareholder Derivative Litigation*, the court noted that *American International Group v. Greenberg* involved pervasive fraudulent and criminal conduct, as opposed to the failure to recognize the extent of the company's business risk.[76] To be liable for the latter, the court concluded that bad faith must be proven based on the fact that the director knowingly violated a fiduciary duty or demonstrated a conscious disregard for a known duty.[77] Ignoring several red flags indicating deterioration of the subprime mortgage market was insufficient for the duty to monitor to be violated.[78] With regard to the company's failure to disclose exposure to subprime assets, the court rejected demand futility, noting that bad faith would have been proven if plaintiffs demonstrated that directors knew that there were misstatements or omissions in the financial statements.[79]

71. *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (emphasis in original). Furthermore, the court viewed the duty to monitor as a subsidiary element of acting in good faith, while it considered good faith, in turn, as a subsidiary element of the duty of loyalty. *Id.* at 368.

72. *See id.* at 370.

73. *See* Eric J. Pan, *A Board's Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717, 733 (2009–10).

74. Desimore v. Barrows, 924 A.2d 908, 940 (Del. Ch. 2007) (relating to backdating of stock options); Wood v. Baum, 953 A.2d 136, 139, 141 (Del. 2008) (relating to inadequate accounting and financial-reporting controls).

75. 965 A.2d 763, 795–99 (Del. Ch. 2009) (relating inter alia to improper accounting).

76. 964 A.2d 106, 130 (Del. Ch. 2009) (contrasting the alleged failure to monitor and manage risks Citigroup faced in the context of subprime lending market as well as disclosure failures).

77. *Id.* at 125.

78. *See* Stephen M. Bainbridge, Caremark *and Enterprise Risk Management*, 34 J. CORP. L. 967, 990 (2009) (concluding that claims alleging risk management failure will rarely result in liability).

79. *In re Citigroup*, 964 A.2d at 133–34; *see also* Kevin F. Brady & Francis G.X. Pileggi, *Recent Key Delaware Corporate and Commercial Decisions*, 6 N.Y.U. J. L. & BUS. 421, 429 (2010) (summarizing the court's ruling on the plaintiff's demand futility argument in *In re Citigroup, Inc. Shareholder Derivative Litigation*).

3. Impact on Reliance

The purpose of this review of recent Delaware decisions is to shed light on the interpretation of good faith. Good faith, as noted, is the main pathway to eliminate blind reliance cases under Delaware law.[80] When interpreting "good faith" in Section 141(e), one should not disregard current holdings of Delaware courts relating to this legal concept. In particular, it is fair to speculate that Delaware courts would be unwilling to construe a broad good faith requirement within the reliance framework that would be actually incompatible with its general good faith perception.

Without claiming that the above decisions form a consistent and clear system of rules, the bottom line is that unacceptable blind reliance in Delaware should be limited to cases where directors exhibit bad faith by means of (a) consciously disregarding their duties or (b) demonstrating clearly egregious behavior, such as abdicating their responsibility to make any business decision.[81] At the same time, the court might weigh the magnitude and persistence of the faulty behavior and the director's personal characteristics—mainly the director's experience and position in the company.[82] Therefore, as a rule, "should-have-known" cases do not render reliance unwarranted, as long as the directors act in good faith. Contrary interpretations would be inconsistent with the statute's wording, according to which directors are "fully protected" as long as Section 141(e)'s conditions are met. They would also construe good faith autonomously—that is, regardless of the court's interpretations in other contexts involving bad faith. Therefore, courts will generally not deny Section 141(e) applicability where the director negligently ignores some obvious red flags[83] or otherwise acts in a grossly negligent manner because of the court's (pre-*Caremark*) holdings in *Brehm v. Eisner* and *Ash v. McCall* that reliance is inapplicable where particularized facts show that the issue was material and "so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice."[84]

80. *See supra* Section III.A.

81. *Cf.* Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. Civ. A. 20228-NC, 2004 WL 1949290 *1, *10 (Del. Ch. Aug. 24, 2004) (interpreting "good faith" in the context of Section 102(b)(7)).

