

# Unclean Hands: As Dangerous in the Boardroom as in the Operating Room?

Gary M. Brown, Baker Donelson Bearman Caldwell & Berkowitz PC, Nashville, TN

A recent Centers for Disease Control and Prevention Morbidity and Mortality Weekly Report disclosed a shocking statistic—60% of doctors do not follow hand washing guidelines. Unclean hands—a risk of disease and death to patients. Unfortunately, unclean hands, albeit of a different type, also pose a risk to corporate directors. Consider Point Blank Solutions, Inc.'s (PBS') Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) in March 2008. In it, PBS disclosed that it was resisting a claim for advancement of legal fees incurred by the former chief executive officer (CEO) in various civil and criminal proceedings. PBS' stated reason for resisting the CEO's claim? The CEO's alleged "unclean hands." PBS asserted that the CEO forfeited his right to advancement "due to his bad-faith transfers of assets outside of the United States."

Does this "unclean hands" defense present a "new" risk to directors? No, it does not; however, when this defense seemingly was first recognized, albeit unsuccessfully, in corporate advancement cases<sup>1</sup> it evoked the same concerns as did other instances of potential increased director liability—e.g., 1985's *Smith v. Van Gorkom*<sup>2</sup> (holding directors liable for gross negligence), the Sarbanes-Oxley Act, the Enron and Worldcom settlements in which directors paid personally to settle securities litigation, and the *Emerging*

*Communications*<sup>3</sup> decision, in which two outside directors were held personally liable for approving a transaction despite several fiduciary safeguards<sup>4</sup> and the fact that the directors had no personal financial interest in the transaction. Each of these events caused pundits to pronounce that if directors had to be concerned about individual liability, corporations would not be able to attract qualified persons to serve as directors.

The bar for director liability is quite high and the range of potential defenses and protection from liability is broad.

How times have changed. As late as the early 1940s, a director's right to indemnification or reimbursement of legal fees and expenses for defending derivative proceedings—cases brought by stockholders purportedly on behalf of the corporation—was of questionable validity. In fact, such exposure was regarded as one of the hazards of being a director.<sup>5</sup> In response, states began adopting statutes authorizing indemnification

and advancement of expenses to corporate directors on the grounds that it allowed directors of limited means to retain competent legal counsel to defend themselves with the assurance that payment would be forthcoming from the corporation and to encourage persons to accept directorships, the benefits of which would otherwise not be commensurate with the risk of loss involved.

Every corporate governance or financial markets "crisis" brings directors increasingly under the microscope. Indeed, the anxiety of directors caused by the virtual "siege" mentality that has overtaken corporate boardrooms concerns their potential liability for claimed breaches of fiduciary duty. Although each new media report of director liability heightens this anxiety, the media generally do not report the "good news"—the aberrational nature of some cases, the trivial settlements paid when compared to the true exposure of some directors,<sup>6</sup> or, in the *Emerging Communications* case, the fact that several non-management directors, including the special committee chairman, who arguably was grossly negligent in the manner in which he conducted the transaction process, were ruled not liable as a result of the company's exculpatory charter provision.

Despite the hyperbole of recent years, directors actually have fared quite well from a liability standpoint.

The views are those of the authors and do not represent the position of the Association. Health Lawyers is a non-partisan educational organization that does not take positions on public policy issues and instead provides a forum for an informed exchange of views. Health Lawyers invites those with opposing views on the Feature to submit letters or articles, which will be reviewed, published and edited on a space available basis. Letters to the Editor should be no longer than 250 words in length. If those seeking to respond would like to do so in the form of an article, he or she may submit it for consideration to [editorial@healthlawyers.org](mailto:editorial@healthlawyers.org), and the proposed article will be considered in the ordinary editorial process.

