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Don't Start a Backdating Witch Hunt

The SEC should stick with its past enforcement practices regarding director liability.

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In the midst of the firestorm over backdating stock options, many questions have been asked about the role of boards of directors and specifically about directors who sit on compensation committees.

Some commentators have suggested that compensation-committee directors, who typically had at least some involvement with approving options, should have been—or at least could have been—more vigilant in monitoring management and in demanding answers about options grants that might have been backdated.

Although the Securities and Exchange Commission has not yet brought a case against an outside director in this area, it is clear that SEC officials and enforcement staff are thinking about it. Indeed, SEC Commissioner Raul Campos said in August that "it wouldn't surprise" him if such a case were brought.

Securities & Corporate Governance
A Practice Focus

The SEC should not pursue any such case based merely upon a director's alleged lack of diligence, dereliction of duty, or inadequate response to red flags. These issues are strictly a matter of state corporate law and should be decided, if at all, by the relevant state courts or chanceries, which are well versed in and better suited to rule on these issues.

The SEC's past cases against directors have, at least implicitly, recognized this important distinction and have generally involved allegations that those directors engaged in willful and material securities law violations independent of their status as directors. Any SEC enforcement action against an outside director in the options context should follow the same approach and have as its linchpin the central premise that the director is being pursued not for his role as a director per se, but rather because he actively engaged in or assisted wrongdoing intentionally or severely recklessly.

Directors should not face SEC liability —even limited liability for so-called books-and-records violations—simply for failing to meet an undefined SEC diligence standard in exercising their duties.

Not Hallway Monitors

As all law students learn, directors act as fiduciaries of the corporation's shareholders and owe duties of care and loyalty to the corporation and the shareholders. But American corporate law explicitly recognizes that, although directors are properly viewed as stewards, they are not compliance cops or hallway monitors.

Rather, their job is to oversee—at a strategic and not tactical or "micro" level—the business of the company. In doing so, they are fully entitled to rely on management and to presume that management is telling them the truth and acting in good faith. Moreover, directors are generally protected from civil liability by the "business judgment" rule. That is, if they act in good faith and with an honest belief that they are acting in the best interests of the company, courts will not second-guess their decisions.

The SEC has been cognizant of these principles in the cases it has brought against outside directors, and it should continue to be so in considering any case against directors in the options area.

The SEC's action announced on Nov. 6 against certain directors of Spiegel Inc. is a good example of the approach the SEC should take in considering such cases. Although the Spiegel matter does not involve options-granting issues, it sheds light on how the SEC is (and should be) thinking about director liability in this area.

In the Spiegel matter, the SEC brought actions against three former members of Spiegel's board of directors arising out of Spiegel's decision to withhold its annual SEC filing for some 15 months.

Michael Otto, Spiegel's former chairman of the board, and Michael Cruseman, another former member of the board, agreed to accept a federal injunction against them for aiding Spiegel's decision not to make its required financial filings, as well as to pay a $100,000 fine each. Horst Hansen, the former chair of the audit committee, entered into a consent cease-and-desist order for the same violations.

In announcing the cases, the SEC made clear that the case did not involve the business-judgment rule, a failure of diligence, or any disregard of red flags by these directors.

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Rather, according to the SEC, the case involved the directors' conduct in "keep[ing] important financial information from the investing public by purposely failing to file required financial reports." Specifically, the SEC alleged that the directors were central to Spiegel's decision not to make its required SEC filings, and that they did so because they knew that any such filing would likely be accompanied by a "going concern" opinion from Spiegel's outside auditors. Such an opinion would have indicated that the auditors had substantial doubts about the company's continuing financial viability.

In fact, the SEC's papers strongly suggest that, rather than acting in oversight mode, the directors effectively made the decision to withhold the filing to avoid suffering the market consequences that would result from disclosure of the "going concern" opinion.

