

# BOARD FIDUCIARY DUTIES AND FUNCTIONS

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## I. Duties of Care, Loyalty and Disclosure - Background

- A. Corporate law in the United States includes the statutory schemes and case law of 50 different states.** I will attempt to discuss principal themes reflected in the Model Business Corporations Act (the "Model Act") drafted by the American Bar Association which in one form or another has been adopted by approximately half of the states as well as the corporate law of leading jurisdictions including Delaware and California.
- B.** Both Delaware and California hold that directors owe fiduciary duties to the corporation.
- C.** The classic duties are **duty of care** and **duty of loyalty**.
- D.** The Revised MBCA provides for these duties as follows:

### § 8.30 General Standards for Directors

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

- (1) in good faith;
- (2) **with the care** an ordinarily prudent person in a like position would exercise under similar circumstances; and
- (3) in a manner he reasonably believes to be in the **best interests of the corporation**.

(b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

- (1) one or more officers or employees of the corporation whom the director reasonably

believes to be reliable and competent in the matters presented;

(2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or

(3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.

(c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.

(d) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.

**E. California** has codified the duties at California Corporations Code ("Cal. Corp. Code") §309 which provides:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the **best interests of the corporation** and its shareholders and **with such care**, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following:

(1) One or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented.

(2) Counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence.

(3) A committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

(c) A person who performs the duties of a director in accordance with subdivisions (a) and (b) shall have no liability based upon any alleged failure to discharge the person's obligations as a director. In addition, the liability of a director for monetary damages may be eliminated or limited in a corporation's articles to the extent provided in paragraph (10) of subdivision (a) of Section 204.

**F. New York**, like California, also sets forth the directors' duty of care in its statutes.

**New York Business Corp. Law §717** (“(a) A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances....”)

**G. Delaware** prefers a common-law approach, letting substantive rules evolve from case law. See, e.g., *Malone v. Brincat*, 772 A.2d 5, 10 (Del. 1998) (The fiduciary duties provided for under Delaware law for directors include the duty of **loyalty and the duty of care.**)

## **II. The Duty of Care**

**A. Need to be informed/prepared.** The duty of care generally describes the level of attention required of a director in corporate matters. The duty of care requires that directors **inform** themselves of "all material information reasonably available to them" concerning a given decision prior to acting on that decision.

1. To fulfill the duty of care, directors should follow **deliberate procedures and consult** with appropriate committees, officers and/or employees of the corporation or other outside experts in making corporate decisions.

2. Directors must make **reasonable effort to ensure** that they are being kept appropriately apprised of the company's compliance with the law and its business performance.
3. **Outside directors** by definition lack their own sources of information about internal corporate matters due to their lack of employment and business ties to the company. Accordingly, they must adopt procedures to hold managers accountable for the responsibilities that have been delegated to them.
4. **Timely receipt of information before decision making**
5. **Obtain expert advice where needed**
6. **Right to rely on others in good faith**
  - a. **A. Corporate officers and other employees**
  - b. **Professionals, e.g., lawyers and accountants**
  - c. **Board Committees**
7. **Varies by jurisdiction.** The conduct which constitutes a violation of the duty of care varies in different jurisdictions. Depending upon the jurisdiction, even mere negligence may not be sufficient to constitute a violation of the duty.

### III. **The Duty of Loyalty**

- A. The duty of loyalty requires a director to act **solely in the best interests** of the corporation rather than in his or her own interests or those of entities in which the director has a financial interest. The duty of loyalty includes a director's obligation to avoid conflicts of interest. "[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any personal interest of the director which is not shared generally by the shareholders of the corporation.
- B. Individual directors **breach their duty of loyalty by placing the interests of anyone**--whether themselves, management, a third party, or a subset of shareholders--over **the corporation or the shareholders** generally. (In some states, under some circumstances, the director may have duties to others, e.g. creditors.)
- C. Conflict may include personal financial interest and/or non-financial conflict.
  1. Examples include dealing with director-related businesses and corporate opportunities.