The bar for director liability is quite high and the range of potential defenses and protection from liability is broad. Indeed, directors can go about their jobs even in a grossly negligent manner and have no liability, with one caveat: directors must act in good faith, which can easily be characterized as “clean hands.” In this respect, while some might argue that cases evoking these doctrines are plowing new ground, they actually are merely timely reminders of the basics of director fiduciary duty analysis that often are overlooked.

### **Fiduciary Duties Generally— The Obligation to Act in “Good Faith”**

Most directors and those who advise them are aware of a director’s basic fiduciary duties—care and loyalty.<sup>7</sup> Many may not realize, however, that the fiduciary duties of directors of public corporations, private corporations, and not-for-profit corporations are identical. The risk profiles may be different—for example, private company and not-for-profit directors may not have risks associated with publicly traded securities. Otherwise, corporate directors, irrespective of the form/classification of the entity, have the same basic fiduciary obligations.

Also, an important complement to directors’ fiduciary duties is the obligation to act in “good faith.” “Good faith” began to receive significant attention in 2003 after a Delaware Chancery Court ruled that directors could be personally liable for the results of their decisions despite receiving no improper personal benefit and having no conflicting personal interest in the matter at issue. In that case, the directors’ alleged actions (or, in fact, *inaction*—not paying sufficient attention to corporate affairs) were recharacterized as a failure to act in “good faith.”<sup>8</sup>

Following that ruling, state fiduciary duty cases against directors routinely included claims for breach of the “duty of good faith.” Fortunately, these doctrinally unsound claims were put to rest in a later Delaware Supreme Court case<sup>9</sup> that clarified the concept and ruled that “the obligation to act in good faith

“Unclean hands”  
or lack of good  
faith . . . can result  
not only in an  
actionable breach of  
fiduciary duty; it  
can preclude reliance  
upon the panoply  
of defenses and  
protections otherwise  
afforded directors.

does *not* establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”<sup>10</sup> The notion that a failure to act when under a known duty to do so would violate one’s obligation to act in good faith, however, was reaffirmed.<sup>11</sup> Moreover, acting “not in good faith” has important consequences that are described below and may itself result in a breach of the duty of loyalty and, therefore, personal liability for directors.

So, other than being careful and loyal, are there other ways that directors may be protected?

### **Director Protection Mechanisms—The Continuing Importance of “Good Faith”**

The answer is “yes”—for policy reasons, directors also enjoy broad defenses and protection from liability. There is the well-known but often misunderstood “business judgment rule.” For some nonprofit directors, there is statutory immunity. Finally, there is exculpation and indemnification (both in advance and at the conclusion of a matter).<sup>12</sup> Good faith is an important element of each.

**Business Judgment Rule.** Because directors’ responsibilities often require the exercise of judgment, the business judgment rule was developed as the fundamental standard of judicial review when directors’ actions are challenged.<sup>13</sup> The business judgment rule recognizes that corporate directors operate in a manner different from trustees or other fiduciaries. Corporate directors manage a business, in which undertaking risk to obtain profit is a, if not the, fundamental purpose of the corporation. Accordingly, the business judgment rule shelters ordinary corporate decisions from judicial second-guessing, protects directors from threats of personal liability, and protects transactions from injunctions or rescission.

The business judgment rule requires that directors’ decisions “be respected by courts unless the directors are interested or lack independence relative to the decision, *do not act in good faith*, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.”<sup>14</sup> The practical result of the business judgment rule’s application ordinarily is to sustain the transaction and dismiss

any claim against directors. This provides directors substantial flexibility to undertake transactions that they deem to be for the benefit of the corporation despite the risks associated with such transactions, if they do so after reasonable investigation and deliberation and without self-dealing, fraud, or waste of corporate assets.

The business judgment rule's good faith requirement necessarily focuses attention on the rule's most misunderstood but most fundamental aspect. The business judgment rule applies only when directors *act*, i.e., the directors must *exercise* business judgment. The rule has no application if directors either abdicate their functions, or, absent a conscious decision, fail to act when under a duty to do so. There is a difference between "doing nothing," which can be a failure to act in good faith and therefore not protected by the business judgment rule, and *deciding*, an informed deliberative process, to do nothing, which is protected.

