CURTIS

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CORPORATE GOVERNANCE CLIENT ALERT

A REVIEW OF DIRECTORS' FIDUCIARY DUTIES

FIRST IN A SERIES OF FOUR EDITIONS:

REVISITING DUAL DIRECTORSHIPS IN THE U.S.

A REVIEW OF DIRECTORS' FIDUCIARY DUTIES: INTRODUCTION TO THE SERIES

Prompted by the alleged fraud at WorldCom, as well as a host of other corporate and accounting scandals, President Bush signed the Sarbanes-Oxley Act (the "Act") into law on July 30, 2002. The Act represents the most sweeping piece of securities legislation enacted by Congress since the Great Depression.

While provisions of the Act address the role of outside auditors for publicly-traded companies, the Act also imposes enhanced requirements and penalties on officers and directors and, viewed more broadly, signals a trend toward increased scrutiny of apparent conflicts of interest and breaches of fiduciary duty. This shift in the corporate and legal culture has prompted us to remind our clients of certain duties owed by directors and officers to their companies and stockholders, which, though well-established, may come as a surprise in light of common business practices.[1]

The following topics will be addressed in Curtis' *A Review of Directors' Fiduciary Duties*.

EDITION 1 – Revisiting Dual Directorships
Discusses the problems faced by directors in the U.S. who simultaneously serve on the boards of a parent company and its subsidiary and who must fulfill the fiduciary duties attendant to each position.

EDITION 2 – The Problem of Third-Party Liability
Addresses the potential liability of parent companies or other controlling stockholders who nominate and vote directors onto boards for purposes of information-gathering or exercising control.

EDITION 3 – Heightened Fiduciary Duties of Certain Officers
Examines the duties owed by officers and the possibility that officers, because of their greater familiarity with, and proximity to, the workings of the company, may be subject to a higher standard than directors.

EDITION 4 – Directors' Duties in Financially-Distressed Companies
Discusses the manner in which the focus of a director's fiduciary duties change from equityholders to debtholders, employees and other interested groups when a company becomes financially distressed.

[1] The following commentary focuses primarily on Delaware law due to the persuasiveness of Delaware court decisions in the area of corporate governance.

THE PROBLEM OF DUAL DIRECTORSHIPS: AN INTRODUCTION

Dual directorships are common in today's business climate, with directors often simultaneously serving on the boards of a parent company and its subsidiary or on the boards of two or more affiliated companies. Such directors are often perceived as having been placed on the board of a subsidiary by its parent company in order to facilitate the exercise of control by the latter over the former or to act as a source of advance notice with regard to boardroom information in which the parent may take an interest. Where shareholders other than the parent have interests in the subsidiary (or where a wholly owned subsidiary approaches insolvency, as discussed *infra*), these "dual directors" face the problem of fulfilling competing and sometimes conflicting legal duties while satisfying the concomitant business expectations of the interests that arranged for their placement in the first instance. As discussed herein, such directors should carefully consider the nature and scope of the fiduciary duties of care and loyalty, the identity and interests of the parties to whom such duties run, the potential liability attached to breaches of such duties and the universe of preventative and remedial measures.

KEY CONCEPTS: DUTY OF CARE

The duty of care requires that directors inform themselves, prior to making a business decision, of all material information reasonably available. As a general matter, the more important the decision is to the company, the greater the requirement to explore alternatives.

The duty of care, however, typically does not present conflicts in the context of dual directorships, given that it focuses on oversight responsibilities and the maintenance of procedural integrity. Moreover, in accordance with Section 102(b)(7) of the Delaware General Corporation Law, a corporation may include in its certificate of incorporation a provision exculpating directors from liability for breaches of duty of care.

KEY CONCEPTS: DUTY OF LOYALTY

The duty of loyalty requires that the director both serve and protect the interests of the company and refrain from conduct which would injure the company or its shareholders or deprive them of profit or advantage.

As a general matter, dual directors of a parent company and its subsidiary owe the fiduciary duties of care and loyalty to both companies and to all of each company's stockholders, whether majority or minority:

> The Delaware courts have recognized that directors who hold dual directorships in the parent-subsidiary context may owe fiduciary duties to each corporation. *In re RSL COM Primecall, Inc.*, 2003 WL 22989669 (Bankr. S.D.N.Y. 2003) at *11, citing *In re Digex Inc. Shareholders Litig.*, 789 A.2D 1176, 1205-06 (Del. Ch. 2000), citing *Warshaw v. Calhoun*, 221 A.2d 487, 492 (Del. 1996).

