Client
ALERT

June 2003

Increased Liability for "Audit Committee Financial Experts"?

By Chad Conwell

This Client Alert discusses the potential liability faced by a director designated as an "audit committee financial expert" pursuant to the Sarbanes-Oxley Act of 2002. It concludes that (a) courts should determine that a director does not have additional liability simply because he or she is designated as an audit committee financial expert, (b) a director could be subject to an enhanced standard of care based upon the degree of his or her special expertise in a matter before the audit committee, whether or not he or she is designated as an expert, and (c) nevertheless, such a director with special expertise may still be entitled to the protections of the business judgment rule, the right to rely on expert advice, and exculpation provisions in the company's charter.

Introduction

After proposing rules under the Sarbanes-Oxley Act of 2002 requiring a company to disclose whether or not a financial expert serves on its audit committee, the Securities and Exchange Commission (the "Commission") faced a flurry of comments objecting to the disclosure on the ground that it could increase the personal liability of the designated financial expert.[1]

As discussed in this Client Alert, the Commission has attempted to address these tensions by relabeling the proposed "financial expert" as an "audit committee financial expert," by emphasizing in its adopting release (the "Release")[2] that it does not believe the designation creates any additional liability, and by adopting a safe harbor from increased liability for audit committee financial experts. Yet, despite the Commission's pronouncement that the audit committee financial expert rules should not increase a director's liability, many observers are nevertheless concerned that a federal or state court could subject such an expert to enhanced scrutiny and, ultimately, personal liability for his or her actions. These commenters rightfully point out, among other things, that the Commission has no authority over state corporate governance matters and the fiduciary duties of directors under state law.

The concerns over liability hinge on two connected issues: (a) whether a director is subject to increased liability merely because he or she is designated an "expert" by the company; and (b) whether a director is subject to increased liability merely because he or she possesses the knowledge and skills to be designated an "expert" by the company, even if he or she is not so designated.

Unfortunately, neither of these issues has been definitively addressed by federal or state courts. We believe that the Commission's reasoning in the Release should prevail and federal and state courts should find that the mere designation of a director as an audit committee financial expert does not create additional liability. However, because state and, to some degree, federal laws impose a "reasonable" standard on directors when they exercise their duties, a director could be subject to an enhanced standard of care based upon the degree of his or her special expertise in a matter before the audit committee, regardless of any special designation.

Nevertheless, such a director may still be entitled to the protections of the business judgment rule, the right to rely on expert advice, and any exculpation provisions in the company's charter.

This Client Alert briefly describes the requirements of the audit committee financial expert rules promulgated by the Commission under the Sarbanes-Oxley Act (the "Rules") before addressing various questions raised by our issuer clients regarding the application of the rules and their effect on the liability of directors under both federal securities laws and state corporate governance laws.

The Rules

Section 407 of the Sarbanes-Oxley Act directs the Commission to adopt rules requiring an issuer to disclose whether or not its audit committee includes at least one member who is a "financial expert."

In January 2003, the Commission adopted the Rules to require an issuer to disclose annually that its board of directors has determined that the issuer either:

- has at least one "audit committee financial expert" serving on its audit committee, and if so, the name of the expert and whether the expert is "independent"; or
- does not have an audit committee financial expert serving on its audit committee.

An issuer disclosing that it does not have an audit committee financial expert must explain why it does not.

Definition of "Audit Committee Financial Expert"

The Rules define an "audit committee financial expert" as a person who has all of the following attributes:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the issuer's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

A person may have acquired such attributes through:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or
- other relevant experience.

Independence of the Audit Committee Financial Expert

An issuer, other than a foreign private issuer, also must disclose whether its audit committee financial expert is "independent" and, if not, explain why not. A financial expert is considered independent if:

- he or she does not accept any consulting, advisory, or other compensatory fee from the issuer (other than in connection with services rendered as a member of the board of directors); and
- in the case of registered investment companies only, he or she is not an "interested person" of the company as defined in Section 2(a)(19) of the Investment Company Act of 1940.

Questions Regarding the Rules

When must disclosure be made?

Companies, including foreign private issuers, and investment companies must include disclosure regarding the board's determination regarding its audit committee financial expert in any annual reports filed for fiscal years ending on or after July 15, 2003. Small business issuers must include such disclosure for fiscal years ending on or after December 14, 2003.

Is a company required to have an audit committee financial expert?

