CU*ANSWERS Management Services

Financial Literacy *for* Credit Union Board Directors

Good Director Practices

Part 1: Fundamentals

A BOARD *Member* EDUCATION PROGRAM

Part of the BOARD FINANCIAL LITERACY SERIES *presented to you by* CMS

http://ms.cuanswers.com/

Coming Soon

Part 2: Advanced Liability Concepts

How much should the board worry about what the employees are doing?

Part 3: Legal Ramifications

How does the board avoid lawsuits when there are conflicts within director duties?

Published April 19, 2011

LEGAL DISCLAIMER
The information contained in this document does not constitute legal advice. We make no claims, promises or guarantees about the accuracy, completeness, or adequacy of the information contained in this document. You should retain and rely on your own legal counsel, and nothing herein should be considered a substitute for the advice of competent legal counsel. These materials are intended, but not promised or guaranteed to be current, complete, or up-to-date and should in no way be taken as an indication of future results. All information is provided "as is", with no guarantee of completeness, accuracy, timeliness or of the results obtained from the use of this information, and without warranty of any kind, express or implied, including, but not limited to warranties of performance, merchantability and fitness for a particular purpose. In no event will CU*Answers, its related partnerships or corporations, or the partners, agents or employees thereof be liable to you or anyone else for any decision made or action taken in reliance on the information provided or for any consequential, special or similar damages, even if advised of the possibility of such damages.

contents

accountability 4

- true story 4
- board accountability notes 5

operations 6

- true story 6
- governance basics 7
- recruiting and removal 8
- agendas meetings and minutes 9

corporate officers 10

- true story 10
- general responsibilities 11
- managing conflicts 12
- removing the CEO 13

liability 14

- true story 14
- five essential rules 15
- d&o insurance 16

key differences between for profits and non profits 18

resources 19

accountability

TRUE STORY

a nasty fight at a credit union illustrates board member accountability

In 1990 (for reasons which have been lost to history), the board of directors at Nevada Federal Credit Union by a 5-2 vote chose not to renew the contract of CEO Robert Street. As an unpleasant parting shot, Street was advised that the board no longer had trust or confidence in his abilities. The next day Jeanette Jesinger, the chairperson of the board, officially informed Robert Fleischman, the head of the Credit Union Supervisory Committee, of Street's effective termination. Angered by the news, Fleischman decided to confront the board of directors. After researching his options, Fleischman sent a provocative letter to Jesinger five days later, demanding an explanation and asking if any of the actions of now-former CEO Robert Street threatened the safety or soundness of the institution. Fleischman also got the NCUA involved, and the next day the NCUA examiner called Jesinger to warn her that if the board did not respond to the Supervisory Committee, Fleischman would bring the matter up to the membership. Days passed, and with no response from Jesinger the Supervisory Committee suspended the five board members pending a final member vote.

At the member meeting, Fleischman accused the board of abuse of credit cards, travel and compensation, in addition to an abuse of power allegation regarding Robert Street. Jesinger and the other board members were brought before the membership and allowed to respond to the charges. At the end of the meeting, the membership sided with the Supervisory Committee and duly voted to permanently remove four of the five board members (the fifth anti-Street board member resigned the next day). Jesinger and her fellow aggrieved board members then sued the credit union alleging both defamation and wrongful removal by the Supervisory Committee. Jesinger's complaint claimed her due process rights were violated "through abuse of the suspension process set forth in the credit union bylaws."

Whom does the board of directors serve?

At every level of the proceedings, Jesinger and her co-plaintiffs had their claims dismissed, and the manner in which the

appeals court rejected their claims says a lot about how the courts view the role of the board of directors within a federally charted credit union. The federal appeals court judges ruled that the votes of the membership were all the process she and her board of directors were due.

"Congress provided a remedy in the [Federal Credit Union Act]: the members of the credit union vote either to affirm or reverse the suspension actions of the Supervisory Committee. The process allows suspended officers or members to address the credit union membership and challenge a suspension. The provision of this remedial measure in the [Federal Credit Union Act] and the absence of any other remedies compel an assumption that Congress deliberately omitted the ... remedy now being sought by the Board members."

Furthermore, the court said the Supervisory Committee was immune from charges of defamation. The Supervisory Committee had a responsibility to bring charges against the board members, and even if these accusations were not true, so long as the Supervisory Committee didn't knowingly lie or present the allegations with reckless disregard for the truth the Supervisory Committee could not be held liable. ■

board accountability notes

Accountability for the use of board of director powers falls to two distinct entities:

Membership. For a for-profit corporation, accountability rests with the shareholders. For a credit union, the accountability is to the membership. Either way, the board of directors are compelled to act with the best interests of the parties the board is answerable to. For a credit union board, there is generally no safer way to act or not act than to state clearly and provide proof the decisions of the board were in the best interest of the membership.

Laws and Regulations. The board of directors are also answerable to the authorities that regulate their industry. In the credit union industry, board of directors have the power to be removed by regulators in extreme cases for failing to execute these oversight duties. ■

Questions every board member should ask regarding accountability:

1. Are the decisions made by the board defensible to the people the board is accountable to?
2. Is the board making reasonable efforts to ensure the organization is in compliance with applicable laws and regulations?

operations

What are the mechanics of board functions?

