

Client Briefing on Corporate Governance Requirements and Potential Board Exposures During Economic Uncertainty

Introduction

In today's climate of economic uncertainty, we cannot overstate the importance of boards of directors following robust corporate governance best practices.

Government policy and regulatory changes may provide businesses benefits, burdens, and challenges. Financial, environmental, and social rules are in flux. Directors face increased demands for their attention, and Boards must be nimble and capable of reacting swiftly to the rapidly changing times.

Effective governance protocols ensure legal compliance, mitigate risk of claims by stakeholders and risks to directors and officers, strengthen stakeholder confidence, and position your company for resilience and long-term success.

A Board must understand its duties, to whom it owes those duties, and how to guide a company through troubled times to fulfill its responsibilities. Understanding and implementing the processes and structures in this memo also protects the Board and its members from personal liability.

This memorandum does not address all aspects of fiduciary duties and corporate governance in the context of a Board's decision-making process, but it provides guidance and keeps governance issues at the forefront.

We also do not address the governance of business entities such as Limited Liability Companies or Limited Liability Partnerships. Key distinctions exist between the duties of the Managing Member or Board of Managers in a limited liability entity and those of a corporation's Board of Directors stemming from the fact that a limited liability entity is fundamentally a creature of contract with its operating agreement or partnership agreement defining member/partner rights, duties, and obligations, whereas corporations are creatures of statute. Nor do we discuss the potential consequences of bankruptcy if the company files for Chapter 11 relief or the duties of a Board in the event of the company's insolvency. For a discussion of issues related to these entities or the impact of insolvency or bankruptcy on the Board's duties, please reach out to our Governance Team.

For ease of review, we have provided an **Executive Summary** beginning on page 2 and a more detailed discussion of the points raised beginning on page 3.

Executive Summary: Corporate Governance in Economic Uncertainty

Why Governance Matters Now

- Economic uncertainty heightens the importance of robust governance practices.
- Boards must be agile, informed, and proactive to meet evolving regulatory, financial, and stakeholder demands.
- Proper governance minimizes legal exposure and protects directors from personal liability.

Core Fiduciary Duties Under Applicable Law

- Duty of Care: Informed decision-making with diligence and oversight.
- Duty of Loyalty: Undivided allegiance to the corporation—no self-dealing.
- Good Faith: Implied in all business judgments.

Risks of Inadequate Governance Protocols

- Heightened scrutiny in financial distress.
- Ignoring governance formalities leads to a loss of corporate liability protections. Personal liability risks for directors and officers.
- Potential exposure to employee wage claims and fiduciary breach litigation.

Board Priorities and Best Practices

- Set broad business objectives and policies and core values; consider and approve major decisions and extraordinary actions; hire and establish compensation of senior executives.
- Distinct oversight role—not management.
- Act so as to be able to rely on the Business Judgment Rule if actions of the Board and especially major decisions or extraordinary corporate actions are challenged.
- Enhance documentation, meeting frequency, and committee involvement.
- Involve independent directors to mitigate conflicts and outside experts to provide support for making informed decisions.
- Monitor financials closely and maintain strong audit committee review and oversight.
- Prepare for contingencies with scenario planning and succession strategies.

Role of Legal Counsel

- Advise Board and executives to ensure procedural integrity, regulatory compliance, and proper documentation, which together provide the basis for a defense against claims against directors for breach of the duty of care—see below, e.g., for discussion of ResCap case.
- Assist with conflict management, insolvency concerns, and adapting to legal changes.

Employee-Related Exposures

- States may hold directors/officers personally liable for unpaid wages and workplace violations.
- Strong oversight and legal guidance are essential to mitigate such risks.

Call to Action

- Boards should review their governance frameworks and consult legal counsel proactively.
- Morrison Cohen offers support through its Governance Team.

The Primary Governance Imperative

State corporate laws govern the governance of corporations. This memorandum focuses on the New York Business Corporation Law and the Delaware General Corporation Law. Though the laws in these and other states are not identical, the NYBCL and the DGCL concepts are universal, although sometimes interpreted differently. Generally, corporate laws provide substantial protection from second-guessing actions by Board members who take their responsibilities seriously and operate in an informed, good-faith manner.

