Fiduciary Duties of the Board of Directors

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Introduction

• Every director owes fiduciary duties to the corporation and its shareholders.

• Since directors can be subject to personal liability for breaches of these duties, it is important that they understand their obligations under law.

• This presentation discusses:
  • The core fiduciary duties of care and loyalty.
  • Specific director obligations that flow from the core fiduciary duties.
  • The standards of review that courts apply when judging directors' conduct.
  • How directors can limit their exposure to liability.
The Bottom Line

Directors should:

- Focus on overseeing the business, not learning corporate law.
- Regularly attend and participate in board meetings.
- Make sure management prepares adequate reports before board meetings and that the board receives those reports well beforehand.
- Consult with counsel and experts as needed.
- Not avoid discussing conflicts of interest in the hope of keeping them off the record. Discuss them and keep a record reflecting that the board considered them.

The rest is commentary.
Role of Directors in Management of the Corporation

- Ultimate responsibility for the business and affairs of the corporation belongs to the board of directors.

- Shareholders have two fundamental rights:
  - To elect directors to the board.
  - To exit the corporation by selling their shares.

- The shareholders do not manage the corporation.
  - No less true when there is a majority shareholder.
Role of Directors in Management of the Corporation (cont'd)

The board makes decisions on behalf of the corporation by:

- Appointing officers who run the day-to-day operations of the corporation, propose strategies and objectives, and implement corporate plans.
- Supervising those officers.
- Making major decisions for the corporation (for example, selling the company or entering into a significant joint venture).
Role of Directors in Management of the Corporation (cont'd)

In Summary: The board directors of hospitals are sometimes referred to as trustees because the owners and community entrust them with overseeing the hospital’s best interests. The board of trustees is the governing body of the hospital. They are responsible for developing and reviewing the hospital’s overall mission and strategy. The board guides the long-term goals and policies for the hospital by making strategic plans and decisions.

The board of trustees does not get involved in managing the hospital’s activities; rather, they oversee them. As part of their oversight duties, the board of trustees sets the job description for the CEO and is responsible for hiring, firing and monitoring the CEO. The board typically sets clear goals and expectations for the CEO, in keeping with strategic planning. Trustees assist and support the CEO with input about management policies, procedures and decisions. Upper management, along with human resources, is responsible for hiring hospital staff. Board trustees oversee the employee credentialing process, making sure healthcare professionals have the proper training, licensing and accreditation. The board is also responsible for making sure that processes are in place to discover any history of disciplinary action by prospective employees and to ensure that they have the proper level of malpractice insurance.
Role of Directors in Management of the Corporation (cont'd)

• Specific Functions and Delegation:
  – Human Resources / Employment – The Board’s role is to ensure appropriate processes are in place, not specific personnel (except for senior leadership positions).
    • Board’s job is to evaluate recommendations of Hospital Staff (i.e. CEO/Administrator, Medical Staff leadership, etc.)
    • Board may reasonably rely on information from hospital leadership, but may also request additional information from hospital employees
    • Board authorizes major decisions (i.e. litigation, settlement, significant changes to personnel policies), but generally does not participate in such ongoing matters
  – Financial Reporting – Processes and final review/approval
  – Compliance – Ensure programs are in place, reliance on hospital personnel to create and carry out

• Board’s Role is to ensure systems are in place to effectively operate the hospital, not to create or carry out such processes.
Sources of Director Duties

• The "corporate contract" consists of three components:
  • The state corporate statute (the Montana Nonprofit Corporation Act).
  • The corporation's articles of incorporation.
  • The corporation's by-laws.

• The fiduciary duties of the board are codified in Montana statutes.
The Fiduciary Duties of the Board of Directors

• The core fiduciary duties of the board of directors are:
  • The duty of care.
  • The duty of loyalty.

• Other duties like the duty of good faith and duty of oversight stem from the core fiduciary duties.

• Montana law describes these duties as requiring the Board to act:
  • (a) in good faith;
  • (b) with the care an ordinarily prudent person in a similar position would exercise under similar circumstances; and
  • (c) in a manner the director reasonably believes to be in the best interests of the corporation.
To Whom Are Fiduciary Duties Owed?