2. Under Delaware law, self-dealing transactions for directors (*i.e.*, where the director is effectively on both sides of the transaction) are subject to the entire fairness test. In *Technicorp International II, Inc. v. H. Johnston*, No. Civ. A. 15084, 2000 WL 713750 (Del. Ch. May 312, 2000), the Delaware Chancery Court explained:

Corporate officers and directors, like all fiduciaries, have the burden of showing that they dealt properly with corporate funds and other assets entrusted to their care. Where, as here, fiduciaries exercised exclusive power to control the disposition of corporate funds and their exercise is challenged by a beneficiary, the fiduciaries have a duty to account for their disposition of those funds, *i.e.* to establish the purpose, amount and property of the disbursements. And where, as here, the fiduciaries cause those funds to be used for self-interested purposes, *i.e.*, to be paid to themselves or to others for the fiduciary's benefit, they have the 'burden of establishing [the transactions'] entire fairness, sufficient to pass the test of careful scrutiny by the court.

- D. There may be an overlap with the duty of care, *e.g.*, causing a corporation to violate applicable law or an intentional or grossly negligent disregard of responsibilities.

**IV. Other Duties** - Some courts and commentators have espoused other duties including a duty of disclosure, a duty of obedience and a good faith duty. Others may impose the same requirements upon directors as part of the key commonly accepted fiduciary duties of care and loyalty.

**A. Disclosure.** Some courts have also described a duty of disclosure.

1. Director must disclose **to the other members of the board** when the board's actions may materially affect the director or an entity in which the director has an interest. The director must not participate in any board vote or deliberations on those matters absent board approval of that participation.
2. The duty of disclosure also applies to all material information being disclosed **to shareholders** when seeking shareholder approval.

**B. Obedience.**

1. Commentators have described a duty of obedience pursuant to which the directors of the corporation cannot perform ***ultra vires*** acts, i.e., acts that are prohibited or beyond the scope of the corporation's powers or are otherwise prohibited to the directors.
2. Problems may arise from the opposite conduct. Courts have found directors liable for **abdicating crucial decision making** to an outside advisor.

### C. Good Faith

1. **Good faith is arguably an obligation separate from fiduciary duties.** Thus, courts sometimes speak of a director's duty of good faith. But, case law in Delaware also states, "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.
2. **What is good faith?** The Delaware Supreme Court discussed the issue of good faith in its decision in ***In re The Walt Disney Company Derivative Litigation, supra.*** In that case, the plaintiffs asserted, among other things, that the Disney directors breached their fiduciary duty with respect to the hiring and then the termination of Michael Ovitz, including a severance payout to him of \$130 million. The Delaware Supreme Court affirmed the Chancery Court's decision after trial that the Disney defendants did not breach their fiduciary duty. The decision is notable, among other things, for providing guidance as to what constitutes good faith for directors. The Court then went on to identify **at least three different categories of fiduciary behavior as types of bad faith. These were: (1) subjective bad faith, referring to conduct motivated by an intent to do harm, (2) grossly negligent actions taken without malevolent intent, and (3) intentional dereliction of duty or a conscious disregard of one's responsibilities.**

### D. Other duties which appear to be sub-categories are:

1. Confidentiality (e.g., insider trading, trade secrets)
2. Risk compliance oversight (e.g. risk management, compliance with law)

### E. Duties to Creditors

1. In some circumstances a director may owe a fiduciary duty not only to the corporation but also to its creditors.

2. **Delaware and other states generally do not permit creditors to allege fiduciary duty violations against corporate directors in most circumstances.** The Delaware courts reason that creditors have the protection of other legal tools, such as contract claims, the law of fraudulent conveyance, and federal bankruptcy law.
3. A developing body of law has held that **when a corporation becomes insolvent**, this changes. When a corporation becomes insolvent, its creditors take on the same role as the corporation's shareholders; they become residual risk bearers. ("**Insolvency**" **itself may be a disputed factual issue**, but at least the following four standards have been used: (1) balance sheet test (liabilities exceed assets); (2) the cash flow test (can bills be paid as they become due); (3) the bankruptcy code test at 11 U.S.C. section 101(32), *et seq.*; and the unreasonably small amount of capital analysis.
4. Some decisions have included the period when a corporation approaches insolvency as also a time when this fiduciary duty to creditors may arise.
5. **Delaware's** Supreme Court and a California appellate have restricted this duty to the period of actual insolvency. In 2007 in *North American Catholic Educational Programming, Inc. v. Gheewalla, et al.*, 920 A.2d 92 (Del. 2007) the Delaware Supreme Court held that directors of a solvent Delaware corporation that was operating in the zone of insolvency owed their fiduciary duties to the corporation and its shareholders, and not to creditors. But the Court acknowledged that in the case of an insolvent corporation, however, creditors, as the true economic stakeholders in the enterprise, have standing to pursue derivative claims for directors' breaches of fiduciary duty to the corporation.
6. **California** also recognizes this duty to creditors in some circumstances.