82. *See In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ. A. 16415, 2004 WL 1305745, at *1, *39–40 (Del. Ch. June 4, 2004).

83. *See id.* at *4 (noting that the directors of an acquiring company ignored various "red flags" including news articles and analysts' reports questioning the financial situation of the company to be acquired). *But see id.* at *9–10 (further noting that the court was satisfied by reliance on experts and the "green flags" they provided and thus, even from the perspective of *Ash v. McCall*, the "so-obvious" exception to reliance should be strictly interpreted).

84. *See* Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000); Ash v. McCall, No. Civ. A. 17132, 2000 WL 1370341, at *1, *9 (Del. Ch. Sept. 15, 2000).

4. *Two Examples*

To illustrate this set of rules, this Article considers two real-life examples involving financial statements. The first shows what would *not* occur in Delaware, and the second presents a realistic context of proper reliance under Delaware law.

i. ASIC v. Healey

The following facts took place in Australia, and the circumstances led to the issuance of a well-discussed Federal Court decision entitled *Australian Securities and Investments Commission (ASIC) v. Healey*, which was signed by Justice Middleton.[85] ASIC sued seven directors, six of whom were non-executive, as well as the Chief Financial Officer ("CFO") of the Centro Group over certain errors in the group's financial statements.[86] In particular, about $2 billion (AUD) of current liabilities had been misclassified as non-current liabilities and, in addition, there was a failure to disclose guarantees of short-term liabilities of an associated company of about $1.75 billion (USD) that had been given after the balance date.[87] ASIC claimed that, in failing to notice such a significant error in the statements, defendants breached their statutory duty of care and diligence owed to the group's companies.[88] PricewaterhouseCoopers ("PwC"), a qualified external auditor with complete access to all relevant information, prepared the financial statements.[89] At the same time, the CFO did not warn the directors that there might be irregularities in the statements. The directors, therefore, argued that they reasonably relied on the advice of PwC and of management, adding that they took reasonable steps to ensure that the company had all the necessary procedures and processes in place to prevent such errors.[90] According to Justice Middleton, however, directors (executive and non-executive) retain the ultimate responsibility for financial reporting, and they should recognize the distinction between

85. *Austl. Sec. & Inv. Comm'n v. Healey* [2011] FCA 717 (Austl.), *available at* http://www.austlii.edu.au/au/cases/cth/FCA/2011/717.html; *see, e.g.*, John Lowry, *The Irreducible Core of the Duty of Care, Skill and Diligence of Company Directors:* Australian Securities and Investments Commission v Healey, 75 MOD. L. REV. 249 (2012) (evaluating the impact of the *Australian Securities and Investments Commission v. Healey* decision on the standard of care required for non-executive directors in monitoring the production of financial statements).

86. *Healey*, [2011] FCA 717, at ¶¶ 2–3.

87. *Id.* at ¶ 9.

88. *Id.* at ¶ 8.

89. *Id.* at ¶ 35.

90. David A. Katz, *For Directors, A Wake-Up Call from Down Under*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 4, 2011, 9:21 AM), http://blogs.law.harvard.edu/corpgov/2011/10/04/for-directors-a-wake-up-call-from-down-under/.

current and non-current liabilities even if they are not experts in accounting.[91] In addition, Justice Middleton described a set of responsibilities of the board with regard to its duty to monitor.[92] Even though he did not cite the reliance provision of Australian corporate law, it appears that he adopted the provision's main requirement: boards need to assess the advice independently; otherwise, the reliance defense does not apply.[93] Finally, in a subsequent decision, Justice Middleton was satisfied by a declaration of contravention signed by the non-executive directors and did not impose further penalties.[94]

