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Opinion

THE CHALLENGE OF DIRECTOR MISCONDUCT

In her regular column on corporate governance issues, Holly Gregory explores strategies for preventing and responding to director misconduct.

Every so often a news report surfaces about a disgruntled director who leaks information to the media when unable to convince the board to adopt a particular strategy, or about a rogue director who without authorization enters into negotiations for a corporate transaction. While this conduct is harmful to the company and highly disruptive to the board's efforts and its culture of trust, the board is often limited in its ability to take meaningful action against a director who disregards company and board policies and fiduciary obligations.

This article examines:

- Behaviors expected of directors.
- Forms of director misconduct.
- Types of harm caused by director misconduct.
- Appropriate behavior for a dissenting director.
- Strategies for preventing director misconduct.
- Options available to a board to address director misconduct.

DEFINING EXPECTATIONS FOR DIRECTOR BEHAVIOR

For a board to be effective as a decision-making body in which a variety of views can be raised, explored and debated, directors need to respect, trust and rely on one another, and at times directors will find it necessary to defer to one another's judgment. From a board culture perspective, the goal is to achieve a supportive atmosphere where dissent and disagreement can be both expressed and resolved. A well-functioning board culture encourages directors to ask questions and engage in healthy skepticism. Ideally, directors will understand one another's styles and strengths and adapt to, and accommodate for, one another's weaknesses.

While diversity in director viewpoints should be highly valued and encouraged, and a range of director styles is to be expected, the board must set expectations concerning the norms of director behavior. These norms should address behaviors that are acceptable in the boardroom and in interactions outside of the boardroom as they relate to the company (see *Box, Valued Behaviors for Directors*).

FORMS OF DIRECTOR MISCONDUCT

Director misconduct comes in a variety of forms, including both intentional and inadvertent misconduct. Examples include:

- Leaking or otherwise disclosing without authorization to anyone confidential information, including information about board deliberations.
- Acting or speaking on behalf of the board or the company without authorization.
- Entering into a business that competes directly with the company.
- Acting on and failing to disclose a conflict of interest.
- Accepting other board seats in disregard of board limits.
- Trading in the company's securities without notification or approval.
- Taking any action that is a breach of fiduciary duty.
- Violating the law.
- Failing to abide by the terms of company and board policies, including the company's code of conduct and ethics.
- Engaging in disruptive or inappropriate behavior in the boardroom or in interactions with management and employees.
- Unduly interfering in operations.

Of these forms of misconduct, likely the most damaging to a board's ability to function is publicly disclosing confidential information without authorization. Improper disclosures can also implicate other misconduct. Improperly disseminating the company's proprietary information can violate a director's fiduciary duties whether or not he obtains a personal pecuniary interest. If a director disseminates information for personal pecuniary interest, he breaches his duty of fair dealing. However, the director may have still breached his duty of care, even if the dissemination is not for personal pecuniary interest. (*Am. Law Inst., Principles of Corporate Governance: Analysis and Recommendations* § 5.04 (1994, Supp. 2002).)



Search [Fiduciary Duties of the Board of Directors](#) for more on directors' fiduciary duties.

HARM CAUSED BY DIRECTOR MISCONDUCT

By design, a board acts as a collective body in directing corporate affairs. In forming opinions, individual directors should review all relevant information reasonably available. The board can then work towards building a consensus by discussing and

VALUED BEHAVIORS FOR DIRECTORS

Achieving a desirable board culture generally requires a baseline agreement regarding the conduct expected of directors, such as the behaviors that are valued by the board. For example, valued behaviors may include:

- Respecting managements' and fellow directors' expertise and viewpoints.
- Using constructive skepticism in questions directed to management or fellow directors.
- Promoting opportunities for open discussion and debate.
- Listening to all viewpoints and agreeing to use self-control, as not every director can be heard on every issue.
- Committing to work towards a consensus on issues after an informed and deliberative process.
- Developing and maintaining trust among the directors and between the directors and management.
- Protecting board confidentiality.
- Preparing for meetings and abiding by meeting agendas out of respect for the limited time that the board and its committees have to meet.
- Periodically evaluating board culture.

deliberating about potential courses of action. Well-functioning boards are usually able to achieve a consensus that all directors can support, only rarely resorting to a majority position that a minority of directors oppose.

Boardroom confidentiality is critical if a board is to create and maintain an atmosphere in which full and frank discussion can thrive, and consensus can ultimately be reached. When a director breaches boardroom confidentiality a variety of harms can result. Even the threat of public disclosure of board deliberations and disagreements may:

- Threaten the development of trust and a cooperative and collegial atmosphere among the directors.
- Impede the free exchange of ideas and rigorous discussion within the boardroom that is fundamental to the deliberative process.
- Hinder the formation of consensus and board resolution of disagreements.
- Undermine a board's ability to make timely decisions.



