Wanted: Corporate Directors Not Afraid to Face Millions of Dollars of Personal Liability Since We Cannot Afford D&O Insurance.

By Steven A. Lauer, Robert Z. Slaughter, G. Scott Greenburg and Deepak Massand*

Were you to encounter a "help wanted" advertisement in the newspaper with the above specifications, you'd probably look to see if the paper was dated April 1st. An ad such as that is not as far-fetched as it might have been only a few years ago, however, due to many developments in corporate law over the past few years. Moreover, the trend of reducing the protections that once insulated corporate directors from having to answer for their decisions (their decisions to act as well as their decisions to forgo acting) seems to be continuing. Independent directors,[1] in particular, might face potentially ruinous liability for their actions for companies with which they have very limited relationships.

These developments are particularly ironic in light of the fact that regulators, courts and others consider the presence of independent directors to constitute an important safeguard against executive abuse and corporate scandal.

The 1996 *Caremark* decision by the Chancery Court in Delaware suggested that the directors of a company should exert oversight of that company's compliance efforts.[2] Subsequent decisions by various courts have strengthened that position.

More recent events provide additional justification to fear director liability, especially when you consider their cumulative impact. The Sarbanes-Oxley Act of 2002, for example, explicitly created new duties for members of a corporation's board of directors, including the responsibility to set up and oversee a process by which individuals can submit concerns or complaints regarding accounting, internal accounting controls and audit-related matters.[3] Listing standards issued by the New York Stock Exchange after enactment of Sarbanes-Oxley impose on the board the duty to assist the company's

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[1] By "independent," we mean directors who are not employees of the company for which they serve as directors or otherwise have a contractual or other relationship with that company (except, of course, their service as directors) that might seem to compromise their ability as directors to apply independent judgment to the issues that they face as directors. The Securities and Exchange Commission, the self-regulating organizations (such as the New York Stock Exchange) and others have created more detailed definitions, of course, but this simple one will suffice for purposes of this article.

[2] See In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996). In that case, Chancellor Allen found no reason to override the "business judgment" rule and allow liability to be imposed on the directors. His discussion of that argument, however, is widely viewed as establishing its viability.

[3] See §301 of Sarbanes-Oxley, which directed the Securities and Exchange Commission to require the self-regulating organizations (like the New York Stock Exchange) to adopt rules requiring corporation's boards of directors' audit committees to undertake various responsibilities.

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management with its oversight of the company's compliance with legal and regulatory requirements.[4] Other court decisions have erected hurdles to the successful invocation of the business judgment rule by establishing heightened standards of behavior and independence. Board members must demonstrate independence of thought from that of corporate management and they must act in good faith with respect to the corporation's interests.

Courts that have reviewed the basis of the business judgment rule generally indicate that one of its underlying premises is that the board has no basis to question the actions of corporate management. In other words, absent evidence to the contrary, corporate directors may assume that executives of the company and other employees are acting in good faith and with the best interests of the company at heart. The complaint process required under §301 of Sarbanes-Oxley, however, could very easily undermine the basis for that assumption.

Historically, of course, members of a corporation's board of directors have participated little in the day-to-day affairs of the company. Those affairs are, in effect, delegated to the managers of the firm. That delegation historically insulated directors from the results of the actions of management. What happens, however, if the audit committee receives a submission by means of the procedures set up pursuant to §301 of Sarbanes-Oxley that, if true, contradicts information provided to the directors by management? In that situation, do those directors have an obligation to investigate which is the accurate view?

If the information that the directors receive contradicts data that they receive from corporate management, the court decisions referred to above suggest that the directors must investigate the discrepancy in order to preserve their defense under the business judgment rule. If they conduct such an investigation, though, the directors venture into territory that they have traditionally ceded to management. In doing so, they may assume responsibility that, under that same business judgment rule, they did not have and they thereby may also take on potential liability if they do not adequately shoulder that responsibility. A true "catch 22" for them.

The dilemma intensifies when you take into account even more recent developments. On April 8, 2004, the United States Sentencing Commission approved changes to the federal Sentencing Guidelines for Organizational Defendants.[5] Among other things, those changes mandate that the governing authority of an organization[6] "shall be knowledgeable about the content and operation … and shall exercise reasonable oversight with respect to implementation and effectiveness of the compliance and ethics program." The board, or a subgroup of the board, should receive information periodically on the effectiveness of the compliance and ethics program of the company

[4] See Schwartz and Freedman, "Audit Committee Oversight of Company Compliance," The New York Law Journal, January 22, 2004, posted at http://www.corpcounsel.com/other/3rd_party/audit.shtml.

[5] The Sentencing Commission exists to introduce greater certainty and uniformity into the process by which federal judges sentence defendants in federal court. See *Mistretta* v. *United States*, 488 U.S. 361 (1989). That Commission first issued Sentencing Guidelines for Organizational Defendants in 1991. See Murphy, The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics, 87 Iowa L. Rev. 697, 699 n. 6 (2002). The Commission transmitted those changes to the Congress on May 1, 2004, and, unless Congress acts, those changes will become effective on November 1, 2004. See http://www.ussc.gov/FEDREG/05_04_notice.pdf.

[6] For a corporation, the "governing authority" is the board of directors; for a different type of organization, "the highest-level governing body of the organization" has that responsibility.

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from the employee who is responsible for day-to-day operation of that program. The board will learn about criminal actions of employees and agents of the company that come to the attention of the company's compliance professionals. The board thus has several channels by which it can learn about missteps by the company. All that information has the potential of triggering a duty to investigate and, potentially, take action.

If the directors take action upon receiving such information, how can they ably choose among various courses of action that face them? Should they select their own experts, including counsel and accountants?[7] What infrastructure exists or do they need within the company by which to make such a selection? If the directors decide to get involved, with or without experts, how will they monitor the process by which documentation and other material is prepared? Will they be able to access key documents in the corporate structure, such as existing and in-process disclosure material in the course of their work?

Unfortunately, many of these questions raise issues as to which the rules are changing. Sarbanes-Oxley, the pending changes to the Sentencing Guidelines for Organizational Defendants, court decisions and agency regulations all impact how the directors should proceed. That fact alone, however, suggests both caution and due deliberation when considering the options.

That fact also suggests the value of ongoing director education. While much of the impetus for such training has emanated from assessment bureaus and shareholder advocates, it's time that the directors themselves look at education and training as an integral and necessary component of their own risk-management protocols.

We can debate whether the changes that we have witnessed in the past few years represent a true change in the substance of directors' duties and responsibilities or merely a change in expectations as to how they will meet those duties and responsibilities and reach different conclusions as to the answer to that question. Clearly, however, the focus on directors has become much more intense due to the corporate scandals of late and the legislative and regulatory responses to those scandals.

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[7] Sarbanes-Oxley specifically provides authority for the audit committee of the board to choose such experts. See §301's addition of §10A(m)(5) of Securities Exchange Act of 1934. If any of the issues so raised suggest improper conduct by management of the company, of course, the directors may have to seek separate counsel, for example, on account of conflicts of interest on the part of the company's then-extant counsel relationships.

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