One could speculate that this result would not have occurred in Delaware.[95] First and foremost, there was no evidence of bad faith, which under Section 141(e) would render reliance unwarranted. As Justice Middleton admitted, the directors reasonably expected that PwC would provide sound advice, since no " 'red flags' ought to have alerted the directors to deficiencies in the processes or personnel of Centro or its auditors."[96] Justice Middleton's notion that directors *should have known* of the short-term debt and the guarantees is inconsistent with Delaware's interpretation of oversight duties. Assuming that there is no "sustained or systematic" failure to monitor, the *Caremark*-shaped duty to monitor would not be violated. Consequently, Justice Middleton's finding that directors are allowed to rely upon others—except where they know or, by the exercise of ordinary care, *should know* facts that would deny reliance seems to be incompatible with Section 141(e) and Delaware courts' holdings.[97]

---

91. *Healey*, [2011] FCA 717, at ¶ 18 ("[A] director, whatever his or her background, has a duty greater than that of simply representing a particular field of experience or expertise.").

92. *Id.* at ¶ 17 ("[A] director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged; a director should keep informed about the activities of the corporation; whilst not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies; a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements; a director, whilst not an auditor, should still have a questioning mind.").

93. *Corporations Act 2001* (Cth) § 189(b) (Austl.); *see also* Byrne, *supra* note 63, at 253.

94. *See Austl. Sec. & Inv. Comm'n v. Healey* (No. 2) [2011] FCA 1003, ¶¶ 188–91 (Austl.) (noting that damage to reputation is sufficient as a general deterrent). The CEO and the CFO, however, incurred a monetary penalty and a temporary disqualification ban, respectively. *Id.*

95. Here, this Article refers only to holdings of the court relating to reliance. The rest of the court's holdings imposing heightened responsibilities on non-executive directors do not correspond to practice in Delaware.

96. *See Healey*, [2011] FCA 717, at ¶ 384.

97. *See id.* at ¶ 167.

ii. Chung v. Nara

The second set of facts is taken from *Chung v. Nara Bancorp*, a 2012 California Court of Appeals decision.[98] The court, applying Delaware law, dealt with a suit filed by Thomas Chung, the ex-chairman of the board of a bank holding company, Nara Bancorp. The suit alleged breach of fiduciary duties by the directors due to the restatement of certain financial statements. It alleged that, in 2002, the Chief Executive Officer ("CEO") prepared a letter stating that he would not withdraw half of the profit share due to him in 2003 and 2004 in exchange for future compensation to avoid falling short of analyst expectations.[99] The 2002 financial statements did not reflect the obligation to the CEO, according to this arrangement.[100] Therefore, in 2005, the audit committee initiated an investigation conducted by a law firm that was assisted by an accounting company.[101] The law firm, the accounting company, and Nara's independent auditor concluded that a restatement of the 2002 financial statements was advisable. Accordingly, the board issued a restatement.[102] Subsequently, within the framework of an arbitration initiated by Nara against the CEO, it was held that there was no need to restate the statements.[103] In 2008, the board decided not to restate (again) the statements and not to sue its advisors. According to the plaintiff, this inaction also constituted a breach of fiduciary duties.[104]

The court noted that both Sections 102(b)(7) and 141(e) are statutory defenses implicating the concept of good faith.[105] Bad faith, in turn, is not established by showing instances of gross negligence, but, according to *Walt Disney*, presupposes more acute forms of misbehavior, such as a conscious disregard for known duties.[106] Since the business judgment rule does not always protect an irrational and grossly negligent decision, the question that arises is whether the two statutory defenses impose a higher hurdle to liability than the business judgment rule. The California court explicitly affirms this to be the case.[107] Accordingly, the court held that "it

98. No. B229826, 2012 Cal. App. Unpub. LEXIS 842, at *1 (Cal. App. Feb. 1, 2012).

99. *Id.* at *2.

100. *Id.* at *3.

101. *Id.*

102. *Id.* at *4.

103. *Id.* at *7.

104. *Id.* at *8.

105. DEL. CODE ANN. tit. 8, §§ 102(b)(7), 141(e).

106. *See In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006); *see also Chung*, 2012 Cal. App. Unpub. LEXIS 842, at *14.

107. *Chung*, 2012 Cal. App. Unpub. LEXIS 842, at *14 ("[A]n irrational and grossly negligent decision may not be protected by the business judgment rule, but it could

is unreasonable to infer that the 2005 Directors consciously disregarded duties or risks when they made their decision to issue the restatement only after hundreds of hours of investigation and only after receiving advice from competent professionals."[108] In other words, the court refused to accept bad faith.