**Immunity.** Some state legislatures have determined that certain not-for-profit directors are critical to the efficient conduct and management of public and charitable organizations and that they should be permitted to operate without concern about personal litigation arising from the discharge of their duties. Accordingly, those states grant those directors immunity from suit arising from the affairs of the corporation. That immunity, however, generally is removed for actions involving willful or wanton conduct—i.e., a *lack of good faith*.<sup>15</sup>

**Exculpation.** Until recently, *Van Gorkom* probably was the most significant Delaware duty of care case. That case triggered the last "crisis" in director liability pre-*Enron*, when the court set the standard and held

directors liable for *gross negligence* after they signed off on an agreement to sell their company without displaying much curiosity about the details of the proposed sale.

After *Van Gorkom*, much as was the case after the collapse of Enron and WorldCom, the politicians and regulators moved in. Instead of setting stricter rules for boards, however, various new laws in the 1980s had the effect of *limiting* directors' liabilities. Companies were permitted to add charter provisions removing directors' liability for breaches of the duty of care—exculpation. These exculpation provisions, however, have limitations. They may not shield directors from liability for breaches of the duty of loyalty or for acts or omissions that are "*not in good faith*."<sup>16</sup>

For nearly two decades, many thought that once stockholders adopted an exculpatory charter provision, independent directors could be held personally liable *only* for self-dealing-type transactions, implicating the duty of loyalty, and not otherwise. Allegations against directors based upon "mere" breaches of the duty of care, even cases involving gross negligence, were routinely dismissed.<sup>17</sup> Without much discussion about "good faith," an open question was whether a duty of care breach could be egregious enough to also constitute a duty of loyalty breach or a lack of good faith. The *Disney* decision answered this question in the affirmative.<sup>18</sup>

**Indemnification and Advancement of Expenses.** Interim advancement of litigation expenses and corporate indemnification serve two objectives: allowing corporate officials to resist unjustified lawsuits and encouraging capable persons to serve as corporate directors, secure in the knowledge that the corporation will absorb the costs

of defending their honesty and integrity.<sup>19</sup> Most corporate statutes require *mandatory* indemnification at the end of a proceeding if the director is "wholly successful" on the merits or "otherwise" (e.g., statute of limitations).<sup>20</sup> *Permissive* indemnification is allowed when the director has acted in good faith and

#### Business Law and Governance Practice Group Leadership

**Stuart I. Silverman, Chair**  
Office of Inspector General  
for the District of Columbia  
Government  
Washington, DC  
Stuart.Silverman@dc.gov

**Matthew A. Aiken, Vice Chair  
Educational Programs**  
Balch & Bingham LLP  
Birmingham, AL  
maiken@balch.com

**Susan G. Duffy, Vice Chair  
Research**  
Davis Wright Tremaine LLP  
Seattle, WA  
susanduffy@dwt.com

**Catherine T. Dunlay, Vice Chair  
Membership**  
Schottenstein Zox & Dunn Co. LPA  
Columbus, OH  
cdunlay@szd.com

**William W. Horton, Vice Chair  
Publications**  
Haskell Slaughter Young &  
Rediker LLC  
Birmingham, AL  
wwh@hsy.com

**Dale C. Van Demark, Vice Chair  
Strategic Activities**  
Epstein Becker & Green PC  
Washington, DC  
dvandemark@ebglaw.com

*Thanks go to the Practice Group  
for sponsoring this feature.*

in a manner reasonably believed to be in the best interests of the corporation.<sup>21</sup>

