

SPECIAL REPORT 2004

# Directors & Boards®

## Avoiding Personal Liability as a Director

- What Is the Landscape?
- What Protections Are Available?
- What Are the Limitations?
- What Preventive Practices  
Can Be Followed?

BY JOHN L. REED AND MATT NEIDERMAN

**DUANE MORRIS LLP**

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The DIRECTORS & BOARDS Special Reports are a series of advisories on critical issues of corporate governance and director accountability and liability. They are produced in collaboration with leading experts in corporate law, finance, executive and director recruitment, strategy, communications, and other key components of business leadership.

# Avoiding Personal Liability as a Director

**E**NRON, HEALTHSOUTH, WORLDCOM — these and a number of other recent, high-profile corporate scandals make the news on an almost daily basis, adding to a modern environment of corporate cynicism and distrust. Along with the seeming rash of corporate scandals has come a rising tide of lawsuits seeking to hold officers and directors personally accountable for corporate losses. The claims made in such lawsuits, if ultimately successful, could easily bankrupt most individuals if left without indemnification from the company or adequate D&O insurance coverage. The expense of litigating such lawsuits, even if found to be unmeritorious, can itself be extremely expensive and, if not covered by insurance or paid by the company, something that cannot be borne by most individuals. In addition to the rising tide of litigation, recent legislative reforms, such as the Sarbanes-Oxley Act, and regulatory enforcement actions emphasize increased directorial oversight, involvement and accountability.

Now more than ever, it is important for directors of corporations to understand the legal safeguards available to them and, perhaps more im-

portant, the limits of those safeguards. This Special Report provides an overview of several of the substantive and procedural protections afforded to directors of Delaware corporations (and to directors of corporations in states that follow Delaware law)<sup>†</sup> and the key limitations on those protections.



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## The Business Judgment Rule

The business judgment rule is the bedrock of corporate governance and the primary substantive protection available to directors under Delaware law. The rule — which is the standard by which Delaware courts review many, but not all, decisions of directors — reflects the legal premise that decisions made by directors who are fully informed and free from conflicts of interest should not be second-guessed by a court.

To benefit from the rule, directors must have satisfied their fiduciary duties in the decision-making process. So long as a director is disinterested and independent (duty of loyalty), reviews and considers all pertinent information reasonably available (duty of care), and does not act with an ill or improper motive (duty of good faith), a court will neither disrupt nor hold directors liable for the results of those decisions, even if the decisions can fairly be viewed by others as “poor business decisions.” The business judgment rule recognizes that directors, and not stockholders, manage the business and affairs of a corporation, and it reflects an underlying policy of freedom in directorial decision-making. Although relatively straightforward, the key to understanding and taking advantage of the business judgment rule is understanding its limitations.

**Independence and Disinterestedness.** As noted, the business judgment rule is applied by courts in reviewing the actions of directors who are both *disinterested and independent*. Also known as the duty of loyalty, this qualification to the applicability of the business judgment rule requires that directors act in the best interests of the company and not in their own interest or in the interest of another person or entity to whom the directors may be beholden.

As a general rule, Delaware courts consider a director to be “interested” if the director stands to receive a personal financial or other benefit from a transaction not shared

vidual director and officer liability; and (iii) Delaware’s judicial system is consistently ranked No. 1 among all 50 states in an assessment conducted by the United States Chamber of Commerce, which notes the fairness, reasonableness, competency, and impartiality of the Delaware judiciary as well as its timeliness in resolving disputes.

<sup>†</sup> Why the focus on Delaware? The answers are well known within corporate America and include: (i) Delaware is the state of incorporation for the majority of the Fortune 500 and most companies whose securities trade on the NYSE, Nasdaq, and other large exchanges; (ii) the Delaware Court of Chancery, which has statutory jurisdiction over directors and

certain officers of Delaware corporations, has become the forum of choice for resolving corporate governance disputes and today the Court of Chancery issues nationally significant corporate law decisions concerning challenges to the decisions of boards of directors, claims for breaches of fiduciary duty, mergers and acquisitions litigation, and issues of indi-

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equally by the company's stockholders. Non-financial benefits can also create conflicts, the most common of which is entrenchment — i.e., a director's desire for perpetuation of office. Simply stated, directors are generally considered "interested" when they have a unique or competing personal interest with respect to a given corporate decision or transaction.