Therefore, the court concluded that Section 141(e) shields directors from liability,[109] since there was no evidence that the directors acted "for a purpose other than advancing the best interests of Nara or [that they] intentionally fail[ed] to act in the face of a known duty to act[.]"[110] It also determined that the directors had not "act[ed] with the intent to violate the law[.]"[111] It was undisputed that the advisors had the "requisite expertise to conduct the investigation," "that they were selected with reasonable care," and that the directors "in fact relied on the recommendation of [the advisors]."[112] In fact, the court referred to the elements of Section 141(e), and, as far as the good faith element is concerned, it adopted the Delaware interpretation.[113]

Finally, with regard to the 2008 directors, the court was satisfied by the defendants' declaration that they "exercised their business judgment in making post arbitration decisions, and that they relied on management and legal counsel to make all legally necessary public disclosures about the arbitration."[114] The same statutory defenses, therefore, protected the directors.[115]

iii. Comparing the Outcomes of the Two Cases

While both cases relate to financial statements, the behavior of the Delaware directors sounds less outrageous. First, the misstatement in the Australia case involved a very substantial sum of money ($2 billion AUD). Second, the Australian directors failed to deal with a very central accounting topic, namely the characterization of liabilities as short term, while the Delaware directors were confronted with a disputed issue. Third, Delaware directors consciously adopted the unanimous view of three independent experts, while the Australian ones just listened to their accountant.

---

very well be protected by an applicable statutory defense.").

108. *Id.* at *21.

109. *Id.* at *22.

110. *Id.* at *15.

111. *Id.*

112. *Id.*

113. *Id.* at *12–15.

114. *Id.* at *23.

115. *Id.* at *25.

On the other hand, for directors, especially for those with no significant financial literacy, there is no meaningful difference between the Australia and the Delaware case: in both cases, they relied on their qualified experts. Since PwC, one of the most well-known accounting companies, failed to spot the irregularity in the statements, the same occurred with non-experts directors. Imposing liability on directors—especially non-executive directors whose duties are mainly supervisory—renders directorship a hazardous job. That is supposedly why Justice Middleton ultimately decided that reputation damages were a sufficient penalty for non-executive directors. He found these directors to be "intelligent, experienced and conscientious people" who undertook their duties honestly, leading him to the conclusion that "they are not people from whom the public must be protected in the future."[116] Justice Middleton, in other words, imposed the most important penalty Delaware directors face, reputation damages.

While the Australia and Delaware statutes differ significantly, they both fail to address all possible issues. Ideally, in assessing reliance, a court should weigh all available information, especially the expertise of the director, the magnitude and nature of the misbehavior, the expert selection process, the efforts to understand the opinion, and then choose a suitable penalty from the ones available in the relevant jurisdiction (declaration of contravention, disqualification, monetary liability, etc.). The good faith requirement in Section 141(e) is too abstract to capture all thinkable sets of facts, while the independent inquiry requirement of the Australian law is too harsh.[117] As the cases examined in this Article show, courts are flexible enough in their effort to reach a fair result.

5. *Remaining Uncertainties*

The *Smith v. Van Gorkom* holding requiring a reasonable inquiry into the reports submitted by officers (and, inferably, by outside experts) does not correspond to Section 141(e)'s wording and recent judgments relating to good faith.[118] Generally, courts will not condemn "blind reliance"—even if there are signs of grossly negligent behavior—as long as the statutory requirements are met. "Good faith" is interpreted relatively narrowly, according to Delaware court decisions.

One should take note, however, that *Smith v. Van Gorkom* involved an extremely important transaction, namely the acquisition of the company through a cash-out merger. In the context of transactions involving corporate control, the subsequent *Revlon* decision imposed enhanced judicial scrutiny that greatly affected the application of the business

116. *Austl. Sec. & Inv. Comm'n v. Healey* (No. 2), [2011] FCA 1003 ¶ 184 (Austl.).