No. The Sarbanes-Oxley Act and the Rules require a company's board of directors to disclose whether or not the company has an audit committee financial expert sitting on the audit committee of the company's board of directors or similar governing body. If the company does not have such an expert, it need only explain why it does not.

Can a board of directors disclose that it was unable to determine whether it has an audit committee financial expert?

No. Although not required by the Sarbanes-Oxley Act, the Rules provide that a company must annually disclose that its board of directors *has determined* that its audit committee either (a) has a financial expert or (b) does not have a financial expert and the board's reasons why not. In other words, the Rules specifically require the board of directors to *determine* that a member of its audit committee is a financial expert or that none of its members is a financial expert. The Rules do not allow for disclosure that the board did not, or was not able to, make a determination.[3]

If a board determines that it does have an expert, the disclosure required by the Rules is relatively simple – the name of the expert and whether or not the expert is independent.

However, if a board determines that none of its audit committee members are financial experts, the board must explain why it does not have an expert serving as a director. Since the explanation may potentially be detailed, it could subject the company and its directors to liability under both federal securities laws and, potentially, state laws regarding directors' communication to shareholders, if such disclosure makes any untrue statement of a material fact or omits to state a material fact necessary in order to make the disclosure made, in the light of the circumstances under which it was made, not misleading. Consequently, if applicable, a board of directors should carefully consider and fully explain the reasons why it determined that none of its audit committee members is a financial expert.

Whatever the board determines, the board should carefully maintain a record of its deliberation and support that deliberation through the use of a questionnaire, checklist or similar document that analyzes all the required attributes of a financial expert.

Questions Regarding Liability

Does designation as an audit committee financial expert by itself create additional liability for a director *under federal securities laws*?

Having received comments that the proposed rule could create additional liability for any named experts, the Commission created a liability safe harbor providing that:

- an audit committee financial expert will not be deemed an expert for any other purpose, including for purposes of Section 11 of the Securities Act of 1933 (the civil liability provision), merely as a result of being designated or identified as such an expert;
- the designation or identification of the expert will not impose on such person any duties, obligations or liabilities that are greater than his or her pre-existing duties, obligations or liabilities; and
- the designation or identification of the expert will not affect the duties, obligations or liabilities of any other member of the audit committee or board of directors.[4]

In adopting this liability safe harbor, the Commission underscored its belief that the designation as an audit committee financial expert does not enhance the duties, obligations or liabilities faced by such expert. However, the Sarbanes-Oxley Act does not expressly provide for the safe harbor adopted by the Commission. A plaintiff could assert that Congress required the designation of such an expert director to enhance shareholder confidence, that a shareholder relied on the designation (and the knowledge) of such director in connection with his or her purchase of securities, and that such an expert had an enhanced duty to perform in a manner commensurate with his or her expertise.[5] Nevertheless, we believe that a reasonable court should respect the Commission's authority to promulgate the safe harbor and not find an audit committee financial expert to have any greater liability than his or her peer directors as a consequence of being so designated.[6]

However, to the extent experts are subject to greater liability under federal securities laws simply as a consequence of their expertise (see the discussion below), the designation may provide evidence that the director has acknowledged that he or she possesses the necessary attributes to qualify as an expert, and may preclude the director from denying in response to a lawsuit that he or she possesses those special attributes and should not be considered an expert.

Do audit committee financial experts have greater liability than other directors *under federal securities laws* simply as a result of their expertise?

Section 11(a) of the Securities Act allows any person acquiring a security pursuant to a registration statement which contains a material misstatement or omission to sue the issuer, every director of the issuer, the underwriter and certain experts. Because plaintiffs are not required to prove that they relied on the statements or omissions to succeed, many securities claims are brought under Section 11(a).

Section 11(b) of the Securities Act provides several defenses for directors (that are not available to the issuer itself). With respect to portions of the registration statement which are not prepared by an expert (such as an accountant), a director can raise a defense of due diligence (*i.e.*, that he or she had, after reasonable investigation, reasonable ground to believe that the statements in the registration statement were true and did not omit to state a material fact). In other words, each director must make some reasonable effort to investigate whether the statements in a registration statement which are not proposed by an expert are true or not.

It does not seem that audit committee financial experts would typically have any consistently differing skills or expertise than their peer directors with respect to those portions of a registration statement that are not passed upon by the company's outside accountants.