Equally important is director independence. Most typically, directors are considered not to be "independent" where they are beholden to a person or entity who has a personal interest in the action under consideration. A director may be deemed "beholden to" another where, as a result of personal, professional, or financial relationships or dependence, the director cannot reasonably be thought capable of acting in the best interests of the corporation. In most cases, casual social ties or friendship, in the absence of other factors, will not create a lack of independence; however, close familial or financial ties or extensive professional and social ties may.

Where present or even potentially present, self-interest or a lack of independence may require that a director abstain from the decision-making process or take other steps aimed at ensuring that the director's potential conflict does not taint an otherwise valid exercise of directorial discretion. Other steps may include the involvement of a disinterested and independent committee of directors or stockholder ratification.

**Good Faith.** Although exceptions to the applicability of the business judgment rule traditionally have focused on loyalty issues (i.e., the existence of an improper pecuniary interest), the requirement that a director act in good faith may represent the largest source of potential director lia-



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bility in the near future. The law regarding what type of action or inaction will be considered not in good faith is still evolving. However, good faith at present appears to be a catch-all category, denying the protections of the business judgment rule to directors who, although not financially interested in a decision or transaction, act or fail to act out of a motive other than the best interests of the company. Conduct may also be deemed to be in bad faith where it is so far outside of the realm of reason that it cannot be explained on any other grounds. Finally, sustained or systematic inattention to significant corporate issues or “red flags” potentially resulting in harm to the corporation may also be deemed not to be in good faith.

Steps that directors can take to avoid liability for claims based on allegations of bad faith may include establishing internal reporting and control mechanisms to help maintain knowledge of events or issues that may have a significant effect on the company.

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**Adequate Information.** Inherent in the business judgment rule is the assumption that directors' decisions are based on adequate information. In other words, to be deemed adequately informed regarding a given business decision, the directors must have informed themselves of all information reasonably available to them that is material to the decision before them.

Directors need not follow any particular formula or pattern for informing themselves with respect to a given decision, and the judicial standard by which challenges to the informed nature of directors' decisions are reviewed is gross negligence — that is, reckless indifference to, or intentional disregard of, material information. Typically, so long as directors make a good-faith effort to undertake an investigation or gather pertinent information, courts will not second-guess the directors' procedures. The question of what information is material to a given decision can only be answered based on the specific facts and circumstances of the decision, and it may therefore be prudent for directors to consult with management, attorneys, or other advisors in seeking information before making a decision.

### Consequences of Failure to Satisfy the Business Judgment Rule

There are special situations, not the subject of this Special Report, where heightened scrutiny will apply to directors' decisions, such as situations involving the sale of the company or the adoption of defensive measures in re-

sponse to a hostile takeover.‡ Aside from those out-of-the-ordinary situations, the heightened “entire fairness” standard may be applied to review decisions made or transactions entered into by directors who cannot invoke the benefit of the business judgment rule because they failed to satisfy their fiduciary duties as discussed above. In such cases, the particular decision or transaction at issue is not void, but voidable.

Significantly, however, under such circumstances the burden then shifts to the directors to prove that, notwithstanding the failure to satisfy the prerequisites to the applicability of the business judgment rule, the decision or transaction at issue is otherwise fair to the company and its stockholders. Cases arising out of such situations have come to be known as “entire fairness” cases. Satisfying this burden is extremely difficult for a director, and, accordingly, there have been only a few cases where entire fairness has been demonstrated to the satisfaction of a court. To state the obvious, the preferable path is for a director to understand and to be vigilant in the satisfaction of his or her fiduciary duties.

### Reliance on Reports and Opinions

Another significant, substantive protection available to directors of a Delaware corporation is a Delaware statute that protects directors who, in the performance of their duties, rely in good faith on the records of the corporation or on information, opinions, reports, or other statements provided to directors by officers, employees, or committees of

‡ When a conscious decision has been made to sell the company, or when market or other conditions make the sale of the company inevitable, the board operates in a so-called “Revlon” mode (derived from the 1986 case of *Revlon, Inc. v. McAndrews & Forbes Holdings, Inc.*). “Revlon” duties obligate the

directors to obtain the best price reasonably available for the stockholders. When the company is subject to a hostile takeover and decides to take defensive action such as the adoption of a “poison pill,” directors must satisfy what has come to be known as the “Unocal” standard (derived from the

1985 case of *Unocal Corp. v. Mesa Petroleum Co.*). This standard puts the burden on the board to demonstrate that the defensive action taken was reasonable in relation to the threat to the company and its business objectives. These clearly become fact-intensive inquiries.

the corporation or by certain outside advisors, such as attorneys and auditors.

