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Overcoming the Challenge of Director Misconduct

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For corporations in the United States, the board of directors plays a critical oversight role in ensuring that management is accountable for the enterprise's success or failure in achieving its goals. The board also oversees the corporation's compliance with a sometimes bewildering array of federal, state, and local laws and regulations in often challenging economic and legal environments, while also dealing with the many and sometimes conflicting demands and pressures from constituencies both inside and outside the corporation, including government agencies, stockholders, employees, customers, suppliers, lenders, and competitors.

To execute this oversight role properly, a board of directors, which acts collectively, needs to function effectively. At its ideal, a well-functioning, highly-performing board will foster a collegial, supportive, and respectful environment in which a diversity of thought and perspective is encouraged and directors have the ability to express and explore differing viewpoints. After all, not all disagreement is disruptive, and an amicable exchange of opposing viewpoints can help the board arrive at well-informed and thoughtfully considered decisions.

But there are times when a board's culture is not collegial, supportive, or respectful and unhealthy dynamics have taken hold in the boardroom. When this happens, boards become dysfunctional, conflict becomes corrosive, and corporate performance can suffer. In the worst situations, some directors may become disruptive or engage in other forms of misconduct, necessitating corrective action by the board.

What, then, can corporations do to foster a collegial and supportive board culture that encourages open debate and respectful disagreement among directors, while also ensuring that directors adhere to standards of appropriate conduct and expected behavior? Answering that question is the purpose of this article. The first section begins the discussion by examining in greater detail the characteristics of a high-performing board. Next, we explore potential forms of misconduct by directors and how they relate to directors' compliance with their fiduciary duties to the corporation. Finally, we explore potential ways a board can address director misconduct. This article focuses primarily on Delaware's General Corporation Law, but also reviews and considers relevant provisions of the Model Business Corporation Act (the "Model Act"), as well as the American Law Institute's Principles of Corporate Governance.

The Importance of a Well-Functioning Board

Stockholders have an equity ownership interest in a corporation and the ability to exercise voting power on key matters, but state corporate law vests a corporation's board of directors with general oversight and decision-making authority. For example, the Delaware General Corporation Law and the Model Act provide that the business and affairs of a corporation shall be managed by or under the direction of a board of directors. Accountability to stockholders and the ability to supervise management effectively are, in turn, fundamental principles for boards of directors. Thus, the maintenance and growth of a corporation's value to stockholders depends in large part upon the thoughtfulness, diligence, and integrity of its directors and upon the board's ability to function in an effective manner.

A well-functioning board is one in which the oversight and decision-making processes are employed in a manner that protects and grows the corporation's value. To this end, individual directors must develop a deep understanding of the corporation's business, operations, competitive pressures, legal and regulatory requirements and risks, and prepare in advance for board and committee meetings in order to facilitate thorough discussion. Deliberations and other board activities are most effective when they are conducted within a framework of agreed-upon acceptable conduct that also affords room for individuality. A culture of respect and trust is critical to ensuring that directors debate matters openly, expressing both favorable and unfavorable opinions, and thereby engage in a robust decision-making process. Following deliberation, a well-functioning board typically achieves consensus, agrees upon the appropriate way for the board to operate, and shares a common understanding of what is in the corporation's best interest.

The responsibility to ensure that the board is functioning properly and that individual directors are performing in accordance with expectations lies with the board itself. Yet, defining improper behavior and inadequate performance is difficult. Boards of directors are typically made up of high-performing individuals whose opinions may differ, and as discussed above, the exchange of viewpoints is essential for thorough decision-making. However, repetitive disagreements handled in a disrespectful manner may discourage open discussion, lead to dysfunctional group dynamics, and diminish the board's ability to function effectively.

It is not uncommon for a board to experience dysfunction at some level, particularly when the corporation is facing unfavorable economic conditions, heightened competition, or uncertainty with respect to its strategic direction. Disagreements among board members may relate to a variety of issues, such as identification of the best management talent to lead the corporation, whether to acquire another company or divest a division, the development of new products and service lines, or the best approach to respond to legal changes and inquiries from regulatory bodies. In addition, the tone of boardroom discussions may be influenced by changes in board composition, particularly if incumbent directors are replaced by individuals nominated by activists or significant investors.