“Advancement,” a corollary to indemnification, is a payment by the corporation during the pendency of a proceeding of expenses (usually attorneys’ fees) that would be indemnifiable at the conclusion of the proceeding. Recognizing the enormity of defense costs that can accrue during a proceeding, most corporate statutes give corporations permission to make advancements. Generally, in order to receive an advancement, a director must agree to repay the amount advanced if it is ultimately determined that the director is not entitled to indemnification. The undertaking to repay does not have to be secured.<sup>22</sup>

Advancement under most statutes is entirely discretionary; however, corporations may (and many do) include mandatory advancement provisions in their charters, bylaws, and indemnification agreements. Courts have repeatedly and emphatically emphasized that when a corporation agrees to make unconditional, unsecured advancements to directors, the corporation does so at its risk and will be held to that decision and deemed to have waived the opportunity to examine whether the advancement is in the corporation’s best interests at the time of the request.<sup>23</sup> Conversely, as certain former directors recently learned,<sup>24</sup> without carefully worded provisions, advancement rights can be limited or eliminated for former directors even if the operative bylaw provision continues to require *indemnification* of directors.

A ruling that a requirement for indemnification implied no vested right to *advancement* underscores what courts repeatedly have emphasized—indemnification is related to but distinct from

advancement. Consistent with well settled law, this is why determining whether *advancement* of potentially indemnifiable litigation expenses is appropriate during the pendency of an underlying proceeding is a separate question from whether the corporation must ultimately *indemnify* the official for expenses or liability at the *end* of the proceeding. As a result, issues regarding a director’s alleged conduct in the underlying litigation ordinarily have no bearing on the right to advancement, and in cases in which a requirement to repay is required, the financial ability of the director to repay is irrelevant.<sup>25</sup>

The latter point is what should concern directors about recent assertions of an “unclean hands” or a “lack of good faith” defense in an advancement proceeding.<sup>26</sup> Although neither “good faith” nor “clean hands” is a statutory prerequisite for advancement, the recent *Tafeen*<sup>27</sup> decision suggests that courts will be willing to allow such a defense in appropriate circumstances, ruling that the defense does not undermine the public policy favoring indemnification and advancement. Although no case in the *corporate*<sup>28</sup> context has sustained the defense, *Tafeen* expressly puts directors on notice that they may be denied advancement if they engage in inequitable or other improper actions *with respect to the claim for advancement* at the expense of the corporation’s stockholders.<sup>29</sup>

So, the concepts of “good faith” and “unclean hands” (and the negative of each) are critical in director liability analysis. “Good faith” is precondition to reliance upon the business judgment rule and for immunity, exculpation, and indemnification. Also, whether couched as “unclean hands” or “breach of the covenant of good faith and fair dealing,” *Tafeen*

indicates that courts will be willing to review a director’s conduct in connection with requesting advancement to determine whether advancement is appropriate.

### “Good Faith” (or lack thereof) and “Unclean Hands”—Two Sides of the Same Coin?

Although “good faith” has long been an important concept in fiduciary duty analysis, it has not been well defined. A director’s behavior arguably violates the obligation to act in good faith if it is “reckless, disingenuous, irresponsible, or irrational.”<sup>30</sup> A lack of good faith also can be established by a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure that a reasonable information and reporting system exists.<sup>31</sup> More recently, examples of actions potentially “not in good faith” include: intentional or unintentional misconduct;<sup>32</sup> reckless behavior given a certain duration or magnitude;<sup>33</sup> conscious disregard of known risks;<sup>34</sup> and behavior that cannot rationally be explained on any other grounds.<sup>35</sup> Indeed, directors can be acting not in good faith if they act (or fail to take action) as if they simply do not care about the risks inherent in the matter at hand.<sup>36</sup> This type of behavior can lead to personal liability for directors even when their actions are not necessarily self-dealing in nature.<sup>37</sup>

