Directors' Liability

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United States of America

Robert Ripin

I NATIONAL FRAMEWORK FOR US CORPORATE BOARDS

[A] Regulatory Structure

Corporations in the United States must comply with rules on corporate governance enacted pursuant to relevant state statutes, US federal statutes, applicable stock exchange rules and case law and may be responsive to market expectations regarding their behaviour. The chief component in the regulatory framework for all US corporate boards is the state corporation statute of the relevant state of organization, although the US federal securities laws, as well as applicable stock exchange rules, will apply to public companies. While each state has a separate statutory regime and corporate jurisprudence, many companies choose to organize in Delaware due to its developed corporate case law, flexible statutory framework and the ease of organizing there. Thus, our analysis generally focuses on Delaware and typical US state corporate law but note that the statutory regime may differ in a particular state.

[B] Board Composition

[1] Board and Corporate Structure

A US corporate entity has three primary layers comprised of shareholders, directors, and officers. In general, shareholders are the owners, directors set the policy, and officers manage and operate the corporation on a day-to-day basis. A US corporation usually has a unitary, or single-system, board structure generally referred to as the 'board of directors', which contrasts with the two-tier, or dual, board system which is followed in Germany and other countries. The US board consists of individuals elected by the shareholders. Directors can be shareholders, officers, or employees of the corporation.

[2] Number of Directors

A US corporation must have at least one director and each must be a natural person. While there is no legal maximum number of directors, the articles or certificate of incorporation and the by-laws (collectively known as charter or organizational documents) often set minimum and maximum numbers. Public corporations may be required to have a minimum number of directors due to the requirements of the relevant stock exchange on which it is listed.

[3] Age and Nationality Restrictions

There are typically no age or nationality restrictions on directors of US corporations. Charter documents can, however, set age requirements, and public corporations often impose a mandatory retirement age as a matter of corporate governance policy. In addition, there may be nationality restrictions on directors of corporations with business in certain regulated industries.

[4] Independence

Relevant stock exchange rules generally require that a majority of the directors of a domestic listed corporation be independent. While definitions used by the stock exchanges vary, an independent director must generally have no material relationship with the corporation. Inside directors, on the other hand, would include those directors who are employees of the corporation.

[C] Multiple Roles

Typically, US state law does not impose restrictions on the roles of individual directors. The same person can usually be both the chairman of the board (chairman) and the chief executive officer (CEO). In order to achieve a system of checks and balances on the authority of a particular individual, many corporate governance observers support a separation of these functions, and some public corporations have enacted such a policy.

[D] Board Procedures

A corporation's internal management is generally regulated by its charter documents. Boards can further regulate their affairs by adopting corporate governance policies and delegating duties to committees. Although notice of a board meeting is typically required, a director can waive this requirement by attending the meeting or providing written consent. A simple majority of the board must typically be present for a valid

quorum. A majority of the directors in attendance at a properly constituted meeting can typically pass resolutions or they may be passed by unanimous written consent if permitted by the charter documents.

[E] Board Elections

Generally, the full slate of directors is elected at each annual shareholders' meeting. Shareholders of private corporations where the shares are owned by a single party often elect directors by unanimous written consent of the shareholders, but this process is often impractical for corporations with many shareholders. Typically, each outstanding share equals one vote and the director with the most votes is appointed. However, the manner of voting or composition of the board can be customized as specified in the charter documents. For example, the by-laws can permit the following.

[1] Classified Boards

Certain classes of shares can vote for specified director positions or a certain number of directors so that their interests are directly represented on the board.

[2] Cumulative Voting

Shareholders can split their votes in different proportions so that minority shareholders have a greater chance of ensuring the election of at least one selected nominee.

[3] Staggered Board

Directors are generally elected for one-year terms and state law generally does not prohibit re-election. However, a corporation's by-laws can require staggered terms, where the board is divided into multiple groups each serving a staggered two- or three-year term, usually to discourage takeover attempts.

[4] Weighted Voting

Certain classes of shareholders can be entitled to more votes than others.

