The Audit Committee's Ethical and Legal Responsibilities: The State Law Perspective

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THE AUDIT COMMITTEE'S ETHICAL AND LEGAL RESPONSIBILITIES: THE STATE LAW PERSPECTIVE

LYMAN P.Q. JOHNSON*

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I. INTRODUCTION

This Article provides a state law perspective on the post-scandal, post-reform audit committee. Federal laws, along with NYSE and Nasdaq (together, “SRO”) rules, recently have made sweeping changes in corporate governance, including numerous provisions that bear on audit committees. These changes are unprecedented and dramatic, and rightly have received wide attention and careful study. Certain basic principles underlying the governance functions and duties of audit committees, however, originate in, and are still determined by, state law. Moreover, state law applies to all corporations while federal law and SRO rules on audit committees apply only to those companies coming under federal law or SRO coverage. This Article describes how audit committees fit into the governance arrangement ordained by state corporate statutes; how longstanding state fiduciary duties will affect post-reform audit committees; and how, on a variety of issues, federal law and SRO rules will interact with the pre-existing state law system to alter the functions of audit committees and how their conduct is assessed. It closes with some brief observations on how audit committee reforms dovetail with other reform efforts—such as the new SEC “reporting up” rule—to reflect a reconsideration of the lawyer’s ethical and legal role in corporate governance.
II. BACKGROUND; REGULATORY APPROACH

States, not the federal government, traditionally have regulated corporate governance. This legal landscape dramatically changed with the enactment of the Sarbanes-Oxley Act\(^1\) ("Sarbanes-Oxley" or "Act"), the promulgation of SEC rules under that Act, and the adoption of new SRO listing standards. Today, on some corporate governance subjects, including regulations affecting audit committees, the law comes from three sources—state law, federal law, and SRO rules.

State corporation law fundamentally differs from the recent governance initiatives of federal law and SRO rules. First, unlike the statutory mandates of Sarbanes-Oxley, and in sharp contrast to the detailed SEC and SRO rules promulgated thereunder, state corporation statutes are largely enabling, not regulatory, in thrust. State corporate statutes do contain mandatory provisions; however, they are not strong constraints and often can be avoided through planning. Significantly, under state law much discretion over corporate affairs is left to the board of directors and its committees. Second, federal legal mandates are legislative and administrative in origin, whereas much state corporate law—especially that dealing with fiduciary duty concepts—derives from equity and is created by judges. Third, federal law and SRO rules adopt a rules-based approach to corporate governance, in contrast to the more fluid standards and duties-based approach of judicial analysis under state law. Fourth, the new initiatives largely avoid the subject of private remedies for wrongdoing; the state law system of direct and derivative claims for fiduciary breaches remains intact, though federal law and SRO rules will influence it. Finally, the new federal and SRO rules largely accept as given state corporate law’s basic allocation of decision-making responsibility within corporations. However, in certain areas—including the composition and functions of audit committees—federal and SRO rules both specify structural change and alter how directors and committee members must operate, matters state law largely leaves to director judgment. As a result, audit committees are now governed by both new federal and SRO rules on the one hand, and traditional state law concepts on the other.

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III. CORPORATE STATUTES AND THE AUDIT COMMITTEE

A. Board of Directors Holds Broad Authority and Discretion

State law provides that the business and affairs of every corporation shall be managed by or under the direction of a board of directors. Not only is the board granted plenary authority over corporate affairs, the manner in which it exercises that authority largely is left to the discretion of directors. For the most part, corporate statutes do not specify what directors are to do in directing corporate affairs, or how they are to do it. The same is true with respect to corporate officers; corporate statutes say remarkably little about what officers are to do or how they are to do it.

B. Committees

The board of directors has the power to create committees, including audit committees, and to appoint directors to serve as members of those committees. In Texas, the articles of incorporation or bylaws must authorize the board to create committees. Even though members of the audit committee now must meet federal and SRO standards for independence and perform specified functions, the audit committee remains a committee of the board and must be created and charged by the board.

Subject to certain exceptions for non-delegable, full-board functions, committees may exercise the full powers of the board. An audit committee may exercise board power over a company's audit matters. Federal law and SRO mandates for audit committees are congruent with wide-ranging authority for audit committees under state law.

Some corporate statutes specify that the creating of, delegation to, or action by, a committee does not alone constitute compliance by a director with the required standard of conduct for a director. The comment to the

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7. See infra Part IV; see, e.g., Tex. Bus. Corp. Act Ann. art. 2.36(D) (stating the "designation of a committee of the board of directors and the delegation thereto of authority shall not operate to relieve the board of directors, or any member thereof, of any responsibility imposed..."
Model Business Corporation Act ("Model Act") section expressly cautions, "directors may not abdicate their responsibilities and avoid liability simply by delegating authority to board committees."\(^8\)

State corporate statutes are largely silent on the subject of audit committees. Except for Connecticut,\(^9\) it appears that most state corporate statutes do not require an audit committee. Again, except for Connecticut, state corporate law does not specify the size or composition of an audit committee (other than the general requirement that members of board committees be directors), nor does it mandate the qualifications of committee members or the functions or processes to be followed by an audit committee. These matters are all left to the judgment of the board of directors or the committee itself, as the case may be.

C. Director and Committee Member Reliance on Others

State corporate statutes typically allow directors and committee members to rely on various persons.\(^10\) These statutes vary in wording and must be read carefully. The wording of these statutes may differ from state to state as to the persons upon whom committee members may rely, and as to the preconditions for proper reliance. The Delaware and Texas statutes are set forth in the Appendix as examples.

