United States

John W Blancett
Martin J O'Leary
Katelin O'Rourke Gorman
Eric C Scheiner
Sedgwick LLP

1. Introduction

The laws affecting US directors can be as varied as the 50 states and 16 territories that comprise the nation itself. In the United States, each state has its own corporate law that sets forth the obligations and duties owed by corporate directors to their constituents. This chapter focuses predominantly on the three states – Delaware, New York and California – where a significant percentage of businesses have been incorporated[1] and a majority of the lawsuits against directors have been filed. These lawsuits can involve state causes of action, federal claims or both.

In the sections that follow, we compare and contrast directors' duties under Delaware, New York and California law, as well as under the Model Business Corporation Act adopted by approximately 30 states (and based on the Illinois Business Corporation Act); we discuss who can bring claims against directors and the types of claims usually brought; we address the current regulatory and criminal liability landscape; we explain directors' rights to corporate indemnification; and we analyse the latest filing trends. This coverage enables us to illustrate today's most likely claim scenarios and greatest exposures.

2. Directors' duties

2.1 Who is a director?

Most states' corporate laws require a corporation to be managed by a board of directors.[2] The directors are usually elected by shareholders, with the scope of their authority set forth by state law and further detailed in the corporation's certificate of incorporation and/or by-laws. Directors typically strategise on and formulate overall corporate policy, while the daily management and execution of corporate policy falls to the corporation's officers and other employees.

When an individual is both a director and an officer, that director is typically referred to as an 'executive director' or 'inside director'. If a director is not an officer or employee of the corporation, that director is typically referred to as an 'outside

1 As of May 2016, "[m]ore than 50% of all publicly-traded companies in the United States including 64% of the Fortune 500 have chosen Delaware as their legal home" (http://corp.delaware.gov/aboutagency.shtml).

2 See, eg, Delaware General Corporations Law, 8 Del C §141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

director'. Different liability defences may apply depending on whether an individual is an inside director or an outside director (see section 2.5(d) below).

2.2 Nature of duties

Generally speaking, directors owe the corporation and its shareholders[3] two fiduciary duties:

- *the duty of care:* where a director must ask questions and act diligently in order to become and remain fully informed; and
- *the duty of loyalty:* where a director must make decisions based on the corporation's best interests, and not on any personal interests.

As stated in section 1 above, each state has its own laws outlining the duties of care and loyalty. Some states, such as New York and California, have codified directors' duties by enacting statutes; other states, such as Delaware, have not codified these duties and case law (common law) governs.

Directors' discharge of their fiduciary duties is measured against the so-called 'business judgment rule'. This rule is the rebuttable presumption that, in making business decisions, directors have acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the corporation. See further section 2.5 below.

2.3 Standards of care and conduct

(a) Fiduciary duties delineated by common law – Delaware

The Delaware General Corporations Law is the classic skeletal enabling act, leaving the bulk of corporate law to case-by-case judicial development.[4] As a result, Delaware's case law is most instructive on the nature of directors' duties. Indeed, Judge Veasey (see note 4) stated at page 96 in the quoted article:

> *No Delaware statute sets forth the duty of care, the duty of loyalty, the business judgment rule, or when director liability may attach. Yet, the judicial gloss on fiduciary duties is embodied in about a century of Delaware case law, norms, expectations, and aspirational standards that influence the structure, relationships, control mechanisms, and objectives of corporations.*

In the 1939 seminal case *Guth v Loft*, Delaware's Supreme Court held that Delaware directors owe a triad of fiduciary duties, not only to the corporation itself but to its stockholders as well.[5] This triad was composed of the duty of care, the duty of loyalty and the duty to act in good faith.[6] Through the evolution of Delaware case law, these duties have been streamlined, the duty of good faith now being considered

---

3 In certain instances, such as when a corporation becomes insolvent, directors may have obligations to creditors as well, as discussed in Section 2.5.

4 See E Norman Veasey, "On Corporate Codification: A Historical Peek at the Model Business Corporation Act and the American Law Institute Principles Through the Delaware Lens", 74 *Law and Contemporary Problems* 95–106, 95 (Winter 2011). Veasey served as Chief Judge of the Delaware Supreme Court from 1992 until 2004.

