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From Enron To NYSE

Lessons For Officers and Directors of Private And Not-For-Profit Companies

By Bernard J. Berry, Jr., Esq.

Responsibility for oversight of the corporate financial affairs of private companies has indeed been heightened since the scandals and investigations involving Enron, WorldCom, Adelphia, Rite Aid, Tyco and Global Crossing, to name just a few. More recently, the criticism of a "friendly" Board of Directors' approval of a compensation package to the Chairman of the New York Stock Exchange (a not-for-profit organization) has significantly increased the attention paid to corporate governance. In July of 2002, Congress enacted the Sarbanes-Oxley Act to enhance corporate responsibilities through new corporate governance and disclosure obligations, greater oversight of the accounting and auditing processes for public companies, and tougher penalties for securities law fraud and other corporate misconduct. It did not take long for some of the same principles which are applicable in publicly held companies and expressed in Sarbanes-Oxley to be applied to private companies.

In a 242 page opinion dated May 8, 2003 entitled Pereira v. Cogan (hereinafter “Cogan”), Judge Robert W. Sweet of the United States District Court for the Southern District of New York ruled that officers and directors of private companies could not simply acquiesce to the wishes of “their boss.” In the Cogan litigation, Mr. Cogan drained his company of tens of millions of dollars while the company’s officers and directors stood by and did little or nothing. While they did not profit personally, the court found certain directors and officers personally liable for damages ranging from $21 to $38 million dollars for failure to live up to their fiduciary responsibilities.

It was predictable that Judge Sweet, as well as other courts, would apply the “standards of fiduciary responsibility, commonly applied to public companies, to a privately held company.” This is particularly true where officers and directors owe a greater duty to the corporation to keep a sharp eye on the controlling shareholder (i.e., the boss). By the very nature of Judge Sweet’s decision, the directors’ and officers’ standard of reasonable judgment was “kicked up a notch”. Judge Sweet’s opinion discusses the business judgment rule and the fiduciary duties of good faith, loyalty and due care, and fairness and best interest of the corporation principles when self-dealing occurs.

Cogan emphasizes directors' and officers' responsibilities in the following situations.

1. Controlling shareholder/boss issues (e.g. exorbitant salaries and benefits, expense payments, stock redemptions for the benefit of controlling shareholder, personal loans);

2. Dividends and other arrangements to preferred shareholders to the detriment of common shareholders and third party creditors; and

3. Related party transactions.

Cogan stresses the need for private companies to have board procedures requiring the board members to receive necessary information and conduct an in depth qualitative review of same. This would avoid any concern of a "lack of board oversight." Cogan reinforces the point that directors and officers of private companies must adhere to the same duty of good faith, loyalty and due care as their publicly held company counterparts and the failure of a director to act can lead to severe adverse consequences.

Steps To Take To Eliminate Or Reduce Liability
(Alternatives To Tendering One's Resignation)

1. Audit Committee And Other Independent Committees:

Companies should establish an independent audit committee that has the authority to hire, fire and oversee auditors. The audit committee should also have the authority to implement a "whistleblower procedure" which outlines the steps an employee may take to bring accounting irregularities directly to the audit committee. The audit committee should avoid (or limit) retaining the auditors for "other services" as these "other services" might compromise their independence. Procedures for accounting-related complaints and concerns of whistleblowers must be set up. Another board committee preferably comprised of independent directors should be established to determine compensation for officers, including the controlling shareholders. In addition, it is prudent for independent board members to serve on a nominating committee.

2. Audit Committee's Responsibilities:

Ideally, the audit committee would be responsible for reviewing financial statements in order to (a) determine deviations from accepted and customary practices; (b) question forecasts, assumptions and estimates; (c) create and implement financial systems and controls (i.e., internal procedures to detect fraud and wrongdoing) to serve as a further deterrent against inappropriate conduct; (d) review the possibility of any off-balance sheet transactions; and (e) review any related party transactions. Similar to publicly held companies, the management of privately held companies, particularly the CEO and CFO, may have to certify financials. All of the foregoing must be accomplished with a view

towards an accurate financial report that can be properly certified. Specific inquiry could be made into the areas discussed in (a) through (e) above.