## V. Recent Legislation, Regulation and Litigation Update

### A. Legislation – The Dodd-Frank Reform and Consumer Protection Act

The most notable legislative development during the past year in the area of corporate governance was the enactment in July 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). It is widely considered to be one of the most comprehensive legislative reforms of the financial industry. Much of the Dodd-Frank Act is directed toward banks and financial regulation; however the Act also contains provisions directed to public companies’ corporate governance and executive compensation. Highlights are noted below.

#### 1. Say on Pay

**Once effective, shareholders of public companies will be given the opportunity to cast an advisory vote, commonly referred to as “Say on Pay,” as to whether they approve of their corporation's executive compensation practices.**

It does not provide for the setting of limitations by shareholders, but instead **requires corporations to include a resolution in their proxy statements asking for non-binding shareholder approval of the compensation** of named executives. Thus, executive compensation practices and decisions are to be disclosed in the public company’s periodic Securities and Exchange Commission (“SEC”) filings under the section labeled Compensation Discussion and Analysis.

The Say on Pay vote is to occur **at least once every three years.**

**Public companies will also be required to include a separate non-binding resolution asking shareholders to determine whether the Say on Pay vote will occur every one, two or three years.**

Also, a similar **non-binding vote with respect to certain payments executives are due to receive upon the termination of their employment**

following a change in control would be required in conjunction with any mergers or similar events if not previously subject to the Say on Pay vote.

## **2. Executive Compensation Disclosures**

The Dodd-Frank Act provides that the SEC shall require disclosure in the proxy statement of the **relationship between executive compensation paid and financial performance**, taking into account distributions and any change in the value of shares and dividends.

**Disclosure shall include comparative information concerning CEO compensation** as follows: (a) median annual total compensation for all employees other than the CEO, (ii) the CEO's annual total compensation and (iii) the ratio of the median employee compensation to that of the CEO.

## **3. Disclosure regarding employee and director hedging**

The Dodd-Frank Act provides that the SEC must enact rules to require proxy statement disclosure as to **whether any employee or director, or his or her designee, is permitted to purchase financial instruments that are designed to hedge or offset any decrease in the market value of equity securities granted by the company** as compensation to the employee or director or held, directly or indirectly, by the employee or director.

## **4. Disclosures regarding Chairman and CEO structures**

The Dodd-Frank Act requires that the SEC require disclosure in a proxy statement of **why the company has chosen to have either the same person or different persons in the position of CEO and Chair** of the Board.

## **5. Compensation Committee Independence**

The Dodd-Frank Act requires that the SEC issue rules requiring national securities exchanges to mandate that each member of a company's

**Compensation Committee be independent directors.** In determining a director's independence, companies will be required to consider relevant factors, including: (a) the source of a director's compensation, including any consulting, advisory or other compensatory fee paid by the company to the director, and (b) whether the director is affiliated with the company or any of its subsidiaries or affiliates.

The Dodd-Frank Act also requires companies to provide for funding for the Compensation Committee to hire a compensation consultant and independent legal counsel or other advisor.

## **B. Regulation**

**On January 25, 2011, the SEC adopted, by a 3-2 vote, final rules under §14A of the Securities Exchange Act of 1934, which was enacted by § 951 of the Dodd-Frank Act.** Section 14A requires public companies to conduct separate non-binding shareholder advisory votes to approve Named Executive Officer (NEO) compensation (Say on Pay discussed above) and the frequency of the Say on Pay vote. Section 14A also requires expanded, tabular format disclosure of NEO compensation arrangements in connection with mergers or similar transactions and a related separate advisory vote on “golden parachutes” in merger proxy statements. The final rules are generally effective 60 days after publication in the Federal Register. The rules on golden parachute disclosure and the separate advisory vote are effective April 25, 2011.

## **C. Litigation**

The following are some of the key recent decisions concerning directors.

