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North Carolina Business Court Addresses Key Components of Director Duties

We have long advised our clients that the legal duties of directors under North Carolina law are consistent with, and in some cases more protective of directors than, Delaware law. No single North Carolina decision, however, has addressed these issues in a unified way. That situation has now changed. In *State v. Custard,* decided March 19, 2010, the North Carolina Business Court undertook a comprehensive review of director duties and provided additional guidance in this important area of law. In a decision that should be welcomed by corporations and directors alike, the Court confirmed and clarified the broad protections that are available to directors under North Carolina law.

The *Custard* case involved a specialty insurance company that was taken over by the North Carolina Commissioner of Insurance as liquidator. The Department of Insurance sued three directors. The Department alleged that the directors had breached their duty of "good faith" by, among other things, continuing to sell a high volume of policies after seeing that losses on those policies were coming in at higher than expected rates. The Court dismissed the claims, finding that the directors were protected by the "business judgment rule" because they had followed a rational process and had acted in a good faith effort to advance the corporation's business. The Court concluded that, while management had written the wrong policies for the wrong premiums, their decisions were not made in any conscious effort to disregard the impact on the business.

The insurance company's charter in *Custard* included a director exculpation clause based on provisions of the Georgia Business Corporation Code, under which the company originally was incorporated. The clause exculpated directors from personal liability for breach of their duties, except for, among other things, acts or omissions that were not in good faith. In applying the exculpation clause, the Court held that directors were entitled to the *presumption* of "good faith" under the business judgment rule. As the Court colorfully put it, a plaintiff cannot overcome the presumption of good faith simply by showing that the directors' decisions were "wrong, stupid or egregiously dumb."

North Carolina's exculpation statute permits a corporation's articles of incorporation to eliminate a director's personal liability for breach of their duties, except for, among other things, acts or omissions

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that the director *knew or believed were clearly in conflict with the best interests of the corporation*. Although conduct that a director knows or believes to be clearly against the best interests of the corporation would qualify as "bad faith," the North Carolina exculpation statute contains no explicit requirement that a director must act in "good faith," suggesting that a different standard may have been intended.

North Carolina also permits a corporation to indemnify a director against a claim for breach of duty. There are two separate indemnification statutes in North Carolina. Under the first, the director must have acted in good faith in order to qualify for indemnification. However, under North Carolina's second indemnity statute, a corporation is permitted to provide *additional* indemnity, which may extend to *any* liability arising out of activities taken in official capacities, except that the corporation cannot indemnify against actions that an individual *knew or believed were clearly in conflict with the best interests of the corporation.* As with North Carolina's exculpation statute, the additional indemnity statute does not include an express requirement of good faith.

The absence of any express requirement of good faith in North Carolina's exculpation and additional indemnity statutes distinguishes these statutes from their Delaware counterparts. It is arguable that the North Carolina statutes allow broader protection of directors. The Court in *Custard* did not squarely address that issue, however, so a final answer may have to await further court decision. In the interim, it is clear from *Custard* that directors have significant protections under North Carolina law even without an exculpatory or indemnification clause. The *Custard* decision confirms the following important principles:

- The duties of a director, as established by statute in North Carolina, require a director to act (i) in good faith; (ii) with the care an ordinarily prudent person would exercise under similar circumstances; and (iii) in a manner the director reasonably believes to be in the best interest of the corporation.

- Director duties will be judged in context, and may vary based on the size or type of business or industry involved. Directors must discharge their duties with the care that an ordinarily prudent director would exercise *in a like position and under similar circumstances.* Different directors in the same company may be subject to differing levels of scrutiny based upon their individual knowledge and experience. For example, a director who has actual knowledge about a topic that his or her fellow directors do not have may be subject to a closer review.

- Reliance on qualified outside advisors continues to be prudent. A director who reasonably relies on competent officers, employees and outside experts and believes their advice to be accurate has a "safe harbor" in North Carolina.

- The business judgment rule is alive and well in North Carolina. As long as the process employed by the officers and directors was rational and informed and the directors believed they were advancing the corporation's business, a court will not second guess their business decisions. Absent self-interest in a transaction, the business judgment rule is a *gross* negligence standard for directors. Mistakes or errors in judgment alone will not establish liability.

- The duty of loyalty requires a director to act in the best interest of the corporation, to avoid conflicts between the director's interests and the corporation's interests, and to try in good faith to perform his or her duties with care. Self-interested transactions involving directors are subject to a showing of "entire fairness."

- "Good faith" simply requires an honest belief by directors that their actions are in the best interest of and not harmful to the corporation and are based on adequate information. While a good faith belief must be an *informed* belief, neither errors in judgment nor negligence establish an improper motive. Examples of bad faith are reckless indifference, improper motive, personal advantage or deliberate disregard of corporate interests.

- There is no separate duty of good faith under either Delaware or North Carolina law. Rather, the requirement of "good faith" is a core component of the duty of loyalty.

- As under Delaware law, a director should not be liable for a failure to monitor business risks unless he acted in "bad faith," which is a high bar. Examples of bad faith include an utter failure to attempt to assure any reasonable information and reporting system, or where directors consciously ignored "red flags."

In summary, the North Carolina Business Court's decision in *Custard* does not change the law in North Carolina, but provides further helpful explanation of the standards of conduct and principles of review that apply to directors in North Carolina. As in Delaware, directors are subject to the duty of due care and the duty of loyalty, which includes a component of good faith. Further, director obligations will be judged in context, which includes consideration of the type and size of business involved. Directors will be held to the standard of prudent directors in like companies acting under similar circumstances.

Courts will defer to the business judgment of directors absent evidence of self-interest or bad faith. Errors in judgment, or even negligence, are not enough alone to establish bad faith. Directors will not be liable for the failure to monitor business risks unless they fail to implement any reporting or information system or controls, or they consciously ignore known risks. Under North Carolina statute, directors may continue to rely on the reports of management or board committees and outside advisors, as long as the directors reasonably believe them to be competent and reliable. A director cannot reasonably rely on advice that is known to be inaccurate and the advice must be followed in order to claim the protection of the statute.

For more information concerning the *Custard* decision, or to discuss issues relating to director duties or corporate governance generally, please contact Gerald Roach or Margaret Rosenfeld in our Corporate Group, or Don Tucker or Mike Mitchell in our Complex Litigation Group. Contact information is included below.

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