



# Director Duties, Liabilities and ETHICAL PROTECTION: What Every Director Needs to Know

SEATTLE-NORTHWEST CHAPTER

National Association of Corporate Directors

**Program Chair:**  
**Evelyn Sroufe**

April 19, 2005  
7:30 a.m. – 9:00 a.m.



# Today's Objectives

Scott Greenburg – Chapter president

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- Introduce NACD
- Gain Insights into Today's Board Governance Issues
- Panel Observations and Interactive Discussion



# The National Association of Corporate Directors



- Established in 1977, NACD is the only national organization dedicated to director education and improving board performance.
- 20,000 members and customers, from the Fortune 100 through smaller public, private, and non-profit companies
- 19 Chapters Nationwide

# Upcoming



**May 24, 2005**

**Morning Program:  
7:15am - 9:00am**

**Director Legal  
Briefing: Statutes and  
New Cases You Must  
Know About. Lessons  
from Litigation**

**Program Chair:  
Scott Greenburg**

**The Rainier Club, Seattle  
[www.nacdnw.org](http://www.nacdnw.org)**



# NACD National: OCTOBER 22-23 2005

## THE DIRECTOR CERTIFICATE OF EDUCATION

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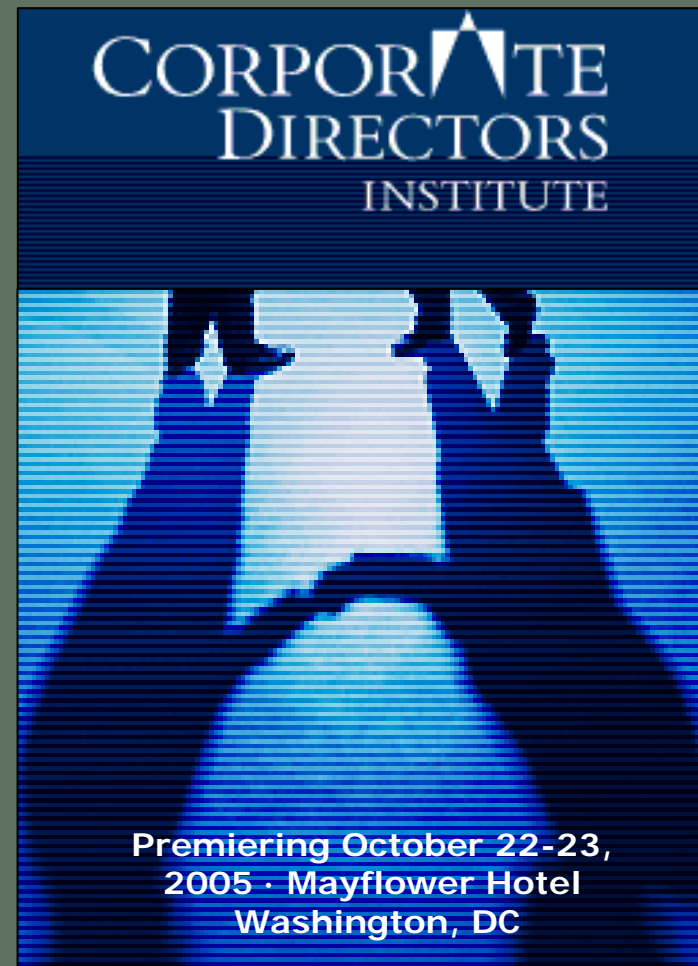
**INTRODUCING, AT THE**  
**October 2005**  
NACD National Meeting

## The Corporate Directors Institute

*The NACD Corporate Directors Institute  
offers:*

- Certificate of Director Education
- Director Professionalism Course
- Continuing Education Menu for Directors  
and Boards

[www.nacdonline.org/cdinstitute/overview.asp](http://www.nacdonline.org/cdinstitute/overview.asp)



# NACD Resources



**Report of the NACD  
Blue Ribbon Commission on**

**DIRECTOR PROFESSIONALISM**  
2001 Edition

Published by  
The National Association of Corporate Directors®

Original Edition Sponsored by  
Heidrick & Struggles International, Inc.