### **1. *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009)**

In 2009, the Delaware Supreme Court in *Gantler, supra*, held that officers have the same fiduciary duties as directors, but also noted that DGCL § 102(b)(7) (**allowing protection for directors for claims against them for**

monetary liability for breaches of the duty of care) does not extend to officers.

**2. *Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 Cal.App.4th 1020**

In California, in *Berg & Berg Enterprises, LLC v. Boyle* (2009) 178 Cal.App.4th an appellate court held that **directors did not owe a fiduciary duty to creditors when the corporation was in the “vicinity of insolvency.”** *Id.* at 1040–41. But, the Court, noted that directors of an insolvent corporation do have a limited duty to avoid actions that improperly divert, dissipate or risk corporate assets that might otherwise be used to pay creditors' claims. The directors' duty to creditors is, however, protected by the “business judgment” rule and directors will not be liable to creditors under corporate common law for acts that diminished the creditors' recovery so long if the directors were personally disinterested and their acts were performed in good faith and following reasonable investigation. *Id.* at 1044-49.

**3. *Johnson v. Couturier*, 572 F.3d 1067 (9th Cir. 2009)**

The Ninth Circuit Court of Appeals held that to the extent directors are also ERISA fiduciaries, they are subject to ERISA fiduciary standards, including duties of loyalty and care, prohibitions against self-dealing, and the “prudent person” standard. *Johnson v. Couturier*, 572 F.3d 1067, 1075–1078 (9th Cir. 2009). **The Court further held that where corporate officers or directors also act as ERISA fiduciaries, contractual or state statutory indemnification provisions may be *unenforceable* to the extent they conflict with federal law.** *Id.* at 1078-81.

### **III. Measures for Directors to Protect Themselves**

#### **A. The Business Judgment Rule**

**The business judgment rule provides a measure of protection to directors for potential personal liability with respect to the duty of care.**

**To invoke the protections afforded by the business judgment rule, the directors cannot breach the duty of loyalty.** See, e.g., *Continuing Creditors' Committee of Star Telecommunications, Inc. v. Edgecomb*, 385 F.Supp.2d 449, 462 (D.Del. 2004) (If a defendant does not breach his duty of loyalty to the company, he is permitted to rely on the business judgment rule or an exculpatory provision, if applicable, to shield him from liability for a breach of the duty of care.”).

The business judgment rule is a standard by which courts review **whether a breach of duty of care has occurred.**

In Delaware, California and other jurisdictions, the rule is regarded as a **judicially created presumption that decisions made by disinterested directors are done on an informed basis in a good faith belief that the decisions will serve the best interests of the corporation.** See, Allen, Jacobs & Stine, “*Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*,” 56 Bus. Law 1287, 1298 (2001) (“[A] standard formulation of the business judgment rule in Delaware is that it creates a presumption that (i) a decision was made by directors who (ii) were disinterested and independent, (iii) acted in subjective good faith, and (iv) employed a reasonable decision making process.”).

**The presumption recognizes both the primacy of the board's role in corporate decisions and the fact that the decisions often involve risks that may be better evaluated by businessmen than judges. Demonstrating informed decision making is key.** “The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision, of all material information

reasonably available to them." *Smith v. Van Gorkom*, 488 A.2d at 872 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

The business judgment rule protects directors who "acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." *Disney*, 906 A.2d at 52 (quoting *Aronson, supra*, 473 A.2d at 812). "The business judgment rule, as a standard of judicial review, is a common-law recognition of the statutory authority to manage a corporation that is vested in the board of directors." *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1127 (Del. 2003). Under the rule, conduct is assessed not by focusing on the board's process in arriving at the decision. See *Paramount Comm'ns Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45 n.17 (Del. 1994).

**To overcome the presumption, a plaintiff may seek to present proof of a conflict of interest, illegality, fraud or bad faith.** In *Bal Harbour Club, Inc. v. AVA Dev., Inc.* 316 F.3d 1192 (11<sup>th</sup> Cir. 1989), the Court described the rule as follows: "[T]he business judgment rule is a policy of judicial restraint born of the recognition that directors are, in most case, more qualified to make business decisions than are judges. In this light, the rule may be viewed as a method of preventing a fact finder, in hindsight, from second guessing the decision of directors." *Id.* at 1994-95, quoting, *Int'l Ins. Co. v. Johns*, 874 F.2d 1447, 1458 (11<sup>th</sup> Cir. 1989).

