Liability of Directors with Special Expertise under Federal Securities Laws and Delaware Corporate Law

Contributed by: Lois F. Herzeca, Gibson, Dunn & Crutcher LLP

Recent economic turmoil and the demand for greater accountability are resulting in increased focus on corporate directors, particularly outside directors. The Securities and Exchange Commission (SEC) recently enacted amendments to the proxy disclosure rules which, among other requirements, mandate that companies disclose, for each director and nominee, the specific experience, qualifications, attributes or skills that led to the conclusion that the individual should serve as a director of the company in light of its business and structure.[1] This disclosure must be made on an individual basis, and be specifically linked to the biographical description of each director and nominee. Some commentators have suggested that companies use these descriptions pro-actively to emphasize to shareholders the strength of the board's nominees. As a result of these new disclosure requirements, outside directors are expressing concern about whether they will be exposed to greater potential liability if they are identified in an SEC filing as having a particular skill or expertise that is valued and relied upon by the company. A close reading of the relevant case law suggests there may be cause for some concern under both federal securities laws and Delaware corporate law.

Director Liability under Federal Securities Laws

The SEC has steadily increased the amount of disclosure required about directors and director nominees in SEC filings. Most notably, in 2003, the SEC amended the proxy disclosure rules to require that a company disclose whether it has at least one "audit committee financial expert" on its audit committee.[2] These rules specifically state that a director who is identified as an audit committee financial expert would not be deemed an expert for any purpose, including for purposes of Section 11 of the Securities Act of 1933 (Securities Act), dealing with liability in connection with registration statements.[3] The new proxy disclosure rules do not have a similar safe harbor, leading commentators to wonder whether the omission was intended to leave open the possibility that a director may have increased liability under federal securities laws based on particular qualifications or expertise.

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Director liability under Securities Act Section 11 and Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder hinges on the knowledge or belief of the individual director. The director's knowledge or the reasonableness of his or her beliefs in a specific situation presumably can be impacted by his or her particular qualifications, background or expertise.

Section 11 of the Securities Act imposes civil liability on directors of an issuer if "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading." A director has a "due diligence" defense to liability under Section 11 if he or she sustains the burden of proof that, with regard to any part of the registration statement not made under the authority of an expert, the director "had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact."

Federal courts have generally taken the view expressed in *Feit v. Leasco Data Processing Equipment Corp.*[4] that "[w]hat constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise and his access to the pertinent information and data." Thus, directors who are insiders, or directors who are attorneys involved in preparation of the registration statement, generally are expected to make a more complete investigation and have more extensive knowledge of the facts at issue.

Exchange Act Section 10(b) and Rule 10b-5 thereunder prohibit, among other things, the making of untrue statements of material fact or omissions of material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. Unlike Section 11 of the Securities Act, however, Section 10(b) requires a finding of "scienter," or the intent to deceive, manipulate or defraud, for there to be liability.

The case law suggests that outside directors with a particular expertise may have difficulty getting Rule 10b-5 claims dismissed because it may be easier for plaintiffs to plead scienter as to them, compared to other outside directors. For example, *In re U.S. Bioscience Securities Litigation*[5] involved a class action by purchasers of U.S. Bioscience, Inc. securities. The Court denied a motion to dismiss Section 10(b) claims against certain outside directors of the company for alleged misstatements, contained in an Annual Report

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on Form 10-K, suggesting that one of the company's products was more effective and further along in clinical trials than was warranted by the facts. Defendants argued that the outside directors should be excluded from the suit. The Court rejected this argument, explaining that "[o]utside directors can be of two very different kinds," those whose role is not intended to be hands on and those who have valuable expertise in the industry.[6] It explained further that "[b]ecause the outside director defendants have valuable expertise in Bioscience's industry, it is unreasonable, at least in the present procedural context, to assume that they were ceremonial figures who did not understand the workings of the company."[7] Defendants in this case allegedly had experience in the pharmaceutical industry, and included CEOs of pharmaceutical companies, a president of a college of pharmacy and a pharmaceutical consultant.[8] The Court concluded that the directors' expertise, along with the company's small size and start-up nature, rendered these directors "more akin to what is typical with inside directors."[9] It therefore denied the motion to dismiss with respect to these outside directors.

Similarly, *Tischler v. Baltimore Bancorp*[10] involved a motion to dismiss a class action brought by purchasers of Baltimore Bancorp stock. Plaintiff alleged, among other claims, that the outside directors were liable under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, for a press release announcing that the board determined an offer for the company was inadequate, while the directors allegedly knew the offer was not inadequate based on the company's financial condition.[11]

In evaluating the defendants' motion to dismiss, the Court considered the potential liability of three categories of outside directors of Baltimore Bancorp.[12] First, the Court held that plaintiff sufficiently alleged culpable conduct on the part of the four outside directors who were audit committee members.[13] According to plaintiff, these defendants "had overall responsibility for supervising the management of Bancorp and verifying the assets, collateral, loan values and determination of appropriate loan-loss reserves and write-downs of non-performing loans and assets."[14] The Court reasoned that these directors had a responsibility to question information they received about the adequacy of the offer, and "[g]iven their level of knowledge of the Bank's financial status, it was their role to question the information being presented to them which Plaintiff alleges did not jive with the information as necessarily known to them."[15] Therefore, plaintiff's allegation that the audit committee directors purposely offered a representation to the public that they knew was inaccurate was sufficient to survive a motion to dismiss.[16]

