

DIRECTORS AND THEIR DUTIES

OVERVIEW

The board of directors of a corporation, be there one or twenty-five members, is the executive authority of a corporation and as such ultimately responsible for its operation and success, although in most instances the actual duty of everyday business is delegated to corporate officers. The director's fiduciary duty runs to the corporate entity itself, rather than to the shareholders, however, shareholders may enforce those duties on behalf of the corporation by way of shareholder or derivative suits. The following is a summary of areas with which every corporate director should be familiar:

- The board of directors is an agent of the corporation as a board only and not individually. Therefore, any action by a member of the board of directors and not as a group is void, unless the board subsequently adopts the member's action.
- Each director is charged with a duty of care in the management of the corporation, meaning that he must use judgment a prudent person in a like position would use under similar circumstances. This has been held to mean that a director can rely upon information, including financial data, presented to him by other corporate agents with impunity so long as the director is not in such circumstances where he should have made inquiry and did not. Most frequently, a breach of the duty of care arises when a director has been negligent in attending meetings even in such instances as where the director lives a great distance from the place of the meeting, when he or she allows the corporation to violate any law, or allows a corporate officer to be derelict in their duties.
- In the same vein as duty of care is a director's duty of loyalty preventing him from acting on any corporate decision in which he is an interested party or taking advantage of any corporate opportunity. In addition, transactions where the director deals with the corporation or where the director is on the boards of two corporations dealing with one or another will be closely scrutinized by courts for full disclosure by the director.
- A director cannot take any action on the board which will enhance the value of his own stock to the detriment of other classes of shares within the corporation.
- A director or an officer cannot make transactions in shares based upon non-public information which he has gained as a result of his position with the corporation.

Any time an individual is considering a directorship, thought should be given as to whether the person has the experience and business judgment to participate in the decisions which are made by the board. Further, it should be ascertained whether or not the persons elected have the willingness to spend the time necessary to review the corporation's operation in sufficient detail to carry out the duties with proper care. Finally, caution has to be taken that a director is not being put into a position whereby a conflict of interest could arise. In situations where a conflict does arise, the director should fully disclose his interest and knowledge and then not participate in further discussion or voting.

STANDARDS OF CONDUCT

Duty of Loyalty

The corporate director commits to allegiance to the enterprise and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interests of his own. The basic principal to be observed is that the director should not use his corporate position to make a personal profit or gain other personal advantage. The duty of loyalty is manifested by certain legal concepts.

- ***Conflict of Interest.*** When the corporate director has a material personal interest in a contract or transaction to which the corporation is to be a party, either directly or indirectly because of an employment or investment relationship with an entity with which the corporation is dealing or otherwise, the director should disclose the existence of such interest, and describe the nature thereof to the other directors prior to the time action is taken by the board, and should abstain from acting thereon.
- ***Duty of Fairness.*** When conflicting interests are present, the director must be concerned that fairness obligations are recognized and satisfied. If a transaction by a director with the corporation involves a possible conflict of interest, its fairness to the corporation should be a primary concern for both the interested director and those disinterested directors entertaining a request for favorable action.
- ***Corporate Opportunity.*** When a business opportunity that is relevant to the present or prospective business of the corporation comes to the attention of a director as a result of his relation to the corporation, the director must first present it to the corporation. Only after an evaluation and a determination by the disinterested directors that the corporation should not pursue the opportunity, should the director pursue the matter for his own account or for the benefit of others.
- ***Confidentiality.*** The director should deal in confidence with all matters involving the corporation until such time as there has been general public disclosure or unless he knows the information is a matter of public record or common knowledge.

Duty of Care

The director assumes a duty to act carefully in fulfilling the tasks of monitoring and directing the activities of corporate management. Most statutes, including Delaware, Oklahoma and the Model Business Corporation Act all require that directors act in good faith, in a manner reasonably believed to be in the best interests of the corporation and with such care as an ordinarily prudent person in a like position would use under similar circumstances.

- ***Duty of Attention.*** Is a general concept that is satisfied in a number of ways. The director has the responsibility to attend meetings, review adequate information and documentation to permit an informed judgement and decision and to monitor those to whom responsibilities have been delegated, such as board committees or special management tasks. The director has the right to rely on information presented to him by management, advisors or other directors, so long as he does not have information or a belief that such reliance is unwarranted.

It is generally recognized that the board is not expected to operate the business — that is a function of management. The responsibility of the board is limited to overseeing such operations. Directors will not usually be held personally responsible for actions or omissions of officers, employees or

agents of the corporation so long as they have been prudently selected and the directors have relied reasonably upon such officers, employees or agents.