Much like a lack of good faith, the equitable doctrine of unclean hands bars litigants who have acted inequitably from seeking what might otherwise be available relief. The doctrine is used to protect the integrity of the court and those who come before it.<sup>38</sup> Courts define the doctrine of unclean hands as the principle that “where a plaintiff seeks equitable relief, he must show that his conduct has

been fair, equitable and honest as to the particular controversy in issue.”<sup>39</sup> When applying the doctrine of unclean hands, courts have articulated that they deny relief when a party has violated an equitable principle, such as the duty of *good faith*. To constitute unclean hands, the misconduct in question does not have to be a crime or an actionable tort. Instead, “[a]ny conduct that violates conscience, or *good faith*, or other equitable standards of conduct is sufficient cause to invoke the doctrine.”<sup>40</sup>

So, “unclean hands” and a lack of good faith are doctrinally related. Although lack of good faith is not the only way a party may come to the court with unclean hands, lack of good faith is subsumed in that doctrine. And if one is acting with unclean hands, it is likely that the person also is acting in bad faith (or with a lack of good faith). It is precisely the conduct that precludes immunity, exculpation, indemnification, or reliance upon the business judgment rule that now also may allow corporations to refuse to advance expenses—even in the face of the most strongly worded advancement provisions.

### **“Good Faith” (or lack thereof) and “Unclean Hands” in the Director Liability Context**

Although not widely discussed in the context of the liability of corporate directors or their loss of protection, courts generally deal with “unclean hands” and “lack of good faith” similarly, if not synonymously. Additionally, although the authorities are sparse, cases invoking these doctrines either have stripped directors of statutory protection or indicated that they would do so if supported by the facts.

In one case,<sup>41</sup> an outside director was denied exculpation and held personally liable when, because of

his “specialized financial expertise,” he knew or had strong reason to believe and was “in a unique position to know that” the merger price for which he voted was unfair. In fact, this director had personally expressed to the chairman of the special committee charged with evaluating a potential merger that

Although not widely discussed in the context of the liability of corporate directors or their loss of protection, courts generally deal with “unclean hands” and “lack of good faith” similarly, if not synonymously.

they might be able to get double the merger consideration that the controlling shareholder was offering. The court reasoned that other directors could have relied on the fairness opinion of the committee’s independent financial advisor in voting to approve the merger. That, however, was “implausible” in the case of the financially expert director, whose expertise was “equivalent, if not superior” to that of the committee’s financial advisor.

The court indicated that the director’s vote to approve the transaction was “explainable in terms of only one of two possible mindsets.” One was that he “made a deliberate judgment that to further his personal business

interests, it was of paramount importance for him to exhibit his primary loyalty to [the controlling shareholder].” Second was that “for whatever reason, [he] ‘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.” Notwithstanding the charter’s exculpation provision, either motivation would render the director personally liable for conduct that “amounted to a violation of the duty of loyalty and/or good faith.”<sup>42</sup>

The now-famous *Disney* lower court decision denied the directors summary judgment on their assertion of the business judgment rule and forced them to establish in a 37-day trial that they had satisfied their fiduciary duties. The court noted that the plaintiffs’ assertion was not that the directors had acted negligently; rather, it was that the directors, contrary to the basic requirement of the business judgment rule, had not exercised business judgment—they had *done nothing*. *Deciding to do nothing* after an informed process gets business judgment rule protection; simply *doing nothing* does not. The *Disney* directors stood accused of the latter, which was characterized as an “I don’t care attitude” that, if true, would have exhibited a failure to act in good faith.<sup>43</sup>

An earlier Delaware case<sup>44</sup> denied advancement to the trustees of a business trust because they had surreptitiously withdrawn \$900,000 from the trust prior to commencing the Delaware advancement litigation. The court ruled that the trustees were barred from advancement because the wrongful withdrawals constituted “unclean hands.” Following entry of judgment against them, the trustees restored the funds to the

trust and filed an unprecedented motion to open the judgment on the ground that they had “purged” their “unclean hands.” The court denied the motion, finding that “plaintiffs’ . . . withdrawals were made in violation of the [court-imposed] standstill agreement and in *bad faith*, rendering plaintiffs’ hands ‘unclean’ with respect to the judicial approval they now seek of their right to advancement.”<sup>45</sup> The court also found that plaintiff’s “self-help” withdrawal was “made in *bad faith* and effected in a way intended to hide the transaction until it was too late to be undone.”<sup>46</sup>