With respect to the portions of the registration statement which *are* prepared by an expert such as the accountants (usually referred to as "expertised" material), the director can avoid Section 11(a) liability if the director can prove that he or she had no reasonable ground to believe, and did not believe, that the statements were untrue or failed to state a material fact. Unlike the defense available for non-expertised parts of the registration statement, this defense does not require the director to conduct a reasonable investigation into the statements made in the registration statement – in other words, Section 11(b) imposes the "reasonable investigation" standard solely upon the expert (*i.e.*, the accountant) and permits the director to rely on the expert's investigation.[7]

With respect to a director's grounds for belief and investigation, Section 11(c) of the Securities Act establishes a standard of reasonableness of "that required of a prudent man in the management of his own property." This may imply that a director with accounting expertise – even if not designated as an "expert" – might be subject to different standards when a court assesses whether he or she had "no reasonable grounds" to believe that the statements were untrue or omitted to state a material fact. If, for example, the accountant recommends to the audit committee a critical accounting policy that is inconsistent with generally accepted accounting principles, and such inconsistency would be apparent to a person with like skills and expertise, an audit committee financial expert may not be able to continue to reasonably rely on the expertise of the accountant – because such director had reasonable grounds to believe that such reliance was unwarranted.[8]

Does designation as an audit committee financial expert by itself create additional liability for a director *under state law*?

The answer is unclear, because there are no reported cases on the subject. However, most state laws and cases analyze the facts and circumstances of a director's exercise of his or her fiduciary duties (*e.g.*, whether the director exercised reasonable care in hiring an independent public accountant) without regard to any titles. Consequently, while there are no reported cases which provide clear precedent, we believe that the mere designation of a person as an "audit committee financial expert" should not add or change this analysis.

However, as discussed above with respect to federal securities laws, if experts are subject to greater liability under state law simply as a result of their expertise, it may be difficult for a designated "expert" to deny that he or she possesses those special attributes and should not be considered an expert.

Do audit committee financial experts have greater liability than other directors *under state laws* simply as a result of their expertise?

In the Release, the Commission stated that its new rule "does not alter [a director's] duties, obligations or liabilities…[and that] this should be the case under federal and state law." In other words, as to the liability of a director, if any, the Commission believes it is the attributes that a director has rather than his or her designation as a person who possesses special qualifications that should control.

Throughout the United States, courts and legislatures have broadly imposed two primary sets of fiduciary duties on directors of corporations: the duty of loyalty and the duty of care. Breaches of the duty of loyalty inherently involve situations where a director has acted adversely to the interests of the corporation to his or her own benefit; consequently, statutes and case law offer little protection for directors who violate this duty of loyalty.

Breaches of the duty of care, however, involve situations where a director has acted (or failed to act) in a manner that damaged the corporation, but where the director did not receive any personal benefit as a result. State law, accordingly, offers directors greater protection from breaches of the duty of care through its application of the business judgment rule, the statutory right to rely on experts, and particularly through permissible protections in a corporation's charter which can completely exculpate directors from personal liability for breaches of their duty of care.

The Duty of Care. The Model Business Corporation Act ("MBCA") imposes the following standard of care upon directors:

(a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interest of the corporation.

(b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.[9]

The official comment to the MBCA states that the combined phrase "in a like position…under similar circumstances" is intended to recognize that the special background, qualifications, and management responsibilities of a particular director may be relevant in evaluating that director's compliance with the standard of care.

With similar proposed standards for a duty of care, the American Law Institute's *Principles of Corporate Governance* observe that "in a like position" recognizes that "the nature and extent of the functions to be performed by a director or officer will vary with the tasks that have been imposed on the director or officer by law or by the corporation, or voluntarily assumed" and also is "intended to recognize that the special skills, background, or expertise of a director or officer may entail greater responsibility."[10] Although, as discussed above, the designation of a director as an expert should not impose greater duties on a director under these model statutes, a director with special skills, background or expertise may have greater responsibility than his or her peer directors whether or not he or she is designated as an expert.

Neither the *Principles* nor the MBCA cite any cases in support of this position that a director's special skills, background or expertise result in greater responsibility, and, consequently, greater potential liability. However, a court could look to these passages to find support for a conclusion that an audit committee financial expert should be held to a greater standard of care than other directors in the performance of duties in his or her areas of expertise.