If dissent and disagreement escalate, the board's ability to oversee the corporation may suffer. Factions may develop, causing behind the scenes discussions to take place. This group dysfunction may either be caused by or lead to misconduct on the part of individual directors. Problematic behaviors may range in severity and may be unintentional or intentional. Examples often cited by practitioners in the field include the following:

- Failure to prepare for, attend, or participate in board or committee meetings;
- Attempts to micromanage the corporation's executive officers or regularly criticizing and second-guessing their decisions regarding day-to-day management of the business;
- Unauthorized disclosure of confidential information;
- Taking action or speaking on behalf of the corporation without prior written authorization from the corporation;
- Undertaking to be a shareholder, director, officer, employee, or agent of, or otherwise assisting another entity that competes with the corporation;
- Failing to properly disclose and resolve conflicts of interest;
- Taking corporate opportunities for personal benefit;
- Serving on other corporate boards in violation of the corporation's policies;
- Inappropriately or illegally trading in the corporation's securities;
- Taking any other actions contrary to applicable laws, board policies, policies of the corporation, and/or the corporation's code of ethics;
- Engaging in disruptive boardroom behavior, dominating discussions, or disrespecting fellow board members, officers, employees, or other agents of the corporation; and
- Otherwise inappropriately interfering with the corporation's operations.

As may be evident from the foregoing list, misconduct may or may not rise to the level of a breach of fiduciary duty. A detailed discussion of fiduciary duties for individual directors and the board as a whole is set forth below, followed by an explanation of the recourse a board has when a director engages in intentional or unintentional misconduct.

The Board's Legal and Regulatory Obligations

Overview

Delaware case law has long held that every director, as well as the board as a whole, owes a duty of care and a duty of loyalty to the corporation. So long as directors observe these duties, a court will defer to the board's business judgment if the board's decisions are subsequently challenged. If, however, directors fail to carefully evaluate the issues before the board or engage in self-dealing, a court will evaluate whether the board's decision was entirely fair to the corporation and its stockholders and may assess personal liability against some or all of the board members.

Although directors are required to observe their fiduciary duties constantly, the exact course of conduct that must be followed to properly discharge their responsibilities is fact-dependent and will vary based upon the specific circumstances. The duty of loyalty is typically characterized as requiring directors to act in the best interest of the corporation and avoid self-dealing. Because directors must avoid (or properly handle) conflicts of interest, engage in fair dealing with the corporation, and act in good faith, the most common examples of a breach of the duty of loyalty involve directors who fail to disclose a conflict of interest and instead use their position to further a personal interest. The duty of care, in turn, requires directors to safeguard corporate assets and carefully evaluate issues before the board. In doing so, directors must act with the care a person in a like position would reasonably believe is appropriate under similar circumstances.

Boardroom Dysfunction and Self-Interested Conduct

The duty of loyalty requires directors to refrain from acting in their own self-interest or the interest of another person, and instead act in good faith for the benefit of the corporation. Accordingly, directors must avoid (or properly resolve) conflicts of interest and cannot engage in self-dealing (unless it is entirely fair or approved by appropriate independent action). A director who determines that he or she has a conflict of interest must disclose the conflict, typically to a designated member of the board and the corporation's general counsel. Further, when directors are on both sides of a transaction, they must demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain and disinterested directors should review the transaction.

Boardroom dysfunction is sometimes closely related to a board member's dissatisfaction or self-motivated director conduct that becomes apparent following a director's unauthorized use of sensitive, non-public information. This information may include trade secrets, strategic and proprietary information, financial results and projections, prospects, significant transactions, the status of litigation, and other sensitive developments, all of which affect the corporation's competitive position, such that it is important for the corporation to control the messaging and timing of disclosure. Unauthorized disclosure of board deliberations or correspondence may also evidence or lead to dysfunction, as disclosure can harm the corporation and erode the trust that is necessary for robust debate and a well-functioning board.

Courts have indicated that it is improper for directors to use non-public corporate information to generate public support for a dissident opinion or to obtain other non-pecuniary benefits. Directors who disclose confidential, non-public information may breach their duty of loyalty. In addition, a director who improperly shares confidential information will likely violate one or more express provisions of the corporation's code of ethics or other policies and procedures.