To avail themselves of those protections, directors must adhere to two types of fiduciary duties:

- *The duty of care and the duty of loyalty*
- Implicit in performing these duties and in all business relationships is the *duty to act in good faith*.

Below, we outline the critical reasons for adhering to governance best practices, key priorities for Boards, the legal benefits of engaging counsel and other experts and advisors, and a discussion of potential liabilities, especially relating to employees.

Why Corporate Governance Is Critical in Times of Economic Uncertainty

A Board of directors of a corporation owes fiduciary duties—primarily the duty of loyalty and the duty of care—to the Corporation itself and its shareholders:

- Fiduciary duties are fundamentally owed to the entity as a whole and to its individual shareholders, but not to other stakeholders directly.
- All Board members have an equal say and owe a fiduciary duty and an undivided duty of loyalty to the entity and all shareholders once they join the Board, regardless of their nominator. Corporations under the NYBCL and the DGCL do not have a “constituency director” concept that exists in some places in Europe, nor do directors take into consideration the different classes of shareholders in exercising their judgment, other than to consider the different rights and preferences that the differing classes of shareholders may be entitled to under the constituent documents. (Note: a voting agreement can provide a Board member with more than one vote.)
 - If the director does not exercise independent decision making when acting, but takes all direction from a shareholder, that shareholder may be treated as a *de facto* director and become subject to all fiduciary duties that a Board member would have—duty of loyalty and duty of care. This could disable that shareholder from acting in his or her personal financial interest.
- **Fiduciary Duties Are Under Heightened Scrutiny:**

Financial distress may prompt a closer examination of these duties. Ordinary course procedures that may be nominally acceptable during periods of growth and financial prosperity may be insufficient today, notably to support the obligation of duty of care.

- **Corporate Waste:** Boards must be mindful of potential liability for corporate waste: a legal doctrine in corporate law referring to a transaction or act by a corporation in which the exchange of corporate assets is so one-sided, or the consideration received is so disproportionately small, that no reasonable person of ordinary, sound business judgment would deem it worth what the corporation has paid. In essence, it is an act equivalent to making a gift or the “spoliation” (destruction or waste) of corporate assets.
 - Accusations of corporate waste may cause a court to scrutinize transactions that do not clearly violate fiduciary duties but also do not appear to result from careful business judgment or disinterested decision-making.

- Waste claims are sometimes brought in the context of shareholder litigation over executive compensation, but few succeed unless the compensation is unconscionably excessive.
- **Risk of Personal Liability:**
Failure to follow governance best practices can expose directors and in some cases officers, to personal liability, particularly if creditors, shareholders, or employees allege mismanagement or breach of fiduciary duties.
- **Preservation of Corporate Protections:**
Observing governance formalities (such as conducting regular meetings, maintaining accurate records, consulting with advisors and experts, and documenting decisions) is essential to maintain the liability shield that corporate law provides.
- **Stakeholder and Regulatory Confidence:**
Proper governance reassures stakeholders, lenders, trade creditors, and regulators that the company is being managed prudently, which is crucial for companies seeking financing and negotiating with creditors during challenging times. Strict adherence to governance best practices that support fulfillment of the duty of care also reduces the risk of and can mitigate enforcement actions and legal challenges.
- **Demonstrating Good Faith and Business Judgment:**
Well-documented decisions, guided by legal counsel, demonstrate board diligence and sound judgment if challenged later.

Key Corporate Governance Requirements to Prioritize

The Board's Essential Role:

- **Ultimate decision maker**
- **Strategist**
- **Risk assessor—it appoints special committees, including an audit committee**
- **Oversight provider**
- **Advisor**

The Board is NOT management. It sets overall policy and then appoints corporate officers to implement and manage the company. Balanced oversight, without micromanagement, is necessary.

There must be a distinction between the Board's oversight responsibilities and management's operational role. Once a policy, major decision or strategy is adopted by the directors, the Board should intervene only when necessary to assure that what has been adopted by the board is being implemented. In addition, the Board will be called upon to act to address conflicts of interest, corporate integrity issues, financial issues, or crisis situations and other extraordinary matters.

The Business Judgment Rule

- The Business Judgment Rule protects Board members if they fulfilled their duty of due care and loyalty.
- The Business Judgment Rule is a deferential standard of judicial review in corporate law that protects directors from liability for business decisions made in good faith, with due care, and what they believe are in the corporation's best interests. Courts apply this rule to avoid second-guessing managerial decisions, provided there is no evidence of fraud, self-dealing, or gross negligence.

