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Harvey L. Pitt

ARTICLES

THE CHANGING STANDARDS BY WHICH DIRECTORS WILL BE JUDGED†

HARVEY L. PITT††

Being an effective director is a learned, not innate, skill. Nor is it a static proposition. Standards for directors change over time, especially as we deliberate more about what directors should do and as we learn what happens when there are important things they don't do.

Corporate directors of public companies represent a company's shareholders.[1] Without honest, wise, and experienced directors, public investors wouldn't trust their funds to corporate managers. As shareholder representatives, directors are responsible for ensuring that their company governs its affairs to maximize shareholder value.[2] Directors do not, and should not, manage the company; that authority is delegated to management.[3] Rather, directors oversee management or *direct*,

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† The text of this article is taken from remarks made by Mr. Pitt to the administration, faculty, alumni, and students at St. John's University School of Law on February 2, 2005.

†† J.D., Hon. L.L.D., St. John's University School of Law; B.A., Brooklyn College. Prior to founding Kalorama Partners LLC, Mr. Pitt was the twenty-sixth Chairman of the Securities and Exchange Commission, from 2001 until 2003, and a partner in Fried, Frank, Harris, Shriver & Jacobson LLP for nearly twenty-five years.

1 *See* DEL. CODE ANN. tit. 8, § 141(a) (2005); *see also* Smith v. Van Gorkom, 488 A.2d. 858, 872 (Del. 1985). In the rush by some states to prevent hostile takeovers of locally domiciled companies, state corporation laws were amended to require directors to consider other constituency groups as well. *See, e.g.*, N.Y. BUS. CORP. § 717(b) (2005); PA. CONS. STAT. § 1715 (2005).

2 *See, e.g.*, MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATION LAW 97 (1995). The Supreme Court of Delaware has most clearly expressed this duty in the context of corporate control transactions. *See* Paramount Communications v. QVC Network, 637 A.2d 34, 45 (Del. 1994); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 181 (Del. 1986).

3 *See Revlon, Inc.*, 506 A.2d at 179.

a word derived from the Latin word meaning to "guide" or "set straight."[4]

For at least a century, the role of non-management corporate directors was often treated as one of passivity, not activism.[5] Power to manage a corporation's affairs was believed to reside exclusively in the hands of its senior officers, with the proper role of outside directors being generically and non-intrusively to oversee, and approve (when asked to do so), significant managerial decisions.[6] This misperception of an outside director's proper role was fostered by several factors:

- Selecting outside directors was seen as a CEO perk;
- Good corporate officers were perceived as focused and effective, and also absolute monarchs;
- Outside directors lacked effective resources to obtain their own guidance and assistance;
- No clear consensus existed on how outside directors should perform their roles; and
- Many corporate advisors were fixated with elevating form over substance.[7]

Corporate scandals bred in the '90s exposed this weak leadership, which at times had permitted practices that were clearly illegal to occur and thrive nonetheless. The passage of the Sarbanes-Oxley Act ("S-Ox") in July, 2002[8] reemphasized the role of directors as elected representatives of the shareholders and the stewards of company assets.

It is axiomatic that directors must act in good faith, in the best interests of the corporation, and with appropriate diligence and care.[9] While S-Ox did not formally change the responsibilities of directors, it has federalized those responsibilities and given regulators and prosecutors new

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[4] *See* DEL. CODE ANN. tit. 8, § 141(a) (2005); *Revlon, Inc.*, 506 A.2d at 179; 4 OXFORD ENGLISH DICTIONARY 701 (2d ed. 1991).

[5] *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) ("[A]bsent cause for suspicion there is no duty upon . . . directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.").

[6] *See* MYLES L. MACE, DIRECTORS: MYTH AND REALITY 52–53 (1986).

[7] *See* Robert M. Estes, *The Case for Counsel to Outside Directors*, HARV. BUS. REV., July–Aug. 1976, at 125–32.

[8] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in various sections of 15 U.S.C.).

[9] *See* Smith v. Van Gorkom, 488 A.2d. 858 (Del. 1985).

weapons in enforcing them.[10] S-Ox also has placed added emphasis on policies, procedures and methodologies by which directors fulfill their responsibilities.[11] The performance of these functions now assumes even more critical importance to the success and well-being of corporate America.