1. Certain Points about Delaware's Reliance Statute Warrant Attention

   (a) The director must rely in "good faith."\(^11\)

   (b) The director may rely upon information, opinions, reports or statements made by officers, employees or committees of the board if those materials were "presented to the corporation."\(^12\) Materials must be presented to directors or committee members in their capacity of acting on behalf of the corporation. Reading the CFO's views as reported in an interview with the newspaper, for example, would not qualify.

   (c) The director may also rely upon materials presented to the

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8. MODEL BUS. CORP. ACT § 8.25(cmt. at 8-141).
10. See, e.g., DEL. CODE ANN. tit. 8, § 141(e) (2001); MODEL BUS. CORP. ACT § 8.30(c)-(e).
11. DEL. CODE ANN. tit. 8, § 141(e); see infra Part IV.B.4 (discussing the meaning of "good faith").
12. DEL. CODE ANN. tit. 8, § 141(e).
corporation by any other person if (i) the director reasonably believes the matter is within the person's professional or expert competence; (ii) the person was selected with "reasonable care"; and (iii) the expert or professional was retained by or on behalf of the corporation.13

Importantly, although Delaware, unlike most states, does not have a general statutory standard of care for directors, the director-reliance statute imposes a reasonable care obligation on directors in selecting professionals or experts upon whom directors wish to rely.14 This statutory reasonable care requirement, along with the good faith obligation, indicates that directors and committee members must meet a threshold fiduciary standard in choosing to rely on professionals (such as lawyers or accountants) or experts (such as an audit committee's financial expert).

2. Certain Points about the Texas Reliance Statute Warrant Attention

(a) The director or committee member must act in "good faith."

A director is not acting in good faith "if the director has knowledge concerning the matter in question that makes reliance . . . unwarranted."16

(b) The director must act with ordinary care in relying on others.17

(c) The Texas statute does not limit reliance to those materials presented to the corporation, as the Delaware statute does. The materials need only be those concerning the corporation.18

(d) Although it may be implicit, the Texas statute does not expressly limit reliance on experts or professionals to those retained by or acting on behalf of the corporation.

13. Id.
14. Id.
16. Id. Also, the Fifth Circuit Court of Appeals recently interpreted the Texas reliance statute, requiring that defendants must affirmatively show that they relied in good faith. Gen. Elec. Capital Corp. v. Posey, 2005 WL 1523848, at *5 (5th Cir. June 29, 2005). This is in contrast to Delaware, where good faith is presumed.
17. Id.
18. See id.
D. Director-Reliance Statutes and the Sarbanes-Oxley Act

State corporate statutes continue to allow the board of directors to rely on materials, such as statements and reports, prepared or presented by the audit committee, provided the board, on an ongoing basis, meets the statutory requirements for relying on the audit committee. Members of the audit committee, in turn, may rely on other persons. For example, committee members may rely on the financial expert as to matters specified by statute, which the financial expert specially undertakes to prepare or present, provided they reasonably believe the matters are within the expert’s competence. Members of the audit committee may rely on legal counsel or other professionals retained by the committee. Members of the board and members of the audit committee should be able to rely on accountants, provided the audit committee is composed as required by federal law and performs the functions specifically assigned by federal law and SRO rules; without affirmative reasonable assurance that federal and SRO mandates have been followed, directors run the risk that they may be deemed to have knowledge that makes their reliance unwarranted.

This last point applies more generally to director reliance under many corporate statutes (including that of Texas). For example, such reliance is not proper if a director (and this may vary from director to director) has knowledge about a matter that makes reliance on another person or group unwarranted. A director with special accounting skills or training may not be warranted in relying in a situation where an untrained director might be warranted in so relying. Likewise, one or more directors with information unknown to other directors may not be able to rely as broadly as other directors. Members of the board and members of the audit committee, therefore, may rely on others—subject to the qualifications noted—but such reliance does not alone constitute compliance with the member’s directorial responsibilities or with the required standards of good faith and due care discussed in Part IV below.

IV. Audit Committees and State Fiduciary Duties

A. Statutory Standards of Conduct for Directors

Forty states have enacted a statutory standard of care for directors.\(^\text{19}\) Delaware and Texas do not have such a statute. As noted earlier, however, Delaware’s director-reliance statute does provide that directors may rely on professionals or experts only if the director relies in “good faith” and only if

\(^{19}\) MODEL BUS. CORP. ACT § 8.30 annot. at 8-177 (2002).
such persons have been selected “with reasonable care.”\textsuperscript{20} The Texas statute also permits reliance if a director acts in “good faith and with ordinary care.”\textsuperscript{21}

Many states (including Delaware\textsuperscript{22} and Texas\textsuperscript{23}) also have enacted statutes partially addressing director (and, in some statutes, officer) conflict of interest transactions, but not addressing other aspects of the director (or officer) duty of loyalty, such as, for example, usurpation of corporate opportunities, wrongful competition with a corporation, or appropriating confidential information—all matters implicating a director’s duty of loyalty.

\section*{B. Director Fiduciary Duties}

Courts impose various fiduciary duties on corporate directors. Delaware’s fiduciary duties are those of due care, loyalty, and good faith. Good faith is probably best understood as a component of the duty of loyalty, but it is sometimes spoken of as a distinct duty. These duties are not generally framed as precise rules, but instead are expressed as general duties or standards. Duties and standards are more open-textured, fluid, and context-sensitive than rules. One drawback of rules in the corporate governance area is that they heighten the risk of “freezing” current practices, whereas standards, being more open-ended, are more conducive to allowing and encouraging change and growth in corporate practices.