2001 Edition Sponsored by  
The Center for Board Leadership  
and its Alliance Partners:  
Aon Corporation  
Heidrick & Struggles International, Inc.  
KPMG Audit Committee Institute  
Mercer Inc.  
Pearl Meyer & Partners  
Weil, Gotshal & Manges LLP

**NACD**  
NATIONAL ASSOCIATION OF  
CORPORATE DIRECTORS

## Board Evaluation Practicalities: Creating a Board Self-Assessment Methodology

Excerpted from Katherine McG. Sullivan and Holly J. Gregory  
Paper presented at American Society of  
Corporate Secretaries' *Issues Update 1995* (Nov. 13, 1995)

*Self-assessment is emerging as an important tool for improving board effectiveness in overseeing corporate performance. A well-designed and well-executed self-assessment by the board should strengthen directors' understanding of their role and facilitate board cohesiveness and performance.*

### Defining Substantive Parameters for Board Assessment

It is axiomatic that carrying out a board assessment should have a...

## Board Evaluation Form

**Rate the following statements in relation to our Board of Directors.  
Rank answers from 1, Not Performing, to 5, Outstanding Performance.**

- \_\_\_\_\_ 1. The Board knows and understands the company's beliefs, values, philosophy, mission, strategic plan, and business plan, and reflects this understanding on key issues throughout the year.
- \_\_\_\_\_ 2. The Board has and follows procedures for effective meetings.
- \_\_\_\_\_ 3. Board meetings are conducted in a manner that ensures open communication, meaningful participation, and timely resolutions of issues.
- \_\_\_\_\_ 4. Board members receive timely minutes or drafts.

**Blue Ribbon Report on Board Evaluation-Reprints Available**

# Founding Sponsors Seattle-Northwest Chapter



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**W&R** Wilson Sonsini Goodrich & Rosati

PROFESSIONAL CORPORATION

# What We Will Cover

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- Director Fiduciary Duties
- Director Protections/"Holes" in That Protection
- Bankruptcy: Enron and WorldCom
- Ethical Programs as a Defense?
- Assessing the "Tone at the Top"/Oversight

# Director Fiduciary Duties

- Care (Emerging Communications)
- Loyalty
- Candor
- Good faith (Disney)
- Oversight (Caremark and Abbot Labs)
- Business Judgment Rule

# Director Protections and "Holes"

- Director Exculpation ("Raincoat") Provisions
- Director Indemnification Provisions
- Advancement of Expenses
- Indemnification Contracts
- D&O Insurance

# Delaware Raincoat Provisions

- Certificate of incorporation can **eliminate or limit personal liability of a director**:
  - to the corporation or its stockholders
  - for monetary damages
  - for breach of fiduciary duty as a director

# Delaware Raincoat Provisions--Exceptions

- Breach of the **duty of loyalty**
- Acts or omissions:
  - **not in good faith OR**
  - **involving intentional misconduct or a knowing violation of the law**
- **Unlawful dividends** or distributions OR
- Where the director derived an **improper personal benefit**

# Delaware Raincoat Provisions—What's Not Covered

- Claims against officers
- Suits by third parties (other than corporation or its stockholders)
- Equitable relief
- Federal law claims (e.g. securities)

# Disney: Good Faith Hole in the Delaware Raincoat

- \$140 million **severance to Michael Ovitz**, hired by CEO/friend Michael Eisner
- **Flawed** compensation committee and board **process**
- Egregious breach of duty of care = lack of **good faith**
- Bad faith=exception to the raincoat provision=**potential director liability**

# Delaware Indemnification

- Corporation *may* indemnify director in suit arising from **status as a director**
- Against **expenses, judgments, settlements** reasonably incurred IF:
  - Acted in **good faith**
  - In a manner **reasonably believed** to be in or not opposed to the **best interests** of the corporation, and
  - If criminal claim, no reasonable cause to believe conduct was **unlawful**

# Delaware Indemnification: Derivative Actions

- **Special case:** shareholder sues on behalf of the corporation
- Director indemnified if acted in **good faith**, with **reasonable belief in best interests** of corporation
- **BUT: expenses only**
- Not judgment unless court order
- Not settlements