This statutory protection, found at Section 144 of the Delaware General Corporation Law, recognizes that directors typically do not run or direct the day-to-day operations and administrative functions of a business, nor are directors typically experts in all aspects of business and, therefore, that directors can and should, within bounds of reason, rely upon information provided to them by those who do run the day-to-day business or who are experts.

The availability of this protection underscores the utility and prudence of establishing effective and thorough accountability and reporting systems within the corporation. Indeed, where particular business decisions fall outside a director's area of expertise, reliance on the reports or opinions of others may be *required* for a director to satisfy the duty to be adequately informed. This ability to rely upon advisors can be of particular importance to directors who serve on the company's compensation committee because such directors now operate in a climate where executive compensation is a constant subject of criticism. Regardless of whether a compensation committee believes this "corporate greed" factor may manifest itself through shareholder action, directors should almost always retain an expert or consultant to pass on the reasonableness of the compensation for their company's senior executives.

Here again, however, the key to this protection is understanding its limitations. The foremost limitation on the principle of reliance is the requirement that reliance be in good faith. The good faith qualification requires that directors not ignore "red flags" raised in reports or opinions presented to them, and that directors ask questions and demand additional information where necessary.

In addition, reports or opinions received by directors must be more than window dressing — they must be pertinent to the decision at hand, and directors must be given

adequate materials and time to consider those materials. Stated differently, directors must exercise at least enough oversight to become reasonably familiar with the reports or opinions presented to them and upon which they rely. Also, if directors are to rely on officers and other advisors, directors must be deliberate and careful in determining whom to appoint and upon whom to rely.

### **Elimination or Limitation of Liability for Certain Breaches of Fiduciary Duty**

Under Section 102(b)(7) of the Delaware General Corporation Law, a corporation may, in its certificate of incorporation, provide for the elimination or limitation of directors' personal liability to the corporation or to its stockholders for breaches of directors' fiduciary duties. Such a provision, when included in a company's charter, shields directors from personal liability for decisions not otherwise protected by the business judgment rule — i.e., gross negligence.

Specifically excepted from the scope of this protection, however, are breaches of fiduciary duty involving improper personal benefits for directors (loyalty issues), bad faith conduct or intentional misconduct, and certain unlawful issuances of dividends, stock purchases, and stock redemptions. As a result, the claims for which directors are most often able to escape liability are those involving alleged waste of corporate assets (conveying corporate property for inadequate consideration), those involving failure to act on adequate information, those involving alleged inadequate disclosure of information to stockholders, and other claims relating to decisions about mergers and other corporate combinations.

The exception for breaches of the duty of loyalty is generally easier to identify and avoid. The exception for breaches of the duty of good faith, however, is not yet fully defined and is still evolving under the law. Currently, the

bad faith exception is used to deny directors protection from personal liability for conduct that is so egregious as to fall outside the bounds of reason or for sustained or systematic failures by directors to properly oversee the affairs of the company. Conduct deemed bad faith for purposes of this exception has included a board's failure to exercise adequate oversight in the employment and termination of high-level officers and a board's inattention to internal improprieties or other problems resulting in significant liability for the company.

Courts have, however, refused to apply the bad faith exception where directors of a company were not informed about and did not take steps to prevent a high-profile officer's alleged personal misconduct not related to the officer's duties but nevertheless affecting the company.

Finally, in certain circumstances, when the company is in the "zone of insolvency," directors may also owe fiduciary duties to the company's creditors. If a breach of fiduciary duty to creditors occurs, it is unlikely that a limitation of liability clause will apply.

## Indemnification

By statute, Delaware corporations are empowered to provide indemnification to directors for expenses related to lawsuits and other proceedings to which directors are parties, and which arise from a director's capacity as such. Under Section 145 of the Delaware General Corporation Law, directors may obtain indemnification for lawsuits or proceedings brought by or against third parties as well as lawsuits or proceedings brought by or on behalf of the company. Where a director is not successful on the merits of a proceeding, indemnification becomes permissive; however, where a director is successful on the merits of a proceeding, indemnification typically is mandatory.