117. *Corporations Act 2001* pt. 2D.1, div. 1, § 189(b) (Austl.).

118. Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985).

judgment rule in such transactions.[119] The reliance doctrine could not have been left untouched. On the one hand, various decisions, mainly from the 1980's, required that boards actively participate in and oversee the transaction, even if they act according to advisors' opinions.[120] These decisions also questioned the quality of fairness opinions provided by investment banks when their preparation was obviously deficient.[121] On the other hand, there are numerous cases where courts, without citing Section 141(e), treat fairness opinions as a serious indicator that directors properly acted in approving the relevant transaction.[122] Consequently, fairness opinions are an element supporting that the director was not "grossly negligent" in informing himself, and therefore that business judgment presumption applies. Section 141(e) as a defense is usually not dealt with or is seen as inapplicable in gross negligence cases.[123] Without asserting that Section 141(e) is the appropriate tool to deal with the complexities of fairness opinions, it is clear that there are a lot of uncertainties, which this Article will not address.

B. *Should the Advice Be Written and Formally Presented?*

The court in *Smith v. Van Gorkom* was not satisfied by an oral presentation; it required a written report to fulfill Section 141(e)'s dictate.[124] Since the current version of this provision includes

119. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184–85 (Del. 1986).

120. *See* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1281 (Del. 1988) (holding that "in a matter as significant as the sale of corporate control," directors cannot avoid an "active and direct duty of oversight" simply by conditioning the transaction on the outsider's opinion); *see also In re* Healthco Int'l, Inc., 208 B.R. 288, 305–06 (Bankr. D. Mass. 1997); Cede & Co. v. Technicolor, 634 A.2d 345, 369 (Del. 1993); William T. Allen, Jack B. Jacobs & Leo E. Strine, *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1300 (2001) ("[O]utside directors who had approved an arm's-length-negotiated sale of their company to an unrelated third party, in reliance upon the advice of independent counsel and investment bankers, were found to be . . . grossly negligent for not having "shopped" the company before agreeing to the sale . . . .").

121. *See* Joseph v. Shell Oil Co., 482 A.2d 335, 344 (Del. Ch. 1984) (criticizing opinions that were prepared in a very short period of time); *accord* Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983).

122. *See, e.g.*, Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557, 1599 n.221 (2006).

123. *See, e.g.*, *Cede & Co.*, 634 A.2d at 366; *see also* Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 985 (Del. Ch. 2000) ("Section 141(e) of Delaware's corporation law provides that directors are protected from a breach of the duty of care 'when the directors reasonably believe the information upon which they rely has been presented by an expert 'selected with reasonable care' and is within that person's 'professional or expert competence.' ").

124. 488 A.2d 858, 884 (Del. 1985).

"information, opinions, reports or statements," one could hardly argue that oral presentations are unacceptable only because of their oral nature.[125] Of course, directors might prefer written reports, since judicial review will be easier.[126]

Similarly, there is no need for a formal presentation to the board of directors.[127] The wording of Section 141(e) ("presented to the corporation") does not exclude written presentations but requires some form of presentation. If the director fails to attend oral presentations or does not read the reports, it could be argued that there was no *stricto sensu* reliance—that is, an act *based on* the advice.[128]

C. *Waste or Fraud*

Decisions of the board "so unconscionable as to constitute waste or fraud" are not excused by reliance.[129] There is no need to expand Section 141(e), since bad faith covers both concepts. With regard to fraud, that is obvious. In considering waste, the Delaware Supreme Court has held that waste constitutes bad faith.[130] It should be noted, however, that waste will rarely be found. If "there is *any substantial* consideration received by the

---

125. *See* Uebler, *supra* note 24, at 1037–38 ("[P]urpose of the 1987 amendment was 'to clarify that directors may rely in good faith upon . . . written or oral advice or opinions of any professionals and experts . . . .' ").