# Delaware Indemnification

- Picks up third-party claims, federal claims that are not subject to exculpation
- Covers **expenses** of defense
- Virtually all companies make indemnification **mandatory** in Bylaws
- **SEC**: indemnification for **federal securities law violations** against public policy (note in registration statements)

# Delaware Advancement of Expenses

- Expenses advanceable BUT
- D must provide **undertaking** to repay if determined he/she is not entitled to indemnification
- Other states: D must **affirm good faith belief that he/she meets standard** for indemnification
- Courts: if not **specifically provided** in Bylaws, no advancement

# Indemnification Contracts

- Most states: statute is **nonexclusive**
- Agreement=**separate contract right**—but subject to same limitations as Bylaw indemnification
- **Provides detail** that may be lacking in statute/bylaws
  - Definitions; time frames for decisions; other procedures
  - Useful presumptions in favor of director (advancement of expenses)
- May need **shareholder approval** for fullest protection

# Martha Stewart 10—K Disclosure

- Claim for **reimbursement of expenses** of \$3.7 million
- Successful defense of **federal criminal complaint**: false/misleading statements to influence price of Martha Stewart Living Omnimedia stock
- Stewart/Corporation submitted claim to **independent expert** on DEL law
- Result: **entitled to indemnification**
- Corp: **reimbursable** under D&O Policy

# D&O Coverage

- Delaware, other **states, specifically authorize** purchase of D&O insurance
- Generally **claims made**
- **Third party payer:** protects against insolvency, change of control
- Covers **gaps in exculpation** (e.g., breach of loyalty), and **indemnification** (e.g. derivative suits)

# TOWERS OF COVERAGE

## TRADITIONAL POLICY

**SIDE A** (Individual  
D's & O's;  
Non-Indemnifiable  
Claims)

**SIDE B**  
(Individual  
D's & O's;  
Indemnifiable  
Claims)

**SIDE C**  
(Corporate Coverage  
for Securities Claims)

# TOWERS OF COVERAGE

## *DIC / BROAD FORM POLICY*

DIC / BROAD  
FORM POLICY

DIC / BROAD  
FORM  
POLICY

TRADITIONAL  
POLICY

**SIDE A**  
(Individual  
D's & O's;  
Non-  
Indemnifiable  
Claims)

**SIDE B**  
(Individual  
D's & O's;  
Indemnifiable  
Claims)

**SIDE C**  
(Corporate  
Coverage for  
Securities  
Claims)

**DROP  
DOWN  
CAPABILITY**

- Policy is Side A Coverage only
- DIC Policy may afford broader coverage than the underlying policy

# Common Exclusions, Other Terms

- **Insured vs. insured**
- **Improper personal benefit** (Dennis Kozlowski/Tyco)
- **Deliberate fraud** (Cutter & Buck)
- **Regulatory proceedings**
- **Severability** clauses

# Current Pricing and Underwriting Trends

- Is there a **crisis** in D&O coverage?
- Impact of the **AIG**/Elliot Spitzer investigation?
- How much **coverage** is enough?
- How much should it **cost**?

# Bankruptcy: Enron and WorldCom

- Both cases: **D's contributed** to settlements out of **own pockets**
- **WorldCom**: first not approved due to proportionate liability provisions-PSLRA
- Allen Hevesi, NY State Comptroller: want **pain inflicted on individual directors** as condition to settlement (Enron)
- Claims that D's responsible for **material misstatements/omissions** in '33 Act prospectuses **never proved** BUT
- Bankruptcy report highly critical of D's

# "Structural" Ethical Protections: Sarbox/NYSE

- **Sarbox 406:** Code of Ethics for senior financial officers; disclosure of code of ethics waivers
- **Sarbox 302:** CEO/CFO certifications of financials
- **Sarbox 301:** Audit Committee oversees whistleblower procedures
- **Sarbox 307:** Lawyer "Up-the-Ladder" reporting

# New Board Seat: Assessing the "Tone at the Top"

- Company information
- Analysts reports
- Management reputation
- Other Board members