Although corporate governance codes are not definitive on the subject of varying degrees of standards of care for different directors, other governance structures are less circumspect in their application. For example, trustees of a Massachusetts business trust, a common form of organization for investment companies, are subject to general trust principles which provide that "a trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has such special skills or expertise, shall have a duty to use such special skills or expertise."[11]

The Role of Audit Committees. *In re Caremark International Derivative Litig.*, 698 A.2d 959, 967-68 (Del. Ch. 1996), describes potential claims for a breach of the duty of care in two contexts:

> Director liability for a breach of duty of care to exercise appropriate attention may, in theory, arise in two distinct contexts. First, such liability may be said to follow from a board decision that results in a loss because that decision was ill advised or "negligent." Second, liability to the corporation for a loss may be said to arise from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss…

Most director liability cases have arisen in the first context (*i.e.*, shareholders claim that the directors breached their duty of care in approving a merger). If a plaintiff were to assert that the audit committee financial expert breached his or her fiduciary duties in recommending that a company's financial statements be filed with the Commission, as discussed below, it is relatively well-established in most U.S. jurisdictions that the business judgment rule would insulate the director from liability as long as the director exercised good faith and due care in the process of arriving at his or her decision.

Cases arising in the second context suggested by *Caremark* ("an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss") do not afford directors the protection of the business judgment rule because in such cases the directors did not exercise any judgment.[12] Such cases could potentially involve the directors' failure to adequately supervise the affairs of the corporation.

In proposed rules relating to audit committees and other Sarbanes-Oxley Act issues, the New York Stock Exchange observed that "[w]hile it is not the audit committee's responsibility to certify the company's financial statements or to guarantee the auditor's report, the committee stands at the crucial intersection of management, independent auditors, internal auditors and the board of directors." In analyzing the potential liability of an audit committee financial expert, it is useful to note what roles an audit committee member has at this "crucial intersection," and whether such roles involve active decision-making or supervision.

Members of audit committees typically could make (or will make, once new rules relating to corporate governance procedures become fully effective) the following types of pro-active decisions which may be afforded the protection of the business judgment rule:

- Selecting and retaining the issuer's independent auditor, making findings as to its independence and pre-approving services provided by it;
- Preparing the audit committee report to be included in the company's annual proxy statement (not required for mutual funds);
- Considering and responding to significant deficiencies in internal controls and to fraud raised by the principal executive and financial officers in their certifi cations required by Sections 302 and 906 of the Sarbanes-Oxley Act;
- Responding to company employees who confidentially or anonymously report to the audit committee regarding questionable account ing or auditing matters; and
- For operating companies, recommending the inclusion of the financial statements in the issuer's Form 10-K.

Areas of responsibility that involve the audit committee's supervisory duties, but may not involve actively making a judgment and thus may not have the protection of the business judgment rule, could include:

- Supervising the independent auditor, including the committee's required review with the auditor of critical accounting policies, alternative treatments of financial information and communications between the auditor and management;
- Discussing earnings releases with management; and
- For operating companies, reviewing and supervising management's preparation of financial information in annual and quarterly financial statements, including "Management's Discussion and Analysis of Financial Condition and Results of Operations."

What state law protections are available to directors?

The Business Judgment Rule. Under the business judgment rule, a director will not be held liable to the corporation or its shareholders for any decision to take or not take action as long as the director acted in good faith and in a manner the director reasonably believed to be in the best interests of the corporation.[13] The business judgment rule creates "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 interest of the corporation."[14]

Caremark held that whether a judge or jury considering the matter after the fact believe the decision to be substantially wrong, or "degrees of wrong varying from stupid to irrational," provides no ground for director personal liability, so long as the court determines the process employed was either rational or employed in a good faith effort to advance corporate interests.

The primary analysis under the business judgment rule consequently centers on whether the directors complied with the applicable duty of care in the process of reaching their decision. In other words, the court will not analyze the substance of the directors' decision, but merely the process by which they arrived at the decision.

Delaware, like many other states, uses the gross negligence standard for reviewing most decisions made by the board of directors.[15] Although the context of business judgment cases typically involves major corporate decisions, as opposed to more day-to-day decision making, the concepts of the rule should apply to the ordinary decision-making of an audit committee. For example in the context of recommending financial statements for inclusion in an issuer's annual report,[16] if the audit committee financial expert is not grossly negligent in his or her process of approving the financial statements, he or she should be protected by the business judgment rule. Stated another way, a director would be protected by the business judgment rule unless his or her level of investigation and inquiry was so reckless or outside the bounds of reason that the decision was effectively uninformed.

