I
T HAS FREQUENTLY been said that the passage of the Sarbanes-Oxley Act and its progeny has not altered the fiduciary duties of directors under applicable state law. It is equally clear, however, that judicial interpretations of state fiduciary duty law, and the standards of acceptable director conduct, are shifting in response to both recent legislation and regulatory initiatives and the highly publicized corporate governance failures that prompted their passage.

Courts and government regulators are growing increasingly impatient with inadequate board oversight and are heightening their scrutiny of board independence and oversight. Recent judicial decisions, and an unusual Securities and Exchange Commission enforcement proceeding, indicate that the traditional safeguards of the business judgment rule, and charter provisions which eliminate personal liability for duty of care violations, will not protect directors who intentionally disregard their duties.

Although diligent directors acting in good faith should not be unnerved by these developments, directors are well-advised to become proactive in matters of corporate governance. Independent directors should assume a corporate leadership role through focused oversight and periodic self-evaluations. At the same time, directors should be proactive in reviewing the corporate law protections and insurance coverage available to them, to be well-positioned if, despite their good faith and diligent efforts, they become defendants in a shareholder suit.

Lois F. Herzeca is a corporate and securities law partner, and Ruth Ku is an associate, of Fried, Frank, Harris, Shriver & Jacobson.

Examining Director Conduct

Director conduct is generally measured by the business judgment rule, which defers to the judgment of the board of directors and presumes the directors’ action is in good faith and in the best interests of the corporation. To rebut the presumption, plaintiffs must show that the directors breached their fiduciary duties of due care, loyalty or good faith. Historically, directors were thought to have the greatest exposure to personal liability in situations where they sought to personally profit from corporate activity.

Recent judicial decisions suggest, however, that courts will more closely examine director conduct, even where there are no self-interest concerns, if a board appears to have abdicated its oversight function. Each of the Disney, Abbott and Cogan cases suggest that directors may be held personally liable, and may not be entitled to the benefit of the business judgment rule or exculpatory charter provisions, if they consciously fail to consider significant matters and such failure constitutes a lack of good faith or a breach of the duty of loyalty. These cases are significant not so much for their holdings, which in Disney and Abbott are procedural, but for their focus on board process.

In Disney, the plaintiffs sought to hold the Disney directors personally liable for damages arising from Disney’s severance payments to former Disney President Michael Ovitz, because the board consciously determined not to review the terms of Mr. Ovitz’s employment and termination arrangements. The Delaware Chancery Court determined that the plaintiffs’ allegations, if true, established that the board failed to exercise any business judgment, and therefore its conduct was not in good faith or involved intentional misconduct.

In Abbott, the plaintiffs sought to hold the Abbott directors personally liable for damages incurred by Abbott in connection with Abbott’s violations of Food and Drug Administration regulations, because the board knew of the violations, occurring over a six-year period, but took no preventative or remedial measures. The U.S. Court of Appeals for the Seventh Circuit found that the Abbott directors were not insulated from personal liability by the exculpatory provisions of Abbott’s charter because the allegations, if true, showed a sustained and systematic failure to exercise oversight, constituting a conscious disregard of known risks, which amounted to a lack of good faith.

In Cogan, the trustee in bankruptcy for Trace International Holdings, Inc. brought an action against, among others, the directors of Trace alleging a violation of their fiduciary duties in regard to self-dealing by Marshall Cogan, Trace’s majority stockholder and chief executive officer, when Trace was in the “zone of insolvency.” After a bench trial, the Southern District of New York found that the directors of Trace, a private company, violated their fiduciary duties of loyalty and due care with respect to Mr. Cogan’s self-dealing because they were aware, or should reasonably have been aware, of such self-dealing but took no action to review, discuss or investigate it. The court ruled that exculpatory provisions in a corporation’s charter will not shield directors from personal liability if they have abdicated their functions or completely failed to exercise any diligence in the performance of their duties.

The SEC Enforcement Division took a similar approach to support a finding of a
securities law violation in a recent proceeding against an outside director of Chancellor Corporation. In a particularly egregious factual situation, the SEC found that the director, an audit committee member, had caused Chancellor’s violation of federal securities laws because he was reckless in not knowing that Chancellor’s periodic filings contained materially misleading statements; the director never reviewed Chancellor’s accounting procedures or internal controls, and completely failed to exercise any oversight over financial reporting.