3. Establishment Of A Code Of Corporate Ethics:

Sarbanes-Oxley requires that public companies disclose whether they have adopted a code of corporate ethics and if not, why not. By creating and vigorously enforcing such a code, a corporation's officers and directors may have a much stronger defense to civil and/or criminal litigation. A ban on controlling shareholder and related third party member transactions may be, at a minimum, appropriate. The board could place a ban on personal loans to management or, at least, to controlling shareholders and parties related to the controlling shareholders. In some instances, the ban on personal loans may be necessary for all officers and directors. Where there is self-dealing or a potential conflict of interest or competitive interest, full disclosure and approval by disinterested directors and perhaps shareholders' approval may be in order. Most of all the transactions must be fair and in the "best interest" of the company.

4. Directors Fiduciary Duties – Not-For-Profit-Charities:

Directors must take seriously the principles of fiduciary duty of due care, loyalty and fair dealing in not-for-profit companies. New Jersey generally limits the liability of such directors, officers and trustees of non-profit companies "unless the actions evidence a reckless disregard for the duties imposed by the position". A failure of not-for-profit directors or officers to exercise any responsibility could result in exposure to a charge of "reckless disregard." Directors of a not-for-profit who (i) permit a dominant CEO, CFO or management team to use the company for inappropriate personal gain, or (ii) fail to have an adequate understanding of their company's business conduct as it engages in inappropriate and potentially illegal (if not criminal) practices; or (iii) fail to challenge inappropriate behavior, can face charges of recklessness. By way of illustration, directors and officers of not-for-profit companies in the health care industry that engage in Medicaid or Medicare violations (i.e., up coding of charges systematically to enhance revenue) may be subject to a claim of reckless disregard.

Recommendations To Individual Directors And/Or Officers

Amongst the recommendations to be made to individual officers and directors in private for-profit as well as not-for-profit corporations are as follows:

1. First and foremost, the company must have the appropriate directors' and officers' liability insurance in place. Note that such policies may have disclaimers for certain types of inappropriate conduct. Also, for some not-for-profits, the price of procuring this insurance may present a significant cost issue.

2. The company, either in its certificate of incorporation, by-laws and/or by agreement, should indemnify the directors or officers to the fullest extent permitted by law.

3. Individuals accepting director positions, must, given their fiduciary duties, receive and review all necessary information. It is important to note that private companies have a tendency to neglect corporate formalities. However, the lessons of the last few years along with Judge Sweet's decision, stress the importance of maintaining formalities and exercising proper board oversight. In many instances, particularly where the private company has numerous shareholders, an independent board of directors may be appropriate. The independent directors should hold regular meetings without management present and set up independent board committees (e.g. audit, compensation, nominating and code of ethics compliance).

The principles discussed in Cogan will no doubt be applied in future cases as a basis for scrutinizing directors' and officers' conduct in privately held companies. One key distinction in director versus non-director officer liability is that the non-director officer could not be held liable for acts they could not control (e.g. compensation payments to the majority shareholder). However, the officers can be held accountable for not bringing issues such as improper loans and payments to the board's attention. Some privately held companies that do business with the government must furnish certified financials. Other companies may be regulated by government agencies which may require certified financials pursuant to those regulations (e.g. state regulated insurance companies and state licensed health care facilities). Other companies in the process of procuring venture capital financing or embarking on a public offering or a merger will warrant and represent the accuracy of financial statements. Directors of not-for-profit companies are also subject to a higher fiduciary standard and cannot simply acquiesce in a trusting, carefree manner to the business executives of the not-for-profit corporation. Heightened diligence is in order and codes of ethics must be imposed. A system to assure the ethical operation of a business must be established. If controlling management and ownership does not permit such systems to be implemented, those persons serving as a directors or officers may be subject to significant exposure and should consider resigning from their positions.