TRUE STORY

what can happen if the board fails to fulfill its functions

The Grand Union Mount Kisco Employees Credit Union grew from assets of $200,000 in 1978 to over $3,000,000 in 1987. During this time the Treasurer was Stanley Kanaryk, a semi-retired former NCUA examiner. Things were going so well under Kanaryk's watch, that in 1987 Grand Union's board of directors happily authorized dividends of $67,466, collectively.

Unfortunately, all was not well with balance sheet. Kanaryk had invested large amounts of the credit union assets into Ginnie Mae funds which were rapidly dying. Because of Kanaryk's misunderstanding of how the funds worked (indeed, he utterly bungled the investments), none of the directors understood this. Not until 1986 did NCUA examiners begin to point out problems with the financial statements. When the board of directors finally took action, the Ginnie Mae funds cost the credit union losses of $150,000 .

Grand Union promptly sued Kanaryk for restitution of the loss, including the authorized dividend. The credit union claimed Kanaryk, systematically and deliberately overstated the value of investments on Credit Union financial statements to avoid revealing the Ginnie Mae losses, and failed to keep accurate records of loan losses for much the same reason. Kanaryk's alleged motive in deceiving the Board was his desire to receive dividends on his Credit Union deposits.

The courts found in favor of Kanaryk, claiming there was no evidence of disloyalty. But worse, the court laid the blame squarely on the board's lack of oversight. The court stated that by punishing Kanaryk they "would only reward the Credit Union board of directors for its own misfeasance."

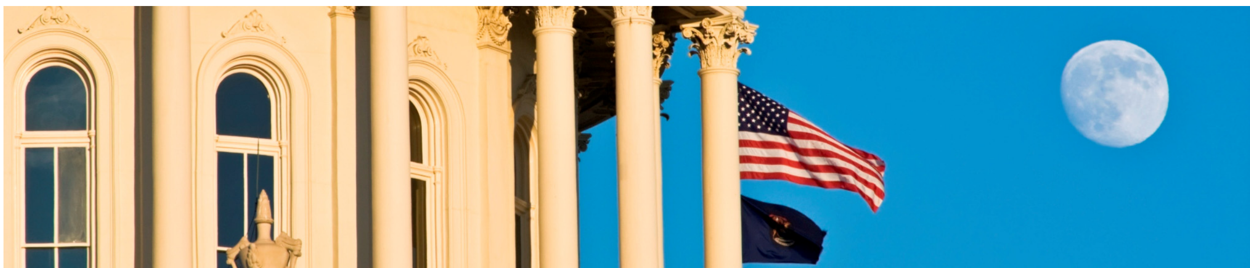
Kanaryk's treasurer position was originally intended to be a part-time job, but had grown much more demanding in intervening years. The 1500% increase in asset size all but guaranteed that a part-time Treasurer would make mistakes. An independent auditor commissioned by the Credit Union supervisory committee in April, 1987 to review financial records noted that "the vast growth of the credit union has taken it out of the realm of a `one man job,'" and advised that an assistant with bookkeeping experience be hired.

Both in September, 1986 and in May, 1987, the NCUA examiner assigned to review the Credit Union's financial records noted in detail the accounting inaccuracies on financial statements and explicitly advised the Board to get more involved in running the Credit Union and to obtain outside accounting help. Even though the board relied on Kanaryk's assurances that the financial statements were not substantially inaccurate, and that as treasurer, Kanaryk should have

apprised the Credit Union of the urgency of the NCUA's recommendations, the court still refused to make Kanaryk financially liable for the loss. Instead the court concluded that the board was duty-bound to apprise itself of the NCUA recommendations regarding outside accounting help. The NCUA's report in 1987 was especially damning to the board's case, stating in the Examination Overview:

"In continuing to rely totally on the treasurer, who is retiring from the credit union at the end of the third quarter of 1987, the officials confirmed and acknowledged their lack of understanding and comprehension of existing regulatory restrictions and accounting requirements."

The specific issue in this case addressed the fact that the board of directors should take appropriate measures to ensure that they are aware of the accuracy of the credit union's financial records and are aware of the ramifications of the investment of credit union assets. In a larger sense, the board through governance and participation show their engagement and understanding of the issues, as directors are ultimately responsible for the acts of their employees and officers. The following section details some of the details surrounding board composition and governance. ■



governance basics - board of director roadmap

Articles of Incorporation
The Articles of Incorporation (or Charter) are what bring a business into legal existence. For credit unions, usually one of the key provisions is defining who can be members. For federally chartered credit unions, this fulfils a key provision of Section 109 of the Federal Credit Union Act, "[f]ederal credit union membership shall be limited to groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district." Credit unions can choose to be state or federally chartered. This is known as the dual charter system. Regulatory policies and oversight for federal credit unions are controlled out of Washington, D.C., while state credit unions deal with local state officials in regulatory matters.

Bylaws
Bylaws are the official rules and regulations which govern a corporation's management. Credit unions are limited in the choice of bylaws (federally chartered credit union have to use NCUA provided bylaws, state credit union generally have to follow state provided bylaws). FCUs all amend their bylaws in the same fashion, per Article XVII of their bylaws. Any amendment requires the affirmative vote of • two-thirds of the board, and NCUA approval must be obtained before amendments take effect. (NCUA approval is essentially perfunctory, but still required, thus adding time to the process.)

