Fiduciary Duties for Directors

Charles R. Parker
Tracy N. LeRoy

YetterColeman LLP
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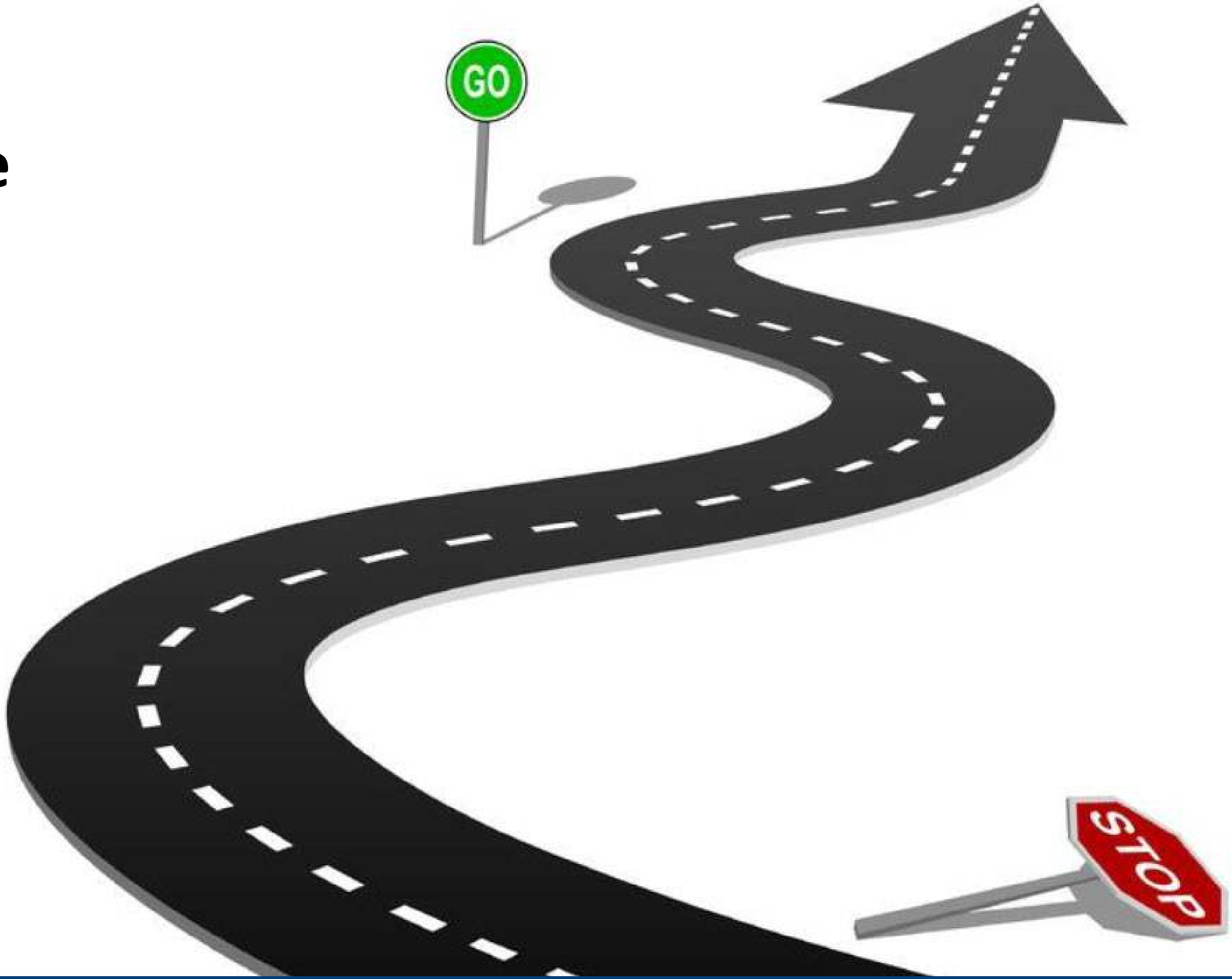
Roadmap

- Fiduciary Duties of Loyalty and Care
- The Business Judgment Rule
- Standing and Special Committees
- Guidance for Fiduciary Excellence