In Oracle,4 the Delaware Chancery Court, in another instance of heightened scrutiny, focused on the issue of independence by examining the social and personal connections among directors. The court determined that a special litigation committee of Oracle directors could not terminate a derivative action alleging insider trading by other Oracle directors because the committee did not establish that it was independent. The court found that certain ties unrelated to the traditional “domination and control” analysis of independence, such as the web of connections among Oracle directors and Stanford University, were so substantial that they caused reasonable doubt about the committee’s ability to impartially consider whether the other directors should face suit.

Effective Corporate Monitors

The most effective response to concerns about director conduct is for directors to become proactive about corporate governance. It is incumbent upon independent directors to consider whether they are truly free of improper influence, to exercise the right degree of diligence, oversight and critical analysis, and to seek the timely advice of qualified and independent experts.

Although directors are not expected to guarantee corporate conduct, proactive directors can serve as the best safeguard of the shareholders’ interests. Richard Breeden’s recent report, “Restoring Trust,” which recommends far-reaching corporate governance improvements for WorldCom, Inc., while not a viable model for most corporations, does reflect the critical role of active directors in restoring investor confidence.

Effective corporate directors are diligent, involved monitors, but not day-to-day managers, of the corporation. To provide effective oversight of management performance, independent directors should understand the corporation’s capital structure, cash flows, debt levels, strategy, growth opportunities, risks, vulnerabilities and marketplace. They must also have the information necessary to enable them to make informed judgments.

Most state corporate law provides that directors are entitled to rely on management, and independent outside advisors and auditors, if due care was used in selecting such persons. It is imperative that when directors rely on management and experts, they ascertain that such reliance is reasonably justified. Care should be taken in hiring and reviewing senior management and outside advisors and auditors with a view toward trustworthiness, qualifications and appropriate compensation and incentives.

Most importantly, directors should continually question management, outside advisors and the external auditors, on significant corporate matters. One commentator has said that directors would do well to employ the Socratic method: “Ask enough of the right questions, in the right way and at the right time, and the probabilities are high that everything worth knowing will be known and everything worth exposing will be exposed.”

Directors should examine their ties to the corporation, its management, those entities with which the corporation has business or philanthropic relationships, as well as to the other directors, to determine whether their independence is, or would reasonably be perceived to be, compromised. In the current environment, conformity with the standards promulgated by recent legislation and proposed by the stock exchanges, and the absence of financial relationships, should not necessarily be viewed as dispositive on the issue of independence.

Directors should also commit the time necessary to be active, involved board participants. They should regularly attend board and committee meetings and make sure they are kept fully informed by management and the outside counsel and auditors. They should take an active role in setting and reviewing board agendas. They should participate in director and other appropriate education programs. And, they should limit the number of boards they join.

Self-Evaluations

The board, and each board committee, should undergo periodic self-evaluations. The Business Roundtable, numerous institutional shareholders and corporate governance experts have identified annual self-evaluations as a corporate governance “best practice” for assessing whether a board is effectively performing its oversight function. Indeed, the proposed New York Stock Exchange corporate governance rules specifically provide that the board should conduct an annual self-evaluation, and that each of the audit, compensation and nominating/corporate governance committees must have a charter which addresses an annual performance evaluation. By conducting a disciplined evaluation process, a board dramatically demonstrates that it is proactive and will hold itself accountable for its performance.

Board self-evaluations typically focus on the board’s internal functioning and its relationship to management, particularly:

- Board size, composition, and committee structure.
- Communication with management, management performance, and management succession planning.
- Corporate strategic planning.
- Financial statements, financial reporting systems and internal controls.
- Crisis management.
- Conflicts of interest.

Self-evaluation processes do entail risks. A self-evaluation has the potential to produce information that could lead to civil or criminal liability. Significantly, Delaware courts have not recognized a privilege for critical self-analysis by directors. If the evaluation process uncovers information which could indicate a serious problem, counsel must be alerted immediately and the matter must be pursued until it is resolved appropriately. It is also important to monitor the board after the evaluation has been completed to ensure that the board acts promptly to address any identified issues.

Active Audit Committees

Effective board oversight hinges on the Audit Committee, which serves as the critical connection among the directors, management, the outside auditors and the internal control process. The Business Roundtable advocates that the board, and in particular the Audit Committee, should
have a thorough understanding of the corporation's financial statements, including why the corporation's critical accounting principles were chosen, what key judgments and estimates were made and how they impacted the financial results. Similarly, the Audit Committee also should review the corporation's internal control procedures and compliance with applicable legal requirements.