Using Michigan as an example, the bylaw amendment procedure for a state chartered credit union is set forth in credit union's bylaws. A Michigan chartered credit union can either allow amendment by:

- Majority vote of the members at an annual or special meeting;
- Unanimous vote of directors present at a meeting of the board (called after proper notice); or
- Both methods.

Credit unions tend to get in the most trouble when their internal procedures do not match what the bylaws require, especially in hotly contested high pressure events such as elections or director removal.

Resolutions

Resolutions are legally binding actions or decisions made by a company and approved by its board of directors. One example of a corporate resolution is a statement specifying which officers and employees can act on the company's behalf. Resolutions can be critical proof during an examination that the board of directors knowingly took action or knowingly chose not to act on an issue facing the institution.

Board Policies and Handbooks

These are the guidelines for how the board members can best work together. Some of the key items should include frequency of meetings, Committees, recruiting and orienting new members, attendance management, formal relationship with the chief executive officer, and avoidance of conflict-of-interest.

Committees

Examples of committees that serve the board are:

Supervisory Committee, which is responsible for ensuring the reports on the condition of the credit union to the membership are accurate. As seen in the *Jesinger* case, Supervisory Committees have the power to suspend officers and directors, and to call a meeting of the membership to make those suspensions permanent. The board can suspend Supervisory Committee members by a majority vote of the board of directors. The members of the credit union will decide after any suspension, whether the suspended committee member will be removed from or restored to the supervisory committee.

Credit Committee, which by majority vote of its members, appoint one or more loan officers to serve at its pleasure, and delegate to them the power to approve application for loans or lines of credit, share withdrawals, releases and substitutions of security, within limits specified by the committee and within limits of applicable law and regulations. ■

recruiting and removal of board members

Credit unions generally appoint board members through the nominating committee and/or election through nomination by petition. Federally chartered credit unions are not required to have term limits on serving directors. When there is significant board turnover, it is important to consider the following losses to the institution, including the loss of expertise and organizational memory, more time dedicated to recruitment and orientation, and efforts needed to keep the group cohesive.

However, boards with long-serving directors can experience stagnation, perpetual concentration of power within a small group, intimidation of the occasional new member, loss of commitment by the board, and loss of connection to the constituency due to a change in demographics or environmental factors. Each organization needs to consider what factors are important to the well-being of the institution when considering whether to make changes at the board level.

Removal of board members needs to be done in accordance with the bylaws of the credit union and with applicable law. The key for removal of any director is to carefully establish whether the criteria for removal has been met and to ensure that information is properly evidenced. ■

diversity issues

The SEC approved a rule that would require disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director. If the nominating committee or the board has a policy with regard to the consideration of diversity in identifying director nominees, the final rules require disclosure of how this policy is implemented and how the nominating committee or the board assesses the effectiveness of its policy.

While this rule has not filtered down to credit unions, boards should consider some of the advantages of diversity in their directors. ■

lawsuits

As a side note, if a credit union ever faces a lawsuit for unlawful removal of a director, you can guarantee torts such as "intentional infliction of emotional distress" and "defamation" will be tacked on. ■

wisconsin law director removal

Director removal. The board of directors *shall remove* a director from the board if *any* of the following applies:

The director withdraws from membership in the credit union.

The director causes a loss to the credit union because of a delinquency or a known conflict of interest

The director is unable to be bonded in accordance with the standards set by the board of directors.

In the judgment of the board of directors, removal of the director is in the best interests of the credit union.

Removal notice and appeal. A director who is removed … shall be given notice of removal. The removed director may petition the board of directors to reconsider its decision. If the board of directors does not reinstate the director, the director may appeal the decision of the board of directors to the office of credit unions. If the office of credit unions determines that the removal of the director was improper, the office of credit unions shall order the reinstatement of the director and, if the board of directors has already appointed a person to fill the vacancy created by the removal of the director, the removal of such person. [emphasis added]

federal bylaws director removal

If a director or a credit committee member, if applicable, fails to attend regular meetings of the board or credit committee, respectively, for 3 consecutive months, or 4 meetings within a calendar year, or otherwise fails to perform any of the duties as a director or a credit committee member, the office may be declared vacant by the board and the vacancy filled as provided in the bylaws.

The board may remove any board officer from office for failure to perform the duties thereof, after giving the officer reasonable notice and opportunity to be heard.

Notwithstanding any other provisions in these bylaws, any director or committee member of this credit union may be removed from office by the affirmative vote of a majority of the members present at a special meeting called for the purpose, but only after an opportunity has been given to be heard.

agendas, minutes, and meetings

Agendas. Agendas are the way of organizing the limited time the board members have to spend with each other and what issues will be discussed. Often, planning out an agenda for a calendar year can help a board focus, ensuring enough time is provided to go over necessary reports, provide board education, and leave time for discussion for other items that come up during the fiscal year. **Minutes.** Minutes are the key evidence an institution can use to prove the board members were engaged and made decisions to act or not to act based on the information. Minutes don't have to be extensive, but should have enough information to document board involvement. Minutes are proof of the board's involvement in issues facing the institution and can save the board in liability suits. ■

meeting best practices

Before the meeting, put the topic on the meeting agenda, with the type of decision needed for the topic , the information needed to support the decision and the specific amount of time in the meeting to address that topic.