Along with these changes, the liability landscape for corporate directors has been changing dramatically. Most recently, three events are causing greater focus by directors on the thorny issue of personal liability: (1) The *Emerging Communications* case, decided by the Delaware Chancery Court last June;[12] (2) the Disney shareholders' suit over former President Michael Ovitz's $140 million severance package;[13] and (3) the recent proposed settlements, by outside directors, of WorldCom[14] and Enron[15] class action litigation last month. The outcomes of these three phenomena suggest the need for outside directors to adopt a proactive stance in performing their oversight functions.

Traditionally, corporations shield individuals from personal liability except in egregious circumstances.[16] This is why corporations are separate legal entities.[17] As a separate "person," the corporation is generally responsible for the firm's actions. This is so because corporations are expected to take appropriate business risks.[18] If personal liability extended to

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[10] *See* Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 671 (2002).

[11] *See* Sarbanes-Oxley Act of 2002, § 302, 15 U.S.C. § 7241 (2005).

[12] *In re* Emerging Communications, Inc. S'holders Litig., No. 16415, 2004 Del. Ch. LEXIS 70, at *1 (Del. Ch. June 4, 2004).

[13] *In re* The Walt Disney Co. Derivative Litigation, No. 15452 (Del. Ch. letter opinion Feb. 4, 2005).

[14] News Release, Office of the New York State Comptroller, Hevesi Announces Historic Settlement, Former WorldCom Directors to Pay from Own Pockets, (Jan. 7, 2005), *available at* http://www.osc.state.ny.us/press/releases/jan05/010705.html.

[15] News Release, Office of the President of the University of California, UC Reaches $168 Million Settlement with Enron Directors in Securities Fraud Case, (Jan. 7, 2005), *available at* http://www.universityofcalifornia.edu/news/2005/jan07.html.

[16] *See* Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE J. ON REG. 387, 387–88 (1992) ("Under the doctrine of limited liability, if a judgment is rendered against a corporation in an amount that exceeds its ability to pay, judgment creditors cannot pursue the corporation's shareholders to collect the residual amount.").

[17] *See* Frank H. Easterbrook and Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 89–90 (1985).

[18] *See* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982); *see also* Easterbrook &

managers and directors, they would take far fewer risks. That would mean fewer corporations, fewer investments, and fewer jobs. Managers and directors would not be inclined to pursue transactions where the costs exceeded the benefits to *themselves*, the wrong measure for any corporate decision. Therefore, from a policy perspective, corporate law traditionally has embraced the view that it is better to encourage directors and managers to take risks, so corporations can create wealth and jobs.[19] In the end, the threat of personal liability might make directors and managers excessively risk averse in their decision-making, thereby injuring shareholders, chilling investment, and diminishing efficiency.

I. THE EMERGING COMMUNICATIONS DECISION

The *Emerging Communications*[20] decision by the Delaware Chancery Court involved the privatization of a telephone company in the U.S. Virgin Islands by the company's controlling shareholder, Chairman and CEO. The Board of the company formed a special committee to negotiate the two-step going-private transaction on behalf of minority shareholders. The Special Committee recommended the merger to the rest of the board, which approved it at a price of $10.25 per share. The full board approved the transaction, the Chairman abstaining due to his conflicts of interest. After the privatization was completed, shareholders brought an appraisal proceeding against the board. The Chairman's conflicts of interest rendered the business judgment rule inapplicable. Instead, the defendant directors had to prove the transaction satisfied Delaware's "entire fairness" test, which requires a showing of both a fair price and fair dealing.[21]

In deciding the case, the Delaware Chancery Court (per Justice Jacobs, a former judge on the Court of Chancery and now a Delaware Supreme Court Justice, who was sitting by designation) exculpated the entire board of directors from personal liability, except for the conflicted Chairman and one other director, who had joined all his colleagues in approving the transaction. The director, Salvatore Muoio, had been a

Fischel, *supra* note 17, at 93–103.

[19] *See, e.g.*, *Joy*, 692 F.2d 880, 885–86.

[20] *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *1.

[21] *See* Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

securities analyst and a portfolio manager in the telecommunications sector, and thus was found to possess "a specialized financial expertise" that was "equivalent, if not superior," to the expertise of the Special Board Committee's outside financial experts.[22] This specialized expertise, in turn, made this director liable when his colleagues were not, because he had, in the Court's view, "far less reason [than the others] to defer" to the outside expert's opinions and conclusions.[23] The Court found that Muoio violated his duty of loyalty because he "voted to approve the transaction even though he knew, or should at the very least have had strong reason to believe, that the $10.25 per share merger price was unfair."[24] Muoio did not serve on the Board's Special Committee and did not receive or have access to any more information about the transaction than other board members whom the Court exculpated.