Boardroom Dysfunction and Monitoring Director Performance

In addition to the duty of loyalty, a director owes the corporation a duty of care. The duty of care obligates directors to manage diligently the affairs and assets of the corporation and to consider the possible ramifications of their actions. The Model Act states that directors must act toward the corporation with "the care an ordinarily prudent person in a like position would exercise under similar circumstances."

The question of whether directors have satisfied the duty of care is most frequently analyzed in the context of a challenge to action (or conscious nonaction) of the full board in connection with a corporate decision. In that context, whether the board satisfied its duty of care turns on whether the board employed a decision-making process that was on par with the level of importance of the transaction or decision being considered. The duty of care also applies to the board in its role as overseer of management and others who are responsible for day-to-day operation of the corporation's business. Though the board has a duty to monitor, liability for a failure to provide proper oversight is rare. Historically, liability has been limited to situations in which the board consciously disregards its fiduciary duties and a "sustained or systemic" failure to oversee the corporation exists. Because the duty of care applies to actions and nonactions of the board as a whole, it is less likely than the duty of loyalty to be at issue in the context of individual director misconduct.

Boardroom Dysfunction and Regulatory and Contractual Compliance

Notwithstanding the foregoing, regulatory and contractual requirements reinforce the board's responsibility to oversee and evaluate its own performance, and stockholders depend on the board to execute this responsibility. Although not required by state corporate law, it is common for boards, particularly of publicly-traded companies subject to listing requirements, to adopt codes of conduct, principles of corporate governance, and other policies governing the conduct of directors and others. Failing to establish such standards and policies, or disregarding them once in place, may increase the risk to directors, even if a breach of fiduciary duty has not occurred. Moreover, robust adherence to the reporting and enforcement mechanics contained in internal company policies tend to encourage whistleblowers to seek internal remedies prior to contacting the SEC or other agencies, which benefits the corporation by facilitating internal resolutions and reducing the risk of an investigation.

In addition, a board may determine that its duty of oversight necessitates action if an individual director's misconduct is egregious and if his or her ongoing involvement in decision-making creates a risk of harm to the corporation, such as reputational, contractual, or regulatory harm caused by unauthorized disclosure of sensitive information that is strategic, belongs to a business partner, or would imply improper insider trading or inaccurate public disclosure by the corporation. Thus, it is not only important for a board to have policies in place to prevent misconduct – for example by establishing disclosure protocols, standards, and rules for sensitive information and those who have access to it – but also to understand its obligations and options in the event misconduct occurs.

Potential Avenues for Resolving Director Misconduct

When a director engages in misconduct, boards may tailor their response based on the severity of the misconduct and whether the misconduct was intentional or unintentional. A few potential avenues for resolving director misconduct are set forth below.

Training, Education, and Evaluations

Boards may provide supplementary training and education for an individual director who engages in misconduct and for the full board if warranted under the circumstances. The director may have engaged in misconduct because the director lacks an understanding of his or her role, the corporation's policies, procedures, code of ethics, or laws applicable to the corporation. Appropriate training and education alone may be sufficient when a director's conduct is unintentional. Such training may help to ensure an individual director or the board will not engage in similar conduct in the future.

In addition to training, some boards conduct director evaluations to assist with prevention of future misconduct. Evaluations offer an opportunity to provide specifically tailored feedback for individual directors to take into consideration to improve their own individual performance. Boards similarly may also consider periodically evaluating their culture to ensure effectiveness. These evaluations may address a variety of topics such as the composition of the board, committee structures, director compensation, board culture, and ethics. The board should consider making changes, as appropriate, in response to the findings from these evaluations.

Reprimanding a Director

If the director's conduct is intentional or so egregious that it has caused or may cause harm to the corporation and the board does not believe "soft" solutions such as training and evaluations are sufficient, a board may undertake to reprimand the director. Typically, the chairman of the board or the lead director will take the lead in reprimanding a director whose conduct falls below the accepted standard. A director who has been reprimanded may alter his or her behavior based solely on a formal admonishment and/or accompanying warning that the board will take further action if the misconduct continues.

Removing a Director

Boards that believe an individual director has engaged in misconduct may inquire about whether the board has legal authority to remove the director and appoint a replacement. For corporations incorporated in Delaware, Delaware law vests the power of removal of corporate directors in the stockholders, not the board of directors. The Model Act likewise provides that "shareholders may remove one or more directors with or without cause unless the articles of incorporation provide that directors may be removed only for cause."

