In this turbulent economic environment, directors and officers of US corporations face significant scrutiny and liability from a number of sources. There are five major constituents to whom directors and officers, of U.S. corporations and U.S. subsidiaries of foreign corporations, owe duties and responsibilities, and are subject to liability. They are the corporation itself, shareholders, creditors, corporate employees, and governmental regulators/law enforcement agencies.

**Duties to the Corporation**

Directors and officers of companies incorporated within the United States have three longstanding duties to the corporation itself. These duties, all grounded in state law, include the duty of care, the duty of loyalty and the duty of obedience. The duty of care requires corporate directors and officers to exercise their corporate responsibilities in good faith, with the care of an ordinary prudent person in a similar position, and in a manner one reasonably believes to be in, and not opposed to, the best interest of the corporation. The duty of loyalty requires that directors and officers exercise their powers in the primary interests of the corporation, and not usurp corporate opportunities for their own benefit at the expense of the corporation. The duty of obedience requires that corporate directors and officers make all corporate disclosures in a timely manner; issue dividend checks properly, and adhere to the articles of incorporation, bylaws and guidelines of the corporate charter.

When corporate directors or officers fail to adhere to any of these responsibilities, they face potential liability, often in the form of a derivative action, which are lawsuits filed by shareholders on behalf of the corporation against its directors and officers for malfeasance, misfeasance or nonfeasance. Typically, corporate directors and officers rely on the business judgment rule as a defense against liability. The business judgment rule acts as a presumption that the named defendants exercised a proper business judgment with due care and that they operated in accordance with the corporation’s business model, which is beyond the purview of a court’s competence. Courts typically won’t second-guess the “business judgments” of the corporation’s directors and officers.

The presumption can and has been successfully rebutted by establishing a breach of the duty of loyalty, a lack of due care or nonfeasance. Indeed, directors and officers have been found liable: by abdicating their functions or failing to act, Aronson v. Lewis 473 A.2d 805 (Del. 1984); by ratifying material transactions without appropriate analysis and consideration, Smith v. Van Gorkom 488 A.2d 858 (Del. 1985); and by failing to implement reporting systems allowing directors to monitor corporate compliance and make informed decisions, In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

When a shareholder sues corporate directors and officers in a derivative proceeding and prevails, any damages awarded against the corporation, not the shareholders. In October 2011, the Delaware Court of Chancery awarded approximately US $2 billion in damages, including interest, arising from a challenge to the sale of Grupo Mexico SAB’s 99.15% stake in Minera Mexico SA to Southern Peru Copper, and awarded US $300 million in attorney fees to the plaintiffs’ law firms.

Derivative actions must either be accompanied or preceded by a shareholder demand made against the board of directors, that the directors either sue themselves or selected officers and/or members of the board. Corporate boards will generally respond by appointing a special litigation committee, comprised of disinterested directors or prominent disinterested third parties, to consider whether it’s in the best interest of the corporation to sue its own directors or officers. The committee will typically consider the legal, economic and business implications of suing the directors or officers and will be charged with determining whether it’s in the corporation’s best interest to sue. A court will typically rely on the findings of a special litigation committee in considering whether to dismiss a derivative action on motion, if it finds that the special litigation committee was truly independent.

**Duties to Shareholders**

Directors and officers of U.S. publicly traded companies also have a duty to provide their shareholders with open, honest, and timely disclosures of the company’s financial condition and well being, which are enforced through the federal securities laws. These remedies are codified in several U.S. statutes. They include the Securities Act of 1933 (also known as the 1933 Act), the Securities and Exchange Act of 1934 (also known as the 1934 Act), and the Public Company Accounting and Investor Protection Act of 2002 (also known as the Sarbanes-Oxley, or SOX), and the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (also known as Dodd-Frank).

Congress enacted the 1933 Act following the stock market crash of 1929. According to the SEC, the Act has two basic objectives:
1) requiring that investors receive financial and other significant information concerning securities being offered for public sale; and

2) prohibiting deceit, misrepresentations, and other fraud in the sale of securities. In order to achieve these goals, the 1933 Act requires issuers of stock to disclose important financial information through the registration of securities with the Securities Exchange Commission (SEC). Directors and officers liability for misrepresentations falls under three statutory sections.

Under Section 11 of the Act, a shareholder may sue the corporate directors and any other party, which signs a registration statement filed with the U.S. government, containing material misrepresentations. The elements of liability are:

1) an offer to buy-sell securities;
2) in a registration statement;
3) a negligent misrepresentation; and
4) damages.

The corporate directors are entitled to assert as a defense that after making a “reasonable investigation”, they had reasonable grounds to believe that the statements made in the registration statement were true and that there were no omissions of material facts. Section 12(2) of the 1933 Act creates liability of directors and officers for misrepresentations in a prospectus or public offering. It is similar to Section 11, but applies to the actual selling of securities through oral communications, or sales brochures.

Unlike Section 11, directors have a good faith defense under Section 12(2). In addition, Section 15 of the 1933 Act establishes liability of any person who controls any director or officer liable under Section 11 or 12(2). Small size stock offerings are exempted from the above-mentioned registration requirements.

The 1934 Act established the Securities and Exchange Commission (SEC) and gave the SEC the power to establish an anti-fraud rule governing the daily trading of stock. Section 10(b) of the 1934 Act is the enabling legislation that led to the creation of Rule 10b-5, which established a private cause of action for misrepresentations in the sale and purchase of stocks. The elements of liability under 10b-5 are:

1) the sale or purchase of securities;
2) causation/misrepresentation;
3) scienter (recklessness);
4) materiality;
5) reliance; and
6) damages.