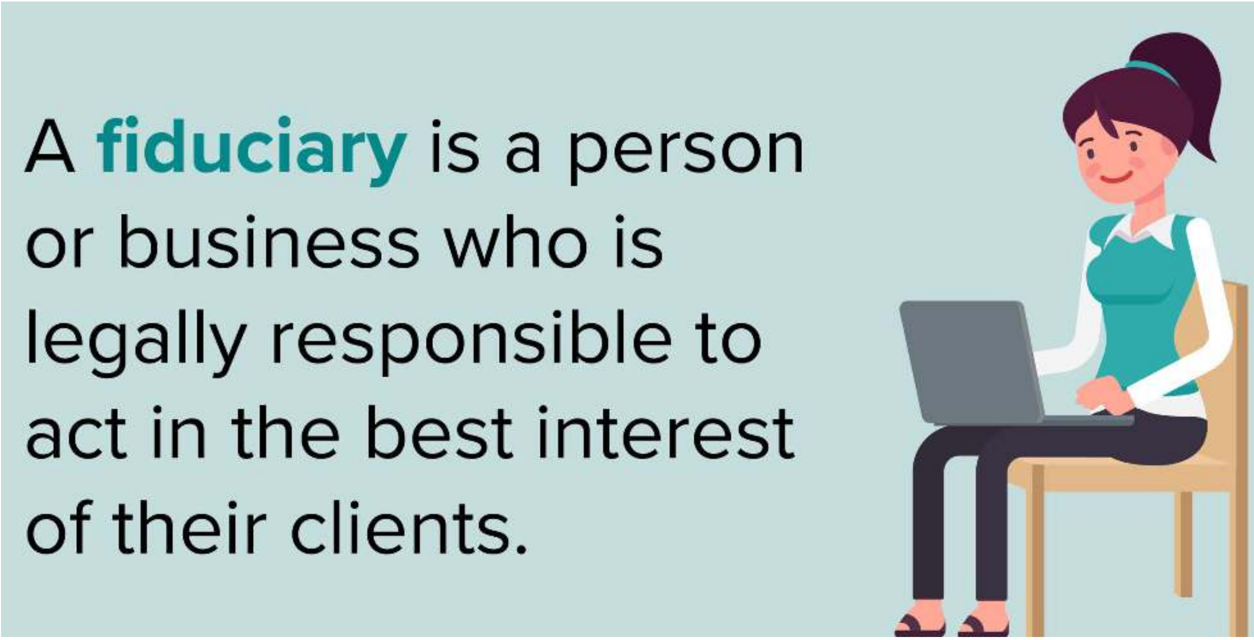
What is a Fiduciary?

- Directors owe fiduciary duties to their corporation

- Fiduciaries must act for the benefit of another person on all matters within the scope of their relationship
  - Normally, directors owe fiduciary duties to the shareholders

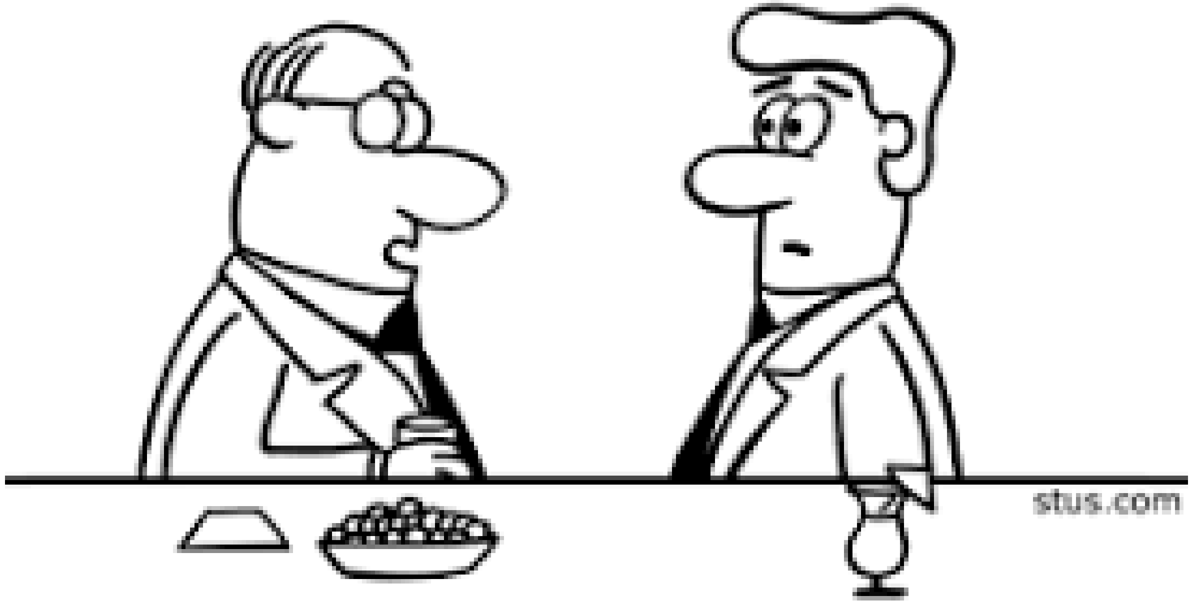
- Other corporate officers may be fiduciaries as well