The **Delaware** courts will **under certain circumstances subject director's action to enhanced judicial scrutiny** before the presumptive protection of the business judgment rule can be invoked." *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A. 2d. 914, 928 (D. Del. 2003); see also, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (1985) (enhanced scrutiny for defensive measures); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (duties attendant to a sale of control). These circumstances, will most commonly arise when directors are confronted with an "'inherent conflict of interest' such as contests for corporate control '[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.'"

*Unocal Corp., supra*, 493 A.2d at 954. Consequently, **during contests for corporate control**, under Delaware law directors have to satisfy the additional burden of enhanced judicial scrutiny before they are afforded the deference of the business judgment rule.

**Enhanced scrutiny consists of a two part test: (1) a *reasonableness test*, which is satisfied by a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (2) a *proportionality test*, which is satisfied by a demonstration that the board of directors' defensive response was reasonable in relation to the threat posed.** Only if the directors are able to satisfy that burden, their actions are accorded the deferential business judgment rule. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1373 (1995). If the directors are not able to satisfy the burden (or if the presumption of the business judgment rule is defeated for any other reason), the more critical entire fairness standard applies instead. *Grobow v. Perot*, Del.Supr., 539 A.2d 180, 187 (1988). This standard requires judicial scrutiny of both “fair dealing” and “fair price.” *Unitrin, supra*, 651 A.2d at 1373.

Like, Delaware courts, **California courts at least assert that they afford directors the benefit of the business judgment rule which provides a presumption the directors' decision are based on sound judgment.** *Gaillard v. Natomas Company* (1989) 208 Cal.App.3d 1250, 1269. However, in *Gaillard*, the Court of Appeals reversed a grant of summary judgment in favor of the outside directors by holding that it was a jury issue as to whether these directors exercised due care. **The Delaware courts' use of “enhanced judicial scrutiny” of directors in certain instances before determining whether to apply the business judgment rule is language that is not frequently seen in California case law. It is not, however, entirely absent in California.** See, e.g. in *Mueller v. Macban* (1976) 62 Cal.App.3d 258, 274 discussing circumstances involving “rigorous scrutiny” with respect to directors and controlling shareholders). The widespread use of the concept in Delaware

decisions suggests that a similar argument in an appropriate California case could prove successful.

Some commentators have suggested that a distinction be made between a “business judgment rule” which would immunize directors from liability and a “business judgment doctrine.” See, e.g. Hinsey, “Business Judgment and the American Law Institute’s Corporate Governance Project: The Rule, the Doctrine and the Reality,” 52 Geo. Wash. L. Rev. 609, 611-12 (1984) (“Courts and commentators have generally overlooked the distinction between the business judgment rule and the business judgment doctrine. . . . This has resulted in unfortunate misunderstanding and confusion. **The business judgment rule shields individual directors from liability for damages stemming from decisions, whereas the business judgment doctrine protects the decision itself.**”

## **B. Exculpatory Provisions**

Directors may also be protected from claims of liability by exculpatory charter provisions that eliminate monetary liability for breaches of the fiduciary duty of care.

The DGCL allows corporations to grant their directors certain protections from monetary liability with respect to the duty of care. Section 102(b)(7) states:

[T]he certificate of incorporation may also contain . . . [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director . . . provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit.

Section 102(b)(7) was enacted in the wake of the Delaware Supreme Court's decision in *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) to permit corporate charters to immunize directors from liability to the corporation for breaching the duty of care.. See Strine, Hamermesh, Balotti and Gorris, "Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law," 98 Geo. L. Rev. 629, 659 (2010).

The statute carves out several exceptions, however, including, "for acts or omissions not in good faith...." Thus, a corporation can exculpate its directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith. In *In re The Walt Disney Company Derivative Litigation*, 906 A.2d 27, 35 (Del. 2006) the court rejected the idea that good faith represents a free-standing fiduciary duty and that bad faith stands in for gross negligence in duty-of-care analyses—a contrast to California's use of good faith in its duty-of-care statute. By characterizing good faith as a duty-of-loyalty issue, the Delaware Supreme Court in effect removed these cases from the exculpation/indemnification provisions covering breaches of the duty of care.

