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CORPORATE DIRECTOR CONDUCT: DUTIES OF LOYALTY AND CARE

by James V. Irving, Esq.

A pair of statutes found in the Corporations title of the Virginia Code and a related common law principle set out several important standards of officer and director conduct. In combination, they describe the parameters of acceptable conduct, point out the risks of self-interested choices, and establish safe harbors that may insulate a director's actions.

THE BUSINESS JUDGMENT RULE

Code of Virginia Section 13.1-690 embodies what is known as the "Business Judgment Rule." It provides a sweeping protection for business men and women, allowing them to manage their businesses with minimal risk of personal liability in most cases.

Subsection A of this statute provides that a director of a corporation "shall discharge his duties… in accordance with his good faith business judgment of the best interests of the corporation." Subsection B provides that in exercising his or her judgment, a director is entitled to rely on information and advice provided in the regular course of business by a broad range of advisors, including legal counsel, accountants, and committees of the board. If a director acts in accordance with his good faith business judgment and in reliance upon advice and expertise he believes in good faith to be reliable and competent, then he "is not liable for any action taken as a director or any failure to take any action." The existence of this safe harbor is one of the principal reasons Virginia is increasingly regarded as a business-friendly jurisdiction.

The breadth of the Virginia protections are perhaps best understood by comparison to the laws of Delaware, a state synonymous with corporate protection. The Delaware counterpart to Section 13.1-690 (as well as the provision of the Model Corporations Act) insulates a director's conduct provided it accords with the actions of a "prudent" or "reasonable" person acting in similar circumstances. Delaware thus provides great latitude to the director, but Virginia courts do substantially more.

In *WLR Foods, Inc. v. Tyson Food, Inc. (1995)*, Tyson, seeking to challenge the reasonableness of certain of WLR's directors' actions, sought to discover the substance of the advice given to those directors. The District Court sustained WLR's objection to this discovery on the basis of relevance, ruling that whether or not the advice was sound did not matter, as long as WLR's directors had relied in good faith. In an opinion notable for the road map it provides, the Fourth Circuit affirmed, concluding that the directors' standard is "process-oriented and not subjective," and that it is sufficient that the director utilized an informed decision-making process. Provided the process is sound, a Virginia director need not demonstrate that his conduct, or the result of his decision, is proper or even rational. The court limited discovery to inquiry into the "procedural indicia of whether the directors resorted in good faith to an informed decision-making process."

WLR does not stand for the proposition that Virginia directors operate without risk;[1] the director who makes an uninformed decision may still be exposed to liability. The *WLR* Court specifically re-affirmed the continuing vitality of *Sandberg v. Virginia Bankshares, Inc.*, a 1989 case in which the Fourth Circuit held that Directors who "rubber-stamped everything before them" could be liable for a lack of good faith precisely because they failed to exercise any independent judgment.

Between the two, *WLR* and *Sandburg* set forth a clear path for business directors to follow as they manage their businesses. By following the approved practice, a director can reach business conclusions comfortably insulated from the negative result that might flow from those decisions.

CONFLICTS OF INTEREST

Code of Virginia Section 13.1-691 defines the "direct or indirect personal interest" that gives rise to a director's conflict of interest, sets out the acceptable means of addressing conflicts, and provides an interesting corollary to the Business Judgment Rule.

Without question, in cases of business conflict, a director is held to a much higher standard in his decision making process. As the Supreme Court of Virginia noted in *Simmons v. Miller (2001)*, directors may not rely on the Business Judgment Rule in the case of conflict.

What constitutes a direct conflict should be obvious; an indirect conflict arises for a director any time an "entity in which he has a material financial interest or in which he is a general partner is a party to the transaction; or [an] entity of which he is a

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Emergency Points If A Divorce Is Impending

by James W. Korman, Esq.

When you are considering a separation from your spouse, it is important to consider whether or not actions need to be taken to prevent dissipation of assets by your spouse prior to a final resolution of your case. You should discuss the following with your attorney to determine whether or not you should take special actions to safeguard property and if so, the timing and notice to be given to your spouse of actions taken. With each of the below listed categories, you must weigh the risk that your spouse may take action if you do not, against the possibility that action by you may anger your spouse. And, of course, time can be of the essence. While you are deliberating, your spouse may be taking action.

FINANCIAL INSTITUTIONS

(banks, savings and loans, credit unions, stock brokers)

Either party to a joint account can go to the financial institution and clean out the balance. You should talk with your attorney about whether you should withdraw some or all of the amounts in your accounts, close the joint account and give your spouse a check for his/her share of the account, with a separate check for you. While withdrawing large sums of monies from a joint account or closing the account is not advisable in all cases since it may exacerbate the tensions between the parties, it should be seriously considered if you believe your spouse will make unreasonable withdrawals from the account. It is usually best not to "freeze" the joint accounts, because, while your spouse will be denied access without your approval, you would also be denied access.

Set up separate accounts in your own sole name, preferably at different financial institutions than those that had your joint accounts.

See that your paycheck is deposited to your new separate account(s), and no longer deposited to your joint accounts.

You should consult with your attorney about what if anything should be taken out of any safety deposit boxes. You should definitely make copies of everything that is in them.

CREDIT & CREDIT CARDS, DEBIT CARDS

Accounts are joint if you have ever signed an application for the loan or card, and/or if the bill is addressed to both you and your spouse. You will be liable on the joint account as long as it is open.

If you believe your spouse will run up the credit card debt, you should discuss with your attorney whether any joint credit card should be closed. The credit card company will usually close accounts only if there is a zero balance, and if all cards are returned to it.