- Bad faith breaches of fiduciary duties can expose directors to personal liability for harm to shareholders or creditors



The Duty of Loyalty

- **What is the duty of loyalty?**
  - **"Each member of the board of directors... shall act:**
    - **(i) in good faith, and**
    - **(ii) in a manner the director reasonably believes to be in the best interests of the corporation"**



This "fiduciary" thingy really complicates pillaging a corporation.

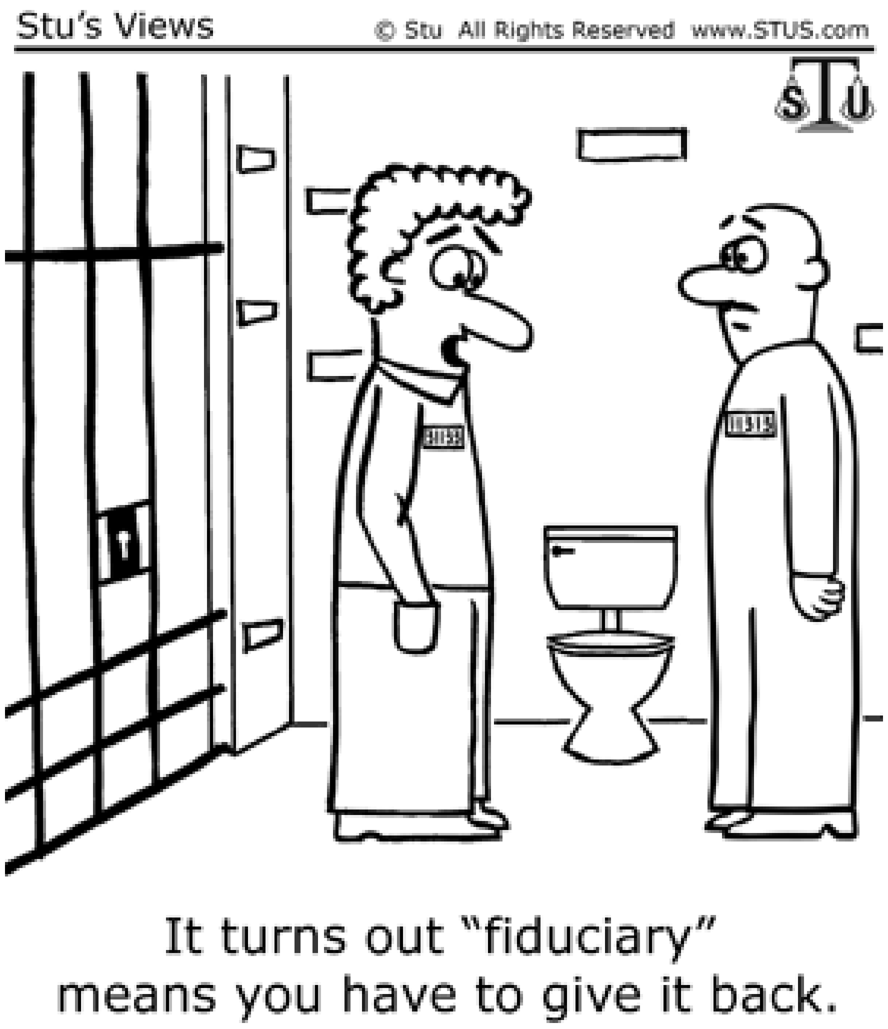
Breaches of the Duty of Loyalty

- **How might a director breach their duty of loyalty?**
  - **Acting with a lack of objectivity or independence**
  - **Receiving an unwarranted financial benefit**
- **Examples:**
  - **Making a public statement about a material matter when the company has not made a press release**
  - **Using company perquisites (e.g., planes) for personal reasons**

