Stop, Look, Listen... and Exercise Independent Judgment: Common Situations in Which Director Fiduciary Duties Arise

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The perils of acting as a public company director or officer have gone up. Specifically, Sarbanes-Oxley increases directors' and officers' risk in connection with a host of possible claims or violations, either by increasing the odds they will be implicated in such claims or by increasing the resulting penalties.[1]

It is widely recognized that, in recent years, particularly since the enactment of Sarbanes-Oxley, director conduct has come under increasingly greater scrutiny. Current data indicates that the most frequent claims against directors and officers involve breaches of fiduciary duty.[2] Yet it is unclear whether directors are improving their knowledge and understanding of their fiduciary obligations and of how to perform these obligations under frequently encountered circumstances so as to minimize exposure to personal liability. This article provides an overview of director fiduciary duties and applies them to common scenarios that directors may face against the backdrop of recent fiduciary duty rulings in the courts.

Director Fiduciary Duties

Directors are responsible for supervising or directing the management of the company's business and affairs.[3] Accordingly, they are responsible for overseeing the affairs of the company and exercising judgment concerning important business decisions. These responsibilities stem from the core fiduciary duties of loyalty and care, which common law imposes and state statute may alter.[4]

The duty of loyalty requires a director to protect the interests of the company and its shareholders, to refrain from engaging in self-interested or conflicted transactions, and to act in a manner that is in the best interest of the company and its shareholders.[5] The director must also act in good faith. The duty of loyalty includes the duty to deal fairly and honestly with the shareholders for whom the director is a fiduciary.[6]

The duty of care requires that directors "use that amount of care which ordinarily careful and prudent men would use in similar circumstances" and "consider all material information reasonably available" in making business decisions.[7] The duty of care includes the directors' duty to take affirmative steps to inform themselves before making a business decision, to disclose material information to shareholders, and to inform themselves reasonably of alternatives.[8]

If there is evidence that a director breached the duty of loyalty, then the business judgment rule (discussed below) will not protect his or her decisions.[9] Furthermore, if a director stands on both sides of a transaction (or is otherwise self-interested), then courts apply the entire fairness standard of review to determine whether the director breached the duty of loyalty.[10] Under the entire fairness test, courts review the transaction to determine whether the terms of the transaction (i.e., price) were fair and whether the negotiation process was arm's length. The entire fairness test applies whenever there is a merger between a parent and subsidiary.

The Business Judgment Rule

While the definitions of duty of loyalty and duty of care appear broad and the applications of these duties may vary under different circumstances, the law typically gives deference to the business judgment of directors, unless self-interest influenced that judgment. Courts' deference is called the business judgment rule.[11] Under this rule, courts must refrain from second-guessing directors' business decisions. Courts, therefore, must presume that the directors acted on an informed basis, in good faith, and in the best interests of the company and shareholders, unless evidence showing the directors failed to act (1) in good faith, (2) in the honest belief that the action was in the best interest of the corporation, or (3) on an informed basis rebuts this presumption.[12]

Common High-Risk Scenarios

To better understand the previously mentioned concepts, the following hypotheticals and parallel judicial rulings illustrate how fiduciary duty rules apply in certain situations that corporate directors commonly encounter.

Acquisition of Company in Which Director Has an Interest

Assume you are director of Company A and you are also a director of Company B, which owns 70 percent of Company A's shares. Company B seeks to acquire Company A. Should you be involved in Company B's decision to acquire Company A?

In this hypothetical, as a director of both Company A and Company B, you are on both sides of the transaction and may receive a benefit from the acquisition that, in general, Company A shareholders do not receive.[13] If you receive a substantial benefit from voting in favor of the acquisition, then you cannot be objectively viewed as independent or disinterested, and you are susceptible to a breach of the duty of loyalty claim. In this circumstance, it is imperative that even if the majority of disinterested directors of Company B voted in favor of the acquisition, that you did not (in any way) influence the directors' decision to do so. It would, therefore, be prudent to recuse yourself from deliberations concerning the acquisition and to permit a majority of disinterested directors to vote on it.

Taking Out Minority Shareholders or "Going-Private" Transaction

Assume you are a director of Company C. Company D makes a bid to buy out the minority shareholders of Company C to increase its ownership and take Company C private. Company D offers $13 per Company C share. What should Company C do in analyzing the offer? What kind of due diligence should Company C undertake to ensure that the deal is fair to its minority shareholders?