Similarly, if you believe your spouse will run up debts without your consent, you should discuss with your attorney whether you should close or put a hold on all joint lines of credit, home equity lines of credit and overdraft checking by sending a written notice to the creditor.

You should consider obtaining a credit report on all debts in your name to determine the current status of the debts for which you may be liable.

BOOKS, RECORDS, & DOCUMENTS

It can be very important for you to have in your possession the family financial records. These should include the sort of items listed below:

- Tax returns from all prior years
- Account statements
- Checkbook ledgers
- Stockbroker statements, pension, I.R.A., Keogh, and 401(k) statements and plans
- Life insurance policies
- Pay stubs
- Deed(s) of trust
- Financial statements
- Loan applications
- Credit card bills
- Loan payment books or statements
- Identification cards and forms for health insurance

At a minimum, you should make copies of the above.

You should discuss with your attorney if you should place the originals where your spouse cannot find and remove or destroy them in a safe location not in the house. Again, there are pros (safety) and cons (exacerbation of tensions) to this action.

MAIL, COMPUTER, VOICEMAIL

Because your spouse should not know what mail you are receiving, you should make arrangements for an alternative place to receive mail. A friend or relative may be willing to receive your mail. Otherwise you could consider opening a post office or mail box. All creditors, financial institutions, and attorneys should be informed of the new address to send all mail to the box. Consider changing the remote access code for your answering machine and voice mail. Change your access code for your home computer (and at work also, if it has remote access). Put all your computer disks and media where your spouse cannot gain access.

THE HOUSE

Usually you should not exclude your spouse from the marital residence, nor should you permanently depart from the marital residence, without careful consultation with your attorney. If, however, your health, safety, or well-being is in immediate jeopardy, you should avoid a confrontation, and call the authorities right away.

CHATTELS & PERSONAL PROPERTY

If there are items that are particularly valuable, or are particularly dear to you, you should discuss with your attorney whether you should place these valuable items in a place where

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EMERGENCY POINTS IF A DIVORCE IS IMPENDING

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your spouse cannot get them. There will come a time when ultimate ownership and possession of marital property is decided, but, if you believe that your spouse will take them unilaterally, you need to consider ways to assure their safekeeping. You should record the items and condition of property by photograph or videotape. You can, in addition, do a written inventory.

VEHICLES

If you want to be assured that you have access to and use of a vehicle after separation, be sure you have at least one, if not all of the keys. If you are concerned that your spouse may try to deprive you of a vehicle, you should discuss with your attorney whether to have the locks on a car changed by a dealer or whether you should purchase a security device like "The Club."

YOUR OFFICE

Consider instructing your staff that your spouse does not have your permission to go through your office records or to remove or duplicate them, and that your co-workers should be careful about what they say to your spouse.

CONCLUSION

You don't have to do any of these things, but you should at least think about them and discuss them with your attorney. As already stated, even if you don't do anything, your spouse may. ◈

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director, officer or trustee is a party to the transaction and the transaction is or should be considered by the board of directors of the corporation."

In such a case, a safe harbor is still available to the director, and the transaction may be approved, provided the interested director makes full disclosure of all material facts of the conflict to the board and thereafter a disinterested majority of the board (or, upon full disclosure, the shareholders, if the board is not disinterested) approves or ratifies the transaction. In the alternative, the director is also insulated and the transaction may be sustained if it is "fair."

Under Section 13.1-690, a challenger to a director's business judgment must sustain the burden of proof. In contrast, in a conflict situation, the director or the board must demonstrate that their actions met the statutory test. Burden of proof aside, it ought to be fairly obvious that an interested director is at a distinct disadvantage when required to prove the subjective fairness of a transaction benefiting him or her. The conservative director will avoid all conflicts; in the alternative, a director must be extremely careful and should fully document all aspects of a transaction involving a conflict of interest.

CORPORATE OPPORTUNITIES

A second common source of director liability is a corollary to the first. It arises when a corporate officer or director undertakes for his own benefit a business opportunity that might otherwise have belonged to the company.

As is true of the conflict prohibition, the source of a director's corporate opportunity liability is his or her duty of loyalty to the company. The prevailing rule is clearly set forth in *Equity Corp. v. Milton*, a 1996 Delaware case:

> When there is presented to a corporate officer a business opportunity which the corporation is financially able to undertake, and which, by its nature, falls into the line of the corporation's business and is of practical advantage to it, or is an opportunity in which the corporation has an actual or expectant interest, the officer is prohibited from permitting his self-interest to be brought into conflict with the corporation's interest and [he] may not take the opportunity for himself.

While the officer or director may feel comfortable in his insulation from day to day decision-making risks by the Business Judgment Rule, the existence of conflicts should always raise a red flag. Since the statutory and common law duty of loyalty prohibits directors and officers from gaining personal advantage through a corporate transaction unless it is open, honest and fair, the presumption is always against the director. A breach of duty of loyalty – either through seizing a corporate opportunity or benefiting from a self-interested transaction – can harm the corporation and open the door to expensive and high risk complaints about director conduct. ◈

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[1] The Supreme Court has established a higher standard for directors of financial institutions, and several types of transactions, such as securities matters, are excluded from the ambit of Section 13.1-690.

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Our responsive and exceptional quality service, coupled with our sensitivity to client needs, has established a professional reputation in which we take great pride. We are dedicated to achieving exceptional results for our clients in every matter we are entrusted to handle, mindful of each client's resources and unique circumstances. Delivering greater value to our clients day in and day out is how we will continue our reputation as one of the most highly regarded law firms in the Washington metropolitan region.

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