During the meeting (as long as a quorum of Board members is present), board members discuss/debate and then decide within the time allotted on the agenda with consensus is attempted within that time. If consensus cannot be achieved, then a seconded motion is sufficient to call a majority vote to delegate to a committee to gather more information by a certain time frame. If delegation is not selected by a majority vote, then a seconded motion is sufficient to call a vote about a certain suggested outcome of the decision. The decision outcome goes to the majority vote and the decision is documented in the next issue of Board minutes. ■

Questions every board member should ask regarding operations:

1. Are the board's actions consistent with the charter, bylaws, and policies of the institution?
2. Do we have a good procedure for recruiting and removing board members?
3. Do the agendas give the board enough time to discuss key issues facing the institution?
4. Are decisions of the board members made with best practices in mind and accurately documented in the minutes?

corporate officers

What should the relationship be between the board and the CEO?

TRUE STORY

how the scandal at worldcom fundamentally changed the legal perception of CEO/board relations

The board of directors for any organization exists to provide governance and oversight to the organization. In gratitude for making tough decisions, the law has traditionally protected board directors from liability. Prior to 2001, courts were highly reluctant to impose liability on the board of directors for failing to discharge their duties. But all of that changed with the scandals of Enron and WorldCom. WorldCom in particular is the perfect example of conduct so egregious by directors that personal liability was imposed.

WorldCom, despite being the second largest telecommunications company in the world found itself in serious trouble in 2000-2001. The price of WorldCom stock was declining and CEO Bernard "Bernie" Ebbers was facing pressure to cover margin calls on the WorldCom stock (used to finance his other enterprises). In 2001, Ebbers asked and was granted a $400 million loan to cover his margin calls. The loan was so Ebbers wouldn't have to sell his shares, thereby driving the stock price even lower. But in addition to the loan, Ebbers, his CFO Scott Sullivan, and the board agreed to deceive shareholders and investors by hiding the accounting entry. The parties agreed that Ebbers could repay the loan once the stock price recovered, but essentially the WorldCom board was financing Ebbers' other companies during this period (something no financial institution was prepared to do).

The problem for WorldCom leadership was that the deception was so shockingly crude – WorldCom had a $400 million accounting entry referencing computer equipment that did not exist – that WorldCom's own internal audit team discovered the loan almost immediately. When the internal audit department reported this to CFO Scott Sullivan, he blocked the investigation; a decision that would later cost him four years in prison. Unfortunately for WorldCom leadership, the SEC independently came to the same conclusion that WorldCom's accounting had to be fraudulent. Within months Ebbers was ousted, and shortly after that WorldCom confessed that even worse than the loan to Ebbers the company had been systematically inflating assets by as much as $11 billion . WordCom subsequently filed for Chapter 11 bankruptcy and eventually merged into MCI. The accounting firm Arthur Andersen, who had nodded approvingly at the financial shenanigans at WorldCom and Enron, killed their own business. In 2002, Arthur Andersen had 85,000 employees; in 2007, 200.

While none of the directors at WorldCom joined Ebbers and Sullivan in jail, they did not avoid punishment. Ten of the directors were held to have breached their duty to the shareholders and agreed to a $54 million settlement for their roles in WorldCom's $11 billion accounting fraud. One-third, or $18 million, was paid by the directors personally, with the balance paid by WorldCom's D&O insurance policy. The $18 million represented approximately 20% of the directors' cumulative net worth, excluding primary residences, retirement accounts and judgment-proof joint assets.

In order to avoid personal liability, the board of directors must maintain some level of independence from the corporate officers. As a practical matter, however, maintaining that independence also must come with an ability to manage relationships with the officers without the dreaded "micromanagement" label. ■

general responsibilities of the corporate officers

President/CEO. Being President/CEO involves being able to plan, direct, and control activities in accordance with the plans, policies, and directives established by the board of directors. Being the President/CEO is a balancing act between making decisions that are within the best interest of the shareholders or members, as well as the employees and the institution itself.

CFO. The CFO is responsible for overseeing all the accounting and financial operations, making investment purchases, preparing the annual budget, directing and coordinating the asset liability management program, establishing accounting policies and procedures within GAAP, providing other financial reporting and analysis and work with auditors and examiners.

CIO. The CIO is responsible for securing information within the organization, and establishing the value of IT related projects within the organization.

COO. COO (Chief Operations Officers) can vary within the organization, but tend to follow one of the following models:

The COO oversees the functions that support the programs but do not relate directly to program participants, and other senior managers are responsible for the programs themselves.

In contrast to the first job description, some COOs are responsible primarily for programs, while the chief financial officer, or another senior executive oversees the more administrative functions.

This third job description is the broadest: the COO oversees everything internal, freeing up the CEO to focus on external matters such as public relations and partnerships.

The COO role described in this job description has overall strategic and operational responsibility for all programs. In addition, the individual in this role also manages a group of program directors and work with the nonprofit's board of directors to keep them abreast of programmatic changes. ■

insights on CEO selection from jack welch

“First, make sure every candidate has a solid reputation for honesty and fairness before they get in the door, as integrity is a must for your next CEO. Once that step is done, the whole interview charade can be circumnavigated by tightly linking questions to the key characteristics you’re after—vision, leadership, crisis management ability, “runway,” and authenticity.