One implication of this holding, especially given S-Ox's requirement that public companies disclose whether or not their audit committees contain at least one outside director with financial expertise,[25] is that those with special expertise need to take extra care if they wish their utilization of and reliance on outside experts to exculpate them from liability in shareholder litigation. Another significant implication is that those directors who lack "specialized financial expertise" may be entitled to rely upon the judgments and opinions of those who in fact do possess specialized financial expertise.[26]

II. THE DISNEY SHAREHOLDERS' SUIT OVER MICHAEL OVITZ'S PAY PACKAGE

Testimony wrapped up last month in the shareholder suit against Disney's former President, Michael Ovitz, and the directors who approved the enormous pay package for the Hollywood powerbroker who briefly and unsuccessfully took charge of Disney in 1995.[27] The Delaware Chancery Court likely will issue a decision some time in the late spring. If the Court

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[22] *Id.* at *144, *145.

[23] *Id.* at *145.

[24] *Id.* at *143.

[25] Sarbanes-Oxley Act of 2002, § 407, 15 U.S.C. § 7265 (2005).

[26] *Emerging Communications*, 2004 Del. Ch. LEXIS 70, at *144.

[27] *In re* The Walt Disney Co. Derivative Litigation, No. 15452 (Del. Ch. letter opinion Feb. 4, 2005). *See Evidence Phase of Disney Trial Concludes*, WALL ST. J., Jan. 20, 2005.

finds that Disney's independent directors failed to exercise their business judgment and fulfill their fiduciary duties in good faith, then the directors may be held personally liable for their decision to approve Ovitz's pay package, which included a $140 million severance package that was triggered and paid out.

Executive compensation, both during service and in parting ways, is a lightning rod issue that is attracting all sorts of attention from regulators, investors and the media,[28] and rightly so. The chasm between Wall Street's perception of what constitutes fair compensation and Main Street's contrary view is enormous. Yet, CEO pay keeps rising—often at faster rates than profits.[29]

Executives should not be allowed to profit on false earnings statements. Companies increasingly are trying to recoup severance payments, salary, bonuses, option profits and other payments to executives who bear responsibility for a company's subpar performance or malfeasance. Last month, for example, Nortel Networks restated its earnings and said twelve executives would voluntarily return $8.6 million in bonuses awarded on the prior numbers.[30] And in December, Congressman Richard Baker, Chairman of the House Financial Services Subcommittee on Capital Markets, called for the return of all bonus payments awarded to Fannie Mae executives based upon faulty earnings statements.[31]

Executive compensation will remain a spotlight issue for the foreseeable future.[32] It is critical for boards of directors to revisit their compensation policies and procedures. Compensation

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[28] *See, e.g.*, Susan J. Stabile, *Viewing Corporate Executive Compensation Through A Partnership Lens: A Tool to Focus Reform*, 35 WAKE FOREST L. REV. 153, 153–54 (2000).

[29] *See, e.g.*, Louis Lavelle, *Special Report: Executive Pay*, BUS. WK. Apr. 19, 2004, at 106.

[30] News Release, Nortel Networks, Nortel Networks Corporation Files 2003 Financial Statements, (Jan. 11, 2005), *available at* http://www.nortel.com/corporate/news/newsreleases/2005a/01_11_05_2003_financial_statements.html.

[31] News Release, Congressman Richard Baker, In Letter to Baker, OFHEO Vows, Spells Out Authority to Recapture Fannie Bonuses Based on Faulty Financials, (Jan. 19, 2005), *available at* http://www.baker.house.gov/html/release.cfm?id=119.

[32] *See* Alan L. Beller, Director of the SEC's Division of Corporation Finance, Remarks to the National Association of Stock Plan Professionals, the Corporate Counsel, and the Corporate Executive, outlining the SEC's recent initiatives in the area (Oct. 20, 2004), *available at* http://www.sec.gov/news/speech/spch102004alb.htm.

should be structured to align management's interests with those of shareholders. CEOs should be rewarded for producing growth in fundamental company values, such as market share, markets served, etc., and setting the right tone at the top, *not* for achieving some measure of earnings per share. It's too easy for companies to manipulate earnings per share, at least in the short run.

