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Corporate Governance Update: Advice for Directors in Complicated Times:  
The Fundamentals Still Apply

David A. Katz  
and  
Laura A. McIntosh\*

If there is one thing that market participants know for certain these days, it is that no one can predict accurately what will happen next. Forecasts range from dire to optimistic, and unexpected events make headlines almost every week. Seemingly solid financial institutions have been publicly shaken by unforeseen market conditions; merger and acquisition transactions that appeared certain to be completed have fallen apart. In the current period of volatility, directors may be surprised at how quickly a company's fortunes can change and they may find themselves in a difficult situation through no fault of their own. It is important for directors to remember that, even in the most uncertain of times, the fundamentals of directorship continue to apply: directors must responsibly oversee company affairs and the business judgment rule remains the standard for judicial review of their ordinary-course business decisions.

Directors' Oversight Responsibility

In the broadest sense, it is the responsibility of directors to oversee the affairs of a company and it is management's job to run the day-to-day business of the company.<sup>1</sup> To this end, in times of market uncertainty, generally there are three main areas on which directors should focus their attention: the state of the company's business, the quality and depth of the company's management (including succession planning), and the company's liquidity.

Paying careful attention to the overall state of the company's business is central to a director's responsibilities. Directors should, from time to time, in response to changing economic conditions, evaluate the sustainability of the company's business model. For example, the collapse of the subprime mortgage market caused significant collateral damage to many companies in different industries, some of which was foreseeable and much of which was not. Financially disruptive events may occur with little warning; however, if a company's management and its board are aware of potential

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\* David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz. Laura A. McIntosh is a consulting attorney for the firm. The views expressed are the authors' and do not necessarily represent the views of the partners of Wachtell, Lipton, Rosen & Katz or the firm as a whole.

<sup>1</sup> See Del. Gen. Corp. L. § 141(a).

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vulnerabilities arising from changing market conditions, and are willing to adapt their business model and strategy, they may be able to reduce their exposure in time to avert a crisis.

Similarly, as economic conditions change, it is important that the board continue to believe that it has the appropriate management team in place to weather any crisis. Management's qualifications and capabilities should be assessed in terms of experience, expertise, commitment, leadership ability and depth of the overall management team. Moreover, the board should be satisfied that the chief executive officer feels that he or she has the support of the board for the company's strategic direction, if that is the case, or understands the board's concerns if there is any difference of view on strategic direction. An important part of this process is making sure that the board hears regularly from the chief executive officer's direct reports so that the board has sufficient confidence in the entire management team. This should be an important component of the board's succession planning process as well. These matters should be addressed during the board's executive session, which should be on the agenda for each board meeting.<sup>2</sup>

Once directors have satisfied themselves that the business model and the chief executive officer's strategy continue to be appropriate, and that the current management team is capable of effectively managing the company's current circumstances, directors should be sure that they understand the key elements of the company's business' performance. Directors should have a clear understanding of how revenue is being generated and whether the company's revenue sources are vulnerable to changing conditions in the economy in general or the industry in particular. For example, directors should have a general understanding of the company's customer base and whether it is changing in meaningful ways. Directors also should have a good overall sense of the company's operating costs, including labor costs, cost of goods sold, and selling, general and administrative expenses. Directors should take a broad view of the company's financial and market position in order to be able to ask management about potential vulnerabilities in performance depending on different economic scenarios. Moreover, directors should be attuned to various contingencies that the company faces in its current business in addition to legacy liabilities, and directors should have a general understanding of the company's overall risk profile.

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<sup>2</sup> See New York Stock Exchange Rule 303A.03 (requiring that the nonmanagement directors of each company must meet at regularly scheduled executive sessions without management). Though the rule requires only occasional executive sessions, the practice has migrated towards scheduling regular executive sessions at every board meeting. When scheduling executive sessions, it is important to make sure that there will be sufficient time to cover the matters to be considered. It is common to set the executive session as the last item on the board meeting agenda, which in some cases may restrict the time available. Some boards of directors have made a practice of moving the executive session to an earlier part of the board meeting to ensure that there will be sufficient time to consider the matters that are to be discussed. Other boards have scheduled the executive session for the end of the board dinner preceding the next day's board meeting. Each board should fashion a schedule that meets that particular company's needs and determine the most appropriate time for the executive session.

