

Overview of Fiduciary Duties of Directors



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Anthony Cross
Partner
Munich



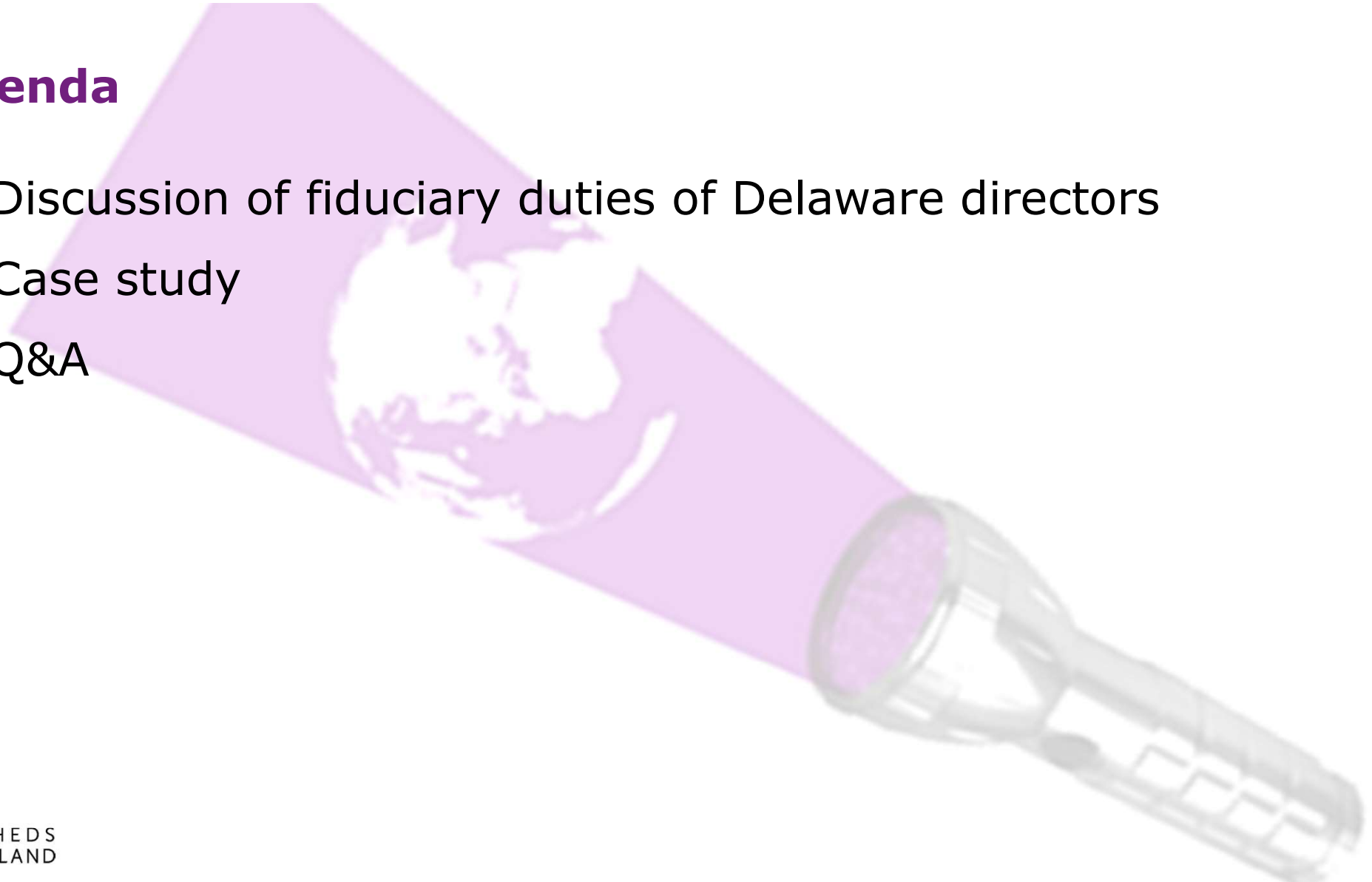
Baird Fogel
Partner
San Francisco



Craig Alcorn
Partner
Chicago

Agenda

- Discussion of fiduciary duties of Delaware directors
- Case study
- Q&A



Duties of Directors-In General

- Duties of directors of a corporation are governed by the corporate law of the corporation's jurisdiction of incorporation
 - We will cover duties of directors of a Delaware corporation in general (but excluding in certain special circumstances such as a change of control or where company is in/near insolvency)
- Under Delaware law, the business and affairs of a corporation are managed by or under the direction of its board of directors
 - In this capacity, members of the board serve as fiduciaries of the corporation and its stockholders

Duties of Directors-In General

- In their capacity as fiduciaries, directors owe fiduciary duties to the corporation and its stockholders
 - In Delaware, these duties are in general a product of case law, but in some states are codified in statutes
 - Breaches of these duties may subject directors to personal liability
- The core fiduciary duties are:
 - Duty of care
 - Duty of loyalty
- Other duties, such as the duty of good faith, duty of disclosure and duty of oversight stem from the core fiduciary duties

Duty of Care

- Requires a director to perform duties with the care that an ordinarily prudent person in a like situation would use under similar circumstances
- Duty is to act on an informed basis and in a deliberative manner
 - Directors have duty to inform themselves of all material information reasonably available to them and to then act with requisite care in discharge of their duties
 - No per se duty to maximize profits-directors can take actions that do not directly increase profits if there is connection to a rational business purpose
- Generally, liability for breach of duty of care will exist if director is found to have been grossly negligent (for example, if directors are recklessly indifferent to, or deliberately disregard, the interests of stockholders or take actions outside the bounds of reason)

