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Directorial Activism In The Face Of Alleged Or Actual Officer Misbehavior

By Harvey L. Pitt, Compliance Week Columnist—March 30, 2004

For at least a century, the role of non-management corporate directors was often treated as one of passivity, not activism. 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.

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 leaders 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.

Today, defining the proper role of outside directors is in flux and under continuous review. Corporate scandals bred in the '90s exposed practices that were clearly illegal, but nonetheless were allowed to occur and thrive. Changes in corporate governance standards have been (and are) coming at corporate America at a fast and furious pace.

Some changes already wrought are positive; others are mere window dressing or worse. One thing is certain, however: Slavish adherence to formalistic changes holds forth the prospect that the governance of corporations, not to mention their profitability and viability too, may well suffer as a result of too many poorly thought-out changes occurring too rapidly for anyone to digest, assess and inculcate.

Add to this mix the fact that the SEC has, in recent enforcement proceedings, logically targeted outside directors who don't direct, and these developments produce a significant tension for outside directors. Some, clinging to the past, are unduly (and illegally) deferential to corporate managers. Others, fearful of their own liability, have assumed an adversarial posture in the boardroom, making it difficult for some companies to function effectively and efficiently.

What can be lost in this swirling and roiling scene are the responsibilities of outside directors, especially in circumstances where pressure to accommodate management may be greatest. Recent case law and practical developments suggest outside directors need to reflect carefully on

things they're asked to do, and things they aren't being asked to do, especially when corporate officers are accused of breaches of their oath of office.

It's axiomatic that corporate officers owe a duty of loyalty to the corporations they serve. This has taken on added importance with the effective requirement that public companies have codes of conduct to which officers and directors must be unrelentingly held. But, what if a corporate officer is accused of having breached an obligation he or she owes to the corporation, or worse, actually did breach such an obligation?

In many situations involving allegations of wrongdoing, the presumption of innocence kicks in, and companies continue to allow accused officers to defend themselves at corporate expense, while continuing unfettered in the corporate offices in which the alleged wrongdoing occurred. Indeed, corporations have taken advantage of state corporation law to provide seemingly "ironclad" guarantees to accused managers for an advancement of expenses. But, this "knee-jerk" reaction may be too facile, and can be inconsistent with an outside director's obligation to the company on whose board he or she sits, and the shareholder-owners of the company.

Counsel's response often is that, until there is a conviction, adjudication or admission of wrongdoing, the presumption of innocence applies, and the corporation should advance expenses, including attorneys' fees. But, in this new era of corporate governance, outside directors should adopt a program for dealing with such issues, and consider the following questions or issues:

1. **What's the nature of the alleged wrongdoing?** If the charge is insider trading, for example, should the corporation blithely agree to pay the freight for an officer to defend himself or herself? Insider trading, if proved, is an offense against the corporation and its shareholders, not just the public at large.

2. **Who's making the allegations?** There's ample precedent that the identity of the entity making the allegations is a relevant factor for directors. For example, if the accuser is a federal, state or local government agency, the allegations may still have to be proved, but they take on a greater degree of surface legitimacy, and put outside directors on inquiry notice.

3. **Should the outside directors conduct their own inquiry into the situation?** If allegations, or the identity of the accuser, are significant, directors should consider whether they have an obligation to conduct their own independent review of the situation before giving effect to the presumption of innocence.

4. **To what restrictions has the accused officer agreed, as a condition of receiving advancement of expenses and attorneys' fees?** Often, companies require accused officers to agree to repay any advanced expenses if they're adjudicated to have acted wrongfully. Is this enough? Should the accused officer also agree to:
   i. escrow part of his or her salary and any bonuses, or make other arrangements, so promised repayment is meaningful?
   ii. cooperate completely with any internal review the board conducts?
   iii. waive attorney-client privilege or Fifth Amendment concerns in responding to internal corporate inquiries?
   iv. respond fairly, fully and honestly to all regulatory inquiries?

v. notify the Board if he or she receives a "Wells Notice" from, or asserts privilege or the Fifth Amendment before, a government agency, or takes any other action inconsistent with the company's interests?

5. **Have restrictions been placed on an accused officer's continued performance of duties?** Depending on the allegations, is the Board satisfied an accused officer isn't in a position to engage in conduct similar to the type alleged to have occurred, if the accused continues in office?

6. **Have steps been taken to avoid breaching the "faithless servant" doctrine?** Under most state laws, a "faithless servant" is subject to discharge and economic forfeiture and privation. In its recent "Phansalkar" decision, the Second Circuit sanctioned the denial of all forms of compensation to an errant officer, not just compensation related to the specific obligation breached. This holding poses significant landmines for outside directors:
   i. unadjudicated officers may seek termination packages rather than stay on;
   ii. continuing to pay an accused officer may result in charges of corporate waste if the officer did breach a duty to the company, and no independent review was undertaken; and
   iii. advancing expenses and attorneys' fees to an officer accused of breaching a duty owed the company could result in charges of corporate waste to board members involved.

   The presumption of innocence permits a company and its outside directors to accord the benefit of any doubt to an officer accused of wrongful conduct; but directors are obligated to look behind the presumption to assess the type of conduct alleged (and by whom), to explore corporate consequences, and to make sure shareholder interests are fully protected.

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