126. *See* Carlton Invs. v. TLC Beatrice Int'l Holdings, No. Civ. A. 13950, 1997 Del. Ch. LEXIS 86, at *54 (Del. Ch. May 30, 1997) ("[A]lthough a written legal opinion is preferable from the standpoint of a court engaged in a post facto review of a board's decision, whether an opinion is oral or in writing is of no consequence to the board at the time of its decision."); *see also* Hawes & Sherrard, *supra* note 16, at 33.

127. *See In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 769 n.550, *aff'd*, 906 A.2d 27 (Del. 2006) ("Nor is it necessary for an expert to make a formal presentation at the committee meeting in order for the board to rely on that expert's analysis, although that certainly would have been the better course of action.").

128. *See In re* Healthco Int'l, Inc., 208 B.R. 288, 307 (Bankr. D. Mass. 1997) ("The defendants say they relied on the solvency opinions of Valuation Research Corporation. But they never saw those opinions before approving the transaction, so the opinions can hardly constitute 'reports' of an expert the directors were entitled to rely upon under section 141(e) of Delaware's corporation law."); MODEL. BUS. CORP. ACT ANN., § 8.30(e), at 8-202 (2011 Revision) ("Reliance . . . is permitted only if the director has read the information, opinion, report or statement in question, or was present at a meeting at which it was orally presented, or took other steps to become generally familiar with it."). However, as this Article notes previously, a director who read the report but failed to familiarize himself with it loses the reliance defense only in bad-faith cases.

129. *See* Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000).

130. *See In re* Citigroup, Inc. S'holder Derivative Litig., 964 A.2d 106, 136 (Del. Ch. 2009) (quoting White v. Panic, 783 A.2d 543, 554 n.36 (Del. 2001)) ("To prevail on a waste claim . . . the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests.").

corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste," and Section 141(e) will be applicable.[131]

D. Full Disclosure

Even before the enactment of Section 141(e) and MBCA Section 8.30(e) in their current versions, courts unanimously held that the reliance defense is not available to directors who fail to disclose all relevant facts to their advisor.[132] For example, factual distortions calculated to result in favorable advice clearly violate good faith principles and thus exclude the use of the defense.[133] Similarly, withholding from advisors facts that the director thinks are relevant can be a "clear indication of bad faith."[134] For example, directors of an oil company should disclose material, non-public information on the value of probable oil reserves to an investment banker; otherwise, the fairness opinion is deficient.[135] Due to Section 141(e)'s wording, it is unclear whether an honest, but grossly negligent failure to disclose some facts taints the defense. This would be the case when the director, due to the complexity of the issues involved, fails to recognize which facts are relevant. If this failure is not attributed to negligence, the omission would be "innocent."[136] If the failure is attributed to gross negligence, but the director acts in good faith, the result of a strict interpretation of Section 141(e) would not exclude reliance. The exercise of the advisor's duty, though, to ask appropriate questions to receive the necessary information might prevent some of these cases of gross negligence.[137]

---

131. Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (emphasis in original).

132. Hawes & Sherrard, *supra* note 16, at 29 (regarding disclosure to attorneys).

133. Comment, *Reliance on Advice of Counsel*, 70 YALE L.J. 978, 989 (1961).

134. *Id.* at 981; *see also* Uebler, *supra* note 24, at 1044 ("[A]nything less than full disclosure by the directors to the expert of all material facts related to the subject of the expert advice might evidence bad faith.").

135. Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984).

136. Hawes & Sherrard, *supra* note 16, at 29 (noting that requiring negligence is consistent with the general structure of the defense, since, for example, directors are shielded if they reasonably believe in the advisor's competence).