The Delaware Supreme Court, in one of its key business judgment decisions, stated that "the business judgment rule operates only in the context of director action…[t]echnically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act."[17]

Although possibly overreaching, some courts have read meaning into this distinction of the "judgment" aspect of the business rule,[18] and found that "where the business judgment rule does not apply – and particularly in situations where directors have abdicated their functions or have failed to act – the standard is said to be ordinary care, meaning that a director may be held liable for simple negligence."[19] Although the business judgment rule may not be available in such cases, and an ordinary negligence standard may apply, directors are still entitled to rely on experts and may be protected by exculpation provisions in their corporate charters, as discussed below.

Reliance on Experts. California's legislative committee comment to its duty of care statute (Section 309 of the California General Corporation Law) cites Lord Halsbury in *Dovey v. Cory*, A.C. 477 (1901) as follows:

> I cannot think that it can be expected of a director that he should be watching either the inferior officers of the bank or *verifying the calculations of the auditors himself*. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to the details of management. (emphasis added).

As with federal securities laws, the principle that directors are entitled to rely on experts is well-founded in American state corporate governance laws.

The American Law Institute suggests that a director can rely on outside experts[20] and, if such reliance is accordance with the applicable standards, it will provide a complete defense.

> In performing his or her duties and functions, a director…who acts in good faith, and reasonably believes that reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other data)…prepared, presented, made, or performe by…(b) legal counsel, public accountants, engineers, or other persons who the director…reasonably believes merit confidence.[21]

Comment (c) to the ALI's *Principles of Corporate Governance* notes that:

> if the only issue in a case relates to the propriety of a director's reliance on an accounting firm, and if the director (i) acted in good faith, (ii) reasonably believed the accounting firm merited confidence when it was delegated responsibility, and (iii) reasonably believed that continuing reliance on it was warranted, then the director will have a complete defense and will have fulfilled his or her [duty of care].

Section 8.30 of the MBCA states that "a director, *who does not have knowledge that makes reliance unwarranted*, is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by [public accountants]...as to matters the director reasonably believes are matters (i) within the particular person's professional or expert competence or (ii) as to which the particular person merits confidence" (emphasis added). As the MBCA notes in its comment to this section, whether a director is entitled to rely on the expert will hinge on whether the director "reasonably believes" that the reliance was warranted.

Given the complexity of modern corporate decisions and a corporation's need for expert advice, most U.S. jurisdictions have adopted this reliance on experts protection for directors.[22]

In the context of an audit committee, therefore, the analysis again returns to whether the director has exercised the due care which a like person under similar circumstances would exercise. While it is normally difficult and fact intensive to pinpoint whether a director has exercised reasonable due care, where experts are involved the statutes in effect provide that due care will be deemed to be exercised when the reliance on the expert is justified.

Directors need only act reasonably and in good faith in relying on the opinions of the issuer's accountants. If an audit committee (including a director with accounting experience) engages in routine discussions with the accountant and diligently reviews the financial statements of the issuer, such directors should be considered to have fulfilled their good faith requirements and be entitled to rely on the opinions of the issuer's accountants. A director with accounting experience could protect him or herself further by asking questions and exercising diligence to establish that the accountant is reliable and that a reasonable director, in like position and under similar circumstances, even with such special skills, would find such accountant to be reliable.

Exculpation. Delaware and most other states have adopted provisions in their corporate codes that permit corporations to insulate directors from breaches of their duty of care.

For example, Section 102(b)(7) of the Delaware General Corporation Law permits a certificate of incorporation to contain a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of a fiduciary duty as a director (including the duty of care), unless the liability was for breach of director's duty of loyalty, for acts or omissions not in good faith or otherwise knowing violations of law, for illegal distributions or for transactions which personally benefit the director.

Investment companies are limited in the scope of protection their exculpation provisions can provide. Section 17(h) of the Investment Company Act prohibits provisions which eliminate or limit the personal liability of a director arising from a director's willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office.

As a result of exculpation provisions, which are commonly found in the governing charters of issuers, to be successful a lawsuit alleging an individual "expert" director breached his or her duty of care would have to establish that the director's act or omission was made not in good faith or in otherwise knowing violation of the law.[23] This is an extremely high burden for plaintiffs to overcome,[24] and it is unlikely in most cases that a plaintiff could sustain such a claim.

* * * *

Chief Justice E. Norman Veasey of the Delaware Supreme Court has observed that the Sarbanes-Oxley Act and related best practices being developed by listing requirements of the New York Stock Exchange and others may be creating "a new set of expectations for directors…that is changing how the courts look" at issues of corporate governance.[25] However, this does not necessarily mean that directors are not entitled to the same protections previously available to them so long as they perform their duties in "good faith."

