

September 1, 2002

Austin

600 Congress Ave., Suite 1600
Austin, Texas 78701-3236
Phone: 512.867.8400
Fax: 512.867.8470

Austin Loop 360

7501 North Capital of Texas Highway
Bldg A, Suite 130
Austin, Texas 78731
Phone: 512.692.8300
Fax: 512.692.8370

Dallas

901 Main St., Suite 3100
Dallas, Texas 75202-3789
Phone: 214.651.5000
Fax: 214.651.5940

Fort Worth

201 Main Street, Suite 2200
Fort Worth, Texas 76102-3126
Phone: 817.347.6600
Fax: 817.347.6650

Houston

1000 Louisiana St., Suite 4300
Houston, Texas 77002-5012
Phone: 713.547.2000
Fax: 713.547.2600

Richardson Telecom Corridor®

2505 N Plano Road, Suite 4000
Richardson, TX 75082
Phone: 972.680.7550
Fax: 972.680.7551

San Antonio

112 E. Pecan St., Suite 1600
San Antonio, Texas 78205-1540
Phone: 210.978.7000
Fax: 210.978.7450

Washington, D.C.

555 11th Street, N.W. Suite 650
Washington, DC 20004-1314
Phone: 202.654.4500
Fax: 202.654.4501

Mexico City

Torre Esmeralda, Boulevard
Manuel Avila Camacho No. 40
Despacho 1801
Col. Lomas de Chapultepec,
México, D.F. 11000
Phone: 011.525.540.5558
Fax: 011.525.540.0630

**Corporate Responsibility:
The Board of Directors' Duty of Oversight**

Part II – Practical Applications and Limiting Director Liability

The information set forth below constitutes Part II of a two-part Alert regarding the board of directors' duty of oversight. Part I of this Alert defined the duty of oversight and distinguished it from the board's responsibilities in the decision making context. Part I is available on our website at [\[insert hyperlink to Part I\]](#). Here, Part II defines the standard of care applicable in the oversight context, identifies situations in which breaches of the duty may result, and explores whether corporations may limit director liability under the duty.

Background

A corporation's board of directors is charged with carrying out two principal functions: *decision making* and *oversight*. The board's duty of care requires directors to perform their duties in good faith and with the degree of care that an ordinary person would use under similar circumstances.

In the *decision making* context, directors are protected by the business judgment rule – courts will not second guess directors' business decisions if the directors act on an informed basis and in good faith. In the *oversight* context, however, directors are not protected by the business judgment rule if they fail to take action when apprised of corporate impropriety.

What Standard of Care Applies to Director Inaction?

The duty of oversight is a component of the duty of care, which is generally judged under a gross negligence standard. Courts have failed to identify a precise standard of care to which directors will be held in the oversight context and have not identified outcome-determinative factors. However, most case law suggests, and commentators agree, that directors will be found liable in the oversight context only upon an express abdication of responsibility or upon an obvious and prolonged failure to exercise supervision and oversight.

The most recent Delaware Chancery Court materially addressing the issue required a showing of a "lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight." *In re Caremark*

Int'l Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996). At a minimum, when directors have actual knowledge of illegal or improper conduct or have knowledge of facts that should put the director on notice of such conduct, the directors must take good faith steps to remedy the problem.

Texas courts have not specifically addressed the legal obligations and standards imposed upon directors in fulfilling the oversight element of the fiduciary duty of care. However, directors of Texas corporations have a similar duty to oversee, monitor and supervise the business and affairs of the corporation pursuant to the board's statutorily mandated duty of directing the management of the corporation.

When Must the Board Investigate a Matter?

Directors are required to inquire into matters where their suspicions are aroused, or should be aroused, by the existence of red flags. If a director has actual knowledge of a material problem, the director may not wait for management to bring the topic before the board. The level of suspicion requiring board action is uncertain. At the very least, liability will result where the director ignores, either willfully or through inattention, obvious danger signs of wrongdoing. However, the Delaware Supreme Court has held that directors may assume the honesty and integrity of corporate officers and employees and are not liable for the failure to ferret out the lapses of officers and employees unless the directors have been warned or unless obvious red flags have arisen.

