

Preparing Your Board Before Litigation: A Primer on Defending Board Actions, Preserving Confidential Information, and Managing Risk

Litigation and Dispute Resolution


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CHEAT SHEET

- ***How to train your board.*** Make sure new board members are aware of their responsibilities and duties, and train them on an ongoing basis.
- ***Avoid conflicts of interest.*** To prevent further complication during litigation, insist that the board remain disinterested and conflicted directors recuse themselves.
- ***Identify industry trends.*** Be aware of ongoing compliance and litigation trends in your industry so your board is not blindsided when investigations occur.
- ***Have a seat (at the table).*** The general counsel is a bridge between the board and management, and they should form a close working relationship with the BOD.

Litigation has become all but inevitable in today's business climate, and the costs may be monetary, reputational, or both. Litigation exposure comes in the form of corporate governance scrunity and regulatory compliance by auditors, government regulators, shareholders, plaintiffs' counsel, and advocacy groups. Investigations and enforcement actions by federal and US state agencies, including the US Securities and Exchange Commission and the US Department of Justice, are also on the rise. Although shareholder litigation outside the United States remains rare despite the growth of litigation overseas, regulatory scrutiny, particularly in Europe, and trademark infringement actions are active areas for board attention.

Also on the rise is cross-border cooperation among regulators of different countries. Thirty-one member nations of the Organization for Economic Cooperation and Development (OECD) agreed in January 2016 to share data on multinational tax avoidance. While the United States did not sign the agreement, the US Foreign Account Tax Compliance Act (FATCA) accomplishes a similar purpose. Nigeria has also recently taken a number of steps to improve investor climate and strengthen its regulatory oversight of business, including signing agreements to stem outflows of criminal funds with the United States and the United Arab Emirates. These collaborative cross-border efforts by regulators are not isolated events.

Although those in favor of — and opposed to — the increasing number of regulatory actions and lawsuits attacking board decisions may be tempted to argue their respective positions, that is not the point of this article. The fact is that the costs to defend such litigation can take a significant financial or reputational toll on a company, confidential and sensitive records may become public, and the commitment of time and energy to defending litigation can be a distraction to employees, management, and the board. The legal department that has the foresight to prepare their board members for potential liabilities before litigation is imminent may be better prepared to defend future lawsuits, preserve confidential or sensitive information, minimize reputational risks, and take advantage of opportunities to reduce expenses or resolve actions at an early stage.

The responsibility to prepare the board falls squarely on the company's legal department. This article is intended to provide some thoughts on how to prepare your board of directors for the possibility that it may face such litigation, and spark a discussion of steps that can be taken to limit the board's potential risks.

The business judgment rule is a good place to start. Then we will delve into other considerations in

preparing your board. A summary of the topics can be found in Figure 1.

Figure 1: Protect the benefit of the business judgment rule presumption

- Train your board
- Be deliberate in creating board minutes
- Avoid conflicts of interest
- Understand the risks of the business
- Identify industry trends
- Develop procedures in advance of litigation
- Other considerations to prepare your board for the risk of litigation
- Have a seat at the table
- Protect privilege and confidentiality
- Promote the corporate culture
- Review the company's governing documents
- Discuss indemnity and insurance for directors and officers

The business judgment rule

Although it differs from state-to-state, the basic premise of the business judgment rule is that it creates a presumption that a corporation's board of directors acted on an informed basis, in good faith, and in the honest belief that its actions were in the best interests of the company. Absent an abuse of one of the board's fiduciary duties, the court will respect the board's judgment. See Figure 2 for a more complete case law description of the business judgment rule.

Figure 2: The Delaware business judgment rule

"The business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a). See Zapata Corp. v. Maldonado, 430 A.2d at 782. It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Kaplan v. Centex Corp., Del.Ch., 284 A.2d 119, 124 (1971); Robinson v. Pittsburgh Oil Refinery Corp., Del.Ch., 126 A. 46 (1924). Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption." Aronson, et al. vs. Lewis, 473 A.2d 805, 812 (1984).