Because both Delaware and the Model Act vest removal power with the corporation's stockholders, the board of directors of corporations incorporated in Delaware or in a state following the Model Act does not have the authority to remove a director. The board may request that the director resign, and the corporation may petition a court to remove a director, but the board cannot on its own remove the director. When the incident occurs mid-term, stockholders must call a special meeting or act by written consent to remove the director.

Request for Voluntary Resignation

When a director's conduct is severe and potentially harmful to the corporation, some boards consider requesting that the director resign. If the director does not resign, the board may refuse to re-nominate the director when the director's term expires, though a decision to refrain from re-nominating a director does not provide any relief to the board when the director who engaged in misconduct is in the middle of his or her term.

Special Committees that Isolate a Director

Given that the Model Act and Delaware law essentially strip the board of the authority to remove other directors, some boards have adopted resolutions creating a committee that excludes a director from participation when the board is dissatisfied with the individual director's conduct. Delaware law authorizes the board to designate committees consisting of one or more directors of the corporation. With a few exceptions, any such committee, to the extent provided in the resolution of the board of directors or in the bylaws of the corporation, may exercise all the powers and authority of the board of directors. It is important to note, however, that even when a special committee is formed, the board must honor directors' rights, including state law informational rights, and it is unclear just how long the board can use such a committee to isolate a director.

Judicial Removal

Though the board does not have the authority to remove a director who engages in misconduct, many jurisdictions allow a corporation to petition a court to remove a director for fraudulent or dishonest acts, gross abuse of authority, or breach of duty. Both Delaware law and the Model Act allow removal of directors by judicial proceeding in certain egregious situations.

Proposed Avenues that Are Impractical or Currently Unworkable

1. Automatic termination provisions and midterm bylaw amendments. In Delaware, a corporation may amend its charter to provide that a director's service will automatically terminate if the director fails to be qualified, but this mechanism depends on being able to define a qualification – and a failure to satisfy it – with enough particularity and clarity to make it be effectively enforceable. The Delaware Court of Chancery also reviewed whether boards may adopt a mid-term bylaw amendment that squeezes some directors out of the board, but concluded that a bylaw amendment cannot legally be designed to eliminate excess sitting directors because it has the effect of granting directors the power to remove other directors.

2. Contingent, irrevocable resignation letters. Because stockholders, not directors, have the power to remove directors, some have suggested that boards should request and obtain contingent, irrevocable resignation letters from directors. If an incoming director provides an advance resignation letter, the director would resign upon the occurrence of a specific event identified in the letter.

Statutory authority exists for contingent, irrevocable resignation letters in the context of majority voting. However, there is no similar statutory authority in Delaware that expressly authorizes directors to provide a contingent, irrevocable resignation letter mandating the director's resignation upon the happening of other events not related to majority voting. Moreover, while these letters seem to offer a workable solution in theory, Delaware courts likewise have not directly addressed the validity and enforceability of these letters.

Conclusion

The board of directors of a corporation owes the duties of care and loyalty to the corporation. In undertaking to fulfill these duties, it is of the utmost importance that the board is a well-functioning body in which the directors respect each other, are knowledgeable about the enterprise, and conduct appropriate due diligence concerning matters before the board.

Although debate and dissent are healthy for an organization, some boards will attempt to take action if they believe the situation is getting out of control. For situations involving unintentional misconduct, boards may focus on training, education, and director evaluations to correct the problem. In cases that are more severe, particularly those involving intentional misconduct, the board may choose to reprimand the director (publicly or privately) or request that the director resign.

Boards will often ask whether they have the authority to remove a director who has engaged in misconduct, but Delaware law and the Model Act vest this authority with the corporation's stockholders. Because of the limitations associated with removal authority, some boards form a special committee that excludes the director who has engaged in the misconduct (while making sure to honor the excluded director's rights). In the most egregious cases, judicial removal of the director may also be an option.

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ADDITIONAL RESOURCES

For other materials related to this topic, please refer to the following.

Business Law Section 2015 Spring Meeting

***Program:* Overcoming the Challenge of Director Misconduct (PDF) (Audio)**

Presented by Corporate Governance, Corporate Documents and Process

Location: 2015 Spring Meeting