\subsection*{1. Judicial Emphasis on Structure and Process}

In general, over the past several years Delaware courts largely have developed a “process-oriented” approach to judicial review of the director duty of care, and a “structure and process” approach to judicial review of the director duty of loyalty, at least in the conflict of interest setting. This approach has characterized Delaware’s approach to the review of committee conduct as well—whether special litigation committees, committees charged to review transactions with self-interested directors, or committees established to respond to tender offers.\textsuperscript{24} It can be expected that, in reviewing the conduct of audit committees, courts will likewise focus on their structure and composition, as well as their procedures.

\begin{itemize}
\item \textsuperscript{20} Del. Code Ann. tit. 8, § 141(e) (2001).
\item \textsuperscript{21} Tex. Bus. Corp. Act Ann. art. 2.41(D).
\item \textsuperscript{22} Del. Code Ann. tit. 8, § 144 (2001).
\item \textsuperscript{24} See, e.g., Emerald Partners v. Berlin, 787 A.2d 85, 90–94 (Del. 2001); Kahn v. Tremont Corp., 694 A.2d 422, 428–29 (Del. 1997).
\end{itemize}
2. Duty of Due Care

The duty of due care specifies the manner in which directors must discharge their legal responsibilities, not the substance of director decisions. The duty of due care arises in both the discrete decision-making context and in the oversight and monitoring areas. In the decision-making setting—whether it involves directors making a routine business decision or responding to a high-stakes unsolicited bid for corporate control, or anything in between—the duty of care inquiry clearly focuses on a board’s “decision-making process.” Directors in that setting are under an obligation to obtain, and act with due care with respect to all material information reasonably available. Gross negligence is the standard.

Directors, due to their statutory responsibilities to direct the business and affairs of a corporation, also have a duty to properly monitor and oversee the business affairs of a corporation. Failure to do so properly may constitute a breach of the duty of care. The Delaware Supreme Court has not yet addressed whether negligence or gross negligence is the proper standard of conduct in the oversight context, as opposed to the business judgment context. As famously noted by former Chancellor William Allen, this monitoring and oversight obligation “includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may ... render a director liable.” Importantly, however, noted Chancellor Allen’s dictum, “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.”

If one focuses on certain language—“sustained or systematic failure” or “utter failure”—the Caremark standard of care for directors in the oversight context seems very low. Often overlooked, however, are repeated references in Caremark to a director’s “obligation to be reasonably informed,” and the duty “to exercise reasonable oversight,” as well as

25. See Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989); see also Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) (“Due care in the decisionmaking context is process due care only.”).
28. See Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 972 (Del. Ch. 1986) (holding that outside the business judgment setting, the care required is that of an ordinarily careful and prudent person).
30. Id. at 971.
31. Id. at 970–71.
32. Id. at 971.
the statement that directors must act to "assure a reasonable information and reporting system." Thus, director failure to act reasonably in the oversight area may allow an inference of bad faith or, more likely, such inaction may constitute a breach of that facet of due care requiring directors to be "reasonably informed." What it means to be reasonably informed is different in corporate law today—after Sarbanes-Oxley—than in 1996, (the year of the Caremark decision) before Congress mandated adoption of certain governance reforms, including internal processes aimed at providing "reasonable assurance" regarding the reliability of corporate information. In Caremark, Chancellor Allen noted the relevance of federal law—in that case, federal organizational sentencing guidelines—to understanding director governance responsibilities under state law. Likewise, Sarbanes-Oxley may infuse new meaning into state law notions of "reasonable" oversight in a way that leads courts to demand greater director and committee member vigilance under the reasonableness standard of Caremark.

3. Director Duty of Loyalty

The duty of loyalty requires directors to act in the best interests of the corporation. The duty of loyalty has a well-recognized dimension prohibiting a director from preferring his or her own interests to the interests of the corporation. Accordingly, a director may not engage in an unfair self-dealing ("conflict of interest") transaction, wrongly usurp a corporate opportunity, improperly compete with the corporation, or use corporate assets or confidential company information for personal gain. The mere absence of a personal, conflicting interest by a director, however, is insufficient, by itself, to fulfill the affirmative aspect of the duty of loyalty. The Delaware Chancery Court has observed that a breach of loyalty can be unintended and can occur even when board action is taken in good faith, and even where self-interest is absent. As the chancery court has noted, "a fiduciary may act disloyally for a variety of reasons other than personal pecuniary interest; and... regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes." Recently, both the "affirmative and harm-avoidance" dimensions

33. Id. at 970.
34. Id. at 970.
36. Nagy v. Bistricer, 770 A.2d 43, 48-49 n.2 (Del. Ch. 2000); see also Hoover Indus., Inc.
of loyalty were reiterated by Chancellor Chandler: "[T]he 'duty of loyalty . . . imposes an affirmative obligation to protect and advance the interests of the corporation and mandates that [a director] absolutely refrain from any conduct that would harm the corporation."38

In a variety of settings raising loyalty concerns, Delaware courts have given guidance as to the structure and process elements likely to enhance judicial approval of committee performance.39 Director disinterestedness and independence are vital, as is care in gathering information and in deliberations, along with the use of independent legal and financial advisors. These factors will remain important as courts review audit committee behavior.

4. Director Duty of Good Faith

The obligation of good faith has long been important to fiduciary analysis in corporate law, but its meaning has been somewhat nebulous. Recently, good faith has been receiving considerable attention. A recent statement by former Chief Justice Veasey helps in understanding the breadth of this concept:

It is all about process, and process is all about due care and good faith, as well as loyalty. In my opinion, good faith requires an honesty of purpose and eschews a disingenuous mindset of appearing or claiming to act for the corporate good, but not caring for the well-being of the constituents of the fiduciary. Although the concept of good faith is not fully developed in the case law, and factual scenarios are difficult to formulate, an argument could be made that reckless, disingenuous, irresponsible, or irrational conduct—but not necessarily self-dealing or larcenous conduct—could implicate concepts of good faith. If the board's decision or conduct is irrational or so beyond reason that no reasonable director would credit the decision or conduct, lack of good faith may, in some circumstances, be inferred.40

v. Chase, No. CIV.A.9276, 1988 WL 73758, at *2 (Del. Ch. July 13, 1988) ("A director does breach his duty of loyalty if he knows that the company has been defrauded and does not report what he knows to the board . . . .").