# Once on the Board—Oversight: Caremark/Abbott Labs

- **Caremark:** omission to act—duty to ensure appropriate compliance program
- **Abbott Labs:** not an omission—conscious decision not to act
  - largest civil fine ever by FDA--\$100 M
  - 6-year pattern of violations
  - Chairman reviewed FDA warning letters (but did they indicate seriousness?)
  - Audit Comm had duty to assess business risk
  - Intentional disregard of duty of care=lack of good faith=no exculpation

## Once on the Board: Oversight—Federal Sentencing Guidelines

- Governing authority of an organization (Board)
- SHALL be knowledgeable about the content and operation of the org
- SHALL exercise reasonable oversight
- Of implementation/effectiveness of compliance and ethics program

# Once on the Board: Oversight—Practical Guidance

- "Ever since [*Caremark*, courts] trying to draw a line as to the effort that directors need to make in order to not be in a situation like the WorldCom or Enron directors."
- What continuing diligence should you do to be sure you are not caught by surprise?

# Director Duties, Liabilities and Ethical Protection: What Every Director Needs to Know

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## Moderator **Evelyn Cruz Sroufe**

Ms. Sroufe is the firm wide chair of the Corporate Governance and Transactions Practice Group at Perkins Coie LLP and a frequent speaker and author on corporate governance issues. She also serves as a board member of the Virginia Mason Healthcare System and of The South Downtown Foundation. Previously she has been director of Willamette Industries, Inc, Portland, OR, a Vice President with Microsoft Corporation and a Senior Vice President of Worldwide Operations with Visio Corporation.

## Panelists



## **Ron Berenstein**

Mr. Berenstein is the firm wide co-chair of the Securities & Corporate Governance Litigation practice at Perkins Coie LLP. He has represented corporations and their officers and directors in securities and corporate governance litigation, SEC enforcement matters and investigations for more than 25 years. His practice also includes representing parties in connection with D&O insurance matters. Recent representative clients include Merix Corporation, Amgen, Inc., Spacelabs Medical Inc., Metawave Communications Inc., Expedia, Inc., Longview Fibre Co., Plum Creek Timber Co., Shurgard, and Amazon.com.



## **Bob Gilb**

Mr. Gilb has been a director of Captaris since 1998. He has been the President of Robert F. Gilb Strategic & Business Consulting, L.L.C. since May 1997. From 1992 to 1997, Mr. Gilb held several positions at Microsoft Corporation, serving most recently as General Manager, Worldwide Business Operations. From 1979 to 1992, Mr. Gilb was an audit partner with Arthur Andersen L.L.P. in Seattle, Washington. Mr. Gilb is an Associate Trustee to the Pacific Science Center in Seattle and is a member of the Seattle University Accounting Advisory Board.



## **Keith D. Grinstein**

Keith D. Grinstein, 43, has been a director of Coinstar since August 2001, serving as its non-employee chairman since June 2002. Mr. Grinstein has senior executive positions at Nextel International, Inc., a telecommunications company, including president, and was a member of its board of directors from 1996 until 2002. Mr. Grinstein also held positions at AT&T Wireless Services, Inc. (formerly McCaw Communications), including president and chief executive officer of the Aviation Communications Division. He served as a member of the board of directors of the Ackerley Group between 2000 and 2002. Mr. Grinstein is currently a partner of Second Avenue Partners, a venture capital fund, and serves as a director of Nextera Enterprises, Inc. and F5 Networks, Inc.

## **Peter Marchel**

Mr. Marchel is the Vice President & General Counsel for Alexander Morford & Woo Inc. His practice emphasizes consulting and assisting clients in obtaining executive liability insurance, as well as prevention of and defense against executive liability lawsuits. Mr. Marchel is a board member of the Lake Washington Chapter of Chartered Property and Casualty Underwriters (CPCU) and a frequent speaker on insurance protection for directors and officers, most recently: "Insurance for the Not-for-Profit" at the Association of Corporate Counsel Annual Convention in San Francisco, California, and "Executive Liability Insurance" at the Washington Chapter - Association of Corporate Counsel in Seattle, Washington.