The Duty of Care

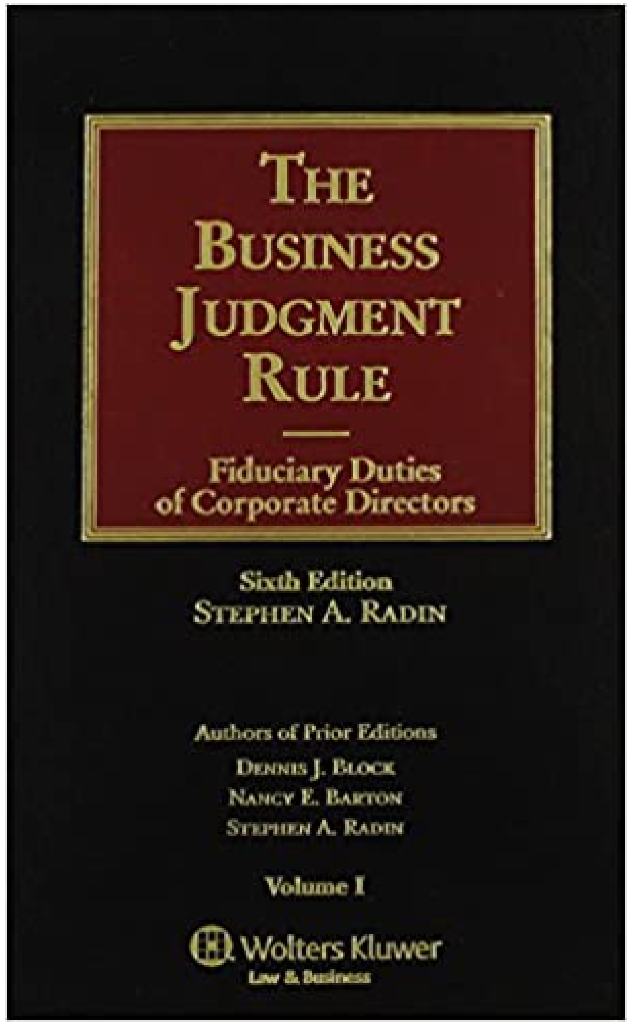
- **What is the duty of care?**
  - **Board members involved in decision-making or oversight “shall discharge their duties with the care that a person in a like position would reasonably believe appropriate given the circumstances”**

Breaches of the Duty of Care



- **How might a director breach their duty of care?**
  - Not reasonably informing themselves before acting
  - Failing to inquire into an issue where a reasonably attentive director would have
- **Examples**
  - Approving a transaction without sufficiently investigating it
  - Failing to prevent management from involving the business in illegal activities

The Business Judgment Rule (BJR)



- Protects against liability for breaches of the duty of care
- Courts will not second-guess decisions made
  - in good faith, and
  - with a reasonable level of care,
  - even if they have negative outcomes
- A good way to keep BJR protections is to explain the basis for board decisions in minutes/proxy statements

When does BJR protection not apply?

- Interested transactions
  - Board members raise the management fee payable to an entity they own
  - Board members arrange a merger such that they will retain their jobs after it is complete.
  - Board members are present on both sides of a transaction
  - A director fails to disclose to the board that a planned merger would increase his compensation
- Can ameliorate by getting shareholder ratification or convening an independent committee

Special and Standing Committees

Standing Committees

Boards of companies listed on the NYSE and other stock exchanges must have certain permanent committees

- These committees oversee sensitive corporate functions on an ongoing basis
- The most crucial permanent committees are audit and compensation committees

Audit Committees

- Oversees/reviews financial statements, accounting procedures, internal controls, and interested transactions
- Oversees the firm's independent auditor
- Generally 3-8 board members, at least one with financial expertise (e.g., experience as a CFO, accountant, controller)
- Strict independence requirements for directors
    - Cannot accept any consulting, advisory, or other compensatory fee
    - Cannot be affiliated with company/subsidiaries