Taking vision first, your questions should seek to uncover a candidate’s ability to see around corners, probe consensus thinking and competitive data with a healthy skepticism, and swiftly make change when the markets demand it. For example, you might ask: In your career, what’s the best example of you anticipating market changes that your competitors did not? When did your curiosity lead you to probe deeply and uncover a competitive trend or marketplace dynamic that others didn’t see, or didn’t want to see?

On leadership, you’re looking for examples of each candidate’s track record with people. Thus, you might ask for examples of their hiring successes and disasters, and explanations of what they got right—and what they missed. (That last query is a nice test of candor!) You might also ask: Can you point to any of your people who “grew up” with your guidance and have gone on to succeed in your own company or beyond?

Every leader faces a crisis, or two or three. What you want your CEO interviews to uncover is candidates with the experience and courage to overcome another. Try asking: What was the toughest integrity violation you have ever encountered, and how did you handle it? Have you ever had to define yourself in the midst of criticism, and did you succeed?

“Runway” is our shorthand for the capacity to grow and learn. When you hire a CEO, it isn’t just to lead the company as it stands but to continually see the organization and its future with fresh eyes. So ask about reinvention. Has the candidate ever willingly gone through a personal or professional metamorphosis?
Finally, authenticity. Well, hmmm. This one’s the trickiest because authenticity, arguably the most important CEO trait, is so hard to ferret out. Sure, you might ask: “When have you been blindsided in life, and why did it happen?” But judging authenticity is a matter of observation.

Does the candidate have a sense of humor about life? Is he excited, in his bones, about watching people grow? Is she comfortable in her own shoes? Watch—and listen. Listen, incidentally, is the key word here. Questions are only questions. You can start to feel quite full of yourself asking good ones, but the real power of an interview lies in how well you listen to the answers. Really listen, to the end, between the lines, through the pauses, and after the awkward silences. That discipline is so much harder than it sounds. And yet, when you let candidates talk, even seasoned veterans of the interview game, they often, in time, reveal what you need to know.

Whether you’ve found your CEO or not.” ■

CEO contract provision considerations

Compensation. Is compensation, including personal use of an employer-provided automobile, justifiable?

Management. Does the contract to provide for the CEO's exclusive authority over engaging, advancing, compensating, assigning, and terminating all other employees so long as budget and legal restraints are observed?

Contract versus bylaws. Are there any conflicts between provisions in a CEO contract and provisions in the bylaws or other governing documents?

Termination. Does the CEO contract provide for specific "with cause" termination criteria (for example, embezzlement or conviction of a felony) and includes an opportunity for the CEO to rebut any allegations of cause? What will severance be if the CEO is terminated "without cause" - in other words, when the CEO is fired for no particular reason related to improprieties or performance deficiencies?

Conflicts of interest. Does CEO contract state that no person who is, or might become, a candidate for the position may participate in negotiating the contract, setting the CEO's compensation, establishing goals, appraising the CEO's performance, or otherwise affecting termination without cause or nonrenewal?

Post-employment. Does the contract specify the expected consulting time and the procedures for reimbursement of approved disbursements, assistants, travel, and the like? ■

managing conflicts with officers

Conflict happens in organizations and can be a positive for the group. The following items can help avoid unpleasant conflicts:

No surprises: an important element of chemistry is that the board not be 'surprised' by news, particularly bad news. This is mostly the CEO's responsibility. Specific processes aid this outcome, but it should also be the desire of both to keep the other fully informed of issues and potential issues that relate to corporate performance and leadership.

Keeping each other in the loop: With regular communications among directors and executives, there is plenty of opportunity for misunderstandings and unintended intrigue. For instance, the Audit Chair may speak with the CFO one-on-one and each brief their counterparts, the Chair and CEO respectively. The Chair and CEO should calibrate these individual conversations to ensure the same messages were heard. Interviewees recommend that the CEO and Chair stay in touch on the tone and content of the important communications occurring among board and management. If either the Chair or CEO is "out of the loop," distrust can fester.

Presumed goodwill: Critical to the relationship between the Chair and CEO is a shared confidence that each wants to see the other be successful. If that is presumed, conflict and criticism are easier to deal with professionally. Said one Chair: "We created a board climate where people voice their ideas, and they don't worry if their proposal isn't the best, if their idea doesn't win – because we are in it together and we all need each other to be successful." ■

removing the CEO

Boards do have the authority to fire CEOs, and there was a sharp uptick in the number of CEO's fired in the last decade due to fears of director accountability for CEO management decisions. Of course, this can also be a challenge for a board who has normally been supportive of the CEO now has to discharge the CEO from employment.

Directors can (and have been) sued for breach of and interference with an employment contract after firing a CEO. However, most courts will not find the directors liable for action taken as a director, or for failure to take an action, if the directors have exercised their business judgment in good faith, with the care of an ordinarily prudent person, in a manner reasonably believed to be in the best interests of the corporation, and the breach or failure to perform constitutes willful misconduct or recklessness. ■

Questions every board member should ask regarding corporate officers:

1. Does the board have sufficient independence from the corporate officers?
2. Does the board have a succession plan and hiring strategy for corporate officers?
3. Has the board carefully considered the contract provisions for the CEO?
4. If the board is considering terminating the CEO, have they considered the appropriate strategy for doing so?

liability

When do directors become personally liable for their decisions?