40. E. Norman Veasey, State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors, 28 J. CORP. L. 441, 447 (2003); see also Hillary A.
Vice Chancellor Leo Strine also has commented on how the notion of good faith may play a more prominent role in fiduciary analysis: "Enron might exert pressure on courts to look more carefully at whether directors have made a good faith effort to accomplish their duties."\textsuperscript{41} Asserting that good faith goes to director "state of mind,"\textsuperscript{42} Strine identifies certain kinds of director conduct that may call good faith into question. These include "a failure to monitor if [the directors'] laxity in oversight was so persistent and substantial that it evidences bad faith."\textsuperscript{43} It can also arise in situations where "committee members knew that their inadequate knowledge disabled them from discharging their responsibilities with fidelity. . . . [Here,] the court will be called on to conclude that a director who is conscious that he is not devoting sufficient attention to his duties is not acting in good faith . . . ."\textsuperscript{44} Finally, in language especially important to audit committee members, the Vice-Chancellor stated:

If an overly busy person serves on the boards of five public companies[,] . . . takes on challenging duties on each of those boards, and then finds himself in a situation where one of his companies is accused of serious wrongdoing that the board arguably should have prevented, he should not be surprised if his good faith comes under severe attack in the financial press and in the courts.\textsuperscript{45}

Chancellor William Chandler also shed new light on the meaning of the duty of good faith in \textit{In re Walt Disney Co.}\textsuperscript{46} The Chancellor noted that the complaint in that case did much more than portray directors who were grossly negligent; rather, it suggested "the defendant directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision."\textsuperscript{47} He stated that such "deliberate indifference by a director to his or her duty to act faithfully and with appropriate care is conduct . . . that may not have been taken honestly and in good faith to advance the best interests of the company."\textsuperscript{48} In other words, deliberate indifference to the director duties of care and loyalty, or consciously disregarding those duties, is conduct sufficiently faulty to indicate a lack of the required motive—i.e., good

\begin{footnotes}
\footnote{Leo E. Strine, Jr., \textit{Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle}, 57 BUS. LAW. 1371, 1373 (2002).}
\footnote{\textit{Id.} at 1386.}
\footnote{\textit{Id.}}
\footnote{\textit{Id.} at 1393.}
\footnote{\textit{Id.} at 1395.}
\footnote{825 A.2d 275, 289 (Del. Ch. 2003).}
\footnote{\textit{Id.}}
\footnote{\textit{Id.}}
\end{footnotes}
faith—of advancing the best interests of the company. The court, in assessing director behavior, is not substantively evaluating conduct, but is drawing an inference about the propriety of director motive from the nature of the conduct. This allows the court an indirect method to accomplish what the business judgment rule precludes—consider the substance of director conduct, not for the purpose of assessing it outright, but to draw an inference of bad motive if it is sufficiently egregious.\(^4^9\)

Overall, these authorities suggest that the key issue with respect to analyzing good faith is whether the directors’ motivation and purpose was to advance the corporation’s interest. Lawyers advising boards and audit committees must keep director eyes focused on this overarching concern: What, in the judgment of directors, is best for the corporation? The absence of proper motivation can be inferred in a variety of ways. These include: approval of a substantively irrational course of conduct; acting with deliberate indifference to known risks; reckless failure to disclose; knowing violation of applicable law; seeking entrenchment of director positions; acting with an awareness that as directors they are not fully discharging their fiduciary responsibilities, as by deliberately acting without sufficient knowledge, hastily, or in a manner that fails to devote sufficient attention to those responsibilities; and egregious process failures that suggest a lack of concern for advancing corporate interests.

C. *Members of an Audit Committee Owe the Same Fiduciary Duties as Directors*

As directors perform their numerous functions as audit committee members, they are subject to all of the fiduciary duties applicable to directors.

V. *STATE LAW PROTECTIONS AGAINST DIRECTOR AND AUDIT COMMITTEE MEMBER LIABILITY*

There are several state law protections against director or audit committee member liability.

A. *The Business Judgment Rule*

In Delaware, the rule is described as a “presumption that in making a business decision the directors of a corporation acted on an informed basis,

\(^4^9\) See Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1246 (Del. 1999) (noting that a business decision may be “so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith”) (quoting *In re J.P. Stevens & Co.*, 542 A.2d 770, 780–81 (Del. Ch. 1988))).
in good faith and in the honest belief that the action taken was in the best interests of the company.\textsuperscript{50} A useful statement of the rule's elements is found in \textit{Brehm v. Eisner}.\textsuperscript{51} From this simple statement—and later case law elaboration—several undisputed points about the Delaware rule emerge. The rule applies to directors.\textsuperscript{52} The rule's application to officers is not established in case law.\textsuperscript{53} "[T]he rule applies to directors when they act collectively, that is, as a board or as a committee of the board . . . ."\textsuperscript{54} "[T]he rule applies only to considered director judgments, not to unconsidered inaction."\textsuperscript{55} To obtain the rule's protection, directors must be independent and disinterested as to the matter acted upon.\textsuperscript{56} Directors must act with due care and in good faith.\textsuperscript{57} The due care inquiry is process-oriented and due care is measured by a standard of gross negligence, not simple negligence.\textsuperscript{58} The burden of proof is on the party challenging the board's decision, to establish facts rebutting the presumption in favor of upholding the decision.\textsuperscript{59} Unless a plaintiff succeeds in rebutting the rule, the court will not substitute its views for those of the board's if the latter's decision can be "attributed to any rational business purpose."\textsuperscript{60} This last point reflects the well-known substantive deference shown by courts to board decisions. As a result of this "hands off" approach, plaintiffs rarely win duty of care cases.