[F] Delegation

The board of a US corporation can delegate responsibility for most matters to committees consisting of one or more directors. Any such committee may exercise specified powers and authority of the board in the management of the business of the corporation, but may not amend the by-laws or take other actions specifically reserved in the relevant state statute. State law generally requires corporations to be managed by their board and allows a board to appoint officers to manage many normal affairs of the

corporation, subject to the board's supervision. Thus, the day-to-day operations are typically managed by officers. Shareholder approval is required for amendments to the articles and fundamental changes to the corporate structure.

[G] Removal of Directors

Directors can generally be removed, with or without cause, by shareholders with a majority of the voting shares at a shareholders' meeting.

II STANDARDS APPLICABLE TO DIRECTORS

[A] General Duties

Directors of US corporations are charged with managing the business of their corporation. Although officers are appointed to manage the day-to-day affairs of the corporation, a director should be familiar with the business of, and give direction to, the corporation and should have a general knowledge of the use of resources as well as the manner in which the business is conducted. A director must perform these, and all of his or her duties, in good faith and with the degree of care which an ordinarily prudent person in a like position would use under similar circumstances. In reaction to the corporation scandals at the turn of the millennium and the financial crisis towards the end of the last decade, various federal laws were enacted, such as the Sarbanes–Oxley Act of 2002 (Sarbanes-Oxley) and the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) which added extra responsibility and requirements to the duties of public corporation directors, or specific committees of directors.

[B] State Statute, Securities Exchange, and Common Law Duties

The generally accepted duties of directors pursuant to Delaware case law are the fiduciary duties of care and loyalty. Some states have also enacted specific statutes governing companies in certain industries (such as insurance), which impose additional duties and liabilities on corporation management. Corporations listed on the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (NASDAQ) must adopt and disclose a code of business conduct and ethics for directors, which establishes policies on conflicts of interests.

[1] Duty of Care

The duty of care requires directors to inform themselves of all reasonably available material information prior to making a business decision and to analyse that information critically.

[2] Duty of Loyalty

The duty of loyalty requires that directors must act in the best interests of the corporation, rather than in their own interests or those of a third party. If a director has a personal interest in a matter, it must be fully disclosed, and that director will likely need to abstain from voting on or participating in discussions of the matter.

[3] Business Judgment Rule

Under the business judgment rule, which is applied by courts to most decisions made by directors, the decisions of disinterested directors are presumed to be appropriate absent evidence that the directors did not act in good faith in the best interests of the corporation or were not reasonably informed, or that there was no rational business purpose for the decision that promotes the interests of the corporation or its shareholders.

III CASES DEALING WITH DIRECTORS' LIABILITIES

[A] Quadrant/Gheewalla

A recent decision by the Delaware Court of Chancery, *Quadrant v. Vertin*, provided a useful restatement of a 2007 decision of the Delaware Supreme Court (*North American Catholic Educational Programming Foundation Inc. v. Gheewalla*) which held that: (i) creditors have no standing to bring a derivative claim for breach of fiduciary duty against directors of a solvent corporation during the period when the corporation is in a 'zone of insolvency' and (ii) Delaware does not recognize the theory of 'deepening insolvency;' directors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors. Rather than there being a 'zone of insolvency,' the insolvency of a corporation is the transition point that affects determinations of fiduciary duty and allows creditors standing to assert derivative claims for breach of fiduciary duty. In *Quadrant*, the court clarified that there is no requirement that the corporation have a continuing insolvency in order for a creditor to have standing in a derivative suit. A creditor must establish that the corporation was insolvent at the time the suit was filed and a creditor does not lose its standing to maintain a derivative lawsuit if the corporation returns to solvency during the course of the lawsuit. Derivative lawsuits are discussed further in section V.