137. *Id.* at 29 n.116; Longstreth, *supra* note 39, at 1192. For example, a bankruptcy court examining a fraudulent transfer was not satisfied by reliance on a solvency opinion issued by a consulting firm where this firm (a) would receive the larger part of its payment only if it issued a favorable opinion and (b) relied on the outdated projections provided by the management—as well as on management's "downside" models—without making an independent inquiry. *In re* TOUSA, Inc., 422 B.R. 783, 839–40 (Bankr. S.D. Fla. 2009), *rev'd, In re* TOUSA, Inc., 444 B.R. 613 (S.D. Fla. 2011), *aff'd in part, rev'd in part* 680 F.3d 1298 (11th Cir. 2012). *But see* Jeffrey Rothschild, *Court Rulings on Solvency and Fairness Opinions Help to Define Liability for Financial Advisors*, MCDERMOTT WILL & EMERY (Feb. 2010),

A variation of the lack of disclosure problem arises when CEOs entrusted with the transmission of information to the expert manipulate the information to prevent undesirable reports.[138] Clearly, Section 141(e) does not deal with that problem in its entirety. As noted previously, there is no prejudice against experts selected by management.[139] Nevertheless, since boards are required to demonstrate reasonable care when selecting advisors, they should not allow conflicted managers to select experts and control the flow of information between the corporation and the experts. In the presence of instances justifying a particular interest of managers in the transaction (when, for example, they are to receive a large bonus or benefit upon the consummation of a deal), directors should prevent them from hiring a "friendly" advisor, or at least ensure that the advisor receives all necessary information, in order to be able to enjoy the benefits of Section 141(e). In the absence of such circumstances, reliance is considered warranted.[140] Therefore, Section 141(e) fails to address the incentives of managers, who, without being conflicted, try to manipulate the information experts receive. Managers attempting to escape the board's oversight by relying on expert opinions will usually be ineffective.[141]

E. Causal Nexus

Opinions that are not pertinent to the decision to be made[142] are not covered by Section 141(e) because there is no *stricto sensu* "reliance." Generally, for liability to be precluded there must be a causal nexus between the challenged aspect of the transaction and the advice.[143]

Sometimes, causal nexus theories may benefit the recipient of the advice,

---

http://www.mwe.com/info/pubs/CRI_3%201_Rothschild.pdf (noting that in various cases courts were unwilling to hold financial advisors liable for fairness opinions, when limitation on liability is explicitly stated in engagement letters).

138. *See* Nina Walton, *Delegated Monitoring: When Can Boards Rely on Outside Experts?*, 14 AM. L. ECON. REV. 271, 277, 294 (2012) (concluding that, to eliminate the incentives of managers to manipulate experts, boards should ask for joint recommendations signed by both managers and experts).

139. *See supra* Section II.D.

140. *Cf.* Cox, *supra* note 43, at 1090 ("Though there is always the fear that managerial self-interest will corrupt the information that reaches the board, absent notice to the contrary, boards are entitled to rely upon reports prepared by managers and their stewards unless the directors are aware of circumstances that make such reliance unreasonable.").

141. *See* Walton, *supra* note 138, at 275, 299; *see also* Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 751 (Del. Ch. 2007).

142. *See* Smith v. Van Gorkom, 488 A.2d 858, 875 (Del. 1985); *see also Valeant Pharms. Int'l*, 921 A.2d at 751.

143. Uebler, *supra* note 24, at 1045–46 ("There may be no causal nexus, however, where, with respect to a fairness opinion by a financial expert, the unfairness of the transaction relates to process (e.g., timing or structure) and not to price.").

for example when there is failure to disclose all facts to the expert, but the challenged aspect of the transaction does not relate to the undisclosed facts.

F. Contractual Relationship

A direct contractual relationship between the company and the advisor is not required,[144] provided, of course, that the advisor is selected with reasonable care and directors act in good faith.[145] The board may equally rely on the accounting company engaged by the company's law firm,[146] on the legal advisor of the underwriter,[147] or on the expert engaged by another company participating in a common project or joint venture. However, according to Section 141(e), there has to be some kind of presentation to the board, such as a written report by the expert. Furthermore, it is questionable whether a total stranger can present to the corporation information, opinions, reports, or statements within the meaning of Section 141(e). Consequently, published articles of experts or published ratings cannot be used to invoke a Section 141(e) defense.[148] Thus, a board approving investments in highly rated investment products may allege that it was not grossly negligent in informing itself, but it cannot invoke Section 141(e).