Although a number of EU jurisdictions have codified the business judgment rule, or something similar, many others have not. Internationally, there is a significant degree of variation between corporate laws, board structures, and directors' duties and liabilities. Many jurisdictions that do not have a business judgment rule per se do require a director to exercise the duties of care, diligence, and loyalty.

The purpose of the business judgment rule where it is applied is straightforward enough. It disfavors a court's substitution of its judgment for that of the board of directors, subject to limited exceptions. In this way, the presumption protects boards from adverse consequences when corporations take prudent risks. Once the presumption attaches, the burden is then shifted to the party challenging the board's decision to establish facts rebutting the presumption. To rebut the presumption, the challenging party must establish that a board breached one of its fiduciary duties; namely, the duty of due care, the duty of loyalty, and the duty to avoid conflicts of interest.

The key takeaway for boards is to defend this strong presumption. For evidentiary purposes, clear and appropriate actions must be taken to document that the board acted in an informed basis, in good faith, and in the honest belief that the actions taken were in the best interests of the company. How then does the legal department advise the board to show they adequately exercised sound business judgment?

Protecting the benefit of the presumption

Train your board

The board should have a deep understanding of its duties, and how to fulfill those duties. A good first step is training, including onboarding of new board members, and ongoing training of existing board members. The company's general counsel or outside counsel can present to the full board annually or at intervals, as the board deems appropriate.

In addition to training the board on its duties, counsel can review the board's procedures and practices and provide specific advice and recommendations on how to improve, if necessary, the board's actions to better demonstrate the exercise of their business judgment.

Be deliberate in creating board minutes

The board should deliberately consider issues before them and document the process and resolution of each issue. Properly created and maintained board minutes can provide evidence of a board's business judgment, compliance with its fiduciary duties, and fulfillment of its obligation to monitor the company's internal controls. This includes such details as the decisions the board has made, as well as identifying action items and accountability for task assignments. Depending on your jurisdiction, your board may be permitted to rely on certifications and reports from management and outside experts to make decisions, and the minutes should not only reflect the documentation referenced, but also clearly identify the documentation for future reference and retrieval. Better yet, attach the certification or report as an appendix to the minutes.

As properly prepared minutes can offer some protection to the board against litigation risks, the legal department has a crucial role in educating the board, documenting procedures, and overseeing board level communications and minutes with compliance to those procedures. Some basics for preparing board minutes to document the board's satisfaction of its duties can be found in Figure 3.

Figure 3: The basics of board minutes

Board minutes are a factual record that the board understood and considered board level issues, as demonstrated by presentations, documents and reports, as well as made inquiries and probed the

various options before the board, before rendering a decision. Properly created and maintained minutes serve a vital function in establishing the board's exercise of its business judgment. Good board minute practices include the following:

- Designate one person to draft the minutes immediately following the meeting. The minutes should convey a sense of deliberation and due care, be largely factual, and devoid of commentary and opinion.
- The minutes should include a list of those in attendance at the board meeting and whether there was a quorum, a record of whether the minutes from the prior meeting were approved, the issues raised in the discussion, the decisions that were made and the factors that went into reaching the decisions.
- Other than for attendance, motions, seconds, and abstentions on the basis of a perceived conflict, avoid using individual's names in the minutes.
- Although privileged communications in the presence of counsel, or confidential discussion amongst the board should be noted in the minutes, the contents of the communication and discussion should be off the record.
- Notes taken at the meeting by board members are to be collected and destroyed following the meeting. Processes should be put in place to ensure compliance.
- The minutes should be reviewed as soon as practical and corrections made to the draft before memories fade. Review the minutes from the perspective of a third-party who may be reading it as a litigation exhibit.
- Attach referenced reports and documents to the minutes, or identify them with sufficient specificity that they can be readily identified and produced if necessary.
- The draft minutes can then be approved at the beginning of the next board meeting.
- Final minutes should be stored where they can be located and retrieved. All prior drafts, including comments and corrections, should be destroyed per a stated document retention policy.