III. THE WORLDCOM AND ENRON CLASS ACTION SETTLEMENTS

In January, plaintiffs settling WorldCom and Enron class action litigation demanded, *and received*, agreement that the outside directors of both companies would put up a significant amount of their own assets in settling those cases.[33] In the WorldCom litigation, ten directors attempted to reach a settlement under which they would personally pay $18 million of a $54 million settlement. Despite the existence of D&O insurance coverage, individual WorldCom directors offered to put up as much as twenty percent of their collective net worth to settle an action where the directors did not know, but also did not prevent, a securities fraud from occurring. The court rejected the proposed settlement under the Private Securities Litigation Reform Act, and presumably, these directors will now face a trial.[34]

In the current climate confronting any defendant in securities litigation, there is clearly a risk that a jury (especially one in the city where a now-defunct company played a major economic role) will impose liability in draconian amounts. In both the *WorldCom* and *Enron* cases, the directors made the judgment that the risk of an adverse jury decision was far more compelling than the burden of employing some personal assets to purchase a settlement of the litigation.

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[33] *See* News Releases, *supra* notes 14 and 15.

[34] It is not possible to predict how a jury will react to the case, but it is interesting to speculate that, apart from the prospect that the defendants might be exposed to a greater damage award, the jury could also award no (or lesser) damages against the outside directors, in which case the plaintiff—who insisted upon personal payments for political, not substantive, reasons—might face his own liability exposure.

IV. WHAT'S A DIRECTOR (OR WOULD-BE DIRECTOR) TO DO?

To some, these recent events confirm their pre-existing view that board service for public companies is no longer feasible or desirable.[35] That is, I suggest, an over-reaction. Equally off the mark is the observation of others that there is (and will be) no dearth of board candidates because directors will still enjoy traveling to pleasant foreign locations for board meetings and the clubhouse status of being a director.[36] There are, rather, prudent steps directors, and especially outside directors, should consider before declining to serve on a public company board, or deciding to resign from a public company board on which they presently sit. These proactive steps can minimize considerably the likelihood of liability, especially personal liability.

1. Due Diligence. The days when a mere invitation to join a board was considered an honor not lightly to be refused are long gone. Board service may not be "an honor," but it is a serious undertaking. Prior to accepting an invitation to join a board, candidates need to do a thorough job of due diligence, examining how the company operates, the working relationships between management and the board, the assets provided to the board, and the company's adherence to good governance and full transparency. Prospective board candidates should not rely solely on their own due diligence, but should be given the tools to have an independent evaluation made of the company's transparency and governance.
2. Understand the Company. Corporations are complex entities, and they often cover very wide swaths. Directors need to understand the nature of the company's business, its culture, its patterns, its industry and the problems that face both the specific

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[35] *See, e.g.*, *Directors Are Getting The Jitters – Recent Settlements Tapping Executives' Personal Assets Put Boardrooms on Edge*, WALL ST. J., Jan. 13, 2005, at B1.

[36] *See id.* ("[C]orporate board members already enjoy tremendous benefits besides handsome compensation, suggests Melvyn Weiss, a senior partner at Milberg Weiss Bershad & Schulman LLP, a major class-action law firm. Citing directors' opportunities to network extensively and travel to exotic places for board meetings, he adds: 'It's a whole way of life. You think they're going to give that up?'").

company as well as other companies in similar lines of business.

3. Know the Management Team. Who are the corporate managers? What are their strengths, their weaknesses? What access does a director, or prospective director, have to *anyone* working at, or for, the company?
4. Know the Strengths and Weaknesses of the Other Directors. Who are the other directors? What expertise, if any, do they possess? How do they approach their jobs? Being the most knowledgeable, or the hardest working, director on a board is a negative, not a positive. The best boards will balance the talents of many individuals who bring unique insights, expertise and perspectives to the boardroom, upon whom the other directors can all rely.
5. Ensure the Existence and Availability of a Team of Outside Experts. S-Ox requires companies to make resources available to directors to perform their myriad responsibilities. In light of the *Emerging Communications* decision, the directors should be satisfied that their outside experts have *far greater* financial and other expertise than the members of the board. The outside directors should select their own outside experts.
6. Have a Game Plan. The outside directors need to be organized, with an active agenda for each fiscal year, and with established experts on hand and on call to assist the directors. How many times will the board and critical committees—the Audit, Compensation, Nominating, Legal Compliance and Disclosure committees—meet? When will substantive issues and risks be examined by the board and these committees? Advance planning, and time for thoughtful evaluation, are crucial.
7. Require Full Disclosure. An effective board is one in which management and the outside directors work collaboratively to achieve the company's desired objectives. A critical element of such a working relationship is full disclosure. While directors cannot