"Good faith" is a recurring theme when describing a director's fiduciary duties and his or her protections from liability: the MBCA directly imposes an obligation on a director to act in good faith; the protection of the business judgment rule and the reliance on experts standards are predicated on good faith; and exculpation provisions are not available for acts or omissions not in good faith.

Stated differently, a director's "bad faith" or, to use California's and the Investment Company Act standard, "reckless disregard" can result in liability for a director. Although courts may analyze directors' actions in light of a new set of expectations, the fundamental tenet that a director whoacts in good faith should be afforded the greatest possible protection has not changed as a result of the Sarbanes-Oxley Act.

As Vice Chancellor Leo E. Strine, Jr., of the Delaware Chancery Court noted, "the legal reality today is identical to the legal reality a year ago: independent directors who apply themselves to their duties *in good faith* have a trivial risk of legal liability…if [he or she] does [his or her] job as a director with integrity and attentiveness, [the] risk of damages liability is miniscule" (emphasis added).[26]

In summary, although a director may be subject to enhanced duties of care under state law as a result of his or her expertise, he or she is entitled to rely on the same protections that protect other directors of a corporation – the business judgment rule, the right to rely on experts and the exculpation provisions in the charter, if any.

If you have any questions regarding the issues discussed in this Alert, please contact any of these attorneys from our Investment Management and Securities Practice Groups:

Julie Allecta *415-856-7006*
julieallecta@paulhastings.com

Lawrence Barcella *202-508-9525*
larrybarcella@paulhastings.com

Kirby D. Behre *202-508-9544*
kirbybehre@paulhastings.com

Robert A. Boresta *212-318-6272*
robertboresta@paulhastings.com

Robert E. Carlson *213-683-6299*
robertcarlson@paulhastings.com

Chad C. Conwell *213-683-6158*
chadconwell@paulhastings.com

Stephen D. Cooke *714-668-6264*
stephencooke@paulhastings.com

John Della Grotta *714-668-6210*
johndellagrotta@paulhastings.com

Wendell M. Faria *202-508-9574*
wendellfaria@paulhastings.com

Michael Glazer *213-683-6207*
michaelglazer@paulhastings.com

David A. Hearth *415-856-7007*
davidhearth@paulhastings.com

Luke P. Iovine *212-318-6448*
lukeiovine@paulhastings.com

Walter E. Jospin *404-815-2203*
walterjospin@paulhastings.com

Kevin Logue *212-318-6039*
kevinlogue@paulhastings.com

Mitchell E. Nichter *415-856-7009*
mitchellnichter@paulhastings.com

Elizabeth H. Noe *404-815-2287*
elizabethnoe@paulhastings.com

Robert Plotkin *202-508-9542*
robertplotkin@paulhastings.com

Gary D. Rawitz *212-318-6877*
garyrawitz@paulhastings.com

Michael R. Rosella *212-318-6800*
mikerosella@paulhastings.com

William F. Schwitter *212-318-6400*
williamschwitter@paulhastings.com

John Turitzin *203-961-7436*
johnturitzin@paulhastings.com

Kaoru Umino *011-813-3586-5643*
kaoruumino@paulhastings.com

1 Historically, as the Commission has adopted rules that went beyond the traditional disclosure principles of the securities laws, and effectively mandated corporate governance practices, many have expressed concern to the Commission that the adopted rules have increased the liability of directors under state corporate laws. For example, in its adoption in 1999 of rules mandating disclosure of reports by audit committees, the Commission responded to commenters as follows: "[i]n adopting the new rules and amendments, we do not intend to subject companies or their directors to increased exposure to liability under the federal securities laws, or to create new standards for directors to fulfill their duties under state corporation law. We do not believe that [the rules] will result in increased exposure to liability or create new standards." Final Rule: Audit Committee Disclosure, Securities and Exchange Commission, 17 CFR Parts 210, 228, 229, and 240 (Rel. No. 34-42266, Dec. 22, 1999).

2 The Commission enacted its audit committee financial expert rules in two separate releases. For operating companies, the Commission amended Item 401 of Regulation S-K and Form 10-K to require such disclosure. *See* Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Release Nos. 33-8177; 34-47235 (Jan. 23, 2003) (the "Release"). For investment companies, the Commission added a disclosure requirement to its newly created Form N-CSR. *See* Final Rule: Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, SEC Release Nos. 34-47262, IC-25914 (Jan. 27, 2003).

3 The Commission also stated in the Release that "a company will not satisfy the new disclosure requirements by stating that it has decided not to make a determination or by simply disclosing the qualifications of all of its audit committee members."