- Directors owe their fiduciary duties to the corporation and its shareholders/members.
  - Board of Trustees is elected by the individuals to whom fiduciary duties are owed – i.e. community members

- The corporation itself does not owe fiduciary duties to the shareholders.
  - If the board commits a breach of fiduciary duty, the complaint is with the board, not the corporation. The corporation cannot aid or abet the board's breach.
Duty of Care

• The duty of care requires that directors be informed of all material information reasonably available to them when making decisions for the corporation.

• Directors must act in good faith.

• A director must act with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

• Directors must act in the best interests of the organization.
• In discharging their duties, the Board may rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

  • (a) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;

  • (b) attorneys, public accountants, or other persons with regard to matters that the director reasonably believes are within the person's professional or expert competence; or

  • (c) a committee of the board of which the director is not a member, as to matters within its jurisdiction, if the director reasonably believes the committee merits confidence.
Duty of Loyalty

- The duty of loyalty requires directors to act in good faith for the benefit of the corporation and its shareholders/members, not for their own personal interest.

- Corporate opportunity doctrine: an officer or director may not divert to himself or his affiliates any business opportunity presented to, or otherwise rightfully belonging to, the corporation.
  - The corporation can renounce its interest in specified business opportunities in its certificate of incorporation or by board action.
The Board's Conduct
Business Judgment Rule

• In making business decisions, directors are generally protected by the business judgment rule.

• The rule presumes that disinterested and independent directors acted:
  • On an informed basis.
  • In good faith.
  • In the honest belief that the action was taken in the best interest of the corporation.
Business Judgment Rule (cont'd)

• **Informed.** Directors must inform themselves of all material information reasonably available to them.
  
  • Directors can rely on information and opinions from consultants and management, if those persons can competently produce those reports.

• **Good faith.** The decision-making process must be substantive and cannot just rubber stamp management's actions.

• **Best interest of the corporation.** The directors must reasonably believe the action was taken in the best interests of the corporation.

The standard for a finding of breach is **gross negligence**.
Corporate Waste

• If the plaintiff fails to rebut the presumption of the business judgment rule (no conflict of interest, no bad faith, no gross negligence), no remedy unless the challenged transaction constitutes waste.

• Stringent standard that is only met in the "rare, unconscionable case where directors irrationally squander or give away corporate assets."

• Spending on items such as employee vehicles, outings, social club dues and holiday gifts has been found to not constitute waste.

• Generally other standards apply to non-profit hospital boards – i.e. CMS Conditions of Participation, Grant funding, etc.
Exculpation from Liability

What if a board of disinterested and independent directors has been found to have acted with gross negligence?

• Breach of the duty of care is grounds for liability, unless (as is common) the corporation exculpates directors for breaches of that duty.

• The articles of incorporation can contain a provision eliminating or limiting the personal liability of directors to the corporation for monetary damages for breach of fiduciary duty.
  
  • This applies **only to a breach of the duty of care**, not a breach of the duty of loyalty, including the duty of good faith.

• It is not retroactive.
Breach of Duty of Loyalty: Bad Faith

• There is no single definition of good faith or bad faith.

• To act in good faith, a director must act with honesty of purpose and in the best interest of the corporation.

• Situations that usually involve bad faith:
  
  • An intentional failure to act in the face of a known duty to act, demonstrating a conscious disregard for one's duties.
  
  • A knowing violation of the law.
  
  • Acting for any purpose other than advancing the best interests of the corporation or its shareholders.

• Beyond gross negligence. Actual or constructive knowledge required.
Bad Faith via Failure of Oversight

- A component of the duty of care is to have a functioning oversight and compliance system. The board must implement an adequate system for reporting issues to the board.

- "Caremark" claim: the plaintiff alleges the board failed to oversee the company to a degree tantamount to bad faith.

- Director liability under Caremark arises where either:
  - The directors **utterly failed to implement** any reporting or information system or controls.
  - Having implemented such a system or controls, the directors **consciously failed to monitor** or oversee its operations.