Importantly, the business judgment rule protects only business decisions. The Delaware Chancery Court has ruled that the issue of whether a contract violates Delaware law "does not fall into the realm of business judgment; it cannot be definitively determined by the informed, good faith judgment of the board."\textsuperscript{61} Consequently, audit committee members will be

\textsuperscript{50.} Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000).
\textsuperscript{51.} 746 A.2d 244, 264 & n.66 (Del. 2000).
\textsuperscript{52.} See Aronson, 473 A.2d at 812.
\textsuperscript{54.} \textit{Id.} at 454; see also R. Franklin Balotti & Joseph Hinsey IV, \textit{Director Care, Conduct, and Liability: The Model Business Corporation Act Solution}, 56 BUS. LAW. 35, 56 (2000) ("[T]he business judgment rule applies both to the decision and to the decision-maker, whereas [Model Act] section 8.31 addresses only the individual liability of a director.").
\textsuperscript{55.} Johnson, \textit{supra} note 53, at 454–55; see Aronson, 473 A.2d at 813 ("[T]he business judgment rule operates only in the context of director action. Technically speaking, it has no role where directors have either abdicated their functions, or absent a conscious decision, failed to act.").
\textsuperscript{56.} \textit{Brehm}, 746 A.2d at 264 n.66.
\textsuperscript{57.} \textit{Id.}
\textsuperscript{58.} Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 n.31 (Del. 1993); Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).
\textsuperscript{59.} \textit{Aronson}, 473 A.2d at 812.
\textsuperscript{60.} \textit{Brehm}, 746 A.2d at 264 n.65 (internal quotations omitted) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).
\textsuperscript{61.} Grimes v. Donald, 673 A.2d 1207, 1212 (Del. 1996), overruled on other grounds by
protected by the business judgment rule only for "business" decisions, not for their interpretation of new legal mandates imposed upon them. They may, however, as noted earlier, rely on legal counsel, where appropriate.

B. Statutory Exculpation

Most states, including Delaware, permit stockholders to approve a provision in the company's certificate of incorporation that reduces or eliminates the personal liability of the director for monetary damages. Importantly, the Delaware statute does not eliminate any fiduciary duties of directors; rather, it simply permits stockholders to approve a provision eliminating director liability for damages for a breach of the duty of care. Directors remain subject to equitable relief such as an injunction. Moreover, Delaware's statute does not permit elimination or reduction of liability for breaches of loyalty or good faith. Given the growing judicial interest in reviving the duty of good faith, directors today may face a heightened risk of liability for damages for breaching this duty even if they fulfill their duty of due care. Furthermore, at least in Delaware, corporate officers cannot be exonerated from liability through an amendment to the certificate of incorporation. Consequently, any officer who breaches his or her fiduciary duties, including the duty of due care, faces full liability exposure.

C. Reliance on Experts

As noted in Part II, directors, including those acting as audit committee members, may rely on professionals (e.g., legal counsel) and experts (e.g., financial experts), and other specified persons. Provided that the specific terms of the statute are fully complied with, these statutes can offer important liability protection.

D. Indemnification

States permit indemnification of directors, thereby reducing director exposure even as to matters not exculpated. Indemnification for federal securities law wrongdoing may violate public policy. Consequently, it is important that fiduciary duty breaches continue to be characterized as state

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Brehm, 746 A.2d at 254.
63. See id.
64. See id.
65. See id.
66. See DEL. CODE ANN. tit. 8, § 145(a)–(b); TEX. BUS. CORP. ACT ANN. art. 2.02–1(B) (Vernon Supp. 2004–2005).
law violations in order for directors and audit committee members to be indemnified.

VI. THE INTERACTION OF FEDERAL LAW, SRO RULES, AND STATE LAW ON AUDIT COMMITTEES

A. Overview

First, members of audit committees now have three sources of obligations: federal law, SRO rules, and state law. In a sense, audit committees and their legal counsel now must understand—and be guided by—three different legal "languages." It being unlikely that any of the three sources will go away or that they will merge into a common scheme of regulation, for now lawyers and audit committee members simply must be "tri-lingual."

Second, the legal sky is not falling on audit committees. Federal law and SRO rules now specify in considerably greater detail the composition and functions of audit committees. Efforts to comply with these mandates of course are motivated in large part by a simple desire to be law-abiding. These legal reforms, however, have generated serious (and healthy) self-examination of audit committee practices by directors and lawyers, and will dramatically alter the norms of conduct for audit committees and legal counsel, but they have done so without using increased director exposure to legal liability as a goal or sanction. These reforms have "fleshed out" responsibilities of audit committees in a way state law never has, while still honoring the board and committee governance system established by state law and, importantly, largely leaving to state law the responsibility of evaluating committee performance and determining the personal liability consequences of faulty performance by audit committee members.

Third, there are several ways in which the federal law and SRO mandates on audit committees may intersect with, or be "translated" into, state corporate law concepts. Several of these interactions are examined below.

