

## Board of Director Fiduciary Duties

This article reviews directors duties in the private company context. Board of director duties and responsibilities are briefly outlined with a focus on avoiding breach of fiduciary duty. Fiduciary duties such as duty of care and duty of loyalty play a part in the analysis of a board of directors liability. Directors liability as an outgrowth of the board of directors duties and function is also discussed. Directors and officers insurance is touched on to the extent directors insurance reduces liability arising from board of director fiduciary duties.

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### Board of Directors

#### Board of Directors

Board of directors in the USA are generally governed by state corporate statute, particularly in the private company context. A corporation's common shareholders, the owners of the company, select the directors who, on behalf of the shareholders, manage the company. However, directors are not agents of the shareholders. Directors must act on behalf of the corporation and all of the shareholders.

Because US law tends to view shareholders as purely capital-providers, board of directors roles center on running the business either through direct management or the appointment of executives. Directors are typically elected annually and, once elected, owe a fiduciary duty to act in the best interests of the corporation. The board of directors is empowered to act as a group, at meetings, usually by a majority vote. Individual, non-officer directors have no authority outside of the board.

### Board of Directors Duties and Functions

#### Directors Duties

Directors duties and individual director responsibilities are dependent on the particular type of company, board structure and board dynamics. For example, a board of directors may delegate certain matters such as executive and director compensation to a committee that is chaired by a director.

The key function of the board is to manage the business so that it is a success and shareholders realize returns. A directors duties greatly depend on how the entire board of director approaches its duties.

#### Board of Director Duties

Board of director duties and responsibilities include:

- Manage, oversee and monitor the business;
- Select, compensate and replace senior executives;
- Review and, in some cases, approve corporate financial objectives;
- Initiate and adopt corporate plans and actions;
- Initiate and adopt accounting changes;
- Advise officers and review corporate actions;
- Make shareholder recommendations;

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- Act on all matters where state law does not require shareholder approval.

As can be seen from the above list, a board of directors duties and responsibilities can be wide and varied. If corporate executives are appointed, responsibilities of a board of directors can be delegated to a certain extent. While independent directors are not required by state law, independent directors may help avoid legal scrutiny in the execution of a board of directors responsibility.

## Breach of Fiduciary Duty

### Fiduciary Duties of Directors

Directors act as fiduciaries to the corporation, and once elected must serve the best interests of both the corporation and *all* of the corporation's shareholders, not just those shareholders who the director was elected by.

A directors fiduciary duty arises out of the board's fiduciary relationship with the corporation and shareholders. Through corporate law, a board is given power to manage the company, and with that power comes the duty to use that power to benefit the company and the shareholders.

Fiduciary duties of directors fall under two general categories: (i) duty of care; and (ii) duty of loyalty. Under the *duty of care*, a director's fiduciary responsibility is to perform his/her duties with the diligence of a reasonable person in similar circumstances. Under the *duty of loyalty*, a director's fiduciary duty is to act in good faith for the best interests of the corporation.

Other duties include:

- Duty to act lawfully – directors have a fiduciary duty to act in a lawful manner
- Duty of disclosure – directors have a fiduciary duty to communicate honestly with shareholders
- Duty to inquire/monitor – directors have a fiduciary duty to ensure that they can adequately receive and report corporate information; if directors are alerted to a need to make further inquiry, they are obligated to do so.

### Breach of Fiduciary Duty

Breach of the fiduciary duty of care arises either through the board of directors making a decision in a negligent manner (e.g. lack of involvement and failure to monitor managers) or failing to act to avoid a preventable loss (e.g. failure to monitor and prevent employees' non-compliance with law).

Breach of the fiduciary duty of loyalty generally occurs when there is director self-dealing – the director obtains a benefit at the expense or to the detriment of the corporation or its shareholders. Examples of breach of the fiduciary duty of loyalty include:

- A director, or an affiliate of the director, has some hidden interest in a transaction;
- A director deprives the corporation of an opportunity that would be of interest to the corporation;
- A director receives undisclosed, third-party compensation (e.g. a broker's fee) for arranging a transaction that involves the corporation; or

- Directors compensate themselves excessively, at the expense of shareholders (e.g. awarding and backdating stock options).

### **Fiduciary Liability**

Breach of fiduciary duties either by a director or the board of directors exposes the entire board or a particular director or directors to shareholder lawsuits. A shareholder(s) can sue the corporation and/or director(s) directly (e.g. Shareholder A sues Director X) or bring a shareholder derivative suit and sue on behalf of the corporation. Remedies vary, but range from the court preventing the taking of an action or ordering that transaction proceeds be handed over to the corporation.

Currently, public company director and executive misdeeds are being addressed quite harshly. Authorities are severely punishing executives that take actions which result in violations of the law (e.g. fraud, option back-dating). Private company directors may be affected by this outlook.

Director liability may be reduced by implementing the full extent of statutory protections and amending the corporate certificate of incorporation and bylaws. Fiduciary liability insurance may also be used to provide for legal expenses.

### **Board of Directors Liability**

#### **Directors Liability**

In a breach of duty of care case, a directors liability will depend on what the court concludes a reasonable person would have done in similar circumstances. This “ordinary prudent person” standard means that directors that have greater access to information (inside directors) or have greater knowledge in a certain area (lawyers, accountants) may be held to a greater standard.

Under the “business judgment rule,” directors are presumed to have been informed, acted in good faith, and had the company’s best interests in mind. Unless this presumption is disproved, courts focus on the *process* by which a decision is reached, not necessarily the outcome.

The potential for director liability increases if a shareholder argues that the duty of loyalty was breached. In this case, the director has the burden of disproving self-dealing, and the court will scrutinize both the process and the substance of a transaction.

#### **Director Insurance and Indemnification**

Before becoming a director, make sure you are adequately protected. A director can be named as a defendant in a class action, derivative suit, or governmental proceeding. Corporate indemnification is possible, but a director must take steps to implement statutory protections. Directors and officers insurance can be used to guarantee access to legal services. Directors insurance may also provide for the payment of any settlement or judgment against a director.

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