When a company's charter or bylaws so provide, a di-

rector may be entitled not only to indemnification, but also to advancement of expenses upon providing the company with an undertaking to repay if it is later determined that indemnification is not legally available. The right to advancement of legal expenses is significant because the defense of actions alleging breach of fiduciary duty can cost hundreds of thousands or even millions of dollars, and it often makes a critical difference if a director must pay first only to be reimbursed at the end of the case (most often, years after the case was initiated). Indemnification generally is available to directors even after they cease to be directors, so long as the lawsuit or proceeding for which indemnification is sought relates back to the directors' service on the board.

As with protection from personal liability discussed above, indemnification is limited to cases in which directors acted in good faith and in a manner they believed to be in the best interests of the corporation. Thus, where directors are found to have acted in bad faith or to have been motivated by an improper personal interest, indemnification will not be available. With respect to lawsuits brought by or on behalf of the corporation, directors typically are not entitled to indemnification where they are determined to be liable to the corporation, unless a court specifically orders otherwise. Also, in lawsuits by or against third parties, directors may be indemnified both for expenses incurred in connection with the lawsuit and for any amounts paid in judgment or settlement of the suit; however, in lawsuits by or on behalf of the company, directors may be indemnified only for expenses.

Because the scope of indemnification may differ in many respects from company to company, a director considering possible service on a board of directors should obtain and, along with his or her counsel, carefully review the company's bylaws, any indemnification agreements, and other company policies governing indemnification.

## Insurance

Under Delaware law, a company may, but is not required to, provide insurance for directors at the company's expense against any liability that may arise as a result of directors' conduct. The company may provide such insurance to directors regardless of whether the company could indemnify the director, thus making insurance a potentially broader protection against personal liability than indemnification.

The primary limitations on insurance are found within the policies themselves. So-called D&O policies differ from corporation to corporation as to scope, coverage limits, and deductibles, among other things. The scope and extent of coverage may vary greatly among corporations; some companies do not even provide D&O insurance. Again, just as with indemnification provisions, a director should obtain and, along with his or her counsel, carefully review a corporation's insurance policy, if any, before agreeing to serve on a board.

## Preventive Measures

In the modern corporate environment, directors must be especially zealous about understanding the protections available to them in the execution of their duties and the limitations on those protections. Having a basic understanding of these topics may help directors avoid personal liability stemming from their service on a board and may help prospective directors make more informed choices about where and whether to serve in such a capacity. It may also help directors understand when outside counsel or advice is needed and, if so, what questions to ask.

Directors who serve on boards of companies engaged in battles for control, companies with "activist" stockholders, companies engaged in or about to be engaged in major transactions, or companies with hostile or divided boards of directors should especially consider receiving ad-

vice from an experienced attorney as to significant decisions and the fulfillment of duties owed to the company and its stockholders. In so doing, directors must carefully consider whether to seek out advice from an attorney other than one retained or employed by the corporation.

There is no single, clearly defined blueprint for taking preventive measures to avoid being sued in the first instance or to avoid personal liability if one is sued. However, adherence to certain, well-established "best practices" by boards of directors can help to significantly reduce the likelihood of liability. Such practices may include, but are not limited to, the following (some of which are already mandated for public companies by the Sarbanes-Oxley Act or stock exchange rules):

- Establishing well-defined and conservative standards of director independence.
- Setting a required number or percentage of independent directors, such as a majority.
- Establishing term limits for directors.
- Establishing a "lead" independent director.
- Considering the establishment of a chief governance officer position.
- Maintaining separate CEO and chairman positions.
- Developing and initiating active compliance monitoring systems, including the creation of a chief compliance officer who reports directly to the board.
- Ensuring that the minimum expectations of director conduct standards, such as Sarbanes-Oxley or NYSE or Nasdaq rules, are met.
- Hiring and training directors with diverse sets of skills and backgrounds.
- Evaluating the quality and effectiveness of board meetings, including the use of agendas, the preparation and distribution of materials, and the timing and length of meetings.

- Keeping apprised of corporate governance trends and legislation.
- Developing and implementing appropriately authorized committees and subcommittees to oversee and monitor areas of potential liability, such as executive compensation, director nomination, financial audits, and regulatory compliance.
- Ensuring that key committees and subcommittees are composed solely of independent directors.
- Prohibiting related-party transactions or requiring independent review of such transactions.
- Creating and maintaining effective internal reporting systems for malfeasance or wrongdoing, including a “whistleblower” policy.
- Developing and adhering to a code of ethics.
- Taking an active role in corporate disclosures.
- Maintaining open and active stockholder relations.