B. The Allocation of Audit Oversight Responsibility

Notwithstanding federal and SRO mandates on audit committee composition and functions, the committee’s legal position within the corporation’s governance structure, and its relationship to the board of directors, is still prescribed by state law. Section 205 of Sarbanes-Oxley adds a new section 3(a)(58), to the Securities Exchange Act of 1934, which defines an audit committee as a committee "established by and amongst the
board of directors.\textsuperscript{67} The board of directors thus creates the audit committee, delegates audit oversight responsibility to it, and may rely on the committee. It would seem as well that the board itself ultimately remains responsible for discharging the audit oversight function, notwithstanding that the federal definition of an audit committee provides that the committee has "the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer."\textsuperscript{68}

C. Evaluation of Audit Committees

The SEC and the SROs are responsible for assessing audit committee compliance with their respective mandates, but the board of directors and the audit committee itself are subject to evaluation under state law as well. Each body must discharge its specified responsibilities (for example, neither can abdicate nor fail to act, as it should) and the committee, on an ongoing basis, must evaluate its performance. All of this must be done in conformance to the fiduciary duties of care, loyalty, and good faith. For example, SRO rules mandate, among other requirements, that independent directors meet in regularly scheduled sessions and that boards determine whether a particular director is truly independent. These functions must be carried out because of SRO rules but they must also be carried out in compliance with state law fiduciary duties. Moreover, the proliferation of audit committee charters—some quite detailed—provides another means by which audit committees must guide their self-examination, and by which boards must evaluate audit committee discharge of delegated functions, and to which courts (at the urging of plaintiffs' lawyers) may turn in assessing how an audit committee measured up to fulfilling its own description of its duties.


\textsuperscript{68} Id. § 205(a), 116 Stat. at 773–74.
D. Fiduciary Duty Analysis of Audit Committee Conduct Remains a State Law Matter, But It Will Be Influenced By Federal and SRO Mandates

1. The Influence on Duty of Loyalty Analysis

a. The Concept of Independence

In regulating independent directors, Sarbanes-Oxley, the NYSE and Nasdaq, consistent with their rules-based approach, provide more detailed definitions of "independence" than does the state law standard.\(^69\) State decisional law essentially asks whether "a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind."\(^70\) This involves, as one aspect, determining whether a director is under the domination or control of an interested party,\(^71\) or is financially or personally "beholden" to an interested party.\(^72\) The inquiry is not limited to specified relationships, however, and can be quite broad ranging. A court will consider, where specific factual allegations support concern, whether financial ties or personal or professional friendships may raise reasonable doubts as to independence.\(^73\) Moreover, a court will not only evaluate various relationships between committee members and an interested party, it will examine whether committee members in fact functioned independently.\(^74\) Also, Justice Jack Jacobs (sitting as Vice Chancellor) recently noted the importance of a board committee having knowledgeable, unconflicted advisors.\(^75\) The independence inquiry arises in numerous settings, including, for example, in the judicial review of a special litigation committee's handling of derivative litigation,\(^76\) and in the review of a board or committee's approval of a transaction with another director.\(^77\) A court will more deferentially review director decisions in those

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69. But see TEX. BUS. CORP. ACT ANN. art. 1.02(15) (Vernon Supp. 2004-2005) (defining the term "Independent" for a director or other person in detail).
74. See Kahn v. Tremont Corp., 694 A.2d 422, 429-30 (Del. 1997) (stating it is the "care, attention and sense of individual responsibility to the performance of one's duties... that generally touches on independence" (alteration in original) (quoting Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984))).
settings—and, likely, in the audit committee setting as well—if the majority of acting directors are disinterested and independent.\(^78\)

The more detailed, rules-based definitions adopted by the NYSE and Nasdaq certainly govern as to the composition of the board itself and of the audit, compensation, and nominating/governance committees, about which state law says little. They do not, however, preempt state fiduciary standards of independence. Section 301 of Sarbanes-Oxley only addresses independence of the audit committee, not the board itself or any other board committees.\(^79\) The NYSE rules, moreover, specifically state that they tighten the definition of "independent director" for purposes of those standards.\(^80\)

Moreover, the focus of NYSE and Nasdaq definitions is to assure that there is no improper relationship of directors to the company. Senior management greatly influence financial relationships with the company and, consequently, senior management may influence any director with such a material relationship. Delaware’s inquiry looks both at disinterestedness (not mandated by Sarbanes-Oxley or SRO rules and meaning a lack of a conflicting interest) and independence, and as to the latter, pointedly focuses on whether a director is independent of the interested party who has a conflict. One way a director might not be independent is through a direct or indirect (such as familial) relationship with the company, but it may happen in other ways as well. For example, a director of a company about to engage in a transaction with the director’s best friend—whether or not the best friend also is a director—does not automatically disqualify the director from being considered independent under NYSE and Nasdaq rules, because he has no improper relationship to the company. The director may not be independent under Delaware law, however, which looks at beholdenness growing out of not only financial but also “personal or other relationships” with the interested party.\(^81\) State law standards applicable to directors, generally, and audit committee members, specifically, on the issue of independence should not be considered to be

\(^78\) Id. at *11–13; see also In re Oracle Corp., 824 A.2d 917, 928–48 (Del. Ch. 2003).
\(^81\) Oracle Corp., 824 A.2d at 938–39; see also Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 833 A.2d 961, 984 (Del. Ch. 2003), aff’d, 845 A.2d 1040, 1057 (Del. 2004) (“[W]ith a bit more detail about the ‘relationships,’ ‘friendships,’ and ‘inter-connections’ among Stewart and the other defendants ... there may have been a reasonable doubt as to one or all of the outside directors [sic] disinterest, independence, or ability to consider and respond to demand free from improper extraneous influences.”).
preempted in the fiduciary duty context. There simply is no express intention for federal law or SRO rules to "occupy the field" in this area, nor is it the case that it is impossible to comply with both federal and state law on this subject or that state law stands as an obstacle to the accomplishment of federal purposes. There now is, to be sure, dual regulation of directors, but that does not mean, for fiduciary duty purposes, that states are foreclosed from applying their own standards of independence. Legal counsel must not be lulled into believing that directors and audit committee members are "out of the woods" on the independence issue if they do not run afoul of SRO rules.