- "Possibly the most difficult theory on which a plaintiff might hope to win a judgment."
Breach of Duty of Loyalty: Conflict of Interest

- **Conflict transactions**: If half or more of the directors hold a personal interest in a transaction, or if half or more of the directors are not independent, they lose the presumption that they acted in the best interest of the corporation.

- Directors are not deemed to have breached their fiduciary duties just because they were not disinterested and independent. However:
  - Their decisions will be judged for their fairness.
  - If found liable, their liability cannot be exculpated away.
Finding a Conflict of Interest

Disinterest and independence are determined on a director-by-director basis.

• If a majority of the directors are disinterested and independent, the decision is not considered conflicted and all directors are entitled to the presumption that they acted in the corporation's best interest.

• If half or more of the directors are not disinterested and independent, the decision is considered conflicted and the presumption of acting in the corporation's best interest is lost.

• The presumption can be restored by convening a special committee of independent and disinterested directors.
Conflict of Interest: Disinterest and Independence

- **Disinterest:**
  
  - Material financial interest not shared equally by the shareholders vs. any self-dealing (even immaterial).
  
  - The materiality of a financial benefit is determined in the context of the director's personal financial circumstances.

- **Independence:**
  
  - The director is so beholden to the controller or so under his influence that the director's discretion would be sterilized.
  
  - Personal and business ties together.
Conflict of Interest: Potential Liability

• Directors are not automatically liable in conflict transactions, even if the transaction is ruled unfair to the shareholders.

• If the articles of incorporation contain an exculpatory provision for breaches of the duty of care:
  • Any directors who themselves are disinterested and independent are only liable if they approved the transaction in subjective bad faith.
  • Any director lacking in disinterest or independence is subject to damages regardless of subjective intent.
Conflicts of Interest: Ratification

**Ratification:** Conflict transactions (majority of the board either not disinterested or not independent) can be ratified by a fully informed, disinterested majority of the shareholders.

- The approval restores the presumptions of the business judgment rule.
- Ratification either by shareholder vote in person or by proxy, or by written shareholder consent.
- Implications for director compensation, which are considered self-dealing actions.
Indemnification and Insurance
Director Indemnification and Insurance

There are two main ways for the corporation to limit its directors' exposure to personal liability for breach of fiduciary duty:

- **Indemnification and advancement.**

- **Directors and officers insurance** ("D&O Insurance").
Indemnification and Advancement

• Directors have a right to **indemnification** when they are made a party to a proceeding, and succeed on the merits, because of their service to the corporation if the director:
  
  • (a) engaged in good faith conduct;
  
  • (b) reasonably believed:
    
    • (i) in the case of conduct in the individual's official capacity with the corporation, that the conduct was in its best interests; and
    
    • (ii) in all other cases, that the conduct was at least not opposed to its best interests; and
  
  • (c) in the case of any criminal proceeding, had no reasonable cause to believe the conduct was unlawful.

• A director may also seek an **advancement of expenses** from the corporation.

• Montana law permits the corporation to advance the director's expenses as they are incurred.

• The expenses must be incurred for the purpose of "defending" oneself, not for initiating "offensive litigation" to vindicate one's reputation.
D&O Insurance

• Montana law permits corporations to insure directors to cover losses (such as settlement costs, fines, and legal fees) resulting from liability arising from actions taken while acting in an official capacity.

• This permission is broad; corporations can purchase insurance that covers liability that the corporation is not permitted to indemnify against.

• Directors should not assume the corporation has the widest-ranging coverage; coverage against fraud is rare.
D&O Insurance (cont’d)

• The three most common types of D&O coverage serve to:
  • Protect directors and officers from personal loss resulting from conduct arising out of their duties to the company ("Side A" coverage).
  • Reimburse the company for indemnifying directors and officers for claims made against them ("Side B" coverage).
  • Reimburse the company for certain claims made directly against it ("Side C" coverage).
Can individual directors recuse their way out of liability?

- A director **may be able to** avoid liability if the individual played **no role** in the board’s entire process.

- This means playing no role at all in the challenged decision, including the planning, negotiation, structuring, approval, etc.

- A director does not avoid liability merely by recusing oneself from the formal board vote after having already been involved in the process up until then.
For Further Information or Questions Contact:

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