- **Decision Making** — The Business Judgement Rule. Business judgement inevitably involves risk evaluation and assumption and the recognition that a director, as such, is not a required full-time commitment to the affairs of the enterprise. A director frequently makes important decisions which may eventually prove to be erroneous. A director exercising his good faith judgement may be protected from liability to the corporation under the Business Judgement Rule. This is a judicial (rather than statutory) doctrine which holds that directors acting in the exercise of free and independent judgement will not be found to have acted negligently. For the Business Judgement Rule to apply, a director must have acted in good faith and with a reasonable basis for believing that the action authorized was in the lawful and legitimate furtherance of the corporation's purposes, and must have exercised his honest business judgement after due consideration of what he reasonably believed to be the relevant factors.

RESPONSIBILITIES OF DIRECTOR

The fundamental responsibility of a director is to represent the interests of the shareholders as a group, as the owners of the enterprise, in directing the business and affairs of the corporation within the law. The law does not hold the corporation or its directors directly responsible to other constituents such as employees, customers or the community, except to the extent expressly provided by public law (OSHA, EPA, etc.). Nevertheless, a director should be concerned that the corporation conducts its business with due appreciation of public and other constituents' expectations.

- **Management Responsibilities.** The Oklahoma statute (which is similar to the Delaware law) expresses the relationship between the board and operation of the corporation by providing that:

“The business and affairs of every corporation ... shall be managed by or under the direction of a board of directors, except as may be otherwise provided for in the Oklahoma General Corporation Act or in its certificate of incorporation.”

Under Oklahoma law (and the law of most other jurisdictions) there are a number of specific statutory duties the board of directors has for corporate management and overseeing the business of the corporation (by-law amendments, electing officers, declaring dividends, calling special shareholder meetings, etc.). In addition, the board should give consideration to approval of material transactions, acquisitions, capital investment, etc. In public companies, a director should be concerned that the corporation's disclosure documents are accurate and complete.

- **Duty to Object.** If a director has reservations concerning a proposed course of action, he has the duty to express them both to management and to his fellow board members. If he disagrees with any action taken by the board having significant implications or consequences, he should vote against the proposal and request that his dissent, and reasons therefore, be recorded in the minutes of the meeting. Genuine disagreement concerning a particular proposal should not cause him to consider resigning.
- **Areas of Special Concern.** A number of areas of concern which warrant a director's attention in varying degrees are as follows:

- Information Flow – the director should be concerned with the establishment and

maintenance of an effective reporting system. The information flow from management to the board should encompass:

- Internal financial statements structured in a way that presents a meaningful breakdown of the enterprise's activities and summarized in a way that permits ready comprehension and reasonable analysis.
- periodic reporting dealing with various areas of compliance, including material litigation, tax issues and reporting
- periodic briefing by senior executives concerning developments affecting the business and affairs of the enterprise
- forward planning

Aside from direct communications from the chief executive officer and the chief financial officer, the corporate secretary frequently acts to convey information on corporate matters. The adequacy of information provided the directors should be reviewed from time to time, perhaps by the audit committee or another board committee.

- **Informed Judgment** – the director should feel that he is sufficiently informed about a proposal so that he can explain a vote for or against it. If he believes that adequate information is not being provided for such purpose and is unsuccessful in his efforts to remedy the situation, he in all likelihood should consider resigning, or at least voting against the proposal and stating clearly the reasons for such vote.
- **Outside Information** – the director should be interested in information from outside sources.
- **Organization and Orientation Issues** – the director should be concerned with organization of the board and its committee structure, balance between inside and outside directors, orientation, meeting schedule and agenda issues.
- **Executive Development** – the director should be concerned with executive development, including management's efforts to assure a sufficient depth of management strength so that competent managers will be able to fill top positions when the need arises.
- **Management Authority** – the director should be aware of, and from time to time reassess, the authority granted to the executives of the corporation to obligate the corporation in material transactions. The director should also be concerned that the corporation maintains adequate systems of internal accounting controls to assure that management authority to deal with the corporate assets is being properly exercised. This has become critical in light of the requirements of Sarbane-Oxley.
- **Compliance with the Law** – the director should be concerned that the corporation has programs looking towards compliance with applicable laws and regulations and that it maintains procedures for monitoring such compliance. It is desirable for compliance that corporate counsel have access to the board, that the corporation be supplied with services

adequate to assure that compliance is being met and that there be appropriate channels within the corporation that compliance problems can be reported and dealt with quickly.