[B] Krasner

In *Krasner v. Moffett,* the Delaware Supreme Court reversed the dismissal of a shareholder class action, finding that the complaint adequately alleged that a majority of the directors recommending a merger of related companies to the shareholders had 'disabling conflicts of interest'. The shareholders alleged that three of the seven

directors, who were also directors of the merger target, stood on both sides of the transaction and thus could not be considered disinterested and independent. The court did not allow the dismissal of claims due to the business judgment rule where the alleged facts suggested that the transaction was not approved by a majority of disinterested directors. As the court noted, when a majority of the board of directors is the ultimate decision maker and a majority of the board is interested in the transaction, the presumption of the business judgment rule is rebutted. It further stated that when the presumption of the business judgment rule has been rebutted, the 'entire fairness' standard is implicated and defendants bear the burden of proof. The entire fairness standard is a strict test where the burden is on the directors to prove that the transaction was entirely fair to the corporation and is meant to apply to transactions where there are actual conflicts of interest such that the directors making the decision did not comprise a disinterested and independent board.

[C] WorldCom/Enron/Emerging Communications

In January 2005, Enron and WorldCom directors agreed to contribute millions of dollars of their own funds to settle securities class action lawsuits stemming from two of the largest corporate governance scandals in US history. Directors' and officers' (D&O) insurance paid millions of dollars more. There are also occasional cases in the United States in which directors are held nominally liable, in the sense that they lose, but all damages and legal expenses are paid by the company and/or D&O insurance. The 1985 case of *Smith v. Van Gorkom* (described below) is one example, and a 2004 Delaware case, *In re Emerging Communications Inc. Shareholder Litigation* (where an outside director was held liable for damages because as an investment banker he knew, or should have known, that the specific terms of a privatization transaction were unfair to minority shareholders), is another.

[D] Disney/Van Gorkom

In 1995, Disney chairman and CEO Michael Eisner hired Michael Ovitz to serve as president. After fifteen months of service, Disney terminated Ovitz's employment, allowing him to leave the company with a severance package of approximately USD 140 million. Due to the exorbitant nature of the severance after only a short period of service, certain of Disney's investors filed a civil suit against the company in 1997. Through this suit, Disney investors demanded that Ovitz, Eisner, and other Disney directors reimburse the company treasury for the severance package with USD 60 million in additional interest. After specifying the aspects of the duty of good faith, the Delaware court concluded that Eisner and the other Disney board members, while not exemplifying best corporate practices, did not breach their fiduciary duty of care or act in bad faith in connection with the hiring and firing of Ovitz. According to the court, after weighing the potential alternatives and costs, Eisner did what he thought was best for Disney and acted in good faith. The court held that even though the rest of the board did not have much information, the directors did not intentionally ignore their duty,

but acted in good faith. Thus, while a breach of fiduciary duty may be actionable, the conduct of the Disney board was not seen to have reached that level.

The court distinguished Disney from the *Van Gorkom* case, a notable instance in which a court found that a board breached its duty of care. In *Van Gorkom*, the board considered the sale of the company for less than two hours with no advance notice, a lack of formal documentation such as a fairness opinion, and misleading and uninformed presentations given by two executive officers. In contrast, in *Disney*, while hiring and firing Ovitz was an expensive task, given Disney's size it was not a material matter and was quite different from a decision that would end the company's existence.

[E] Observations/Recommendations

The court rulings discussed above reinforce the idea that directors should strive to meet high standards of corporate governance and serve as a warning that while the business judgment rule provides a level of protection, a director may be personally liable for failing to act in good faith on an informed, unconflicted basis. The law is clear that a board can make informed business decisions and be mistaken without fear of personal liability. The case law makes clear, however, that the way a director came to a decision can impact his or her personal liability. The cases show that directors must follow a process that enables them to act in an informed manner. The practices that a board must follow to preserve the protections of the business judgment rule vary depending on the size, nature and materiality of the transaction at issue.

There are several best practice recommendations that directors should bear in mind to avoid potential liability for their actions, including:

- attentiveness to all board matters, avoidance of self-dealing, and strict observance of procedures for addressing conflicts of interest;
- fulfilment of their duties meaningfully and responsibly, giving consideration to the integrity and qualifications of their fellow directors and attention to setting the correct overall ethical tone with emphasis on improving governance;
- appreciation of the business, financial and competitive environments, the systems of controls and compliance, understanding of the corporation's financial statements and the business strategies and risks faced by the corporation, and the director's own legal obligations and fiduciary duties;
- being well-prepared to engage actively at board meetings with particular attention to the agenda and the flow of information while maintaining an attitude of healthy scepticism; and insistence that management follow up on issues, including progress reports; and
- understanding each item put before the board for approval and asking for appropriate assurances regarding the integrity of reporting and the processes relied upon.