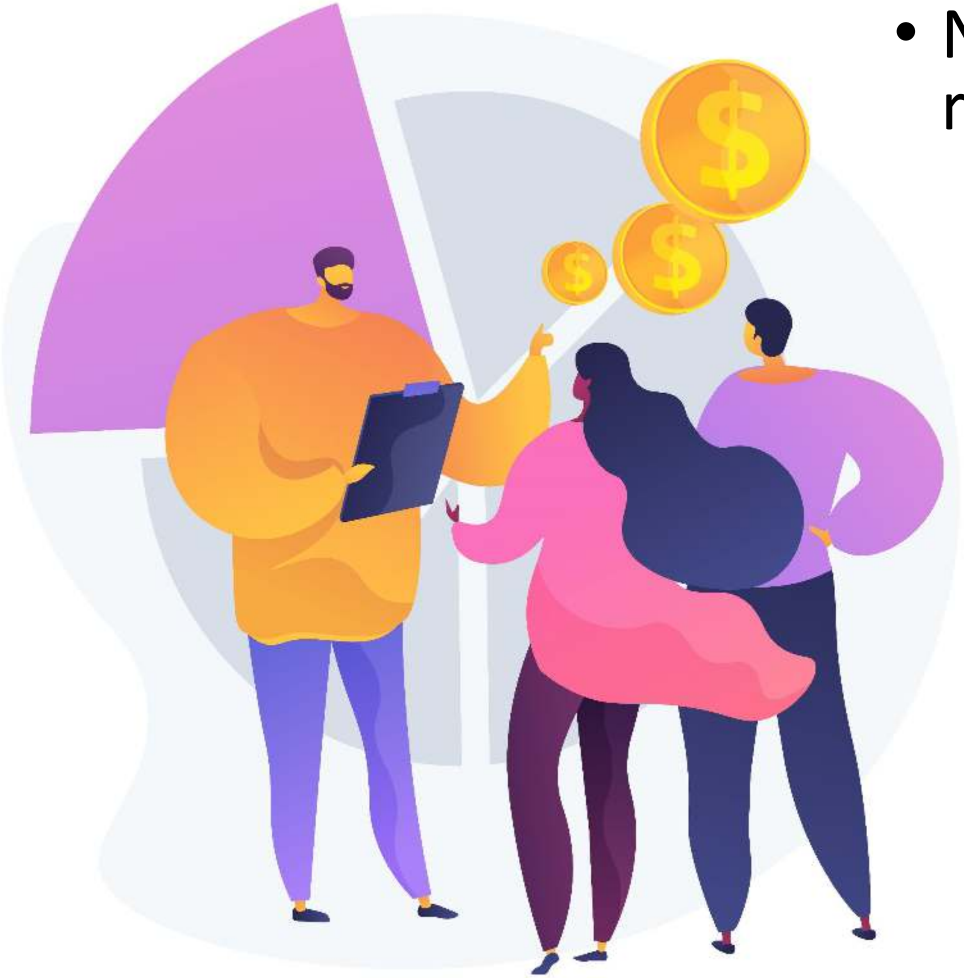
Audit Committees – Litigation Risks

The BJR does not apply where directors:

- Fail to convene an audit committee
- Fail to use or rely upon their audit committee
- Defund or obstruct their audit committee

- Not relying on or resourcing an audit committee is a breach of the duty of loyalty
- Audit committee reports in proxy statements that reflect insufficient oversight can lead to litigation