5 *Guth v Loft*, 5 A2d 503, 510 (Del 1939).

6 *Ibid.*

a subset of the duty of loyalty.[7] Thus, under Delaware law, directors owe two basic duties: the duty of care and the duty of loyalty.

In order to satisfy the duty of care, directors' decisions must be based on "informed business judgment".[8] This means that "all material information reasonably available" must be considered.[9] In order to satisfy the duty of loyalty, directors must ensure the "best interest of the corporation and its shareholders takes precedence over any interest possessed by a director".[10]

(b) Statutory fiduciary duties – Model Business Corporation Act

Approximately 30 states, preferring a statutory and clear-cut approach, codified directors' fiduciary duties by adopting the Model Business Corporation Act. Based largely on the Illinois Business Corporation Act, the Model Business Corporation Act was drafted in 1946 by a committee of the American Bar Association; revisions continued thereafter, including a major rewrite in 1984, and periodic revisions continue to this day (although the act has remained unchanged since 2011).

Section 8.30 of the Model Business Corporation Act defines the duties of loyalty and care imposed on corporate directors as follows:

- each member of the board of directors, when discharging the duties of a director, must act in good faith and in a manner the director reasonably believes to be in the best interests of the corporation; and
- the members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

The states, along with the District of Columbia (Washington, DC), named in Table 1 have adopted the Model Business Corporation Act in whole or in part, as of May 2016.

Table 1: States where the Model Business Corporation Act has been adopted (in whole or in part)

Alabama	Alaska	Arizona	Arkansas	Connecticut
Florida	Georgia	Hawaii	Idaho	Indiana
Iowa	Kentucky	Maine	Massachusetts	Mississippi
Nebraska	New Hampshire	New Mexico	North Carolina	Oregon
Rhode Island	South Carolina	South Dakota	Tennessee	Utah
Virginia	Washington	West Virginia	Wyoming	–

7 See, eg, *Gavin v Tousignant* (*In re Ultimate Escapes Holdings, LLC*), 2014 WL 5861765, at *9 n32 (Bankr D Del, November 12 2014) (supporting citations omitted).
8 See *Smith v Van Gorkom*, 488 A2d 858, 872–873 (Del 1985).
9 See *Reed v Linehan (In re Soporex)*, 463 BR 344, 371 (Bankr ND Tex, July 1 2011) (applying Delaware law).
10 See *Cede & Co v Technicolor, Inc*, 634 A2d 345, 361 (Del 1993).

(c) California: Model Business Corporation Act plus 'reasonable inquiry'

Section 309 of the California Corporations Code codifies the fiduciary duties owed by directors under California law. Section 309 adopts most of the Model Business Corporation Act's language although, notably, it inserts a specific duty of 'reasonable inquiry' as part of the duty of care. This duty of reasonable inquiry modifies – and actually diminishes – a director's ability to rely on information from officers, committees or professional advisors.

For example, even if a director has no knowledge that would render reliance on such advice or information unwarranted, he may still have a duty to investigate further "where the need therefor is indicated by the circumstances". The added "including reasonable inquiry" language is emphasised below.

Section 309 defines the duties of loyalty and care imposed on corporate directors as follows:

- a director must perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner that such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances; and
- in performing the duties of a director, a director is entitled to rely on information, opinions, reports or statements (including financial statements and other financial data), in each case prepared or presented by any of the following:
  - one or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented;
  - counsel, independent accountants or other persons as to matters that the director believes to be within such person's professional or expert competence; or
  - a committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence – so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances, and without knowledge that would cause such reliance to be unwarranted.

(d) New York: duty of loyalty differs from Model Business Corporation Act

Section 717 of the New York Business Corporations Law codifies the fiduciary duties owed by directors under New York law.

While California modified the Model Business Corporation Act's duty of care by adding 'reasonably inquiry', New York modified the Model Business Corporation Act's duty of loyalty by deleting "in a manner the director reasonably believes to be in the best interests of the Corporation". (Section 717(a) of New York's Business Corporation Law retained the Model Business Corporation Act's "in good faith" language.) The difference between the Model Business Corporation Act and New York's duty of loyalty language may, however, be a difference without distinction.