- ***Rights of Directors.*** As a corollary to his responsibility, the director has important rights appropriate to performance of his job.
 - **Management Access** – the director should feel free to communicate with key executives, subject to reasonable time constraints.
 - **Books and Records** – the director has the right to inspect the corporation’s books and records and to be provided such data derived therefrom as he may reasonably request.
 - **Notice** – the director should be given notice of all meetings in which he is entitled to participate.
 - **Minutes** – the director should be given a copy of minutes of all meetings of the full board and each board committee (whether or not he is a member).
 - **Outside Advice** – there may be occasions when there is need for the director to have outside advice. The director should be assured that, in appropriate circumstances, he (alone or together with fellow directors) has a reasonable channel of communication with the business’s principal outside advisors, including its auditors, regular corporate counsel, investment banking advisors, etc. Further, there may be occasions when an outside advisor should be specially retained to assist the board or a committee in connection with a particular matter.

LIABILITIES AND INDEMNIFICATION

Introduction

Although it is true that directors may incur liabilities for activities in connection with their positions, it is believed that the likelihood of such liability will be reduced if they act within the framework of conduct outlined herein. Obviously, if a director engages in an activity which amounts to fraud, he will be subject to liability under both state and federal law. However, if he acts in good faith and meets his duty of attention, neither state nor federal law is likely to impose liability upon him. In such circumstances, if liability is imposed, the director whose conduct measures up to prescribed standards normally will be entitled to indemnification by his corporation.

State Law Liability

If a director violates his duty of loyalty to the corporation or to the shareholders, it is likely that personal liability will be imposed upon him under state law. Thus, a director who engages in conflict-of-interest transactions, takes personal advantage of corporate opportunities, engages in transactions that are unfair to minority shareholders, or otherwise acts to further his own interests at the expense of the corporation or its shareholders, should not be surprised to find himself faced with lawsuits and imposition of damages.

In contrast, if the director meets his duty of attention to the corporation, he will probably not be subject to liability. Section 35 of the Model Business Corporation Act states that a director “who performs his duties in accordance with the standards of [that Section] shall have no liability by reason of being or

having been a director of the corporation.” Both Oklahoma and Delaware has similar language in their General Corporation Acts. Thus, a director who acts in good faith and in a manner he reasonably believes to be in the best interests of the corporation, who properly relies on information, opinions, reports and statements of others, who properly delegates certain functions traditionally associated with board activities, and who exercises free and independent business judgment, should find that state law imposes on him no further accountability. Although a minority of critics seek to place liability upon directors for activities conducted in the manner set forth above, state courts uniformly have recognized the desirability of encouraging able persons to act as directors and accordingly have not imposed liability upon them for their good faith activities in behalf of the corporation as described above.

Federal Securities Law Liability

Personal liability under the federal securities laws for the most part parallels liability under state law. If directors act intentionally, knowingly or recklessly in a manner which injures others in connection with a securities transaction, they risk liability under the federal securities laws. Thus, a director may not utilize inside corporate information to his own advantage or provide tips to others. He may not knowingly or recklessly participate in distribution of misleading information by his corporation. He may not knowingly participate in transactions which will have the effect of injuring minority shareholders.

In addition, there are certain federal securities laws which impose liability upon directors even though they act in good faith.

- **Registration Liability.** The 1933 Act imposes liability for participation in an illegal distribution of securities. If a corporation distributes securities through a registration statement which contains untrue statements or omits to make necessary statements, the directors of the corporation will be subject to suit by those persons who purchased the securities. Section 11 of the 1933 Act imposes liability upon directors who fail to demonstrate that they made a reasonable investigation (consistent with the individual’s role and training) of the facts set forth in the registration statement. To this end, directors should have an opportunity to question management, the outside auditors and legal counsel as to the procedures followed to achieve adequate and accurate disclosure.
- **Participation in Sales of Securities.** Section 12(2) of the 1933 Act imposes liability upon any person who negligently sells a security by means of a written offer to sell or an oral communication which includes an untrue statement or a half-truth. Under expanded definitions of the phrase “person who sells,” a director could be included in the category of seller. As a result, the director who participates in the sale of his corporation’s securities may be subject to liability for his negligence in failing to assure that statements in selling documents are accurate.
- **Failure to Register.** Likewise, if a director participates with an issuer in an unregistered distribution of securities, he may, under the expanded definitions of the phrase “person who sells,” be subject to liability for violation of section 12(1) of the 1933 Act, which grants remedies against a person who unlawfully offers or sells a security without registration.
- **Secondary Liability.** All of the federal securities law restrictions which apply to the corporation’s dealings with others and to its compliance with the federal securities laws generally also apply indirectly to those persons within the corporation who assist the corporation in its activities. These persons may violate the federal securities laws as participants, as controlling persons, or as aiders and abettors.