Directors should also focus their attention on the company's liquidity. This issue is especially important in today's market environment.<sup>3</sup> Directors should have a clear understanding of the company's cash flow, credit arrangements, bank facilities, and covenant obligations, and be knowledgeable as to whether the company is at risk of failing to meet any of its financial covenants. This information needs to come from the company's management. Directors should also be aware of whether the company's business has a seasonal need for cash and be assured that at the point of the company's greatest need for cash, the company will continue to have sufficient access to cash to meet the needs of its business. Directors should also understand from management what will happen if cash flow is not as good as anticipated; for example, if a business downturn were to coincide with a peak cash need, how severely would the company's liquidity be affected?

Liquidity and its close cousin, solvency, are key in the merger and acquisition context. The recent failed purchase of footwear retailer Genesco by its smaller competitor Finish Line is a cautionary tale. Finish Line attempted to acquire Genesco in a highly leveraged transaction. The transaction had no financing condition, but the financing commitment provided to Finish Line was contingent on the solvency of the combined company. Although the strategic transaction appeared to be relatively certain of closing when it was announced, that was no longer the case when, due to a sharp decline in business, the solvency of the combined company was put in doubt. In the merger and acquisition context, directors should be careful to examine the liquidity and solvency risks, particularly in highly leveraged transactions where financing is at risk, and consider the impact on the company if the transaction is announced but fails to be consummated.

It is worth noting that, in the zone of insolvency, directors' obligations may shift from the company's shareholders to the company's creditors depending upon which state law applies to the circumstances. Under Delaware law, when a company is insolvent, the board's priority potentially shifts to encompass the interests of creditors.<sup>4</sup> This is an area that is highly dependent on specific factual circumstances, and directors of a company that is facing potential insolvency should seek expert legal counsel in determining the contours of their duties.

In addition to business affairs and liquidity, directors should focus on succession planning on a regular basis, especially when a company is operating in a challenging economic environment. If a company experiences a downturn at the same

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<sup>3</sup> Whether the global banking system is experiencing a liquidity crisis or a solvency crisis is a matter of some debate. For an interesting (and optimistic) view that it is the former, see Anatole Kaletsky, "Loss of Liquidity, Not Insolvency, Caused Credit Crunch," *The Times* (UK), March 24, 2008.

<sup>4</sup> See, e.g., *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d. 92 (Del. 2007), in which the Delaware Supreme Court ruled that the fiduciary duties of directors of an insolvent corporation continue to be owed to the corporation but that in the case of an insolvent corporation, creditors, as the true economic stakeholders in the corporation, have standing to pursue derivative claims for directors' breaches of fiduciary duty to the corporation.

time that the chief executive officer (or another key member of management) exits without a clear successor, it will be very difficult for the board and the remaining management team to effectively deal with the challenges facing the company. As directors are considering contingencies, they should be mindful of the succession plan and whether it continues to be appropriate in light of changing circumstances, both internal and external.

In sum, directors should satisfy themselves periodically that the company is pursuing the right strategic direction, that business and liquidity are sufficiently stable and that management is prepared for contingencies in both its specific industry and the economy generally. If there are no storm clouds on the horizon for a particular company, there is no need to schedule additional board meetings or seek the advice of outside consultants simply because economic conditions are uncertain. That said, directors should stay in contact with management between board meetings, particularly when external events occur that could potentially affect the company's business and strategy. Directors may request information from management between board meetings and offer counsel to the chief executive officer or other members of management as appropriate for their particular company. In a volatile business climate, directors should be active, and not passive, in exercising their oversight responsibilities.

It is important to note that, absent any substantial reason to believe that the company's management is not providing appropriate information or that management is ignoring "red flags," the directors are entitled to rely on managements' reports, advice and decisions.