IV CORPORATE GOVERNANCE

[A] Regulation

Corporate governance specifies the distribution of rights and responsibilities among different participants in a corporation, such as the board, officers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions. Sarbanes-Oxley ushered in sweeping reforms that required US public companies to modify and in many cases formalize their governance guidelines.

In the United States, corporate governance is regulated by mandatory laws of the state of incorporation and a corporation's charter documents and for public corporations, stock exchange requirements and federal laws and regulations, such as:

- the Securities Act of 1933 (Securities Act), which requires public disclosure of financial and corporate information when issuing securities to the public;
- the Securities Exchange Act of 1934 (Exchange Act), which requires the disclosure of a wide range of matters in public reports and extensive information in proxy solicitations of shareholder votes;
- Sarbanes-Oxley and US Securities and Exchange Commission (SEC) rules adopted under it, which have heightened governance standards for public corporations by increasing the civil and criminal liability of directors, requiring greater independence of boards and increasing the transparency of corporate operations; and
- Dodd-Frank and SEC rules adopted under it, which have, among other matters, imposed requirements that national securities exchanges adopt requirements that publicly listed domestic corporations must have a compensation committee consisting only of independent directors.

[B] Board Composition/Independence

Private corporations are not required to have, and often do not have, non-executive or independent directors. However, a majority of the directors of NYSE- and NASDAQ-listed corporations must be independent. While each exchange in the United States has its own requirements, this analysis focuses on the NYSE rules (NASDAQ rules are generally similar).

[1] Independence of Majority of Board Members

The NYSE requires that the board of each listed corporation consist of a majority of independent directors. No director would qualify as 'independent' unless the board affirmatively determines that the director has no material relationship with the corporation, its parent or any subsidiaries. The NYSE requirements prohibit many relationships that otherwise could impair the independence of directors, such as employment, business, financial and family relationships. In addition, in affirmatively

determining the independence of any director who will serve on the compensation committee of the corporation's board of directors, the NYSE requires that the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the corporation which is material to that director's ability to be independent from management in connection with that director's duties as a compensation committee member.

[2] Application to Foreign Private Issuers

NYSE-listed companies that are foreign (non-US) issuers may follow home-country practice in lieu of the independence requirements, except that: (1) certain requirements of the Exchange Act must be met in relation to the audit committee; (2) such companies must notify NYSE of non-compliance; and (3) a brief summary of the significant governance differences and certain written affirmations must be disclosed.

[3] Corporate Governance Guidelines/Code of Ethics

The NYSE rules also require each listed company to adopt and disclose corporate governance guidelines and a code of business conduct and ethics for directors, officers, and employees, and promptly disclose any waivers of the code for directors or executive officers.

[C] State Law Requirements (Delaware)

State statute and case law play the predominant role in determining the corporate governance rules applicable to a particular US company. The Delaware General Corporation Law sets forth powers and responsibilities for boards of directors and provides that the business and affairs of every corporation shall be managed under the direction of the board, except as otherwise provided in the statute or the company's certificate of incorporation.

V LIABILITY ISSUES

[A] Who Can Sue?

[1] Shareholder Derivative Lawsuits

Directors and officers are agents of the legal entity, the corporation. Consequently, if they fail to perform their fiduciary obligations, they potentially cause direct harm to the corporate entity and indirect harm to others, including shareholders, creditors, and employees. Note that the party with the power to enforce and seek a remedy for violations by directors and officers is the corporation. The issue is that the corporation is under the control of those alleged to have violated their duties and those persons

would have to authorize an action against themselves or fellow directors. In recognition of this issue, corporate law allows shareholders, and, in the case of an insolvent corporation, creditors, to bring a derivative suit against the corporation's directors.