As a director, you should ensure that all board members exercise their duty of care by conducting due diligence and by engaging in meaningful deliberations of Company D's bid. It would be prudent to create a special committee of the board composed of disinterested board members. The special committee should also hire independent legal and financial advisers to gather due diligence and to obtain a fairness opinion. These advisers should be independent and have no conflicts or prior relationships with Company D. The special committee should engage in an arm's length negotiation process and obtain a price that is fair and beneficial to the shareholders. All interested directors should refrain from participating in any deliberations or correspondence regarding this bid offer.

In Gesoff v. IIC, Inc.,[14] for example, CP Holdings (CP) owned 80 percent of IIC Industries, Inc. (IIC) and sought to take IIC private by buying out the remaining 20 percent of shares in IIC. CP expected minority shareholders to demand $16.20 per share, adopted a bid approach, and initially offered $13 per share.

Thereafter, IIC's board of directors appointed a special committee. The special committee, however, consisted of only one active (and independent) director who approved the transaction by hiring the same financial and legal advisers of CP, settling at $10.50 per share with no meaningful negotiations with CP and failing to conduct adequate diligence to consummate the transaction quickly at the will of CP.

A former minority shareholder brought a class action against CP and IIC, seeking a statutory appraisal of the price of minority shares.[15] In analyzing the claims, the Delaware Chancery court applied the entire fairness standard of review and found that neither the agreed on price of $10.50 per share nor the negotiations with CP were fair.

The dealing was unfair because the special committee consisted of only one director who was easily influenced by CP, retained the same legal and financial advisers, failed to engage in "vigorous and spirited" negotiations, failed to seek alternative third-party buyers for the company, and to a certain extent, colluded with CP to consummate the transaction on CP's timeline.[16] The price was unfair because it was less than the illiquid market price of IIC shares and IIC failed to show otherwise; there was no independent evaluation of the price because IIC relied on the valuations of CP's financial advisers.

Raising Capital by Issuing Preferred Stock

Company X would like to issue $20 million in preferred stock to Company Y to finance Company X's business expansion strategy. What steps should Company X undertake to be sure that it honors its fiduciary duties to Company X shareholders?

A good example of best practices is Benihana of Tokyo, Inc. v. Benihana,[17] where the Delaware Chancery court found that the board of directors exercised due care and loyalty by issuing $20 million of preferred stock to a holding company. In Benihana, plaintiff Benihana of Tokyo, Inc. (BOT) sought rescission of an agreement between defendants Benihana Inc. (Company) and BFC Financial Corporation (BFC) to issue $20 million of the Company's preferred stock to BFC. The Company entered the agreement to finance the renovation of its restaurant facilities. BOT alleged that the transaction was invalid because, among other things, the Company's directors breached their fiduciary duties of loyalty and care in approving the transaction.

Although BOT claimed that the entire fairness test should apply because the director of the Company was also the director of BFC, the business judgment rule applied because the interested director recused himself from deliberations and the vote on the transaction and a majority of disinterested directors voted in favor of the transaction. By applying the business judgment rule, the court found that the transaction was entered into for a proper purpose and that a majority of independent directors approved the transaction. Therefore, no grounds existed for a claim of breach of the duty of loyalty against the director defendants.

Regarding the claim for a breach of the duty of care, the court stated that director liability for breaching the duty of care "is predicated upon concepts of gross negligence," and in this context, gross negligence is defined as "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason."[18] Applying a standard of gross negligence, the court found that the defendant directors' conduct did not rise to the level of malfeasance. The court explained that the directors properly exercised their duty of care by, among other things, understanding the purpose of the transaction, reviewing the terms of the agreement, discussing alternative methods of financing, deliberating on objections raised, obtaining a fairness opinion, conducting numerous meetings, reviewing substantive materials, and retaining independent and legal financial advisers.

Hiring and Terminating an Executive Officer

Suppose you are the CFO of Company C and a member of its board of directors. Company C's CEO passes away from a heart attack. You recommend the hiring of a good friend for the position of CEO as well as the compensation package that Company C should offer. You believe that your friend will serve as an excellent CEO and is fully qualified for the position. How should you present your recommendation to the board, and what steps should you take?

In In re Walt Disney Co. Derivative Litigation,[19] Walt Disney CEO Michael Eisner recommended Michael Ovitz for appointment as Disney's president after the death of its previous president. Eisner and Ovitz had been friends and professional colleagues for almost 25 years. Eisner and the chairman of the Compensation Committee of Disney approached Ovitz about the position, but their initial negotiations failed because Ovitz received an offer from a competing company that Disney could not match.