4 The liability safe harbor is enacted in differing ways for operating companies and investment companies. Rule 401(h)(4) of Regulation S-K and Rule 401(e)(4) of Regulation S-B set forth the safe harbor language for operating companies. The safe harbor for investment companies is set forth in the instructions to Item 3 of Form N-CSR.

5 The legislative history of the Sarbanes-Oxley Act states that "[i]nvestors may find it relevant in making their investment decisions whether an issuer's audit committee has at least one member who has relevant, sophisticated financial expertise with which to discharge his or her duties." Report of the Committee on Banking, Housing, and Urban Affairs of the United States Senate to accompany S. 2673 (July 3, 2002), *cited in* James Hamilton & Ted Trautmann, Sarbanes-Oxley Act of 2002, Law and Explanation 180 (CCH 2002).

6 Section 3 of the Sarbanes-Oxley Act provides that "[t]he Commision shall promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of [the Act]." *See also* United States v. National Association of Securities Dealers, Inc., 422 U.S. 694 (1975); Udall v. Tallman, 380 U.S. 1 (1965) (an agency's construction of its own regulations is entitled to substantial deference). *But see,* Int'l Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979) (refusing to grant deference to the Commission's interpretations of Section 3(a)(10) of the Securities Exchange Act of 1934).

7 In the context of expertised portions of a registration statement, the leading case on Section 11 liability, Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968), notes as follows:

> In considering [the outside director's] due diligence defenses, a distinction is to be drawn between the expertised and non-expertised portions of the prospectus. As to the former, [the director] knew that [the accountant] had audited [the financial statements]. He believed them to be correct because he had confidence in [the accountant]. He had no reasonable ground to believe otherwise.

Accordingly, the court in BarChris found that the director, a chairman of the board of a bank, had established his due diligence defense with respect to the financial statements.

8 Rule 176 under the Securities Act provides that in determining whether the reasonableness standards of Section 11(c) have been met, consideration should be made regarding the type of issuer, the type of security, the type of director, the presence of another relationship to the issuer (*e.g.*, an inside director), and the reasonable reliance on persons whose duties should have given them knowledge of the particular facts being alleged. While BarChris did focus on different types of directors, it emphasized the difference between outside and inside directors – and not on expert or inexpert directors in their roles as directors.

[9] Model Bus. Corp. Act § 8.30 (1984) (amended 1998). This version of MBCA Section 8.30 was extensively amended in 1998 and has only been enacted in four states. The prior version, adopted in 1984, has been enacted in 40 states. Although the prior version did not intend to create a standard of liability for directors, according to its official comments, many courts interpreted it (and the statutes modeled on it) as establishing a negligence test for director liability. These court decisions blurred the distinctions the MBCA attempted to make between model standards of care and model standards of liability, and further created difficulty when the business judgment rule was applied. When the MBCA was revised in 1998, Section 8.31 was added to explicitly describe the situations in which liability should be imposed on directors and to offer directors defenses from such liability. Section 8.31 has only been enacted in a handful of states.

Although it is not one of the states that has adopted a statutory duty of care similar to the MBCA duty, Delaware case law imposes similar standards of care upon directors. In Delaware, directors must act with the care that an ordinarily careful and prudent director would exercise in similar circumstances. Graham v. Allis-Chambers Mfg. Co., 188 A.2d 125 (Del. 1963). Directors must also act on an informed basis to meet the duty of care. Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993); *see also* Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987) (holding that the duty of care requires a director of a corporation to proceed with a critical eye when making business decisions, acting in an informed and deliberate manner respecting the corporate merits of the matter before the board).

[10] American Law Institute, *Principles of Corporate Governance*, 151 (1992) provides that a "director…has a duty to the corporation to perform the director's…functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." The ALI's *Principles of Corporate Governance* has been referred to by the Third Circuit as "the new Restatement of Corporate Governance." Resolution Trust Corp. V. CityFed Fin. Corp., 57 F.3d 1231 (3d Cir. 1995).

[11] Mass. Gen. Laws ch. 203C, § 3(f) (2003). As discussed below with respect to corporations, this prudent investor rule can be restricted or eliminated by the provisions of the trust instrument. *Id.* at § 2(b).

[12] *See* n. 18 below.