If a shareholder believes that the corporation is being mismanaged, that shareholder can seek to change or remove the directors. Shareholders of public corporations must comply with applicable law and regulations for elections and proxy contests.

[2] Creditors' Rights

Generally, directors owe fiduciary duties to the corporation and do not owe fiduciary duties to creditors, except that they may face derivative lawsuits from a creditor on behalf of the corporation if the corporation is insolvent.

[3] Regulator Actions

In addition to shareholder derivative lawsuits, federal or state governments can bring criminal or civil actions against directors or officers. Many corporate officers have been brought to criminal trial and some have received lengthy prison sentences (e.g., the sentencing of Bernie Ebbers, the former chairman and CEO of WorldCom, to twenty-five years in prison for his role in the demise of WorldCom). The US Department of Justice is the regulatory entity that enforces federal criminal law and the SEC can bring civil actions for securities laws violations. State attorneys general and local state prosecutors enforce the criminal law of their jurisdictions.

[B] Grounds for Liability

[1] Criminal and Civil Liability

Directors can be civilly liable for breach of their duties of care and loyalty in managing the corporation's affairs. They can also be criminally liable for committing securities fraud and for obstructing justice in connection with accounting and other matters.

[2] Securities Law

Directors can incur criminal and civil liability for breach of the anti-fraud provisions of state and federal securities laws. Directors can face civil damages for signing a registration statement filed with the SEC for the sale of the corporation's securities if the registration statement contains an untrue statement of material fact or a material omission. No intent to defraud need be shown, although a due-diligence defence is available. The US securities laws have numerous other civil and criminal provisions which expose directors to potential liability.

[3] Antitrust

Directors can be civilly and criminally liable if they knowingly participate in illegal acts that breach federal antitrust statutes (e.g., the Sherman and Clayton Acts).

[4] Theft and Fraud

Directors can face criminal or civil liability for theft and fraud under federal or state statutes.

[5] Other

Directors can face criminal liability under various other statutory schemes, including in relation to environmental, safety and pension issues.

[C] Thresholds and Limitations/Caps of Liabilities

Many states permit a corporation to limit the monetary liability of directors to the corporation or its shareholders. However, limitations may have restrictions. As an example, in Delaware, among other restrictions, a corporation may not limit the liability of a director for any breach of the director's duty of loyalty.

[D] Shareholder Liability

Generally, shareholders and other third parties not involved in the management of a corporation are not liable as directors. Shareholders can be liable if they treat the corporation as their alter ego and ignore corporate formalities, the corporation is inadequately capitalized, and they use the corporation to avoid personal liability or perpetrate a fraud. The process of looking through the corporation to hold a shareholder liable is generally referred to as 'piercing the corporate veil'.

VI INDEMNIFICATION

Corporations are generally permitted to indemnify directors so long as the director acted in good faith and in a manner the director reasonably believed to be in or not opposed to the best interest of the corporation and, with respect to a criminal action, the person had no reasonable cause to believe that the person's conduct was unlawful. Delaware's statute makes indemnification mandatory to the extent the director has been successful in the defence of the proceedings. There may be restrictions imposed on indemnification in the relevant statute, including that indemnification will not be available in respect of liabilities owed to the corporation. Indemnification provisions may be included in the articles of incorporation and may also be part of an employment or services contract. Almost all public corporations have adopted charter documents

indemnifying directors, and many public and private corporations choose to eliminate director liability to the fullest extent permitted by law, rather than to limit it to a dollar amount. It is also noteworthy that, in the opinion of the SEC, indemnification of directors for liabilities arising under securities law is against public policy and is therefore unenforceable.

VII INSURANCE

Corporations may purchase insurance on behalf of directors and officers that may provide coverage for litigation-related losses beyond the indemnification available under the general corporation statutes. A director can obtain insurance against personal liability for breach of a fiduciary duty and corporations can pay the premiums for the D&O insurance. Virtually all US public corporations purchase D&O insurance to cover all anticipated damages claims against directors.