CONCLUSION

In all walks of corporate life—from creation to expansion and from restructuring to demolition—experts are available to advise all players—directors, managers, shareholders, financiers, etc. Section 141(e) does not regulate the role of experts, but only the conditions under which reliance on them is statutorily protected. This Section, specifically the part relating to experts, does not come into play as often as one would imagine. First, it applies only to directors. Second, when it comes to liability, directors are shielded by various alternative mechanisms, ranging from the business judgment presumption and the Section 102(b)(7) exculpatory clause to indemnification and D&O insurance provisions.[149] At the same time, when Section 102(b)(7) is inapplicable due to the bad faith of the director,

---

144. *See* MODEL BUS. CORP. ACT § 8.30(f)(2) ("persons retained by the corporation"). This wording invites contrary interpretations.

145. *See supra* Section II.B, II.D.

146. Chung v. Nara Bancorp, No. B229826, 2012 Cal. App. Unpub. LEXIS 842, at *3 (Cal. Ct. App. Feb. 1, 2012).

147. Hawes & Sherrard, *supra* note 16, at 26–27.

148. *Cf.* Lyman P.Q. Johnson, *The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective*, 47 S. TEX. L. REV. 27, 31 (2005) (noting that reliance on a CFO's views as reported in an interview with a newspaper is not appropriate).

149. DEL. CODE ANN. tit. 8, §§ 102(b)(7), 145(a), 145(g).

Section 141(e) will not usually be applicable either. Therefore, Section 141(e) would be useful for the director, for instance, in the event of conflicted transactions or when there is gross negligence in the information gathering process and no Section 102(b)(7) protection is in place.

In such cases, unfortunately, the holdings of Delaware courts are not completely consistent. One would expect that the elements of Section 141(e) would provide satisfactory (and exclusive) guidance to the courts, but the courts often are either indecisive with regard to the interpretation of the good faith element, add extra elements to the rule, or do not cite Section 141(e) at all. While, for example, a court decision inferred from the particular qualifications of a director that he "should have known," another decision stated that even directors who are experts are fully protected under Section 141(e).[150] Most importantly, although the provision does not require directors to conduct an independent inquiry, Delaware courts, especially in merger and conflicted transactions, (a) require boards to be active,[151] (b) take into account facts the directors did not know[152] or could not have known, (c) consider reliance inapplicable when "the subject matter that was material and reasonably available was so obvious that the board's failure to consider it was grossly negligent regardless of the expert's advice or lack of advice,"[153] or (d) consider reliance as "a pertinent factor in evaluating whether corporate directors have met a standard of fairness in their dealings with respect to corporate powers."[154] While not resolving all uncertainties, this Article concludes that, according to the wording of Section 141(e), and taking into account *Caremark*,[155] Delaware courts are expected to interpret this provision as the *Chung v. Nara* court did.[156] Accordingly, Section 141(e) is construed as a "standalone" defense, which can shield grossly negligent directors even when they are not protected by the business judgment presumption.

Had the Wisconsin schools been a Delaware corporation, its directors would probably have been fully protected by both the business judgment presumption and the reliance provision. Of course, in Delaware there are alternative mechanisms, most notably reputational mechanisms that could

150. *See In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 135 (Del. Ch. 2009).

151. *See supra* Section III.A.5.

152. *See* Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 751 (Del. Ch. 2007) (admitting that the board probably did not know that the advisor had already issued an opinion favoring the award of bonuses).

153. Brehm v. Eisner, 746 A.2d 244, 262 (Del. 2000).

154. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1142 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995); *see also Valeant Pharms. Int'l*, 921 A.2d at 751.

155. *See supra* Section III.A.2.

156. *See supra* Section III.A.4.ii.

have affected their behavior. "In Delaware," as two Delaware attorneys put it, "the answer is not to expand their personal liability."[157]

157. *See generally* Dominick T. Gattuso & Vernon R. Proctor, *Reining in Directors and Officers in Corporate America*, 19 BUS. L. TODAY 1 (Jan./Feb. 2010). However, even from a reputation perspective, this does not mean that there is no need for more predictable rules. For directors, even having to participate in a trial might (at least temporarily) damage their reputation.

* * *