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Audit Committee Brief

From the **Business, Industry & Government** Team

Be prepared: Serving on a Board of Directors today means living in a fishbowl

Today and in the future, "serving on a Board of Directors means living in a fishbowl" according to Chief Justice Myron Steele of the Supreme Court of Delaware. Justice Steele has served on the Delaware Supreme Court since 2004 and has presided over major corporate litigations as well as LLC and limited partner governance disputes. He is a frequent writer and speaker on issues of corporate governance and corporate document interpretation.

Chief Justice Steele was the keynote speaker at The Citadel Directors' Institute, a series of presentations and panel discussions for CEOs, corporate directors, institutional investors, and attorneys interested in the issues and challenges facing individuals who serve on Boards of Directors, both for-profits and non-profits.

Chief Justice Steele highlighted several areas of potential concern for directors and discussed the litigation trends on the horizon. He stressed that directors today must be prepared for the glare of media attention that can throw them into the "fishbowl" and must take steps now to minimize the damage to their reputations and those of their companies.

First, any litigation against the corporation can throw a director into the media fishbowl. Directors should have a written agreement regarding the payment of personal legal fees in the event a director is sued in conjunction with performing his or her fiduciary duties as a director. Directors cannot rely on statues to protect them in this area. An agreement that legal fees will either be advanced or covered by the corporation must be in compliance with state laws and specify the "*who, what, where, and when*" of potential situations. There is a high frequency in Delaware (the state of most incorporations) of embarrassing litigation in which a director has to sue his own company for reimbursement of legal fees. Once a difficult situation arises with the potential for litigation and its accompanying damage to the company's reputation, the media will descend on the company, and directors must show 1) that they had a plan in place to deal with such situations in accordance with their oversight or compliance duties, 2) that the plan was reasonable and adequate, and 3) that the plan was followed.

It is worth noting here some of the recent trends in corporation litigation. Two major categories of corporate litigation that a director might face include the traditional class actions based on breach of fiduciary duty, and derivative actions which are filed on behalf of the corporation due to wrong doing on the part of the board, either for its actions that resulted in a loss or its failure to act which also resulted in a loss through missed opportunity. In derivative actions, an action should have been instigated by the board, but since the board lacks independence, it fails to do so. Any gains resulting from the action goes to the corporation. Because Delaware courts are most current on the laws regarding corporation litigation, plaintiffs with the more solid cases are likely to bring their actions in Delaware. Therefore, if an action is brought against your board in Delaware, be very aware of the likely merit of the case. However, in the case of weaker actions, the trend has been for those cases against Delaware-chartered corporations to be brought outside of Delaware and in jurisdictions believed by plaintiff's attorneys to be somewhat less current in corporate litigation law, such as California and south Texas.

A second way in which directors may find themselves in the fishbowl is through public criticisms from self-appointed experts who claim the board is not following "best practices" of corporate governance, ranging from whether or not the Chair and CEO are separate positions, whether or not there is a lead director, if they have a pill in place, the staggering of board terms, etc. Unfortunately, while many of these so-called best practices sound plausible, in fact there is a lack of empirical evidence of their effectiveness in terms of what should be the only test: do they improve the company's performance in terms of adding value for all investors. Often hired by institutional investors (which own 60% to 70% of publically held stock) and activist investors (which may also have political and economic agendas) to examine the board's structure, these corporate governance gurus are often looking at short-term goals rather than the long-term success necessary to support the organization and ultimately all shareholders. Certainly all criticisms need to be examined for validity and changes made where doing so would benefit all shareholders, but it can be challenging to a board to resist prematurely reacting with unwarranted changes, just for the sake of change, in the glare of media attention and focus.

Another concern for those serving as directors should be the lack of regard for the value of litigation to act as a private ordering system. For example, a derivative action that is instigated not just for recovery of money for the corporation but for the purpose of making a justified change in its corporate governance, has value in that it changes a specific corporate board that had a specific problem. This is far more useful than having the federal government pass new regulations that will have a burdensome application on all corporations, regardless of appropriateness. If, for the first time, the SEC is, as it has announced, going to pursue actions of "breach of good faith" by directors, the resulting uncertainty raises new concerns for all directors. "Breach of good faith" is a not only an elusive term, but is also a common law doctrine which is not the purview of the federal government but of the states. The value of common law is that it is built upon past cases which provide a basis for decision making while identifying pitfalls to avoid. On the other hand, a "code regulated" definition of fiduciary duty provides no such guidance. The result is an increase in unpredictability for corporations and directors, who will have to take costly steps in an attempt to reduce uncertainty.

A third trend with the potential to throw directors into the fishbowl is litigation resulting from the increased use of the SEC's proposed proxy access rule. The proxy access rule provides the opportunity for shareholders to run a short slate of directors and if one or more of them are elected, they will be reimbursed for running the slate, up to but not exceeding the cost management incurred in running its own slate. This is the first time the federal government has stepped into the state law arena and prescriptively determined a corporation must make proxy access available based on shares owned and holding period. Under Delaware state law, each corporation determines its own proxy access rules based on industry standards. If the SEC proposal becomes law, it will create new areas of litigation against directors. The board will be challenged on if the proxy access was successful or unsuccessful and whether or not it properly managed the process. If a vocal minority director is seated, there will be challenges to the decisions made in the board room. Even in the absence of litigation regarding the proxy access process and its outcome, there exists the potential for new areas of strife and a loss of collegiality in the boardroom. This can arise from questions such as does the short-slate selection act in the best interest of the entire investor body or will they only owe allegiance to those who elected them, which may have a narrower and more short-term agenda. There will also be issues of confidentiality. There is a concern regarding how much information a short-slate director, if brought in by hedge-fund owners or institutional investors, would feel compelled to share with those interests.

In summary, these new challenges to those serving as directors much be recognized and addressed, through increased attention to communications and improved investor relations. If a director does what is right in the first place, any litigation and public scrutiny from living in the fishbowl, if not avoided, can be handled. In the final analysis, the board of directors is the only neutral, objective, fully-informed, and loyal entity able to handle the diverse interest of its shareholders and provide balance to the competing factions.

Author's Bio

Dr. Moody received an MBA and PhD in Management Information Systems from the University of South Florida. She received a BSBA degree in Statistics from University of Florida and certification as a Certified Public Accountant (CPA) in Florida. Dr. Moody joined The Citadel faculty in 1993, where she teaches graduate and undergraduate courses in Management Information Systems, as well as Accounting and Accounting Information Systems.

Prior to joining the faculty, Dr. Moody worked for Price Waterhouse CPAs, GTE Corp., Eastern Airlines, and Jack Eckerd Corp. Dr. Moody has published articles in numerous journals, including *MIS Quarterly*, *Expert Systems with Applications*, and *JMIS*. She is a frequent presenter at both national and international conferences. Her research interests are in the areas of the behavioral aspects of systems development and the managerial aspects of IS personnel.