Key Features of the Business Judgment Rule as a Judicial Standard *Presumption of Good Faith*

Courts presume directors acted:

- On an informed basis (after reasonable deliberation and investigation)
 - Without conflicts of interest (duty of loyalty)
 - What they believe are in the corporation's best interests
- **Burden of Proof**
Plaintiffs must rebut this presumption by proving:
 - A breach of fiduciary duty (care, loyalty, or good faith)
 - Corporate waste
 - Gross negligence in decision-making
 - **Scope of Deference**
 - Courts refrain from evaluating the wisdom of decisions, focusing instead on the process (e.g., whether directors were informed and unconflicted).
 - A reasonable decision-making process protects even objectively poor outcomes.
- This rule protects a Board from being second-guessed by a litigant, creditor, or a court, even where hindsight suggests a different decision may have been optimal or the results of the Board's decision are unsuccessful.
 - *Perfection is not required to secure the rule's protection.* However, the Board must make its ultimate decision among reasonable alternatives, acting in good faith and carefully complying with its fiduciary duties, especially the duty of care.

To Obtain the Protection of the Rule There Should Be:

- **Rigorous Risk Management and Oversight:**
 - Board members should personally participate in Board and committee meetings, be proactive, informed, and knowledgeable about the company's business and not be an echo chamber for management or "potted plants."
 - Ensure the Board has the right mix of skills and expertise to address emerging risks (technology, cybersecurity, regulatory compliance).
 - Bring in external experts or legal counsel if specialized knowledge that may be outside the expertise of members of the Board is required.
 - Both the New York Business Corporation law and the Delaware General Corporation Law specifically allow directors to rely on external experts and counsel to reach a decision as part of their exercise of duty of care.
 - *Reliance upon outside professionals does not relieve directors of the obligation to evaluate the advice and information critically and, if appropriate, investigate further or seek additional information or confirmation by other outside professionals.*
 - Stress-test alternative strategies and ensure management's assumptions are reasonable and well-documented, either alone or with third-party experts and advisors with requisite expertise.
 - Proactively, in consultation with management and third-party advisors, identify, evaluate, and prioritize direct, indirect, and non-ordinary course risks, including those from economic volatility, supply chain issues and disruptions, and changes in the regulatory landscape.
 - Maintain a strong focus on compliance with all applicable laws, regulations, and contractual obligations.

- Require management to promptly elevate material contractual issues or disputes to the Board for oversight and resolution. Add claims of malfeasance, fraud, harassment, sexual misconduct, etc.—all things that can result in claims against the company.
- Approve and monitor strategic initiatives, including digital transformation, privacy issues, and other priorities.
- Regularly review and adapt incentive and compensation structures to align with evolving business realities and the marketplace.
- **Enhanced Board Procedures and Documentation:**
 - Increase the frequency of Board meetings—in person or virtual—and require detailed, timely management reports.
 - Annually, or more often during times of stress (and whenever a new Board member is appointed), company or outside counsel should give the Board and its members a refresher on their duties and obligations.
 - Establish special committees (e.g., crisis management or risk committees) as needed.
 - Bring independent directors on Board to mitigate any conflict issues. Directors must act in good faith and prioritize the entity's interests above personal gains or interests. They must avoid conflicts of interest, refrain from competing with the entity, and avoid self-dealing transactions unless fully disclosed and approved by disinterested parties as provided in applicable corporate statutes. This is especially important when an officer or director of a parent company sits on the Board of a subsidiary or portfolio company.
 - Meticulously document in Board and committee meeting minutes (i) that a meeting of the Board has been held even if no action is taken at the meeting and (ii) all material decisions and the factors considered. To the extent feasible material regarding any material decision should be distributed to the Board prior to the meeting to give directors the opportunity to review and prepare for the meeting—another good factor in exercising the duty of care and being informed. Always assume that reports, minutes, and notes will be discoverable in a litigation. (Whether directors should take or maintain notes is for a separate discussion, although we generally think the potential harm in a litigation from separately maintained notes of meetings outweighs any benefit).
- **Financial Oversight and Liquidity Management:**
 - Closely monitor the company's financial position, liquidity, and capital needs.
 - Install an active Audit Committee with financial expertise.
 - Oversee financial reporting, internal controls, and audit functions to ensure compliance.
- **Scenario Planning and Business Continuity:**
 - Engage in scenario planning to assess long-term impacts and develop contingency plans.
 - Ensure robust business continuity and emergency succession plans for key leadership roles.
 - Discuss purchasing "Key Person" insurance.