Members of the Audit Committee should understand the business purposes, appropriate accounting and general risks associated with all major corporate transactions and should review the corporation's projections. The Audit Committee also should review the procedures for the identification, assessment and reporting of non-accounting risks of the corporation, since these risks typically have financial statement and disclosure implications. Most importantly, the Audit Committee should meet separately with the outside auditors on a periodic basis and should be alert for signs of financial problems — SEC accounting comments on public filings, financial statement restatements, precipitous declines in stock prices, repeated failures to meet management's or analysts' expectations, or serious regulatory issues.

At a minimum, the Audit Committee should have a written charter that complies with the applicable legal and regulatory requirements, and should comply with the charter's mandates. Many Audit Committees have found it advisable to meet in person at least quarterly, and by conference telephone in between meetings, in order to fulfill their important responsibilities.

# Reviewing Protections

Even the most well-intentioned and diligent director can become a defendant in a shareholder suit. Directors would be well-advised to commission a review of the legal provisions and insurance policies that would be applicable to their conduct in the event of litigation. Directors who are vigilant in exercising their responsibilities should be entitled to appropriate corporate protections.

The corporation's charter and bylaws form the basis of a director's available legal protections. These documents should contain exculpatory provisions which eliminate or limit, to the fullest extent permitted under applicable state law, the personal liability of directors for monetary damages for certain breaches of their fiduciary duties, generally the duty of due care.

Directors should also review the provisions of the charter and bylaws that mandate indemnification by the corporation of directors and officers in identified situations. Under Delaware case law, a provision that simply mandates indemnification does not also mandate advancement of expenses. Accordingly, any indemnification provision should expressly require the timely advancement of expenses before final disposition of an action. The provision should also obligate the corporation to reimburse attorneys' expenses in a successful effort to enforce the indemnification obligation.

Corporate D&O insurance policies should be reviewed to clarify the scope of the coverage provided. D&O policies should have both Side A and Side B coverages. Side A coverage insures directors and officers in circumstances where the corporation cannot or does not indemnify them, and Side B reimburses the corporation for proper indemnification payments. Directors should be aware of the deductible or co-insurance amounts, the type of insurance (typically “claims made,” providing coverage only for claims made during the policy period) and the term (typically one year).

Directors should have a clear understanding of what exclusions apply to their policy. D&O policies generally exclude from coverage matters which are uninsurable under state law (i.e., for public policy reasons), criminal or fraudulent acts, acts involving illegal profit or personal advantage and violations under the Employee Retirement Income Security Act. It is particularly important to have D&O insurance protections where the coverage provided may extend beyond corporate law indemnification, such as judgments and settlements in derivative suits; securities law violations; liability based on gross negligence (but not intentional dishonesty); and insolvency.

It is also important to consider the limits of D&O coverage. Coverage of the corporation under the same policy as the directors' could adversely affect the directors to the extent that per-claim and aggregate limits are satisfied or reduced by the corporation's costs. A better alternative is to obtain completely separate primary or excess policies for individuals with limits that cannot be affected by claims against the corporation. Moreover, a D&O policy that insures only individuals will not be treated as property of a debtor's estate. In addition, the D&O policy should be reviewed to ascertain that the acts of one insured are not imputed to the other insureds for purposes of coverage.

An indemnification agreement, which affords a director a basis in contract to sue the corporation, may serve as an important complement to a corporation's exculpatory charter provisions and D&O policies. Indemnification agreements cannot be unilaterally amended, unlike charter and bylaw exculpatory and indemnification provisions, and cannot be rescinded, unlike a D&O policy. Payments under indemnification agreements can also be secured with letters of credit or trust arrangements. Of course, an indemnification agreement cannot indemnify a director beyond what is permitted by law.

# Conclusion

In the current climate of heightened scrutiny, directors are well-advised to assume a more proactive role in corporate governance. Continuing attention to corporate conduct, through focused and disciplined oversight, is the best means of preventing, identifying and remedying corporate misconduct. But, if that misconduct occurs, or is alleged to have occurred, despite the board's good faith and diligent oversight, the directors should be able to avail themselves of the protections afforded by applicable law and available insurance coverage.

(2) In Re Abbott Laboratories Derivative Shareholders Litigation, 325 F.3d 795 (7th Cir. March 28, 2003).

This article is reprinted with permission from the September 29, 2003 edition of the NEW YORK LAW JOURNAL © 2003 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact American Lawyer Media, Reprint Department at 800-888-8300 x6111. #070-10-03-0006