Compensation Committees

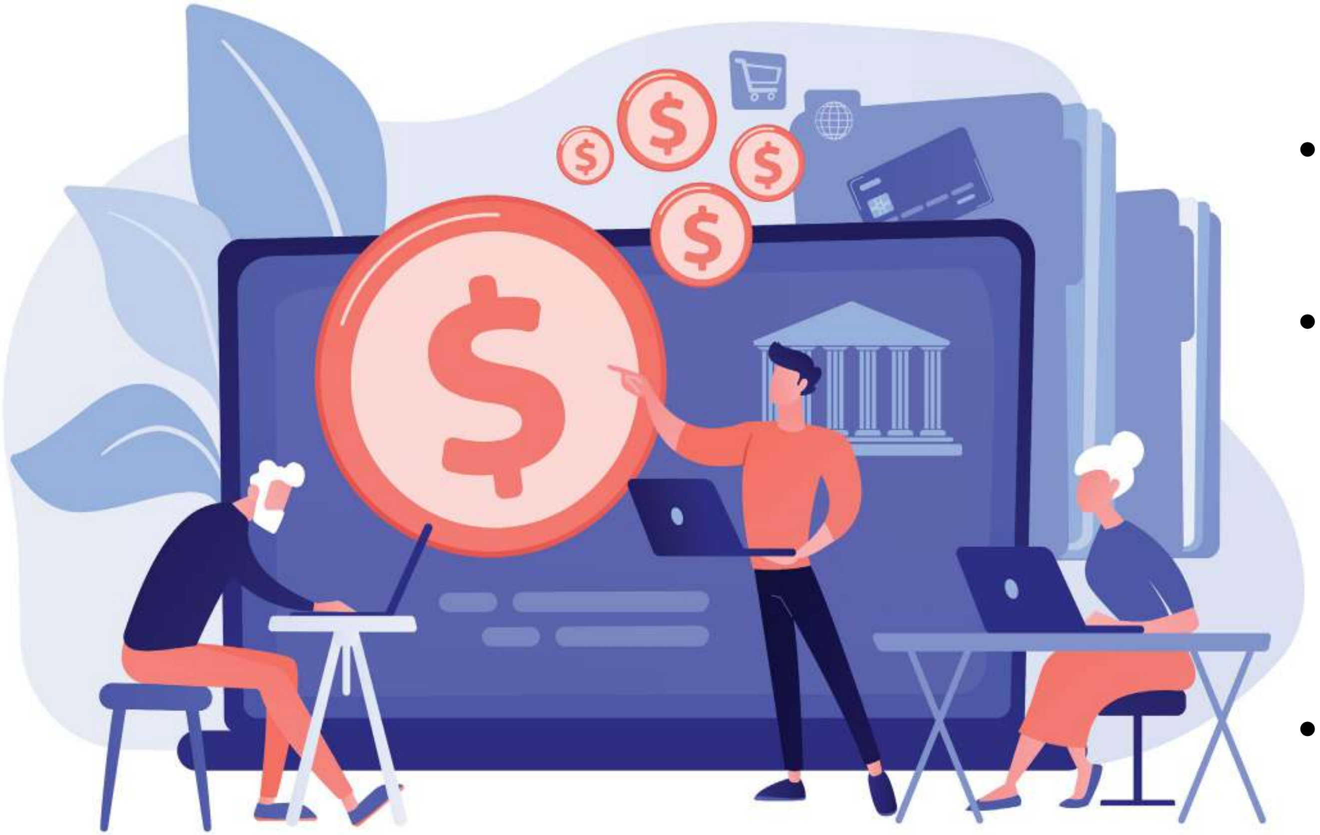


- NYSE companies are subject to express, detailed requirements for compensation committees
  - Determine CEO’s compensation based on performance relative to set targets, sometimes with input from other independent directors
  - Recommend non-CEO executive officer compensation to the board, including incentive/equity-based compensation plans
  - Produce an executive compensation report to be included in the company’s annual proxy statement or 10-K
  - Conduct an annual-self evaluation

Compensation Committees – Litigation Risks

- Excessive compensation is a breach of the duty of loyalty
    - Transparency and objectivity in committee decisions reduce the risk of litigation
    - It can be difficult to get a lawsuit dismissed with post-hoc justifications
- Compensation for directors serving on special committees should rarely depend on outcomes
- Compensation for controlling shareholders should be:
    - set by an independent, fully-functioning compensation committee
    - approved by a majority of disinterested shareholders

Special Committees



- Boards can also establish ad hoc independent committees
- ***Special negotiation committee***: responsible for considering an interested transaction
- ***Special litigation committee***: decides whether shareholder derivative litigation should proceed
  - Decisions always scrutinized for independence, adequacy, good faith, and rationality
- ***Special investigation committee***: convened to help respond to whistleblower reports, regulatory investigations, or concerns about management

Guidance for Fiduciary Excellence

- **Ask yourself:**
  - **Am I certain that I have no conflicts of interest?**
    - **If so, do I disclose them and recuse myself from voting?**
  - **Do I ensure that I am reasonably informed before making a decision?**
  - **Do our board and committees strive to make well-informed decisions?**
  - **Do our minutes reflect the effort we have made?**
  - **Do we retain and utilize advisors when necessary?**

Best Practices for Individual Directors

- **Know the company**
  - Familiarize yourself with the company’s board minutes, SEC filings, and outside analyses of the company
- **Actively participate in board meetings**
  - Do not hesitate to press unresolved points with your board colleagues until you have a satisfactory answer
- **Honor the office**
  - Keep the company’s interests before your own and do what you honestly believe is in its best interests

Best Practices for Boards

- **Solicit complete and timely information before meetings**
- **Allow adequate time for deliberation**
- **Keep adequate records of board deliberations**
    - Have internal or external counsel review the minutes *before* they are circulated
- **Delegate and reclaim managerial powers as necessary**
- **Utilize executive sessions appropriately and as guided by counsel**