TRUE STORY

how the fourteen-month tenure of disney's president
sent shockwaves through american boardrooms

In 1995, Disney CEO Michael Eisner recruited his friend Michael Ovitz to be President; in effect Eisner's second in command. Ovitz accepted the job despite having no experience in running such a huge operation. In order to convince Ovitz to take the job, Eisner included a monstrous severance package with a no fault termination clause. Despite initial reluctance, the contract was rubber-stamped by Disney's board of directors (which at the time included Oscar-winning actor Sidney Poitier, the CEO of Hilton Hotels Corporation Stephen Bollenbach, former U.S. Senator George Mitchell, Yale dean Robert A. M. Stern, and Eisner's predecessors Raymond Watson and Card Walker). Ovitz himself was also a Disney's board member.

Ovitz's tenure at Disney rapidly got ugly. One of Ovitz's responsibilities was to open up markets to Disney in China, yet Ovitz promptly created an international controversy by brokering a deal to distribute *Kundun*, the Martin Scorsese epic about the Dalai Lama that offended the Chinese government. In the fourteen months Ovitz was President of Disney, he was accused of wasting funds, driving away talent, and even acting without proper decorum at the funeral of Michael Eisner's mother.

Desperate to get Ovitz out of the building, Eisner and the board initially tried to get Ovitz fired for cause. Unfortunately for Disney, while Ovitz might have been incompetent as a Disney corporate officer, he proved masterful at avoiding triggering any of the "for cause termination" clauses in his contract. Finally, Eisner invoked the no-fault termination clause and dismissed Ovitz. Ovitz's severance package included some $38 million in cash and another $100 million in stock options. To put this in perspective, this severance was approximately 140 times what Ovitz made in salary and paid him approximately $310,000 a day for each day Ovitz reported to work (including weekends).

Disney's shareholders, predictably, went berserk. The shareholders filed a suit alleging that the board of directors breached their fiduciary duty and lacked independence (due to Ovitz presence on the Disney board when his contract was negotiated). A finding of a breach of fiduciary duty would have made Eisner and the board personally liable for the damages to shareholders. Never before in American history had any directors been liable for so much, simply because they approved the contract. In order to overcome this claim, Disney's attorneys were forced to make a nearly ridiculous defense, as Kurt Anderson of New York Magazine put it:

"The argument that Disney's lawyers have had to make is comically contorted: *Hiring Ovitz was entirely prudent . . . but on the other hand so was firing him after only a year, because he sucked . . . but on the other hand, so was paying him $140 million in severance, because even though he sucked, he wasn't so terrible that he could have been fired for cause*." [emphasis in original]

Amazingly, this nutty argument carried the day. The Chancery court beat up Eisner and his board but ultimately let them off the hook, finding:

"Despite all the legitimate criticisms that may be leveled at Eisner, especially at having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom, I nonetheless conclude, after carefully considering and weighing all the evidence, that Eisner's actions were taken in good faith."

In other words Eisner and the Disney board did not

violate the duty of care owed by a corporation's officers and board to its shareholders. The board of directors had enough information to have knowingly approved Ovitz's contract, which was enough to – barely – squeeze them through the business judgment rule.

Unlike a typical Disney film, neither Eisner nor Ovitz had a happy ending. Eisner was forced out by a shareholder revolt led by Roy E. Disney in 2003. Ovitz, once the most feared and powerful deal-maker in Hollywood watched his next entertainment project fail as well, effectively eliminating what was left of his reputation and influence. ■

the five essential rules regarding director liability

1 business judgment rule

The business judgment rule dictates that a court must presume a director based his decision on an informed and honest belief that the decision was in the best interests of the corporation and its shareholders or members. The business judgment rule bars a plaintiff from recovering against the directors in the absence of fraud, bad faith or self-dealing. If the plaintiff is able to rebut the presumption of the business judgment rule with proof that indicates a director acted in bad faith, was disloyal, or committed waste, then the burden shifts to the director to demonstrate otherwise. The application of the business judgment rule is performed on an individual basis, director-by-director, with a focus on the process employed by each director in reaching his business decision.

To receive the business judgment rule's presumptive protection, directors must inform themselves of all material information and then act with care.

2 duty of due care

Fiduciary duty of due care requires directors to "use that amount of care which ordinarily careful and prudent men would use in similar circumstances," and "consider all material information reasonably available" when making business decisions. As long as the director's decisions were pursuant to a rational process and made in good faith to advance the corporation's interest, the court will not consider the content of the director's decision—regardless of how "stupid," "egregious," or "irrational" the decision may appear. Director inaction will only constitute a breach of the duty of due care if the plaintiff establishes a "sustained or systematic failure [of a director] . . . to exercise reasonable oversight."

In 1985, the Delaware Supreme Court held that the board of Trans Union had breached its duty of care in approving a merger after having just a 20 minute presentation and not any additional outside expertise. The Delaware Supreme Court concluded that Trans Union's board was not entitled to the presumption of the business judgment rule because the board had failed to act on an informed basis. After finding that the Trans Union directors had breached their duty of care in approving the sale of the corporation, the Delaware Supreme Court took "the unprecedented step" of holding all of Trans Union's directors jointly and severally liable for more than $23 million. This case (*Van Gorkom*) caused panic in board rooms and sharp increases in D&O premiums. Several legislatures, including Delaware, allow for corporations to put in charter amendments to exculpate directors who have breached the duty of due care. The case lives on as a reminder that directors should take reasonable actions to inform themselves before acting.