The applicable standard, as articulated in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), requires that:

> [I]ndividuals who act in a dual capacity as directors of two corporations, one of whom is the parent and the other subsidiary, owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure, or the director's total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies.

In the eyes of the law, therefore, the duty of loyalty is "undivided," positioning the dual director as servant to two masters, each with a discrete set of interests and constituencies and each requiring the exercise of unfettered and entirely independent judgments on its behalf.

An undivided loyalty requires that the director do what is best for the company and its stockholders, without regard to other interests, duties or obligations to which the director may be subject. Further, the director must refrain from self-dealing, usurpation of corporate opportunity, as well as any other act that would result in an improper

personal benefit or injury to the company or its stockholders.

Where a director sits on the boards of a parent company and its subsidiary, a tension exists among the loyalties which are owed to each company and to each company's stockholders. This is particularly true when the director is placed on the subsidiary's board for the express purpose of voting in accordance with the interests of the parent and keeping the parent informed of boardroom discussions that may be confidential in nature.

Such a director may well violate his fiduciary duties to the subsidiary and its minority stockholders in the event he merely votes as directed by the parent company and does not duly consider the minority interests at play. On the other hand, a dual director who participates in a board decision at the parent level regarding the future strategy of a subsidiary of which he is also a director runs the risk of violating his duty to disclose such information to the subsidiary's board, which in turn conflicts with the duty of confidentiality he owes the parent.

Moreover, where the parent company enters into a transaction with its subsidiary, there is a high likelihood that the director would violate his duty of loyalty when voting on the subsidiary's board because, given his directorship at the parent level, he would stand on both sides of the bargaining table, would likely have inside information regarding both the parent and the subsidiary's respective interests in the transaction and hence would probably not be able to exhibit undivided loyalty.

Thus, a dual director must remain mindful of the fact that his fiduciary duties simultaneously run to each of the companies, not one company rather than another, and to all of each company's stockholders, whether majority or minority, as opposed to specific stockholders or groups of stockholders that may have appointed him. Under the watchful eyes of the law, a dual director cannot simply "change hats" when alternately fulfilling his duties as a director of different companies with divergent interests.

WHOLLY OWNED SUBSIDIARIES

Where a dual director sits on the board of a parent company and its wholly owned subsidiary, barring special circumstances, such director's sole responsibility is to manage the affairs of the subsidiary in accordance with the parent's and its stockholders' interests. Under most circumstances, the identity of interests as among the parent, its stockholders and the wholly owned subsidiary effectively subordinates the director's duty of loyalty owed to the subsidiary.

However, special consideration should be given to the duties owed to the wholly owned subsidiary where such subsidiary is nearing the "zone of insolvency" or becomes insolvent.[2] In this event, the dual director will owe fiduciary duties not merely to the parent and its stockholders, but also to the "community of interests" attached to the subsidiary, i.e., the subsidiary's creditors, stockholders, employees and other interested groups.

FOREIGN PARENTS AND SUBSIDIARIES

In the event a dual director serves on the board of a foreign parent company and its U.S. subsidiary, or a U.S. parent and its foreign subsidiary, the director should be aware of potential disparities as between the requirements of the U.S. fiduciary duty laws and those of the foreign jurisdiction. A director acting solely with reference to the mandates of U.S. fiduciary duty law, but in the capacity of director of a foreign entity, may well violate his duties under foreign law.

THE COSTS OF FALTERING

The consequences of a breach of fiduciary duty can be dire, potentially resulting in enormous personal liability for the breaching director himself and creating a basis for the subsidiary's minority stockholders to challenge the transaction as not being "intrinsically fair."

2 Fiduciary duties in the context of financially distressed companies are treated at greater length in the fourth edition of this series.

PREVENTATIVE MEASURES

The traditional method of avoiding such conflicted loyalties is for the dual director to recuse himself and to abstain from discussions and voting which pertain to both companies. Alternatively, where special circumstances presenting conflicts of interest issues, such as financial difficulties at the subsidiary level, are anticipated, the subsidiary may consider delegating decision-making responsibility for such matters to a committee of non-dual directors.

Given the business expectations normally associated with a dual directorship, careful consideration should be given to the legal issues raised in this client note by anyone asked to undertake such a dual role. It is therefore highly advisable that an individual considering accepting a nomination to a dual directorship, as well as a dual director already in place who faces apparent conflicts of interest, seek counsel with regard to the legal pitfalls and liability risks at issue.

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ABOUT CURTIS

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