The board must implement an information and reporting system adequate to assure the board that information concerning impropriety or violations of law will come to its attention in a timely manner. For example, an oversight committee can review the company's compliance with law and adopt guidelines for management to follow. Additionally, the Securities and Exchange Commission has recently proposed rules requiring Chief Executive Officers and Chief Financial Officers of public companies to certify that adequate internal controls are in place.

How Does this Duty Relate to the Board's Ability to Delegate Decision Making Authority?

The board may delegate general decision making authority or the supervision of a particular matter to reliable officers of the corporation and to committees of the board. An informed decision to delegate a task is as much an exercise of business judgment as any other. Additionally, the board may rely in good faith upon information, opinions, reports and recommendations provided by officers, employees and outside experts.

Directors will not be found liable under the duty of oversight for misinformation provided by an officer or corporate employee absent suspicion that the officer or employee is untrustworthy. Where the board has delegated decision making authority, or acts upon the reports and recommendations of corporate personnel or outside experts, the board must continuously monitor and evaluate these individuals.

Limiting the Board's Liability for Breaches of the Duty of Oversight

Delaware General Corporation Law § 102(b)(7) allows a corporation, in its certificate of incorporation, to eliminate or limit the personal liability of directors for breaches of fiduciary duty, including the duty of care. Although the duty of oversight is considered a component of the duty of care, Delaware courts have not specifically held that such a charter provision would bar a duty of oversight claim.

Some Delaware case law suggests, in dicta, that a charter provision under Section 102(b)(7) might prevent a duty of oversight claim. However, such a provision would not protect a director from acts or omissions not in good faith, or which involve intentional misconduct or knowing violations of law. Texas law permits similar limits on director liability.

Plaintiffs can be expected to argue that if a board knew of wrongdoing or was aware of red flags, its failure to act was not a good faith omission, and that the board's knowledge indicates intentional misconduct or knowing violations of law. Thus, the availability of these commonly used charter provisions to limit director liability is uncertain.

Recommendations

Proper board action will always be the best defense to a duty of oversight claim. Boards should:

- implement a reporting and information mechanism, such as an oversight committee, that adequately informs the board of company activities' misconduct or violations of law.
- conduct internal investigations when material problems or suspicions arise, and make corrective business decisions.
- encourage reporting of suspected officer or employee misconduct without reprisals.
- consciously delegate supervision of specific matters to reliable officers, subordinates, and outside experts (see the discussion above regarding delegation of duties), and monitor the performance of these people.
- take the initiative to investigate signals of problems within the company and encourage board inquiry, deliberation and process.
- be involved in the hiring, firing, replacing and evaluating the performance of corporate officers.
- be apprised of and approve all fundamental operating and financial plans.
- adopt policies regarding corporate conduct and compliance with laws, and ensure that the company's officers implement these policies.
- understand and approve significant contracts and transactions.
- actively review management's proposals.
- review and make suggestions regarding the board's agenda, rather than leaving the agenda entirely in the control of management.
- seek outside legal, accounting, financial and other expert advice and evaluation.

Further Information

If you have any questions regarding these issues or need advice regarding a specific situation, please contact your Haynes and Boone attorney or Bill Kleinman at (972) 680-7565.

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Authors: Bill Kleinman
Gary Thompson

The leading Delaware cases addressing the duty of oversight and related issues are *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963); *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Boeing Co. v. Shrontz*, No. 11,273, 1992 Del. Ch. LEXIS 84 (Del. Ch. Apr. 20, 1992); *In re Dataproducts Corp. Shareholders Litig.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,227 (Del. Ch. Aug. 21, 1991).

See also Charles Hansen, *The Duty of Care, The Business Judgment Rule, and The American Law Institute Corporate Governance Project*, 48 BUS. LAWYER 1355, 1359 (Aug. 1993).