Thus, the SEC's documents recite, Spiegel was bought in 1982 by Otto Gmbh & Co., a German mail-order concern owned largely by Michael Otto; Spiegel's CEO as of 2001 was an Otto employee; both Otto and Cruseman sat on a board committee that had "the authority to make decisions for Spiegel between the semi-annual Board of Directors meetings"; Otto and Cruseman formed a quorum of this board committee in making the decision "not to file until . . . an unqualified opinion was in place"; and Hansen was the chairman of Spiegel's audit committee and recommended the decision.

Warned by Counsel

The SEC also alleged that the directors affirmatively chose this action despite being told categorically that it violated American law and exposed the company and its officers to legal liability. The SEC's documents include allegations that Spiegel's inside and outside counsel specifically advised the directors that not making the filing violated securities laws and exposed the company and its officers to considerable liability.

Moreover, according to the SEC, Cruseman and others received a memorandum titled "Pros/Cons to Filing the Form 10-K" that specifically indicated that officers could be liable for the failure to file. The document also attached a copy of the relevant section of the securities laws indicating that officers and directors may be liable for such actions. The SEC's papers contain many allegations of meetings and discussions where the issues were vetted with the directors.

The Spiegel directors cases, as well as the others summarized in Commissioner Campos' August speech, make clear that the SEC is not—and should not be—in the business of second-guessing directors who conduct themselves in good faith and consistent with ordinary business practices.

Indeed, what is remarkable about the Spiegel matter is that it emphatically did not involve any lack of diligence or carefulness on the directors' part or any willful blindness to red flags.

To the contrary, the SEC's allegations, to which the directors consented in a settlement without admitting or denying them, make clear that the directors acted carefully and deliberately, with full knowledge of the legal consequences of their decision. The allegations suggest that the directors simply chose to pursue an illegal course of action based on the belief that it was better not to file at all than to risk the market consequences of a "going concern" opinion.

When viewed through this prism, the Spiegel matter is not a close case, and it certainly does not suggest any expansion of director liability. One can hardly gainsay the basic proposition that directors are not and should not be immune from liability if they knowingly pursue an illegal course of action.

Extremely Rare

The SEC should adhere to the Spiegel approach to considering director liability in the options area, and this means that cases against outside directors should be rare.

They should be limited to situations where the evidence is clear and compelling that a director actively and knowingly engaged in or materially assisted an improper options dating scheme, fully understanding the legal, accounting, and disclosure ramifications of her actions.

In such a case, particularly if the director benefited personally from the misconduct, there is no tension between state law principles and the federal securities laws. The defendant's status as a director in such a case would be wholly secondary to her status as wrongdoer. Moreover, any such action would inherently involve the notion that the director did not act in good faith or consistent with his duties of care and loyalty.

An action might also be appropriate where a director was confronted by obvious evidence of wrongdoing such that it was severely reckless for the director to have continued to execute approval documents or otherwise approve options grants.

Again, however, such a case only makes sense as a policy matter if the evidence is clear that the director understood the legal and accounting consequences of the scheme and his role in approving options in that context, such that it could fairly be said that the director was a knowing participant in the scheme. Given the appropriate but limited oversight role directors typically played in this area, cases like this are sure to be exceedingly rare: Most directors had little or no awareness of the legal and accounting issues raised by backdating, much less the kind of fulsome understanding required to impose liability.

But even if there is evidence that a director had some understanding of the ramifications of executing problematic approvals, the SEC should limit enforcement actions to those situations where it is clear the director profited or benefited in some meaningful way from the misconduct. Absent this requirement, it is too easy to slide down the slippery slope and to view mere negligence as severe recklessness.

Finally, the SEC should not pursue backdating actions arising simply from a director's failure to act or to intervene to halt management misconduct. The SEC's own cases, and the securities laws themselves, make clear that such inaction cannot form the basis for a case. Rather, the SEC should reserve such actions for those situations where, in addition to undeniable evidence of misconduct, a director truly provided substantial assistance to the scheme in some fashion by, for example, repeatedly executing backdated or phony approval documents.

In short, the SEC should pursue actions against directors only when the facts are clear that they engaged in or substantially assisted serious wrongdoing either intentionally or severely recklessly, with a full understanding of the legal, accounting, and disclosure consequences of their conduct.

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