3
duty of loyalty

This duty forbids corporate directors from using their position of trust to further their own private interest (i.e., "self-dealing"). Directors are required to take affirmative steps to put the interests of the corporation and its shareholders above their own non-mutual interests. These steps include refraining from any action that would deprive the corporation of profit or advantage. Additionally, directors are required to act in an "adversarial and arms-length manner" when negotiating transactions between the corporation and the director himself. Directors can be held personally liable for loyalty breaches and these breaches may not be covered by D&O.

4
duty of good faith

Breach of the duty of good faith occurs if the directors "consciously and intentionally disregard their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision." Moreover, "[d]eliberate indifference and inaction in the face of a duty to act" epitomizes bad faith. Thus, plaintiffs must still rebut the presumption that directors acted in good faith. Plaintiffs can only rebut this presumption by proving that the director intentionally (1) acted to further an interest other than one in the shareholders' or members best interest; (2) violated applicable law; or (3) failed to act in the face of a duty to do so.

5
doctrine of waste

Corporate waste is defined as a director irrationally squandering corporate assets. To prove waste, the plaintiff must establish that an exchange was "so one-sided that no business person of ordinary, sound judgment could conclude that the corporation . . . received consideration." This is almost never litigated, but all directors should be aware that it exists. ■

d&o insurance

Directors and Officers Personal Liability Insurance provides general cover to a firm's directors and senior executives. Paid usually by the firm, it reimburses (in part or in full) the costs resulting from law suits and judgments arising out of poor management decisions, employee dismissals, shareholder grievances, and other such acts committed in good faith. Criminal offenses are not covered under this insurance.

A D&O policy may have more than one side or schedule, including:

Side A: Protects a corporations directors and officers when the company cannot indemnify.

Side B: Reimburses the organization when the organization indemnifies the individuals (balance sheet protection).

Side C: Eliminates disputes of coverage allocation when directors and officers and the insurance organization are named co-defendants in securities law suits.

Another consideration is Employment Practices Liability ("EPL") Coverage in

oversight liability

Oversight liability for a board generally happens only where (1) the directors utterly failed to implement any reporting or information system or controls or (2) having implemented such a system or controls, the directors consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

addition to corporate coverage – often by endorsement to the D&O policy or as a stand-alone policy issued to the company. This coverage typically protects directors, officers, employees and/or the company against employment-related claims brought by employees and, in certain circumstances, specified third-parties. For example, it provides coverage for wrongful dismissals or failures to promote, sexual harassment, and other violations of federal, state or local employment and discrimination laws brought by the company's employees. EPL claims have also seen a dramatic increase in frequency and severity over the past decade.

Most D&O policies do not impose a duty to defend on the insurer. They do, however, provide coverage for defense costs and give the insurer the right to associate with the defense and approve defense strategies, expenditures, and settlements.

exclusions commonly found in d&o insurance policies

Directors should be familiar with the exclusions in the D&O policy. Some of the more common exclusions include:

Dishonesty Exclusion. Dishonesty exclusions bar coverage for claims made in connection with an insured's dishonesty, fraud, or willful violation of laws or statutes. The dishonesty exclusion also may be coupled with a personal profit exclusion, barring coverage in connection with an insured's illicit gain. These exclusions typically are followed by a severability clause – that is, a caveat providing that the acts or knowledge of one insured will not be imputed to any other insured for the purposes of applying the exclusion. In other words, the exclusion only bars coverage for the insured(s) whose acts or knowledge are the basis of the claim at issue.

Insured v. Insured Exclusion. As the name implies, an insured versus insured ("IvI") exclusion bars coverage for claims made by an insured (e.g., a director, officer or corporate insured) against another insured. In addition, the exclusion may bar coverage for claims brought (1) by anyone directly or indirectly affiliated with an insured, (2) by a shareholder unless the shareholder is acting independently and without input from any insured, or (3) at the behest of an insured. The exclusion essentially prevents a company from suing or orchestrating a suit against its directors and officers in order to collect insurance proceeds. Questions regarding the application of the exclusion arise in the context of derivative lawsuits, bankruptcies and receiverships.

Professional Liability Exclusion. As a general matter, D&O policies do not provide coverage for liability associated with the provision of professional services. Thus, where a bank officer is liable for acts as a banker rather than an officer of the bank, a D&O policy with a professional liability exclusion would not provide coverage. Similarly, where a doctor is the president of a professional corporation, the D&O policy would only protect him or her against liability from acts as president of the corporation, and would not provide coverage for professional malpractice claims.

Prior Acts Exclusion. Prior acts exclusions bar coverage for claims arising out of an insured's wrongful acts prior to a specified date. The date may coincide with the termination of coverage under a previous policy. The date may also coincide with a change in corporate status – such as a merger or acquisition. For example, where a subsidiary is acquired, the prior acts exclusion may exclude coverage for the subsidiary prior to the time it became a subsidiary. In such situations, the subsidiary may have run-off coverage from a previous policy to protect against liability arising from those excluded acts.