From this point on, the chairman of the Compensation Committee led negotiations with Ovitz and eventually offered him a five-year contract with two tranches of options.[20] Before the terms of Ovitz's compensation package were presented to the board, the chairman recruited an executive compensation consultant to analyze the financial terms of Ovitz's employment agreement. After several negotiations and deliberations with the board, the company hired Ovitz as its president and awarded him a compensation package that included (1) an option strike price of 100 percent of the company's stock price on the day of the grant for 2 million options that would become exercisable in the sixth and seventh year of Ovitz's employment, (2) a $10 million severance if the company did not renew Ovitz's contract, and (3) a $1.25 million annual salary.

Fewer than 14 months later, Ovitz was performing poorly and the Disney board determined that it should terminate his employment.[21]

The directors found that they could not terminate Ovitz for cause because he had neither breached any material term of his employment agreement nor committed any wrongdoing. Therefore, they had no choice other than to honor Ovitz's employment contract by paying him a severance worth roughly $130 million, despite his relatively brief service as president. Soon thereafter, class representative shareholders sued the company's directors for breach of the duty of care and waste of corporate assets for having approved Ovitz's employment agreement in the first place.

Upon applying the business judgment rule, the Delaware Supreme Court found that the directors neither breached their fiduciary duties nor wasted corporate assets because the directors acted in good faith, were not conflicted, and made decisions based on the best interests of the company at that time. The court explained, "Our law presumes that 'in making a business decision the directors of a corporation 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."[22] The class representative plaintiffs never rebutted this presumption.

The court also explained that there was ample evidence showing the directors were adequately informed regarding the terms of Ovitz's employment agreement. On the basis of the minutes of the compensation committee, the court found that the committee knew that if Ovitz was terminated, the severance payout would be approximately $130 million. The court emphasized that the compensation committee obtained independent financial opinions approving Ovitz's employment agreement and that the figures in Ovitz's employment agreement was based on substantial documented negotiations and deliberations. Agreeing with the trial court, the Delaware Supreme Court therefore found that the "directors were informed of all information reasonably available and thus were not grossly negligent."[23]

Although the Delaware Supreme Court found in favor of the defendant directors, Walt Disney teaches valuable lessons and shows that the following steps should be taken before directors begin negotiating with a prospective executive:

- Communicate the qualifications of the prospective executive to the board at formal board meetings.
- Obtain official authority to act and negotiate with the prospective executive from the board.
- Discuss the terms of the offer and employment package at formal board meetings.
- Hire independent financial and legal experts and counsel to determine whether the compensation package is in line with market and industry standards.
- Provide all directors the opportunity to review the proposed compensation package.
- Document the negotiation process and the reason for accepting different terms in meeting minutes.

Fiduciary Duties for Directors of Insolvent Companies and Their Subsidiaries

Assume you are a director of a wholly owned subsidiary that is bankrupt. Despite this, you authorize the subsidiary to enter into sale-and-leaseback agreements concerning real estate holdings and the subsidiary subsequently divested itself of the real estate holdings, by selling real estate to entities controlled by you on unfavorable terms. The trustee of the wholly owned subsidiary sues you for breach of fiduciary duty on behalf of the creditors of the parent corporation, the wholly owned subsidiary, and the creditors of the wholly owned subsidiary. Can the trustee pursue these claims on behalf of all these entities?

Certainly. Under Delaware law, directors and officers of an insolvent wholly owned subsidiary owe fiduciary duties to the subsidiary and parent corporation as well as to their creditors.[24] Directors of an insolvent corporation owe fiduciary duties to the corporation's creditors. These duties are "typically derivative of those the directors owed to the subsidiary corporation itself."[25] Therefore, "if the subsidiary's creditors are said to be owed a fiduciary duty upon insolvency, the subsidiary itself must also be owed such a duty."[26] In Delaware and several other jurisdictions, even when a company is in the "vicinity of insolvency,"[27] directors owe fiduciary duties to the corporate enterprise, which is a "community of interests" that includes stockholders, creditors, employees, and any other group interested in the corporation.[28] When a company nears bankruptcy, therefore, directors have an obligation to exercise judgment in an informed, good faith effort to maximize the company's long-term wealth-creating capability.

In the foregoing hypothetical, the directors of the wholly owned subsidiary should have solicited and considered third party offers for purchase of the real estate. The directors also should have sought independent review by financial and legal experts, ensured that a majority vote of disinterested directors approved the transactions, and verified the business purpose of each decision made concerning the transactions.