Your board should also consider migrating to a board portal to manage communications and records in a secure environment. Advantages of board portals include access to the board records through a single encrypted and password protected online platform from any location and time. The board portal itself may implement document retention and destruction policies and, when necessary, simplify the process for preserving board records in the event of litigation.

Board members should not discuss sensitive issues in emails, nor should they retain their own notes of conversations, relying instead on the minutes of meetings as the sole evidence of discussions and decisions.

Avoid conflicts of interest

When considering actions, boards should make decisions from the perspective of the company's shareholders. The existence of a conflict of interest calls into question the motive of those making the decision. Board members who have a conflict of interest can and should recuse themselves entirely from the vote and discussion to avoid any appearance that they may have breached their duty of loyalty.

To ensure that the protections of the business judgment presumption remain in place, when a conflict

arises, there must be full disclosure of the conflict, documented in the minutes, and a vote of the unbiased directors on the issue. The best practice is for the conflicted director to be recused from the discussion and abstain from voting on the issue. Further, there should be no effort by the conflicted director to sway the outcome of the vote. An independent and disinterested board may be found to have breached their duty of loyalty when they capitulate to the demands and intimidation of a self-interested and conflicted director.

Understand the risks of the business

Boards do not need to become experts on all the risks that a company faces in its operations. The board is entitled to rely upon the reports and information provided by management and, being informed of the risks, be satisfied that management has put the appropriate controls in place. That the board has considered such risks must be documented. As risks evolve and change, regular updates may be necessary to satisfy the board's duties.

Identify industry trends

As counsel for the company, you are particularly well situated to identify and educate the board on industry and litigation trends affecting the company, and attendant risks faced by the board. Regulation of various industries and investigation of possible wrongdoing continues to be a focal point of government regulators, and today's boards have an increased responsibility for risk management.

The board's responsibilities include oversight of the company's risk management, which is the process of identifying, measuring, monitoring, and implementing controls to address risks to the business. Enterprise risk is not limited to internal risks and controls, but to external events and conditions, and compliance efforts. You should engage the board to encourage a comprehensive enterprise risk management approach to the company's risk philosophy and appetite.

Develop procedures in advance of litigation

Long before the procedures are needed for an investigation or to respond to a potential lawsuit, the board of directors and management should adopt, in consultation with the general counsel's office, procedures to implement when government investigations occur or litigation commences.

Much has been written on litigation hold practices, and the need to know where your company's data resides. As mentioned above, board portals are an effective way of managing board-level records for this purpose. Prior to the need for such a litigation or preservation hold, the company should have created a comprehensive records management policy that sets out what documents are retained for business purposes and what records are destroyed. The board must understand the expectation that it comply with the policy.

In addition, the board should review the crisis management plan adopted by the company, which should be updated regularly. The crisis management plan addresses what actions should be undertaken by the company and personnel under various scenarios. While having a blue print or action checklist is a valuable tool for the board, the process of thinking through how the company and board will respond to various scenarios allows the board to learn and anticipate the best course of action for the company.

Other considerations to prepare your board

In addition to steps taken to protect the benefit of the business judgment rule, there are other things you can do to prepare your board for the potential exposure that future investigations or litigation may cause.

Have a seat at the table

In-house attorneys are well-equipped to anticipate potential problems and advise the board on the company's available options. In order to fulfill this role, the general counsel should have a close working relationship with the board of directors and management. It is not uncommon for the general counsel to attend board meetings and report to the board on specific matters, including M&A transactions, regulatory issues, and company litigation involving high reputational or financial exposure. Providing legal advice at the formative stages of major events can avoid costly missteps and reduce risk. Many companies require counsel to be present, or at least available, during board meetings. Beyond advising the board on specific matters, the general counsel can provide insights into trends and events that may impact the business and its strategic objectives.

And because board minutes need to be artfully drafted to meet the legal obligations of the board, as well as maximize the protections afforded by the record created, the responsibility to draft those minutes should fall on the legal department. Similarly, the corporate secretary, whose primary responsibilities include ensuring the board complies with its legal and fiduciary obligations, should be a function within the legal department.