b. Self-Dealing; Related Party Transactions

The Nasdaq rule—Rule 4350(h)—that a company's audit committee or other independent board committee must approve all related-party transactions does not preempt the state law duty of loyalty governing such transactions because a state may adhere to its own standards for fiduciary duty purposes, but it will likely have that practical effect in substantial part. Currently, under Delaware law, a director conflict of interest transaction may be substantially immunized from attack on loyalty grounds either by taking, usually in advance, certain procedural safeguards—such as making full disclosure of all material facts and obtaining independent and disinterested director approval, or obtaining stockholder ratification, or by the interested party later proving the entire fairness of the transaction to the corporation. Under the Nasdaq rule, approval is mandatory. If done properly, this procedure also will lead to more deferential judicial review for state law fiduciary duty purposes. Specifically, such pre-approved transactions with directors will be reviewed under the business judgment rule, not the stricter "entire fairness" standard. Nonetheless, if for some reason the mandatory Nasdaq procedures were not followed, state fiduciary duty law would still allow the director to prove the fairness of the transaction to the company for the purposes of determining compliance with state fiduciary standards. Moreover, the Nasdaq rule only governs "transactions." Consequently, director or officer actions such as usurping a corporate opportunity, competing with the company, or improperly using corporate assets and information—all of which also implicate the duty of

83. DEL. CODE ANN. tit. 8, § 144 (2001).
85. Id. at *13 n.41.
loyalty—will continue to be governed, in law and practice, only by state law fiduciary standards.

2. The Influence on Duty of Care and Good Faith Analysis

Sarbanes-Oxley and SRO rules impose certain direct responsibilities on those directors who are members of a company’s audit committee, such as engaging an outside auditor, overseeing the auditor’s work, responding to reports from the CEO and CFO concerning internal control problems and from legal counsel concerning evidence of securities law or fiduciary duty violations, and authorizing the services to be performed by the auditor.\(^87\) Sarbanes-Oxley and SEC rules also mandate identification of any financial expert on the audit committee.\(^88\) In addition, SEC rules under section 404 of Sarbanes-Oxley define “internal control over financial reporting” as a process for providing “reasonable assurance regarding the reliability of financial reporting,” requiring such a process to be “effected by the issuer’s board of directors” after being designed by the CEO and CFO.\(^89\) These new federal responsibilities, and others, may influence analysis of the fiduciary duties of care and good faith. These significant new audit committee functions will require a substantial amount of time and are likely to be included within those substantive director functions that must be discharged with due care and good faith, under state fiduciary duty law. Moreover, audit committees will need to develop procedures for evaluating, on an ongoing basis, how they are performing their new functions. Those procedures themselves may form part of the committee members’ duty of care.

More specifically, the reasonableness standard for internal controls may be a higher standard than that adopted in the common reading of Caremark, although that opinion is replete with references to reasonableness.\(^90\) The fact that public company directors must, as a matter of federal law, adopt controls affording reasonable assurance does not necessarily displace the due care fiduciary standard of state law. Nonetheless, faced with a claim that a Delaware company failed to comply with the mandates of Sarbanes-Oxley on internal controls, Delaware courts, especially when reminded of the several references to reasonableness in Caremark itself, may be hard pressed, in the right case, not to draw on, or

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be influenced by, federal mandates as the applicable state law fiduciary standard in the monitoring context. Essentially, depending on the reading given the term reasonable, this would amount to a negligence standard, though state courts could require greater culpability. Moreover, recent case law indicates that deliberate or reckless failure in, or indifference toward, discharging director functions in this area may be construed as a breach of good faith, as would any significant deviations from oversight conduct thought essential if directors truly were motivated to advance corporate interests, the hallmark of good faith. As noted earlier, recent judicial developments and judicial commentary indicate a growing sympathy for shareholder assertions that director misconduct implicates the duty of good faith. Consequently, even if courts do not modify their due care analysis under the influence of federal law, they may regard more egregious director or audit committee deviations from federal and SRO mandates as breaching the duty of good faith. Recall too, that any knowing director failure to comply with the requirements of Sarbanes-Oxley may violate the duty of good faith. In this way, state fiduciary analysis would be influenced by federal initiatives, but not controlled by them. This is significant from a liability perspective as well, because breach of good faith, unlike breach of due care, allows a judgment for money damages against directors under Delaware law.

If Caremark is read to require—for liability purposes—a showing that directors were “conscious” of the fact that they were not doing their jobs, as suggested by Vice Chancellor Strine in Gutman v. Huang, then federal and SRO rules may affect audit committee member liability in two further ways. First, in today’s post-reform world, audit committee members know a great deal about what their jobs entail, thanks to the counsel of lawyers. Second, there is more to the job of being an audit committee member, thanks to federal and SRO mandates. Having more to do and knowing more about what one is supposed to do means that a member failing to do what is required is more likely to be found to be conscious of that failure. The lesson is that audit committee members who fail to do what they know they should do face a heightened risk of state law liability.