If a company is insolvent (or in some jurisdictions, in the vicinity of insolvency), directors and officers must evaluate what actions will maximize the value of the company to the benefit of the company, shareholders, and creditors. The following are guidelines for directors and officers of insolvent companies that help ensure compliance with fiduciary duties:

Gather and review all material information relating to every business decision.
Evaluate the impact of business decisions on the company's creditors and shareholders.
Consider creating subcommittees to review certain issues and seek independent legal and financial advice.
Keep detailed minutes of board meetings describing issues raised by the board prior to making a decision.
Maintain detailed written reports identifying the materials that directors and officers reviewed.
Limit or avoid transactions with insiders or other conflicted individuals.[29]

Conclusion

Directors perform a crucial role in overseeing the management of a company's business affairs. Their decisions are appropriately deferred to under the business judgment rule. Yet directors should be aware of instances in which the benefit of the business judgment rule is unavailable, and they should understand how best to discharge their duties of loyalty and care in those circumstances. After all, what could be more unpleasant and financially risky for a seasoned director than seeing the legacy of his or her otherwise devoted and exemplary service crushed by a freight train of litigation that was in plain view and avoidable in advance of a major board decision? This discussion has illustrated why and how directors should, at all times, take reasonable measures to inform themselves, to avoid self-interested transactions, and to act in the best interests of the company and its shareholders and in good faith. In other words, when the board on which you or your client serves confronts its next major decision, remember or advise your client to stop, look, listen . . . and exercise independent judgment.

Endnotes

1. Dan A. Bailey, J. David Washburn & Quentin Collin Faust, Now It's Personal: The Real Impact of Sarbanes-Oxley on Directors and Officers, WALL ST. LAWYER, Sept. 2002.
2. Towers Perrin, Directors and Officers Liability: 2006 Survey of Insurance Purchasing and Claims Trends 56

(2006).

3. This responsibility is found in the Model Business Corporation Act, which most state corporate statutes follow: “All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement.”

4. Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 971 n.16 (Del. Ch. 2003); see also Lymon P.Q. Johnson, The Sarbanes-Oxley Act and Fiduciary Duties, 30 Wm. Mitchell L. Rev. 1149, 1192 (2004); Gary W. Marsh, The Many Faces of Directors’ Fiduciary Duties, 22 AM. BANKR. INST. J. 14 (Sept. 2003).

5. Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A. 2d 362, 370 (Del. 2006).

6. In re Tyson Foods, Inc., 919 A.2d 563, 592 (Del. Ch. 2007).

7. In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005).

8. Id.; Benihana of Tokyo, Inc. v. Benihana, 891 A.2d 150, 154–55 (Del. Ch. 2005); Orman v. Cullman, 794 A.2d 5, 41 (Del. Ch. 2002).

9. Crescent/Mach I Partners, L.P. v. Turner, 846 A.2d 963, 984 (Del. Ch. 2000).

10. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

11. See Paula J. Dalley, The Business Judgment Rule: What You Thought You Knew, 60 Consumer Fin. L.Q. Rep. 24; Lynn A. Stout, In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule, 96 NW. U. L. REV. 675.

12. Crescent/Mach I Partners, 846 A.2d at 963, 984.

13. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993).

14. Gesoff v. IIC, Inc., 902 A.2d 1130 (Del. Ch. 2006).

15. Id. at 1135.

16. Id. 17. Benihana of Tokyo, 891 A.2d at 150.

18. Id. at 192.

19. In re Walt Disney, 906 A.2d at 27.

20. Id. at 37.

21. Id. at 42 (Ovitz allegedly failed in his role as president because he departed from Eisner’s directives, Eisner’s micromanaging undermined Ovitz’s authority to make changes Ovitz thought appropriate, and Ovitz simply failed to transition from a private to a public company and did not otherwise fit or adapt to Disney’s culture).

22. Id. at 52.

23. Id. at 61.

24. See In re Scott Acquisition Corp., 344 B.R. 283 (D. Del. 2006) (“There is no basis for the principle . . . that the directors of an insolvent subsidiary can, with impunity, permit it to be plundered for the benefit of its parent corporation”) (denying motion to dismiss complaint); see also Geyer v. Ingersoll Publ’n Co., 621 A.2d 784, 787–90 (Del. Ch. 1992) (directors of insolvent corporation have fiduciary duty to act for benefit of corporate

creditors).

25. In re Scott Acquisition, 344 B.R. at 288.

26. Id. at 288–89.

27. “The majority of jurisdictions that have addressed the parameters of the zone of insolvency have concluded that a company is operating within the zone ‘once it is reasonably foreseeable that the corporation will have ongoing trouble paying its creditors as a class.’” Patrick M. Jones & Katherine Heid Harris, Chicken Little Was Wong (Again): Perceived Trends in the Delaware Corporate Law of Fiduciary Duties and Standing in the Zone of Insolvency, 16 J. BANKR. L. & PRAC. Art. 2.

28. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

29. See Richard M. Ciere and Michael J. Riela, Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions, 2 DEPAUL BUS. & COMM. L.J. 295 (2004).

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