Similarly, to the Delaware statute, MBCA §2.02(b)(4) permits the articles of incorporation to include "a provision eliminating or limiting the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director, except liability for (A) the amount of a financial benefit received by a director to which the director is not entitled; (B) an intentional infliction of harm on the corporation or the shareholders; (C) a violation of section 8.33; or (D) an intentional violation of criminal law." Other states have similar provisions. See, e.g. Fla. Stat. Ann.§ 607.0831 (West 2007) (shielding directors from liability for any act or failure to act, unless the director engaged in a violation of criminal law, derived an improper personal benefit from a transaction, carelessly approved an unlawful dividend or other distribution, or (in a derivative or direct action by a shareholder) acted in "conscious disregard for the best interest of the corporation, or [engaged in] willful misconduct").

In addition, statutes in both Delaware and California provide a safe harbor for contracts with directors under certain circumstances. Both states provide statutory safe harbors that immunize some interested-party transactions provided there is full disclosure and ratification by shareholders or disinterested directors. See DGCL, §144<sup>1</sup>

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<sup>1</sup> Section 144 (Interested directors; quorum) provides:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or

(footnote continued on next page)

transaction are disclosed or are known to the board

of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the stockholders.

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(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

and Cal. Corp. Code § 310.<sup>2</sup>

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<sup>2</sup> Section 310 provides:

(a) No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm or association in which one or more of its directors has a material financial interest, is either void or voidable because such director or directors or such other corporation, firm or association are parties or because such director or directors are present at the meeting of the board or a committee thereof which authorizes, approves or ratifies the contract or transaction, if

(1) The material facts as to the transaction and as to such director's interest are fully disclosed or known to the shareholders and such contract or transaction is approved by the shareholders (Section 153) in good faith, with the shares owned by the interested director or directors not being entitled to vote thereon, or

(2) The material facts as to the transaction and as to such director's interest are fully disclosed or known to the board or committee, and the board or committee authorizes, approves or ratifies the contract or transaction in good faith by a vote sufficient without counting the vote of the interested director or directors and the contract or transaction is just and reasonable as to the corporation at the time it is authorized, approved or ratified, or

(3) As to contracts or transactions not approved as provided in paragraph (1) or (2) of this subdivision, the person asserting the validity of the contract or transaction sustains the burden of proving that the contract or transaction was just and reasonable as to the corporation at the time it was authorized, approved or ratified.

A mere common directorship does not constitute a material

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California's and Delaware's exculpation rules, both of which are based on statute, differ. Cal. Corp. Code §204(a)(10) excludes from exculpation any acts by directors demonstrating reckless disregard of duty or a persistent lack of attention

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financial interest within the meaning of this subdivision. A director is not interested within the meaning of this subdivision in a resolution fixing the compensation of another director as a director, officer or employee of the corporation, notwithstanding the fact that the first director is also receiving compensation from the corporation.

(b) No contract or other transaction between a corporation and any corporation or association of which one or more of its directors are directors is either void or voidable because such director or directors are present at the meeting of the board or a committee thereof which authorizes, approves or ratifies the contract or transaction, if

(1) The material facts as to the transaction and as to such director's other directorship are fully disclosed or known to the board or committee, and the board or committee authorizes, approves or ratifies the contract or transaction in good faith by a vote sufficient without counting the vote of the common director or directors or the contract or transaction is approved by the shareholders (Section 153) in good faith, or

(2) As to contracts or transactions not approved as provided in paragraph (1) of this subdivision, the contract or transaction is just and reasonable as to the corporation at the time it is authorized, approved or ratified.

This subdivision does not apply to contracts or transactions covered by subdivision (a).

(c) Interested or common directors may be counted in determining the presence of a quorum at a meeting of the board or a committee thereof which authorizes, approves or ratifies a contract or transaction.

(when the act poses a risk of major harm to the company or shareholders). Delaware, in DGCL §102(b)(7), does not provide for such exclusions from exculpation, although some commentators argue that Delaware courts can still impose liability on directors under these circumstances.

Directors cannot escape liability by deferring to the viewpoints of some or even all of their shareholders. For example, in deciding whether to approve a merger agreement, a board of directors must act in an informed and deliberate manner, and "may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement." *Paramount Commc'ns, Inc., supra*, 571 A.2d at 1142 n.2. Directors are not merely agents of the shareholders.