Section 14(d)(7) of the 1934 Act and Rule 14d-10 provide a cause of action for unequal treatment in proxy statements or tender offers. Like Section 15 of the 1933 Act, Section 20(a) applies to “Controlling Persons.” Finally, Section 20A establishes liability for insider trading.

SOX is intended to increase corporate shareholder disclosures and audit committees’ responsibilities, and to create a host of regulatory reporting requirements and oversight obligations. It was enacted in the aftermath of Enron, Worldcom, and HealthSouth. Under Section 302 of SOX, directors are required to disclose in quarterly and year-end reports that:

- The CEO and CFO have reviewed the financials;
- To their knowledge, the financials do not contain material misrepresentations or omissions;
- Internal controls have been evaluated;
- The auditors along with the board have been notified of any weaknesses; and
- Certain frauds have been reported to the board.

To the extent any disclosures are false, senior management will potentially face increased liability for securities claims. SOX also provides other restrictions and obligations to a board of director’s audit committee, as well as to a corporation’s outside attorneys and auditors.

In addition to the shareholder remedies under the federal securities laws, many states have “blue-sky” laws that contain civil liability provisions, which track Section 12(2) of the 1933 Act. Further, Section 22 of the 1933 Act provides for concurrent jurisdiction between state and federal courts, allowing for stock drop cases involving initial public offerings to be litigated in state courts. There has been an increase in lawsuits by shareholders in state courts involving corporate governance issues, often arising from mergers and acquisitions. These lawsuits, typically filed as class actions, are based on the statutory or common law of the state in which the “issuer” is incorporated. Although they are usually brought in connection with initial public offerings, California and Oregon, have “blue-sky” laws imposing private causes of action for secondary sellers and purchasers of stock. Plaintiffs seeking state court jurisdiction must overcome the obstacles of the 1998 Securities Litigation Uniform Standards Act (SLUSA) and the 2005 Class Action Fairness Act (CAFA).

Most state courts have determined that creditors’ only recourse in collecting outstanding obligations is limited to the terms of their contractual rights.

### Duties to Creditors

Directors and officers of U.S companies benefit from the protection of the corporate veil against creditor claims. Most state courts have determined that creditors’ only recourse in collecting outstanding obligations is limited to the terms of their contractual rights. They rarely have privity of contract in which to assert direct causes of action against corporate directors and officers. Yet, when a
corporation publicly issues a debt obligation in the form of a corporate bond, debenture, or other security, and subsequently defaults on its obligation, its directors and officers face potential liability for misrepresentations to its creditors, similar to shareholder liability. In addition, depending upon the state in which a company is incorporated, when a corporation becomes insolvent, the directors’ and officers’ duties and obligations to creditors can take on new priorities. In the case of American Catholic Educational Programming Foundation Inc. v. Gheewalla, 2007 WL 1453705 (Del. May 18, 2007), the Delaware Supreme Court ruled that: “individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors.” This extends to preclude creditors from bringing direct or indirect claims against corporate directors when a company is in the zone of insolvency. However, the Delaware Supreme Court recognized a creditor’s right to step into the shoes of the shareholders in the event of corporate insolvency, and thus creditors have standing to maintain derivative claims against directors of insolvent companies for breaches of fiduciary duty.

Duties to Employees

Directors and officers of U.S. corporations also face potential liabilities from current or potential employees in the context of hiring, firing, promoting, paying and providing reasonable accommodations for them. Employment-related claims against directors and officers can take the form of lawsuits for wrongful termination, sexual harassment and discrimination of various forms, along with possible violations of such U.S. statutory provisions as: Title VII of the Civil Rights Act of 1964, the Equal Pay Act, the Age Discrimination in Employment Act, the Family and Medical Leave Act, the Americans with Disabilities Act, and a variety of state statutory provisions. Often, these liabilities are combined with contractual obligations owed directly by the corporation to its corporate employees, through such common law principles as wrongful interference with contractual relationships, breaches of fiduciary duty, intentional or negligent misrepresentations, common law frauds, and tortious inducements.

Duties to Governmental Regulators and Law Enforcement Agencies

Finally, directors and officers of both publicly and privately traded companies have responsibilities and potentially face liability to such federal and state regulatory and law enforcement agencies as the SEC, the U.S. Justice Department and a host of state attorney generals. The SEC is empowered to seek fines and penalties against corporate directors and officers for civil violations of the 1933 Act, the 1934 Act, SOX, Dodd-Frank and the Foreign Corrupt Practices Act (FCPA), while the U.S. Justice Department is responsible for the criminal enforcement of such statutory violations. State Attorney Generals are also empowered to seek civil and criminal remedies against corporate directors and officers for violations of state commercial statutory and regulatory provisions. In addition, Dodd-Frank includes a whistleblower provision that requires the US government to pay an award, according to regulations established by the SEC to “eligible Whistleblowers”, who voluntarily provide the SEC with new information concerning a violation of the federal securities law that results in a successful enforcement actions.

Conclusion

Although the duties and responsibilities of U.S. corporate directors and officers can be overwhelming, and the potential liabilities staggering protection is available in the form of Directors’ and Officers’ Liability Insurance.

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1 See William E. Knepper and Dan Bailey, Liability of Corporate Officers and Directors (7th ed. 2004)
5 As Principal of Granof International Group, Perry Granof specializes in Director and Officer Liability (D&O), Professional Indemnity (PI), and Financial Institution (FI) insurance, with particular emphasis in evaluating coverage and liability for securities lawsuits, insolvencies, and financial institution exposures