- To ensure that the cost of litigation itself does not become financially problematic to the company and to address potential concerns of people the company is seeking to have join the board, secure directors' and officers' (D&O) liability insurance to cover defense costs and settlements and, in the event of insolvency concerns, purchase tail insurance.
- **Stakeholder Engagement and Communication:**
 - Identify and map stakeholder interests, including employees, customers, suppliers, and regulators, to build trust and ensure transparent, timely communication.

Legal Benefits of Engaging Counsel

- **Guidance on Complex Governance and Compliance Issues:**

Legal counsel helps Boards (including committees of Boards) and managers identify and mitigate risks proactively, ensuring compliance with evolving legal standards and the differences in the laws in various domestic and foreign jurisdictions.

- **Documentation and Process Integrity:**

Counsel ensures that decisions are properly documented, records are maintained, and procedures are followed, which is vital for defending actions if challenged. Counsel also provides guidance on note taking by directors and the use of AI, recording, or other automated note taking of Board meetings.

- **Conflict Management and Insolvency Issues:**

Legal advisors provide critical input on potential conflicts of interest, insolvency-related concerns, and regulatory investigations.

- **Demonstration of Best Practices:**

Involving legal counsel signals a commitment to best practices, supports the shield of the Business Judgment Rule, and can be a crucial defense in litigation or regulatory actions.

- **Ensure Compliance with Changes in the Law and Regulatory Environment:**

Develop and assist the company in implementing robust compliance programs with existing and new laws or Executive Orders.

The ResCap Lesson

Over several years beginning 2010, Morrison Cohen represented the independent directors of Residential Capital, a wholly owned subsidiary of Ally Financial (formally GMAC) that originated or serviced over 2.4 million domestic residential mortgage loans with a value of approximately \$374 billion, making it one of the country's largest residential mortgage loan companies. On May 14, 2012, ResCap filed for bankruptcy with assets and liabilities over \$15 billion. It was the largest bankruptcy case filed in 2012.

After the company filed for Chapter 11, the Bankruptcy Court appointed an Examiner to review and opine on allegations made by certain parties that Board had breached its fiduciary duties, especially in connection with transactions that it had consummated with its parent company, and whether it was liable to creditors and other parties on account of any breach.

The Examiner's report was 2,246 pages long and cost the bankruptcy estate over \$82 million. Every transaction the Board reviewed and approved or disapproved of and claims alleged by various parties concerning the conduct of the Board and the independent directors were proctologically examined.

The examiner determined that some of the business decisions the Board made were questionable, and disagreed with certain of the decisions, but found that the Board and all of its directors could not be held liable even if they made mistakes because they had been properly advised:

Based on the foregoing, it would be difficult to prove that the ResCap Board breached its “duty of care,” which focuses on the decision-making process and generally requires a fiduciary to inform himself of all material information reasonably available before making a business decision. Indeed ... a director’s or officer’s reliance on legal or other expert advice is almost a per se defense to a claim based on a breach of a duty of care.

Potential Liabilities of Directors and Officers to Employees

Duty of Oversight: Directors and Officers can face personal liability for failing to address workplace safety, discrimination, harassment, or wage violations.

Failure to Pay Wages, Expenses, or Commissions: Several states impose liability on directors, certain shareholders, and certain officers, for unpaid wages, expenses, or commissions.

Fiduciary Breaches: Breaches of the duty of loyalty, such as prioritizing personal interests over the company, shareholder, or employee welfare, may result in claims.

Conclusion

Economic uncertainty and market turmoil amplify governance risks, including those related to employees and other stakeholders. Boards by prioritizing rigorous oversight, transparency, and legal compliance and engaging legal counsel, can protect themselves and their organizations, fulfill their fiduciary duties, and position the company to navigate uncertainty.

Key Contacts

Our Governance team is available to review your governance framework or to address specific concerns.

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