### **C. Indemnification and Insurance**

Indemnification and insurance may also reduce the likelihood that claims will result in out-of-pocket payments by directors. See DGCL §145 (indemnification and advancement of expenses); MBCA §§ 8.50-8.59.

## **IV. Key Functions**

### **A. CEO Assessment and Compensation**

The directors of public companies have the principal role to perform an assessment of a CEO's compensation and performance consistent with the Board's function in monitoring management and protecting the interests of shareholders.

The passage of Sarbanes-Oxley, and the subsequent increase in the number of lead directors, appears to have arisen from a combination of from the public responses to financial scandals such as Enron Corp. and WorldCom and the financial crises of the past few years. The SEC and the New York Stock Exchange ("NYSE") have adopted requirements that independent directors on the board of a U.S. public company meet not only as part of the full board but also separately and apart from management and non-independent directors.

The Dodd-Frank Act discussed above and the SEC rules adopted late last year, also discussed above, are the most important new public company developments in the Board's functions in this area.

## **B. Oversight and Monitoring Strategies**

In the 1996 Delaware Chancery Court decision in *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), the Court held in the contest of reviewing a settlement, that the Board could not escape liability unless it took some actions to implement a program to detect potential violations of law or corporate policy and exercised a duty of oversight as to matters relating to compliance matters. The Court explained:

Director liability for a breach of the duty to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow *from a board decision* that results in a loss because that decision was ill advised or "negligent." Second, liability to the corporation for a loss may be said to arise from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss.<sup>3</sup>

In its 2006 decision in *Stone v. Ritter*, 911 A.2d 362, the Delaware Supreme Court affirmed the *Caremark* standard for director duty and elaborated on the nature of the directors' responsibilities for conduct found to be in violation of law which violation causes losses to the company. The *Stone* Court set a standard for director liability focusing on whether there is a sustained or systematic oversight failure. There would be such a failure if there was no attempt to assure the existence of a reasonable information and reporting system. The directors under that standard are responsible for ensuring that corporations will adopt reasonable programs to deter, detect and remedy violations of law and corporate policy. In *Stone* the Court held:

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<sup>3</sup> 698 A.2d at 697.

We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary duty in good faith.<sup>4</sup>

Oversight failure cases have included cases where the plaintiff has argued: (1) employees caused the corporation to violate the law thereby exposing the corporation to civil liability, and (2) the Board failed to detect and prevent wrongdoing perpetrated by employees against the corporation.

Noting the serious management failures with respect to risk management which have been identified in connection with the financial crisis of 2008, it has been argued that, “There is no doctrinal reason that *Caremark* claims should not lie in cases in which the corporation suffered losses, not due to a failure to comply with applicable laws, but rather due to lax risk management.”<sup>5</sup> Bainbridge, “*Caremark* and Enterprise Risk Management,” 34 *Journal of Corp. Law* 967 (June 2009).

SEC rules effective February 28, 2010 require public companies to disclose certain compensation policies and practices that could incentivize risk-taking in certain instances, as well as the Board’s role in risk management.

## **V. Board Structural Practices**

### **A. Appointment of a Lead Director**

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<sup>4</sup> 911 A.2d at 370.

<sup>5</sup> Enterprise risk management is the process by which the board of directors and executive of a corporation define the company’s strategies and objectives to strike a balance between growth and return and risk.

In recent years, public corporations have increasingly shifted from a model where a single person occupied the role of Chair and CEO, to one where a leader of the independent directors, typical called a “lead director” and sometimes called a “presiding director,” is selected.

The role of lead director is not definitively defined. In a 2009 policy brief by The Millstein Center for Corporate Governance at the Yale School of Management, the following non-exclusive list was noted as often cited responsibilities of lead directors: (1) to convene and preside over board meetings and meetings of the independent directors without management present; (2) to provide leadership to the board and uphold high corporate governance and ethical standards; (3) to establish the processes the board uses in managing the responsibilities of the board and committees; (4) to organize and establish board agendas with assistance from the CEO, board committee chairs, and the corporate secretary; To plan the agenda and provide sufficient time for discussion of agenda items; (5) to supervise circulation of proper and relevant information to the directors in a timely fashion; (6) to ensure contribution from all directors at the meeting; (7) to focus the board’s attention on relevant matters, limit distraction and discord, and work towards consensus; (8) to communicate effectively with management on a regular basis; (9) to act as a “sounding board” for the CEO; and (10) to take a lead role in board evaluation and succession planning.<sup>6</sup>

The NYSE and Nasdaq have also adopted rules which have been characterized as effectively requiring listed companies with non-independent Chairs to install a lead director among its required independent directors.