Under both the 1933 Act and the 1934 Act, persons who control a corporation will be liable jointly and severally to the same extent as the corporation. The controlling person may avoid liability under the 1933 Act by proving lack of awareness of the facts giving rise to the liability of his corporation and under the 1934 Act by proving good faith and lack of inducement of the conduct in question.

Even if a person assisting in a particular unlawful activity is not deemed to be a controlling person, that person may be an aider and abettor of the unlawful conduct. A person who knows of the existence of a wrongful act and gives substantial aid or encouragement to it may be held liable as an aider and abettor. Therefore, if the corporation or one of its directors, officers, employees or agents is engaged in a securities law violation, those who know of that violation and give assistance to the wrongdoer may themselves be charged with the violation. Naturally, all persons who actively participate will be subject to liability because of their direct wrongdoing.

In summary, except for liability under section 12(1) of the 1933 Act, a director who properly complies with his duty of care, including his duty of attention to corporate activities, and who acts in good faith, is not likely to incur liability for his corporation's activities under the federal securities laws.

Liability Under Other Laws

Directors may also be subject to personal liability under other state and federal statutes. Although discussion of laws in other areas which may rise to such liability (such as antitrust laws) is not provided here, the general statement can be made that good faith actions and monitoring efforts concerned with ongoing management programs directed toward corporate compliance will provide substantial safeguards against personal liability.

Indemnification

The Model Business Corporation Act, the Delaware law and the Oklahoma General Corporation Act all set out in detail the circumstances (under each Act) in which there can be indemnification of a corporate director made a party to litigation by reason of the fact that he is or was a director of the corporation. Such a suit might be brought by the corporation or by a shareholder in the right of the corporation challenging the director's performance of duties as a director (commonly called a "derivative action") or by a governmental agency or private party for a breach of contract, tortious conduct or violation of law (commonly called a "third party action"). The Model Act provisions, which have been adopted by numerous states, including Oklahoma and Delaware, give the corporation power to indemnify directors in third party actions against expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement of the action, and in derivative actions against expenses (including attorneys' fees), but not amounts paid in settlement. A corporate director adjudged to be liable for negligence or misconduct in a derivative action may be indemnified for expenses but only with court approval.

The common standard for such indemnification is that the director must have "acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation" and, if a criminal action or proceeding is involved, the director must also have "had no reasonable cause to believe his conduct was unlawful." The indemnification for expenses is automatic if the director has been successful in the defense of any action, on the merits or otherwise. Indemnification is not mandatory under the customary by-law provision where the director is not successful. If the director meets his duty of loyalty and duty of care, however, it is likely that the standard of conduct required for indemnification will also be met. In the case of settlements or certain adverse court determinations in third party actions, indemnification is permitted upon a determination by an appropriate independent majority of directors or shareholders, or by independent legal counsel, that the director met the applicable standard of conduct.

In passing, it should be noted that the SEC has long held the position that indemnification of directors for liability under the 1933 Act is contrary to public policy, and indemnification in these circumstances would in all likelihood be subject to prior judicial resolution of public policy considerations.

Additionally, directors should be aware that it is possible for the corporation to procure directors' and officers' liability insurance by which the corporation is entitled to reimbursement of any payment of indemnity claims and the individual director is insured (subject to the personal financial exposure, which can be significant, arising from a deductible and a retention) against the corporation's failure to pay such indemnity and, in some cases, against claims - where the corporation is not permitted to indemnify, in circumstances in which the director has acted in good faith. Certain areas of activity are excluded from coverage, either generally (e.g. environmental matters) or selectively (e.g. antitrust matters). Conditions in existence at the time application is made may also be excepted. Such insurance provides uncertain coverage in the case of punitive damages, excludes criminal penalties and fines, and is not available in every case. The insurance coverage provided under particular policy wording requires detailed analysis. In this connection, frequent reevaluation of coverage is appropriate in light of continuing interpretations by insurance underwriters and the courts. The Oklahoma Act and the relevant statutes of many jurisdictions permit the corporation to bear the expense of such insurance.

Advice of Counsel

The foregoing summary of the possible liabilities associated with duties as a director and transactions in the corporation's securities is necessarily abbreviated, and some would say too brief. Accordingly, the corporate director would be well advised to consult with regular corporate counsel (or his own legal adviser) at any time in which he is doubtful regarding proposed action and in particular prior to effecting any transactions in the securities of his corporation.

By: Mark A. Robertson, Partner at Robertson & Williams

RW Robertson
& Williams
9658 N. May Avenue, Suite 200
OKC, OK 73120-2718
405-848-1944
info@robertsonwilliams.com
www.robertsonwilliams.com