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Further, plaintiff alleged that "ten of the outside directors had such special knowledge of the investment, banking, real estate and/or insurance businesses that they knew, or should have known, of the general decline of the banking industry and the real estate market and its obvious effect on the present and future prospects of [Baltimore Bancorp]."[17] The Court did not grant these directors' motion to dismiss, stating that "at this stage the Court cannot say that Plaintiff has not sufficiently alleged culpable conduct as to the 'expert' Defendants."[18]

The Court granted the motion to dismiss with respect to the remaining two outside directors, noting that plaintiff did not allege that the directors had "any particular knowledge of the Bank's financial position, or of the banking industry in general. . . .[19]

Director Liability under Delaware Corporate Law

Recent case law in Delaware suggests that independent directors will not be held to a higher fiduciary duty standard simply because they have special expertise. In *In re Citigroup Inc. Shareholder Derivative Litigation*,[20] plaintiffs claimed that a demand for a derivative suit was futile because the audit committee financial experts on the board failed to fulfill their fiduciary duties by allowing the company to engage in subprime lending, leading to massive losses. In holding that demand was not futile, the Delaware Chancery Court reaffirmed the *Caremark* standard that requires a showing of bad faith,[21] and stated that "[d]irectors with special expertise are not held to a higher standard of care in the oversight context simply because of their status as an expert."[22] The Court viewed the issue as a failure to recognize a business risk, not a failure of management oversight and emphasized that "[e]ven directors who are experts are shielded from judicial second guessing of their business decisions."[23] After *Citigroup*, the 2004 decision in *In re Emerging Communications, Inc. Shareholders Litigation*,[24] in which a director with financial expertise was held to have a duty to voice concerns about the fairness of a proposed transaction's price, has been viewed as limited to the facts of the case, a going private transaction in which defendant director was not disinterested.

Some commentators[25] have suggested, however, that although directors who have special expertise might not be held to a higher standard under Delaware fiduciary duty law, they may lose the safe harbor protection afforded by Section 141(e) of the Delaware General Corporation Law. Section 141(e) provides that a director "shall . . . be fully protected in relying in good faith upon . . . such information, opinions, reports or statements presented to the corporation . . . as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable

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care. . . ." If a director has a particular expertise then he or she may be unable to rely in good faith on an expert's report.

Companies are responding to the SEC's new proxy disclosure requirements by amplifying the disclosure about each director's particular background, qualifications and expertise. As these disclosures become more elaborate and more prominent, plaintiffs may focus on an outside director's expertise in arguing that such director violated the federal securities laws or breached his or her fiduciary duty. These claims often turn on the knowledge or intent of the director in taking action—to the extent that a director has expertise, it may be easier to allege, and perhaps prove, an intent to deceive or bad faith. Therefore, in drafting these disclosures, companies need to strike a balance between providing truthful and informative disclosure and creating a record that may expose outside directors to greater risk.

Lois F. Herzeca is a corporate partner resident in Gibson, Dunn & Crutcher's New York office. Ms. Herzeca's broad corporate practice includes mergers and acquisitions, capital markets transactions, corporate governance counseling and joint ventures in a variety of industries, with a particular specialty in insurance transactional matters. She may be reached at 212.351.2688 or lherzeca@gibsondunn.com.

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[1] Proxy Disclosure Enhancements, SEC Release Nos. 33-9089, 34-61175, IC-29092; 74 Fed. Reg. 68334 (Dec. 23, 2009).

[2] Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Release Nos. 33-8177, 34-47235; 68 Fed. Reg. 5110 (Jan. 31, 2003).

[3] This safe harbor, of course, would not extend to state corporate law issues.

[4] 332 F. Supp. 544, 577 (E.D.N.Y. 1971).

[5] 806 F. Supp. 1197 (E.D. Pa. 1992).

[6] *Id.* at 1203.

[7] *Id.*

[8] *See id.*

[9] *Id.* at 1204.

[10] 801 F. Supp. 1493 (D. Md. 1992).

[11] *See id.* at 1495–96.

[12] *See id.* at 1501.

[13] *See id.*

[14] *Id.*

[15] *Id.*

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[16] *See id.*

[17] *Id.*

[18] *Id.* at 1502.

[19] *Id.*

[20] 964 A.2d 106 (Del. Ch. 2009).

[21] *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

[22] *See* 964 A.2d at 128 n.63.

[23] *Id.*

[24] C.A. No. 16415, 2004 BL 1814 (Del. Ch. May 3, 2004).

[25] *See* Dominick T. Gattuso & Vernon R. Proctor, *Reining in Directors and Officers in Corporate America*, American Bar Association Business Law Section, Jan.-Feb. 2010, http://www.abanet.org/buslaw/blt/2010-01-02/gattuso-proctor.shtml.

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