Protect privilege and confidentiality of records and communications

As counsel for your company, it is incumbent on you to know when a communication triggers the need to keep such information confidential. Legal triggers may include an attorney-client privilege, or the work-product doctrine related to pending or threatened litigation. Other information that the company may seek to keep confidential includes personal nonpublic information, business strategies, or trade secrets. Identify and label such communications as privileged or confidential.

As a cautionary note, practitioners should be fully aware of the protections afforded to the corporate records and communications in your jurisdiction. For instance, in some jurisdictions, the availability of the attorney-client privilege is limited or non-existent altogether. A general counsel must be cognizant of such jurisdictional differences and advise the board accordingly. And even where there is a basis for asserting a privilege, it may be waived either inadvertently or intentionally as in the case of a company cooperating with regulators in exchange for more lenient treatment.

Where such protections apply, a brief description of the nature of the communication and the basis for claiming it to be privileged or confidential will provide contemporaneous evidence to support a future finding by a trier-of-fact. For instance, a corporation's general counsel provides both legal and business advice to the board. Although the legal advice may be covered by a privilege, the business advice is not. Thus, a label in the minutes that states merely "Privileged Attorney-Client Communication: xyz matter" may invite more scrutiny than one that reads "Privileged Attorney-Client Communication: General counsel provided legal advice to board on xyz matter." Labeling the communication or record in this fashion, including portions of the minutes, demonstrates a contemporaneous understanding of the nature of the communication and intention to withhold or restrict the dissemination of such discussions from possible public disclosure.

The communication or minutes must also demonstrate that the information has been kept in confidence. In the case of communications, the communication needs to be limited to only those individuals with a need to be involved in the communication. In the case of board minutes, non-board members and invited guests who may be present should be asked to step out of the room during the confidential discussion, and this fact should be noted in the minutes. This is sometimes referred to as an “executive session” or “closed meeting,” the intent of which is to permit the board to openly discuss certain matters in confidence, and insure that the discussions and records remain confidential. You should work with the board to set out clear rules for the use of such closed discussions. While executive sessions are a vital tool for the board, the lack of a written record creates the potential for misuse and may undermine the evidentiary value of the board’s minutes.

Promote corporate culture

While more difficult to quantify, exposure to some forms of litigation can be avoided or mitigated through a corporate culture that promotes high ethical standards, discourages excessive risk taking, and adopts risk management controls. The corporate culture must be supported by clear policies and procedures, and “tone from the top.” In addition, appropriate compensation systems that do not reward excessive risk taking need to be put in place and approved by the board.

One such issue, for example, is the bribery of foreign officials in the contract award process. Many nations have anti-bribery laws on the books, including The Foreign Corrupt Practices Act (US), The Bribery Act (UK), and The Foreign Contribution (Regulation) Act (India). Although local company representatives may consider this ‘simply the way we do business here’, if it becomes known that such conduct is not condoned by the company, and violations enforced uniformly, the risk of the company becoming embroiled in a bribery scandal may be reduced.

When a culture of high ethical standards is embedded within the fabric of the company, management and employees take great pains to comply with legal and moral obligations. While no person or company is perfect, a company with an ethical culture can avoid many potential problems that an enterprise without a high ethical standard may encounter.

Review the company’s governing documents

Governing documents go by a number of names, such as bylaws in the United States, or constitution in Austria. Regardless of their name in your jurisdiction, the governing documents are created upon the founding of the company, amended from time to time, and describe the rules by which the company, the board, and shareholders will operate.

As difficult as litigation is to avoid altogether, defending against lawsuits in multiple jurisdictions simultaneously is likely to be more complex and costly. In 2013, the Delaware Court of Chancery upheld the validity of exclusive forum bylaws, a decision that has been followed by a number of other US states, including New York and California. Where permitted, these provisions require litigation related to a corporation’s internal affairs to be conducted exclusively in the named forum. To the extent that your jurisdiction permits exclusive forum provisions, consider whether to adopt such restrictions to limit forum shopping and the risks associated with inconsistent outcomes, and to reduce the costs of litigation in multiple jurisdictions. Additional protections may be put in place to bolster the enforceability of such provisions, such as a provision stating that shareholders acquiring stock in the company expressly consent to the exclusive forum restrictions.