Duty of Care: Reliance on Experts

- In discharging their duties, unless the director has knowledge that makes reliance unwarranted, directors are entitled to rely on information, opinions, reports and statements prepared or presented by:
 - officers or employees the director believes in good faith to be competent in matters presented
 - legal counsel, CPAs or other similar persons
 - a board committee of which the director is not a member

Director Protections: Business Judgment Rule

- Directors are generally protected by the **business judgment rule** when making business decisions
 - The rule presumes that disinterested directors acted:



Director Protections: Exculpation, Indemnification and Advancement; Insurance

- Corporations are allowed in their charter to eliminate or limit directors' personal liability for monetary damages for breach of the duty of care—even if grossly negligent
 - Does not apply to breach of duty of loyalty
 - Does not apply to act/omission committed in bad faith or that involves intentional misconduct, a knowing violation of law or improper personal benefit
 - Does not eliminate the underlying breach, so transactions can still be enjoined
- Mandatory indemnification: successful defense
- Permissive indemnification: acts in good faith in manner reasonably believed in best interests of company
- Advancement permitted subject to agreement to repay if not entitled to indemnification; D&O insurance permitted

Satisfying the Duty of Care

Directors should make a **good faith effort** to be thorough and deliberate

Directors should take efforts to **inform** themselves of material information reasonably available

Directors should **exercise reasonable judgment**

The Oversight (“Caremark”) Duty

- A component of the duty of care is to have a functioning oversight and compliance system
- The Caremark line of cases deal with claims that the board was so inattentive that it amounted to bad faith
- Director liability under Caremark may arise when the board either (a) utterly failed to implement any reporting or information system or controls, or (b) consciously failed to monitor or oversee the system or controls
- Delaware courts have noted a Caremark claim is “extremely difficult” to plead, but have increasingly permitted Caremark claims to survive a motion to dismiss

Duty of Loyalty

- Directors are required to act at all times in a manner they honestly and in good faith believe to be in the best interests of the company and its stockholders
 - Bad faith implies more than bad judgment or gross negligence and relates to the state of mind of the director; includes an intentional failure to act in the face of a known duty to act, demonstrating a conscious disregard for duties
- Directors must refrain from self-interested conduct such as fraud, self-dealing and actions that serve to “entrench” them in office
- Directors should act without personal financial self-interest and without personal or private motive, even if non-financial in nature
- Directors’ decision-making is based on the merits of the matter before the board, rather than on outside influences (i.e., avoid conflict of interest and remain disinterested and independent)

Duty of Loyalty: Conflicts of Interest

- Directors may be interested in a transaction if they have a personal or business interest in the transaction. Interested directors to a transaction may lose the presumption of the business judgment rule
 - Disinterest and independence is determined on a director-by-director basis; board is generally entitled to business judgment rule if a majority of board approving transaction are disinterested and independent
 - A fully informed, disinterested majority of stockholders may ratify director-conflicted transactions, which restores presumptions of the business judgment rule
- Corporate opportunity doctrine
 - Waivers permitted if specific and narrow in scope

Duty of Loyalty: Director Interlocks

- When directors sit on the board of more than one company, they owe equal fiduciary duties to each company
 - In these cases, directors must be particularly mindful of whether a conflict of interest exists
- Be aware of increasing scrutiny by antitrust authorities regarding being on board of competitors (see Section 8 of the Clayton Act)

Steps to Take if a Director Is Interested

When a director is interested, they should:

Disclose

As soon as the conflict is discovered, the director should disclose the conflict of interest to the board (with all material facts)



Recuse

After disclosure, the director should recuse him or herself from all (or the portion of) meetings where the matter is discussed, and should not cast votes on any matter related to the conflict

Case Study: *Boeing Company Derivative Litigation*

- Following two fatal crashes of Boeing airplanes, stockholder-plaintiffs brought “Caremark” claims alleging the directors of The Boeing Company failed to fulfill their oversight duties
- The Court found that:
 - The Board did not have regular process or protocols requiring management to apprise the Board of airplane safety. The Board only received *ad hoc* management reports, that only conveyed favorable strategic information
 - Management saw red flags, but that information never reached the Board—showing the Board failed to establish a reporting system
 - Directors knew, or should have known, the Board should have had structures in place to receive safety information, but failed to do so

Takeaways from *In re: The Boeing Company*

- Identify the mission critical risks to the business and include regular discussion and evaluation in Board and Committee meetings
- Keep a record of Board and Committee evaluation of these risks (minutes, committee reports, etc.)
- Maintain an internal monitoring system to ensure Board and Committee awareness
- When a crisis occurs, be proactive in managing the incident and avoiding a near-term repeat

Summary

- Courts look for evidence that directors made careful, honest, educated decisions
- Basic rules for directors:
 - Be informed
 - Take adequate time to act in a deliberate manner
 - Understand alternatives and trade-offs to various courses of action
 - Act on the basis that the director honestly believes is in the best interests of the company and its stockholders
 - Examine the premises for any proposed action
 - Ask questions and get answers
 - Be mindful of conflicts of interest and raise them early on

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Anthony Cross
Partner
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