Prior and Pending Litigation Exclusion. Prior and pending litigation exclusions generally exclude coverage for (1) claims pending prior to the inception of the policy, or another agreed upon date, and (2) subsequent claims based on the same facts or circumstances. Conflicts primarily arise regarding the second component of this exclusion. Specifically, the question arises as to when a subsequent claim is based on sufficiently overlapping facts and circumstances to fall within the scope of the exclusion. Courts have held that the two claims need not be brought by the same plaintiffs to trigger the exclusion. ■

Questions every board member should ask regarding liability:

1. Are our decisions made in good faith and free of self-dealing?
2. Does the board have both an adequate D&O insurance policy, and understand the exclusions?

key differences between profits and non-profits

for profit

Purpose: The purpose of a corporation is for the financial benefit of its owners and/or shareholders. Profit is the goal and the business pays taxes on that profit. The rights of investors have priority.

Board Control: The person or group owning 51% or more of the stock can control both the board and the business with their controlling votes. A shareholder can sell their stock shares and the rights that go with it.

Director Compensation: For profit directors usually receive cash compensation, which is the sum of annual retainer and per meeting fees.

Shareholder Lawsuits: Shareholders can file lawsuits against the corporation alleging financial harm against their interests. A derivative lawsuit is a shareholder lawsuit alleging that an injury suffered by the corporation also harms the shareholders, and that the corporation must take action to protect the corporation from further harm. Derivative lawsuits also usually require the shareholders to make a formal demand of action from the board of directors.

non-profit

Purpose: The purpose of a non-profit is to fulfill the charter. This does not mean the non-profit cannot make a profit, but profits are intended to be used to further the public service aspects of the non-profit organization. No person owns shares of the corporation or interests in its property.

Board Control: In the case of a non-profit corporation there are no shares and thus no owners of shares to vote. In organizations which have a defined membership, it is usually the members who elect the board but each member only has one vote and membership does not give them an ownership right in the assets of the organization.

Director Compensation: Most non-profit directors must volunteer to serve on the board without compensation, and can only be reimbursed for reasonable expenses.

Lawsuits: The vast majority of lawsuits are filed by employees alleging wrongful employment practices. A non-profit board can be sued when their breach a specific fiduciary duty owed to the claimant. This might include the government, for example when the NCUA alleges a breach of director duty impaired the share insurance fund. Members may have standing to sue when activity damages their interests, such as improper repossession of assets.

Note: The general difference between “not-for-profit” and “non-profit” is that non-profits have a separate legal existence outside of their members, i.e. the charter.

references

accountability

Jesinger v. Nevada Federal Credit Union, 24 F. 3d 1127 Court of Appeals, 9th Circuit (1994).
BoardSource: Build Effective Nonprofit Board of Directors through Good Governance (www.boardsource.org).

operations

Grand Union Mount Kisco Emp. Fed. Cr. U. v. Kanaryk, 848 F. Supp. 446 - Dist. Court, SD New York, (1994).
All About Boards of Directors (For-Profit and Nonprofit) (www.managementhelp.org/boards/boards.htm).
SEC Approves Enhanced Disclosure About Risk, Compensation and Corporate Governance (www.sec.gov/news/press/2009/2009-268.htm).
Federal Credit Union Bylaws (www.ncua.gov/GenInfo/GuidesManuals/bylaws/index.aspx).
1997 Wisconsin Act 152 (legis.wisconsin.gov/1997/data/acts/97Act152.pdf).

corporate officers

Pulliam, Susan; Deborah Soloman. "How Three Unlikely Sleuths Exposed Fraud at WorldCom: Firm's Own Employees Sniffed Out Cryptic Clues and Followed Hunches". The Wall Street Journal.
Ripley, Amanda (December 30, 2002). "The Night Detective". (www.time.com/time/magazine/article/0,9171,1003990,00.html.)
"Ebbers indicted, ex-CFO pleads guilty". CNN. March 2, 2004. (money.cnn.com/2004/03/02/technology/ebbers/).
MoneyMix: Launch Your Life (moneymix.cuna.org/12508/).
The Welch Way—The Official Website of Jack Welch and Suzy Welch (www.welchway.com).
What to watch for with CEO Contracts (www.allbusiness.com/legal/contracts-agreements/592484-1.html).
CEO Online | Your Business Resource (www.ceoonline.com).

liability

Masters, Kim (Aug 16, 2004), "Deposed: The strange hiring and firing of Michael Ovitz.", Slate, (www.slate.com/id/2105223).
Anderson, Kurt (May 21, 2005), "Ovitz and Eisner: A Kids Story", New York Magazine, (www.nymag.com/nymetro/news/columns/imperialcity/10900/).
Holson, Laura (Aug 10, 2005), "Ruling Upholds Disney's Payment in Firing of Ovitz", New York Times, (www.nytimes.com/2005/08/10/business/media/10ovitz.html).
Powell, Wendi J. (May 13, 2007), "Corporate Governance and Fiduciary Duty: The 'Mickey Mouse' Rule", George Mason Law Review.
Holland, Randy J. (November 11, 2008), "Delaware Directors' Fiduciary Duties: The Focus on Loyalty", Pennsylvania Journal of Business Law.
Melbinger, Mike (April 2006), "Overview of Corporate Governance and Fiduciary Responsibilities For Board of Directors and Compensation Committee Members", The Cochlan Group, Inc. Net Worth Newsletter.
Gische, David M. (January 2000), "Directors and Officers Liability Insurance", Troutman Sanders LLP, (library.findlaw.com/2000/Jan/1/241472.html).