#### Exposure to Liability

Directors' fiduciary duties do not change with market conditions nor does the applicability of the business judgment rule. The degree of vigilance required of a director will change depending upon the circumstances that a particular company is facing. Thus, directors should pay close attention to market conditions and think carefully about how trends or events affect the business and strategy of the company; as long as directors act on a fully informed basis, in good faith and in the manner they reasonably believe to be in the best interests of the company, their ordinary-course business decisions will receive the protection of the business judgment rule. In cases where the traditional business judgment rule applies, directors' decisions are protected unless a plaintiff is able to carry its burden of proof in showing that a board of directors has not met its duty of care or loyalty.<sup>5</sup> In Delaware, it is clear that directors will not have liability in their oversight role except in exceptional circumstances.<sup>6</sup>

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<sup>5</sup> See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Under Del. Gen. Corp. L. § 102(b)(7), a Delaware corporation may in its certificate of incorporation either eliminate or limit the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty, but such provisions may not eliminate or limit the liability of a director for, among other things, (1) breach of the director's duty of loyalty to the corporation and its shareholders or (2) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. Many Delaware corporations have

In the current economic environment, and in light of recent cases,<sup>7</sup> directors should be active in seeking information that will make them “fully informed,” which is the key principle at the core of the duty of care. To be fully informed, directors need to act on an informed basis after giving due consideration to the relevant materials and engaging in appropriate deliberation. A director’s conscious disregard of his or her responsibilities to the company, either through knowingly making decisions without adequate information and deliberation or through systematically ignoring a known risk, will not satisfy the legal requirement to act in good faith and on a fully informed basis.

In this context, it is the responsibility of the directors to request the information they need to make a fully informed decision as well as the obligation of the management team to provide sufficient information. In turn, directors are entitled to rely on members of management and other experts in making their decisions.<sup>8</sup> Moreover, directors should not hesitate to ask the board’s advisors for advice as to whether the information that has been provided to them is sufficient for them to make a decision.

One final word of advice to directors: In the current litigious environment, it is important to make sure that companies have up-to-date indemnification arrangements in place for board members and that companies have purchased adequate director and officer liability insurance policies. All of these arrangements should be reviewed on a regular basis to ensure that directors have the fullest coverage available to them so that they are protected against the risk of personal liability for their actions as directors. While director and officer liability insurance policies have become more expensive recently, they are generally available in most cases and should be purchased. Retentions and exclusions in the insurance policies should be carefully studied so that directors understand where they have protection and where they do not. Directors also

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either eliminated or limited director liability to the extent permitted by law. Similar provisions have been adopted in most states.

<sup>6</sup> In *Stone v. Ritter*, 911 A. 362 (Del. 2006), the Delaware Supreme Court reviewed the directors’ duty of good faith in the context of directors’ responsibility for oversight of the company and concluded that directors would have liability only if: “(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations, thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.” *Id.* at 370 (footnotes omitted).

<sup>7</sup> See, e.g., *In re The Walt Disney Company Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) (finding that, in the context of approval of a severance payment to the company’s former president, allegations that the board of directors first failed to obtain basic information about the severance arrangements could, if true, state a claim on which plaintiffs could recover); *Abbott Laboratories Derivative Litig.*, 325 F.3d 795 (7th Cir. 2003), *reh’g and reh’g en banc denied* (May 27, 2003) (finding that plaintiffs stated a claim by alleging that the board knew of repeated notices from regulatory agency of safety violations at a major division and decided not to act).

<sup>8</sup> See, e.g., Del. Gen. Corp. L. § 141(e).

should request information as to the financial strength of the companies providing different layers of the insurance coverage. In addition, directors should consider the impact of a bankruptcy of the company on the availability of director and officer liability insurance; it is important to focus on how rights are allocated between the company, on the one hand, and the directors and officers, on the other hand, who may be claiming entitlement to the same aggregate dollars of coverage. In order to eliminate any ambiguity that might exist as to directors' rights to coverage and reimbursement of expenses in the case of a bankruptcy of the company, many companies have decided to purchase separate supplemental insurance policies covering the directors and officers individually (often known as "side-A" coverage) in addition to their standard policies. In the case of a bankruptcy, this will be money well spent.