## **B. Committee Formation**

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<sup>6</sup> “Chairing the Board, The Case for Independent Leadership in Corporate North America,” The Millstein Center for Corporate Government and Performance, Yale School of Management (2009), *citing to* David W. Anderson, “First Among Equals: The Underappreciated Significance of the Board Chair,” *ICD Director*, 136, February 2008, pp. 22–23; “The Non-Executive Chairman,” pp. 2-7; Robert F. Felton and Simon C. Y. Wong, “How to separate the roles of chairman and ceo,” *McKinsey Quarterly* No.4, 2004; Serge Ezjenberg, “The Role of the ‘Non-Executive Chairman’?” Cercle Alexis de Tocqueville

Most companies have the board committees for nominations, compensation, and audit, and finance. Typically, the nominating committee focuses on board nominations, the board of directors; the compensation committee focuses on executive compensation; the audit committee reviews the reports of the independent external auditor and oversees the internal audit function; and the finance committee oversees the capital investment and funding.

The audit committee plays a special role for the board. In response to criticisms of the financial reporting process, the NYSE and the National Association of Securities Dealers (now, FINRA) sponsored the formation of a Committee on Improving the Effectiveness of Corporate Audit Committees. The Committee's report included the recommendations to: (1) have all audit committee members being "financially literate" and meeting several stipulated independence criteria, (2) increase communications with the company's outside auditor, and (3) direct communication from the audit committee in the company's annual report to its shareholders.

Companies listed on the NYSE are required to have audit, compensation and nominating/corporate governance committees that consist only of independent directors.

### **C. Separating the CEO and Chairman Roles**

Traditionally in the United States, corporations filled the role of CEO and Board Chair with the same individual. While this seems to be still true for most corporations, there is a current trend in public companies, to separate those roles. Companies with a combined Chair and CEO may still designate a lead director.

Efforts have been made by various advocates to have the SEC require that the CEO and Chair roles be separated in public companies. The SEC rejected that approach, but has adopted rules to implement the Dodd-Frank Act requirement of proxy statement disclosure concerning why a public company

may chose to have either the same person or different persons in the position of CEO and Board Chair.

In a March 2009 article, the Wall Street Journal reported, “More U.S. companies are dividing the roles, but the trend is spreading slowly because many CEOs resist sharing power. About 37% of companies in the Standard & Poor's 500-stock index have separate chairmen and CEOs, up from 22% in 2002, according to the Corporate Library, a research firm in Portland, Maine. “Chairman-CEO Split Gains Allies,” Wall Street Journal, March 30, 2009.

#### **D. Staggered Elections**

A staggered board of directors, sometimes referred to as a “Classified Board,” is one in which only a fraction of the members of the board are elected at a time.

In public companies, staggered elections make it more difficult for hostile takeovers to be successful because the hostile bidders must win more than one proxy fight to obtain control. Proponents of the staggered board argue that these boards offer greater stability, increased independence for outside directors and a longer perspective. Opponents argue that these boards are less accountable to shareholders and tend to favor management. The current trend appears to disfavor these types of boards for widely held public corporations.<sup>7</sup>

#### **VI. Defining the Roles of Management and Oversight**

Rules of the SEC and the NYSE require that, generally, independent directors not only constitute a majority of directors on every public company board, but that they have a much greater role in the work of the board committees. Specifically, Item 407(h) of Regulation S-K requires proxy statement disclosure describing the board’s role in risk oversight, including how the board administers its

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<sup>7</sup> In 2009, New York Senator Charles Schumer introduced a bill entitled the, “Shareholder Bill of Rights of 2009.” Which would have required the annual election of directors thereby eliminating staggered boards,

oversight function and how such administration operates in the context of the board leadership structure and whether and how the responsibilities are allocated among different board committees. This disclosure includes: (1) the relationship between the board and senior management in managing the material risks; (2) whether risk oversight is performed by the board as a whole or through a committee; and (3) whether the persons who oversee risk management report to the board as a whole or to a committee; and (4) whether and how the board monitors risk.