immerse themselves in the intricacies of a company's many-faceted operations, they can ensure that all critical information is given to them on a timely basis.

8. Assure the Integrity of the Decision-Making Process. Board members need to understand, and be satisfied with, the types of decisions they will be asked to make, and those that will be entrusted to management's discretion. Board packages that either "dumb down" important issues, or create a "sea of impenetrable documents," disserve the company, its managers, and the directors. It is critical for directors to make certain that they are given every important detail regarding any proposed action.
9. Is There a Continuous Stream of Information Flowing to the Board? In years past, some managers had the tendency either to wait until there was no alternative to bring the board "into the loop," or to distrust the ability of the board to maintain confidentiality of sensitive information. Board members should have a continuous flow of relevant and significant data. If management thinks some directors may leak sensitive data, those directors should be replaced. The solution can never be to withhold information from the board.
10. Actively Play-Out Crisis Scenarios. Every day, the business press reports another terrible disaster at an otherwise fine company. Many of these can be handled far more deftly than they actually are, but the lack of crisis preparation impairs the ability of companies to perform well in the face of a crisis.
11. Look for Problems Before They Find You. The ancient wisdom of not looking for problems that haven't surfaced is no longer possible or wise. Boards need to understand what risks a company may implicitly be accepting in the way it does business, and need to be certain that there is a determined effort to ascertain whether problems are lurking just beneath the surface.
12. Regularly Evaluate the Company's Systems, Procedures and Approaches. The Board needs to be

proactive in understanding what systems, procedures, assumptions and approaches management is employing to keep the company on track.

13. Keep Accurate and Complete Records of All Board Deliberations. As we often note, it's important not only to do the right thing, but to be able to demonstrate that you've done the right thing. This places a premium on good recordkeeping.
14. Avoid Two-Dimensional Disclosure and Assessment Efforts. One of the biggest mistakes a company can make is to ignore comparative approaches at similarly situated companies. Particularly in disclosure contexts, it's essential that the company's proposed disclosures are compared with its core group of peer companies.
15. Consider the Advantages of a Forensic Audit. Most companies would benefit if their audit committees sought to have the company undergo a forensic audit on a triennial time frame.
16. Educate, Sensitize, Evaluate. The ability to function effectively is not an inherent skill, it is a learned talent. Companies need to make sure that directors, officers, employees and others are educated periodically about critical issues, sensitized to changing standards and requirements, and evaluated on their performance.
17. Obtain Comprehensive D&O/E&O Insurance Coverage. In addition to broad rights of indemnification under corporate charters, comprehensive insurance coverage is essential because directors may incur personal liability, the company may be insolvent, or state or federal law may limit indemnification or advancement of expenses. Outside directors should be satisfied that the disqualification of one or more directors will not disqualify the remaining directors. Outside directors also should look into excess "Side A" coverage, which protects innocent outside directors when the company's standard policies are rescinded or do not fully protect the outside directors.

18. Keep Apprised of Changing Policies Regarding Personal Liability. The only certain thing about the current landscape regarding personal liability is its uncertainty! We are witnessing evolving standards, sometimes affected not just by substance but by policy and even political concerns. A well-informed director is a smart director; making certain that you know the changing landscape of liability is the surest way to find critical paths to avoiding that liability.
19. Require Periodic Board Effectiveness Assessments. Unfortunately, it isn't enough to be dedicated and proactive. Directors need the comfort of knowing that they are performing the way shareholders reasonably have a right to expect them to perform. This is best done through periodic evaluations by independent outside experts, who can improve the board's performance based on its actual approach to issues.

While recent events understandably give rise to concerns about the new potential for increased personal liability, directors who approach their responsibilities with care and common sense, and who are constructively proactive, should find themselves in a positive situation vis-à-vis personal liability.