[13] The ALI's *Principles of Corporate Governance* restates the business judgment rule in Section 4.01(c) as follows:

> A director…who makes a business judgment in good faith fulfills [the duty of care] if the director…(1) is not interested in the subject of the business judgment; (2) is informed with respect to the subject of the business judgment to the extent the director… reasonably believes to be appropriate under the circumstances; and (3) rationally believes that the business judgment is in the best interests of the corporation.

Stated another way, the leading commentator on California corporate law, Harold Marsh, notes the following about the business judgment rule:

> The courts have for many years asserted that a director has a legal duty to the corporation to exercise "reasonable care" in the performance of his duties as a director. This has been phrased in various ways by the courts and in those statutes that attempted to codify this duty, but in general all of these formulations suggest that a director is liable if he acts negligently in the performance of his duties, even though he has no interest opposed to the corporation and does not himself receive any profit from the transaction being attacked.

Harold Marsh *et al.*, Marsh's California Corporation Law § 1.03 (4th Ed., 2002 supplement).

[14] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)

[15] *See* Aronson, 473 A.2d 805; Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); *see also* Kaplan v. Centex Corp., 284 A.2d 119 (Del. Ch. 1971) (holding that in the absence of bad faith or gross abuse of discretion, the business judgment of the directors will not be interfered with by the courts).

[16] Although our research has not been able to find any cases on the subject of an audit committee approving financial statements, we believe the business judgment rule should afford the audit committee some protection as stated.

[17] Aronson, 473 A.2d at 813. The Delaware Supreme Court later noted that, "[w]here there is no conscious decision by directors to act or refrain from acting, the business judgment rule has no application." Rales v. Blasband, 634 A. 2d 927, 933 (Del. 1993).

Marsh observes that the business judgment rule analysis "would suggest that an honest business decision, no matter how stupid, will not subject a director to liability (when there is no conflict of interests, and the director has ruined himself along with the shareholders)" and that "there is no case in the United States, with one possible exception, holding a director liable for a mere wrong-headed decision." Marsh at 11-17.

[18] *See* Rabkin v. Philip A. Hunt Chemical Corp., 13 Del. J. Corp. L., 1210, 1216-17 (Del. Chr. 1988), *cited in* William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors (7th Ed. 2002).
The Ninth Circuit stated:

> Logically, two different standards must apply to acts within and without the business judgment rule: otherwise the rule has no meaning or purpose. If the business judgment rule insulates covered acts from charges of simple negligence, then it follows that a simple negligence standard must generally apply to acts outside the rule.

FDIC v. Jackson, 144 F.3d 694, 699 (9th Cir. 1998), *cited in* Knepper & Bailey, *supra*. Knepper and Bailey observe that this was a "surprising decision." *Id.* at 2-17.
[19] *Id.* at 3-11.

[20] Non-experts serving on an audit committee do not have decreased duties of care as a result of their reliance on the experts serving on the committee. The ALI notes that there is no case or statutory law supporting a position that a director is entitled to rely on the expertise of another director. Principles of Corporate Governance, *supra note* 13, at 192.

[21] *Id.* at Section 4.02.

[22] All of the 41 jurisdictions that impose a statutory standard of care on directors provide that they may rely on experts. Delaware law, while not imposing general standards on directors, protects reliance on any person as to matters reasonably believed to be within that person's competence, if that person has been selected with reasonable care by or on behalf of the corporation. Delaware General Corporation Law § 141(e).

[23] California's standard hinges on the "reckless disregard" of the director or his or her acts or omissions that constitute an "unexcused pattern of inattention that amounts to an abdication of the director's duty to the corporation or its shareholders." Section 204(a)(10) of the California Corporation Code. New York's standard more closely corresponds to Delaware with liability imposed only "if a judgment or other final adjudication adverse to [the director] establishes that [the director's] acts or omissions were in bad faith or involved intentional misconduct or a knowing violation of law or that [the director] personally gained in fact a financial profit or other advantage." Section 402(b) of the New York Business Corporation Law.

[24] For example, in the federal securities law context, the Delaware Supreme Court has found that a "partial disclosure" in a tender offer document was not sufficient to overcome the certificate of incorporation's protection from personal liability for the directors. *See* Zirn v. VLI Corp., 681 A.2d 1050 (1996).

[25] What's Wrong with Executive Compensation? A roundtable moderated by Charles Elson, Harv. Bus. Rev., Jan. 2003, at 68, 76, *cited in* Thomas A. Roberts, Greg A. Danilow and Stephen A. Radin, Director Liability Warnings from Delaware (2003), *in* The Securities Reporter, 25 (Spring 2003).

[26] *Id.* at 27.