Checklists

Visit [PRACTICALLAW.COM](#) for checklists, handy timelines, charts of key issues and flowcharts. These resources are continuously maintained by our attorney editors.

A breach of confidentiality is particularly problematic if directors worry that their viewpoints, expressed in the process of reaching a consensus, could be disclosed to third parties, including the press. Additionally, leaks often signal more significant difficulties within a board.

Breaches of confidentiality can also directly harm the company. For example, a company may be harmed if a director leaks a disagreement to the press to pressure the board to pursue a different course of action. A company's ability to protect non-public (often proprietary and strategic) information and to control the timing of disclosures would be impeded if directors could unilaterally determine when and what confidential information to disclose.



Search [Director Confidentiality](#) and [Protecting Boardroom Confidences](#) for more on directors' confidentiality obligations.

APPROPRIATE DISSENTING DIRECTOR BEHAVIOR

In the relatively rare circumstances when a director continues to disagree with the position of the board majority after thorough discussion, the director has a range of possible responses. He can continue to try to convince the majority to agree with his point of view. The director may also propose that the board table the issue until additional information can be provided or experts are consulted. Alternatively, the director may decide to defer to and rely on the judgment of the majority and accept the course of action the majority has determined.

However, if a director chooses not to pursue these options or has exhausted them, further options include:

- Abstaining or voting against the proposal, if the director disagrees with any significant action the board is taking.
- Requesting that his abstention or dissent be recorded in the meeting minutes to express disapproval of the decision and as a means of seeking protection from future liability for the particular decision at issue.
- Resigning, in a case of serious and continuing disagreement, particularly where the director believes that:
 - management is not dealing with the directors, shareholders or public in good faith;
 - information being disclosed by the company is inadequate, incomplete or incorrect; or
 - his point of view is being disregarded entirely.

(*Corporate Laws Comm., Corporate Director's Guidebook* (6th Edition, 2012).)



Search [Minutes of the Board of Directors](#) for more on handling a board vote that is not unanimous.

For a public company, a resignation may trigger an obligation to disclose in an SEC filing the disagreement underlying the resignation. Companies are well-advised to obtain advice of counsel before filing this disclosure (see *Box, Director Resignations: Form 8-K Disclosure Obligations*).

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STRATEGIES TO PREVENT DIRECTOR MISCONDUCT

As discussed above, identifying norms of behaviors that are acceptable in the boardroom is an important part of developing and maintaining a well-functioning board. In addition, boards can take steps to help prevent director misconduct, including by:

- Conducting individual director evaluations.
- Reminding directors of confidentiality requirements and other key policies.
- Requiring directors to confirm in writing that they have read and understood company and board policies.
- Periodically reviewing company and board policies with directors.
- Discussing how the board would address director misconduct.
- Reviewing with counsel the potential merits and risks of instituting contractual means of requiring director resignation in instances of intentional breach of company or board policies or a breach of fiduciary duties (for example, through irrevocable contingent resignation letters).
- Assessing director candidates carefully, before nomination for election or filling a vacancy, by reviewing:
 - how they have handled board disagreements in the past;
 - whether they abide by company and board policies;
 - whether they uphold their fiduciary duties; and
 - their commitment to confidentiality.
- Encouraging the lead independent director or another strong independent director to talk with individual directors about problematic behaviors when they arise.

DIRECTOR RESIGNATIONS: FORM 8-K DISCLOSURE OBLIGATIONS

Pursuant to Item 5.02(a) of Form 8-K, a disagreement concerning the company's operations, policies or practices that results in a director's resignation or refusal to stand for reelection, if known about by an executive officer of the company, triggers a Form 8-K disclosure obligation. This disclosure includes, among other things, a description of the disagreement.



Search [Form 8-K Reporting Executive and Director Departures, Appointments and Compensatory Arrangements Checklist](#) for more on reporting director departures.

Further, correspondence the director has sent to the company about his resignation or refusal to stand for reelection must be filed as an exhibit to Form 8-K. The director must also be provided with a copy of the disclosure on or before the day it is filed and have the opportunity to state whether he agrees with the statement filed as an amendment within two days after receipt by the company.

The SEC has a history of enforcing Form 8-K disclosure obligations with administrative charges. In 2007, the SEC settled administrative charges against Hewlett-Packard Company (H-P) for failing to disclose to investors the reasons for a director's resignation during H-P's investigation into boardroom leaks.