Most recently, in *Homestore, Inc. v. Tafeen*, a former officer incurred considerable expenses defending various actions against him in his official capacity and requested advancement pursuant to the corporation’s unconditional and mandatory advancement rights. The corporation refused his request and asserted an “unclean hands” defense. The defense was premised on the allegation that the officer “purchased an expensive home in Florida, a state with extremely protective homestead provisions against creditor claims, in order to shelter assets, thus avoiding repayment should [the officer’s] claims ultimately be found to be nonindemnifiable.”<sup>47</sup> The defense was rejected and the officer ruled to be entitled to the mandatory advancement because the Florida property was purchased prior to the initiation of the corporation’s investigation and for family reasons with no intent to hinder repayment if required. The court nevertheless indicated that had the officer’s conduct been as alleged (i.e., the officer had attempted to shelter assets that might be used to repay advancements), it might have denied advancement.<sup>48</sup>

Although the *Tafeen* court described the “unclean hands” defense as

“unique” in the context because the claimed inequitable conduct related directly to the director’s advancement claim, that actually is doctrinally sound. The equitable principle of “unclean hands” is not based upon conduct in general; rather, the conduct forming the basis of the defense is required to relate to the matter at hand—i.e., the claim for advancement and indirectly, the potential claim for repayment if it were to be determined that the officer was

**Unclean hands in the operating room subjects patients to risk of disease and death. Unclean hands in the boardroom subjects directors to the equivalent corporate risk.**

not entitled to indemnification. Accordingly, the “lack of good faith” that precluded exculpation to the financially expert director in *Emerging Communications* or the application of the business judgment rule in *Disney* would not have precluded *advancement* in either of those cases. If, however, at the conclusion of either of those cases, the directors were ultimately determined not to be entitled to indemnification, they could have been required to repay any advancements that were made.

### Summary

Negligence—even gross negligence—does not necessarily result in liability for a director. “Unclean

hands” or lack of good faith, however, can result not only in an actionable breach of fiduciary duty; it also can preclude reliance upon the panoply of defenses and protections otherwise afforded directors. Directors are well advised to examine carefully their conduct when taking corporate actions or in dealing with the corporations upon whose boards they sit. Directors also are well advised to review carefully their corporation’s advancement provisions.<sup>49</sup> For example, is the advancement provision more like most statutes (permissive, which is more equitable in nature) or like *Tafeen*’s mandatory bylaw provision (more contractual in nature)? The more permissive language clearly puts a director at a greater risk that advancement might be denied, and *Tafeen* illustrates the weight that courts attach to corporate decisions to grant mandatory advancement and their willingness to enforce those rights in summary proceedings.<sup>50</sup> Nevertheless, whether permissive or mandatory, “unclean hands” or a similar defense might be raised to resist advancement. The best way for directors to avoid a problem is to act honestly, faithfully, and in a manner believed to be in the corporation’s best interests. Unclean hands in the operating room subjects patients to risk of disease and death. Unclean hands in the boardroom subjects directors to the equivalent corporate risk.

*Mr. Brown is the Chairman of the Corporate Department at the national law firm of Baker Donelson Bearman Caldwell & Berkowitz PC. Former special counsel to the U.S. Senate Committee on Governmental Affairs in the 2002 Enron investigation, he also is an adjunct professor of law at the Vanderbilt University School of Law where he teaches corporate and securities law. He can be reached at [gbrown@bakerdonelson.com](mailto:gbrown@bakerdonelson.com) or at (615) 726-5763.*