Courts applying New York law have concluded that 'in good faith' necessarily includes actions in a manner he reasonably believes to be in the best interests of the corporation.

Section 717 thus defines the duties of loyalty and care imposed on corporate directors as given in the following direct quotation:

(a) A director shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances. In performing his duties, a director shall be entitled to rely on information, opinions, reports or statements including financial statements and other financial data, in each case prepared or presented by:

(1) one or more officers or employees of the corporation or of any other corporation of which at least fifty percentum of the outstanding shares of stock entitling the holders thereof to vote for the election of directors is owned directly or indirectly by the corporation, whom the director believes to be reliable and competent in the matters presented,

(2) counsel, public accountants or other persons as to matters which the director believes to be within such person's professional or expert competence, or

(3) a committee of the board upon which he does not serve, duly designated in accordance with a provision of the certificate of incorporation or the by-laws, as to matters within its designated authority, which committee the director believes to merit confidence, so long as in so relying he shall be acting in good faith and with such degree of care, but he shall not be considered to be acting in good faith if he has knowledge concerning the matter in question that would cause such reliance to be unwarranted. A person who so performs his duties shall have no liability by reason of being or having been a director of the corporation.

2.4 To whom duties are owed

As a general rule, directors owe fiduciary duties to the corporation and its shareholders. Whether obligations are owed to creditors when a corporation is insolvent, or even earlier (when it is approaching the so-called 'zone' of insolvency), has garnered attention.

Under Delaware law, when a corporation becomes insolvent, "creditors take the place of the shareholders as the residual beneficiaries of any increase in [the company's] value".[11] Accordingly, the directors of an insolvent corporation must "consider, as fiduciaries, the interests of the corporation's creditors who, by definition, are owed more than the corporation has the wallet to repay".[12] In *Gheewalla*, the Delaware Supreme Court expressly rejected the notion that duties run to creditors when a company is in the zone of insolvency; obligations only run to creditors once insolvency actually occurs. Furthermore, creditors can only assert claims derivatively, on behalf of the corporation – they cannot assert direct claims on their own behalf.

Likewise, under New York and California law, no obligations are owed to

11 *North American Catholic Educational Programming Foundation, Inc v Gheewalla*, 930 A2d 92, 101 (Del 2007).

12 *Trenwick Am Litig Trust v Ernst & Young*, LLP, 906 A2d 168, 205 (Del Ch 2006).

creditors until actual insolvency occurs.[13] Applying New York law, a court has stated that "once a corporation is insolvent, corporate officers and directors owe a fiduciary duty to preserve corporate assets for the benefit of creditors. … In such cases, benefits to the corporation inure in the first instance not to its owners but to its creditors" (internal citations omitted).[14]

This is an extract from the chapter 'United States' by John W Blancett, Martin J O'Leary, Katelin O'Rourke Gorman and Eric C Scheiner is from Directors' Liability and Indemnification: A Global Guide, Third Edition*, published by Globe Law and Business.*

13 See, eg, *Teras International Corp v Gimbel*, 2014 WL 7177972, at *11 (SDNY, December 17 2014).
14 *Berg & Berg Enterprises, LLC v Boyle*, 178 Cal App 4th 1020 (2009) (same).
15 *Brehm v Eisner*, 746 A2d 244 (Del 2000) (regarding allegedly "extravagant and wasteful" executive compensation at Disney) citing Aronson, 473 A2d at 812 (internal quotations omitted)).
16 See *Burt v Irvine Co*, 237 Cal App 2d 828, 852–853, 47 Cal Rptr 392 (1st Dist, 1965) and Cal Corp Code §309(c) (codifying California's business judgment rule); see also, *Auerbach v Bennett*, 47 NY 2d 619, 629 (1979) (internal citation omitted).
17 California Corporations Code §309(b)(3).
18 *McPadden v Sidhu*, 964 A2d 1262, 1274 (Del Ch 2008).
19 See *In re Lear Corp S'holder Litig*, 967 A2d 640, 652 (Del Ch 2008).