Several months before the public revelation of the company's leak investigation, an H-P director had objected to the company's handling of the matter and resigned from the board. However, H-P failed to disclose this resignation. The SEC found the director's disagreement related to H-P's corporate governance and H-P's policies regarding the handling of sensitive information, and therefore was a disagreement related to H-P's operations, policies or practices requiring disclosure. (*In re Hewlett-Packard Co.*, SEC Exchange Act Release, No. 34-55801 (May 23, 2007); see also *Question 217.01, SEC Compliance and Disclosure Interpretations: Exchange Act Form 8-K.*)

ADDRESSING DIRECTOR MISCONDUCT

The board has a limited set of options for addressing director misconduct. The proper approach to handling director misconduct depends on the nature of the conduct at issue, the director's motivations and his willingness to be influenced to change his behavior.

Failing to properly respond to director misconduct can have significant consequences for the board and the company. Depending on the circumstances, a board's failure to address misconduct could be viewed as acceptance or even endorsement of the behavior. If the behavior involves a breach of the company's code of conduct or ethics, failure to address it could constitute a waiver of the code that would trigger a disclosure obligation.



Search [Corporate Governance Standards: Code of Ethics or Conduct](#) for more on the corporate governance standards relating to a company's code of ethics or business conduct.

UNINTENTIONAL MISCONDUCT

Methods for responding to unintentional director misconduct may include:

- **Education and coaching.** If the misconduct is unintentional it is often due to lack of understanding about company and board policies or a director's fiduciary duties. In these cases it may be sufficient to point out the problematic behavior and the relevant policies.

Identifying unacceptable conduct and coaching a director on appropriate conduct can be undertaken by the lead director or another strong independent director with whom the errant director has a close relationship.

- **Director evaluations.** Individual director evaluations can serve as a focal point for providing feedback about more generalized problematic behaviors.



Search [Board Self-evaluation](#) for a form of questionnaire to use for a director's self-evaluation.

INTENTIONAL MISCONDUCT

The more difficult situations involve intentional director misconduct. The mechanisms for addressing intentional misconduct include:

- **Removal.** Generally a board is highly constrained in its ability to remove a director, other than by waiting until the end of the elected term and not re-nominating the individual. A board should review with counsel whether under state corporate law or the company's articles and by-laws there are mechanisms for director removal. Often state law or a company's organizational documents provide that directors may only be removed for "cause," which is a very high bar. Shareholders may be able to remove a director but would need a special meeting to do so mid-term. In a number of jurisdictions, a company can petition the courts to remove a director

for fraudulent or dishonest acts, gross abuse of authority or a breach of duty.

- **Reprimand.** A board may formally reprimand or censure a director. The threat of a formal resolution by the board that a director has breached a board or company policy and reprimand for this conduct may be sufficient to alter behavior, and it removes the concern that the

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board may have waived its code of conduct or ethics. Unless done publicly, however, a formal reprimand does not address the appearance that public misconduct is condoned or authorized by the board.

- **Request for resignation.** A board can request that a director resign. The board cannot, however, force a director to resign. In these situations, a board should review with counsel the potential merits and risks of instituting contractual means of requiring director resignation. Some have suggested that a board could insist that all director candidates provide an irrevocable contingent letter of resignation that would become effective should a board find that the director intentionally breached board or company policies or a fiduciary duty. Under Delaware law, while irrevocable contingent resignations may be used in the context of majority voting policies, it is unclear how courts would view the use of irrevocable contingent resignations to address intentional director misconduct.
- **Isolation.** If a director will not resign and refuses to abide by acceptable standards of director behavior, one option available to the board is to isolate him to some degree from key board deliberations and decision-making. For example, the board may form a committee to undertake those board actions that are not reserved by law to the board as a whole. Of course, care needs to be taken to assure that the director continues to have access to appropriate information.
- **Refusal to re-nominate.** Generally, the board is always free, absent a shareholders agreement to the contrary, not to re-nominate a director. Practically speaking, this option is of little help when a director is behaving badly mid-term, especially on a classified board where it could

be several years before his term is up.

Having candid discussions about these issues from time to time may assist the board to coalesce around a plan of action for the rare times when a director goes rogue. Boards and their counsel should anticipate in advance how they might handle this situation and use recent events to discuss expectations about director conduct and potential remedies for directors acting badly.

The views stated above are solely attributable to Ms. Gregory and do not reflect the views of Weil, Gotshal & Manges LLP or its clients.