## What to Do if You Have Been Sued

If you are sued in your capacity as a director, there are a number of steps you can take to protect your rights and help ensure the best possible outcome. These include the following:

- **Immediately Retain Counsel to Assist You.** The time to respond to a lawsuit varies from jurisdiction to jurisdiction, but you may have fewer than 20 days to act. It is therefore critical that you quickly retain counsel who can assist you in determining when and how to respond to the lawsuit, whether you have been properly served with legal process, and what the best course of action will be.
- **Retain Independent and Experienced Counsel.** Because the interests of the various defendants in corporate lawsuits can and often do diverge to some extent, it is important that you retain counsel independent from the counsel retained or employed by the corporation. In some instances, it may be practical for groups of individual di-

rector defendants to retain common counsel. However, that is a decision you should make after first consulting with independent counsel.

- **Understand the Rights and Protections Available to You.** As set forth above, a director may be entitled to indemnification and advancement of attorneys’ fees and expenses in connection with the lawsuit. However, you may be required to first take certain steps to secure those rights. Your attorney can assist you in determining whether the corporation has applicable D&O insurance and the extent to which the insurer will be involved. Also, your attorney can help you evaluate defenses available to you, including the availability of an exculpatory charter provision.

- **Preserve Documents.** As soon as you are aware that a lawsuit has been or likely will be filed against you, it is important that you take all necessary steps to preserve documents and other evidence that in any way relates to the lawsuit. Documents you should preserve include meeting minutes, personal notes, e-mails, and other correspondence, among other materials. Once a lawsuit is filed or threatened, you should preserve all documents without regard to any company document destruction policy and, in any event, you should consult with your attorney before disposing of or destroying any document that could be related in any way to the lawsuit.

Better understanding the protections available to directors of Delaware corporations and the limitations of those protections is profoundly important in an increasingly litigious environment. As a director, you can and should take a progressive, proactive approach to the current corporate client by educating yourself as to both the duties owed by and rights given to directors under the company’s governance documents and under the law, and by establishing a strong, continuing relationship with independent counsel who can help steer you through any obstacles you may encounter.

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Additional copies of this Special Report are available by contacting John Reed, managing partner of the Wilmington, Del., office of Duane Morris LLP, at [jlreed@duanemorris.com](mailto:jlreed@duanemorris.com), or James Kristie, editor of DIRECTORS & BOARDS, at [jkristie@directorsandboards.com](mailto:jkristie@directorsandboards.com).

About the authors' firm,  
**DUANE MORRIS LLP**

**Duane Morris is among the 100 largest law firms in the United States**, as ranked by *The American Lawyer's AmLaw 100* and *The National Law Journal*, with approximately 600 lawyers and other professionals. The firm has 21 offices in the major U.S. markets and an office in London, England. According to the *Insider's Guide to Law Firms*, "Duane Morris has evolved over the years, from ... a regional powerhouse... to an 'emerging national player' today." Duane Morris regularly acts as outside general counsel to many public and closely held corporations and other business entities. The firm's practice in this area includes corporate counseling, transactional and litigation services.

The firm's **corporate counseling practice** includes the issuance of formal legal opinions as well as advice to officers, boards of directors, and special board committees on their obligations under federal securities laws and exchange rules, and their fiduciary duties in connection with mergers and acquisitions, transactions involving subsidiaries, tender offers, asset sales, capital restructurings, stockholder meetings and votes, corporate reporting and compliance programs, dissolutions, bankruptcy considerations, and other issues involving corporate law and governance.

In **corporate litigation matters**, Duane Morris represents corporations, officers, directors, special committees, and investors in both state and federal courts. This practice covers breach of fiduciary duty claims, corporate control disputes, mergers and acquisitions litigation, stockholder appraisal actions, contract disputes, executive employment agreements, covenants not-to-compete, D&O insurance coverage disputes and other areas.

**Duane Morris has extensive experience practicing before Delaware's Court of Chancery**, the nation's preeminent corporate law court. Based on substantive interviews with clients and practicing attorneys, the firm's litigation practice is ranked as one of the best in Delaware by *Chambers USA: America's Leading Lawyers*. Duane Morris' Wilmington, Delaware office also publishes the *Delaware Corporate Law Review*, a quarterly newsletter highlighting recent corporate law decisions, which is available in PDF format at [www.duanemorris.com](http://www.duanemorris.com). For more information, visit the firm's website or contact John L. Reed at 302.657.4900 or [jreed@duanemorris.com](mailto:jreed@duanemorris.com).