Also consider whether similar restrictions can be employed in your jurisdiction to govern a

company's dealings with customers and suppliers. The goal is to ensure, as far as possible, that disputes are heard in a particular jurisdiction, to limit forum shopping and, in the case of multiple claims arising from the same incident, having the dispute dealt with in a single forum.

Another provision to consider in the bylaws is a provision that if a stockholder sues the company and fails to obtain a judgment on the merits for the relief sought, the stockholder is liable to the company for the fees incurred in defending the action. This type of fee-shifting bylaw has been upheld as valid, though it is not without its critics. Those that oppose fee shifting provisions point to the chilling effect on shareholders who may be discouraged from bringing legitimate claims. Legitimate, however, may be in the eye of the beholder.

Discuss indemnity and directors and officers (D&O) insurance

Under the concept of indemnity, the corporation pays or reimburses the board member for expenses and, where applicable, losses related to a lawsuit against a board member in their individual capacity. Since board members are not immune from lawsuits against them in their individual capacities, many US states permit corporations to indemnify board members, as well as officers and directors, when they are named in their individual capacity. Indemnity can and should include not only reimbursement for the potential exposure, but the cost to investigate and defend against such lawsuits as well.

In addition to the right to be indemnified, board members may also be covered under an insurance policy, where the expenses and losses related to a lawsuit are borne, wholly or partially, by a third party insurer. Such director and officer insurance protections may be available to board members, and will act to limit both the board member's exposure to lawsuits, but also limits the company's exposure under the indemnity provision. The cost of D&O insurance should be borne by the corporation. In the event of a potentially large exposure, this provides a valuable source of third party funding to reduce the financial drain on the corporation's resources that an indemnity provision may cause. Board members are encouraged to review the terms of any available D&O coverage, and address their questions or concerns to the legal department.

While many countries permit the use of indemnity and insuring provisions by companies, you must be aware of the particular rules that apply in your company's jurisdiction, and advise your board accordingly. One common difference is whether allegations of illegality must be excluded from insurance coverage, or not. Various jurisdictions also impose their own limitations on indemnity and insuring provisions for directors.

The existence of such indemnity provisions in the bylaws and availability of D&O insurance, and the limits of such protections, should be discussed upfront and understood by each board member.

Conclusion

Although the frequency of investigations and board level lawsuits continues to grow, steps can be taken to minimize the impact of such adverse events. Preparing your board for possible litigation before it becomes reasonably foreseeable involves educating the board of directors on the broad range of risks faced by the company and the board, having the board create governing documents that address how those risks will be managed, and implementing procedures to maximize the board's defenses while minimizing those risks.

A board that both understands its fiduciary duties and adopts practices to address risks is better able

to defend board actions, preserve confidential information, and manage its exposure to investigation and litigation risks when they do occur.

Further Reading

1 Aronson, et al. vs. Lewis, 473 A.2d 805, 812 (1984); see Brehm, et al v. Eisner, et al., 746 A.2d 244, 259 (2000) (“[T]he standard for judgment the informational component of the directors’ decisionmaking does not mean that the Board must be informed of every fact. The Board is responsible for considering only material facts that are reasonably available, not those that are immaterial or out of the Board’s reasonable reach.”).

2 In re Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106, 139 (Del. Ch. 2009) (“Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses. This doctrine also means, however, that when the company suffers losses, shareholders may not be able to hold the directors personally liable.”).

3 In re The Walt Disney Company Derivative Litigation, 907 A.2d 693 (Del.Ch. 2005).

4 New Jersey Carpenters Pension Fund vs. InfoGroup, Inc., 2011 WL 4825888 (Del. Ch. 2011).

5 Boilermakers Local 154 Retirement Fund, et al. v. Chevron Corp., et al., 73 A.3d 934 (Del. Ch. 2013).

6 ATP Tour, Inc., et al. v. Deutscher Tennis Bund, et al., 91 A.3d 554 (Del. 2014).

The opinions expressed in this article are those of the author and do not necessarily reflect the views of his employer.

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