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Directors face increased scrutiny, need to stay well informed

Insider view

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Boards of directors have been under increased scrutiny as shareholders, creditors and the public demand greater accountability. The shareholders in high profile court cases involving public companies — such as Enron, Worldcom, and Walt Disney — as well as local venture-backed private firms, have sued the directors. The threat of personal liability has made it more difficult for companies to attract and retain the board talent they require to help grow and manage the business.

When directors take the helm, they assume legal and fiduciary responsibility, which prohibits them from serving their own interests at the expense of the corporation, and requires them to use good business judgment. This means that directors are required to be competent, diligent and act in good faith when they make business decisions. The director's fiduciary duty of care and loyalty is owed to the company and its shareholders, and sometimes its creditors, tax authorities and employees.

Walt Disney CEO Michael Eisner negotiated an employment agreement for his successor, Michael Orvitz, without the Board of Directors' review or discussion. Because of the board's over reliance on Mr. Eisner's recommendation, the directors failed to devote adequate attention to the terms of Mr. Orvitz's employment. As a result of the Disney Board's dysfunctionality, Mr. Orvitz walked away with $38 million payment and millions in stock options when he was terminated only 14 months later.

Shareholders brought a lawsuit against the Disney board, claiming the directors breached their fiduciary duty.

The board should be a resource to the company, not a group beholden to the CEO. Directors can make better decisions for companies by investigating, learning and voicing dissent. In order for the board to be a resource and a value to the company, management should timely deliver board packages in advance of meetings to allow the directors time to analyze the issues and, if necessary, do their own research.

In the landmark settlements of Worldcom and Enron, the directors were personally liable for millions of dollars. Worldcom involved the largest accounting restatement in history when it admitted that fiscal 2001 pretax income was overstated by $74 billion. Worldcom directors were personally liable for $25 million, even though their annual compensation was just $35,000. Enron directors had to personally pay $13 million to settle the securities class action suit after its accounting restatement and bankruptcy.

In a local Silicon Valley case, Epinions' founders and employee shareholders filed suit and won a settlement against the CEO and its venture capitalist directors from Benchmark, August Capital and BV Capital for misleading them. The charges included aiding and abetting, breaches of fiduciary duty, fraud, conspiracy and unfair business acts.

When Epinions entered a merger agreement with DealTime, the board allegedly neglected to inform its common shareholders about a lucrative Google guaranteed Internet distribution deal. The Board of Directors determined only the preferred stock had value at the time of the merger, and all common shares were deemed worthless. When DealTime changed its name to Shopping.com and went public, the Epinions CEO made over $20 million and the VCs realized over $250 million.

Liability is based on the individual, not necessarily the board as a whole. A director should insist on documentation to support the board's deliberating process, and to register and document his or her dissent. They should do their homework to mitigate their exposure and be thorough and attentive. Since corporate counsel reports to, and is often aligned with, the CEO, boards should at times consider retaining their own outside and separate counsel to review minutes and advise the directors. Directors should consider attending corporate governance classes, and insist on the procurement of adequate directors and officers insurance.

Directors need to be aware of the recent lawsuits and trends, and know that their actions will be scrutinized. If they are diligent, directors can successfully mitigate liability and reduce their exposure. If directors are loyal, careful, well informed and make decisions based on advise from legal counsel, investment bankers and other experts, they can be protected from liability. The laws were not written to inhibit decision-making, but to ensure that a prudent decision-making process is used.

Here are some critical protective steps that members of corporate boards should take:

- Investigate the company governance policies
- Require timely delivery of board packages
- Be active, thorough and attentive
- Register and document dissention
- Retain outside experts
- Insist of best-in-class governance practices
- Attend continuing educations for directors
- Document deliberation process
- Procure adequate D&O insurance

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