Some comfort can be taken in the Vice Chancellor’s conclusion in Gutman that the plaintiffs failed to state a Caremark claim because there were no contentions that:

[T]he company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently

91. See supra Part IV.B.4.
92. Id.
inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation.94

Signaling what conduct he expects would meet the fiduciary standard, Strine continued:

For all I know, the NVIDIA audit committee met six times a year for half-day sessions, was comprised entirely of independent directors, had retained a qualified and independent audit firm that performed no other services for the company, was given no notice of the alleged irregularities by either management or the audit firm, had paid its audit firm to perform professionally credible random tests of management’s integrity in recording revenue and other important financial data, and could not have been expected to discover the accounting irregularities, even when exercising a good faith effort, because discovery required disclosure by management or uncovering by the auditors of conduct deep below the surface of the financial statements.95

Post-reform, well-functioning audit committees should easily meet that standard.

3. Responsibility for Failure of the Audit Oversight Function

One question that will arise in the monitoring area will be whether all directors or only members of the audit committee face liability for oversight lapses associated with faulty internal controls or other breakdowns in oversight of the audit function. Section 301 of Sarbanes-Oxley places direct statutory responsibilities on the audit committee, thereby appearing to override statutes such as section 8.25(d) of the Model Business Corporation Act, which provides: “To the extent specified by the board of directors or in the articles of incorporation or bylaws, each committee may exercise the powers of the board of directors under section 8.01.”96 This statute makes the empowerment of committees a board function. Section 301 of Sarbanes-Oxley also states, however, that the specified responsibilities are reposed in the audit committee “as a committee of the board of directors.”97 Moreover, section 205 of Sarbanes-Oxley defines the audit committee as a committee “established by and amongst the board of directors.”98 This language appears to be designed to honor the state law ordained board and committee

94. Id. at 507.
95. Id.
96. MODEL BUS. CORP. ACT § 8.25(d) (2002).
98. Id. § 205, 116 Stat. at 773 (codified at § 78c(a)(58)(A)).
structure. Although Delaware does not have such a statute, section 8.25(f) of the Model Business Corporation Act99 makes clear that delegation of authority to, or action by, a committee of the board does not alone constitute compliance with a director’s duty of care: “The creation of, delegation of authority to, or action by a committee does not alone constitute compliance by a director with the standards of conduct described in section 8.30.”100 Thus, directors not on the audit committee—or any of the other committees mandated by NYSE and Nasdaq rules—do not satisfy their fiduciary duties simply by delegation to that committee. They continue to have state law monitoring and oversight responsibilities. This will continue to be the case even though Sarbanes-Oxley, NYSE, and Nasdaq rules impose certain duties on the audit, compensation and nominating/governance committees, specifically. At the same time, both the Model Act and Delaware’s statute allow a director to rely on committees of the board of directors.101 Thus, provided the good faith and reasonableness conditions of those director-reliance statutes are met, directors not on a mandated committee should not face liability for misconduct by the mandated committee, as opposed to liability for their own misconduct in relation to the activities of the audit and other mandated committees.

4. Liability of Audit Committee Financial Expert

As to the liability standard for the audit committee financial expert, the SEC adopting release states that it does not contemplate greater liability under federal or state law for that person.

We find no support in the Sarbanes-Oxley Act or in related legislative history that Congress intended to change the duties, obligations or liability of any audit committee member, including the audit committee financial expert, through [section 407].

... Our new rule provides that whether a person is, or is not, an audit committee financial expert does not alter his or her duties, obligations or liabilities. We believe this should be the case under federal and state law.102

100. Id.
101. See DEL. CODE ANN. tit. 8, § 141(e) (2001); MODEL BUS. CORP. ACT § 8.30(e).
102. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110, 5116–17 (proposed Jan. 31, 2003) (to be codified at 17 C.F.R. pts. 228, 229 and 249). Section 228.401(e)(4)(ii) provides that “designation or identification of a person as an audit committee financial expert ... does not impose on such person any duties, obligations or liability” that are greater than would be the case in the absence of such designation and providing that such designation or identification also does not affect the duties, obligations or liability of other
This liability "safe harbor" was not expressly provided for by Sarbanes-Oxley. Moreover, the safe harbor addresses only designation or identification, not the issue of actual conduct by the expert. Finally, absent preemption—for which there is no basis—state law, not federal law, will govern the liability for fiduciary wrongdoing by the financial expert and other audit committee members. The SEC rule will have no ipso facto dispositive legal force in that setting.

Nonetheless, a director having a specialized background may find that background relevant in any judicial assessment of his or her compliance with the duty of care. This language may apply to members of the audit committee and other mandated committees as well. Moreover, alleged failures by an audit committee financial expert to act in conformance with accepted standards and practices—as these continue to develop—may be open to proof by expert witness evidence on evolving customs and practices in corporate governance. Extreme departures from such standards of practice (as these develop) may also raise a good faith issue. For the non-experts on the committee, as to specialized financial matters they may be able to rely on the financial expert under director-reliance statutes, although those state law provisions are in some tension with section 301 of Sarbanes-Oxley, which confers responsibility on the committee itself. Still, the language describing the audit committee as a "committee of the board" suggests a federal intention to honor state law governance of the relationship between the committee and board.

Similarly, the American Law Institute's ("ALI") Principles of Corporate Governance note that the phrase "in a like position" acknowledges 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."

members of the audit committee or the board of directors. Id. at 5126.

103. Id.

104. See id.

105. See MODEL BUS. CORP. ACT § 8.30 cmt. 2 (2002) (stating that the statutory phrase "in a like position . . . under similar circumstances" means "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" (alteration in original)).

106. DEL. CODE ANN. tit. 8, § 141(e); Brehm v. Eisner, 746 A.2d 244, 261–62 (Del. 2000).


108. Id.

Moreover, a director with special skills, background or expertise may have greater responsibility whether or not he or she is designated as an expert. A recent decision of the Delaware Chancery Court,\textsuperscript{110} demonstrates this point. In that case, which involved both a statutory appraisal and a class action asserting breach of fiduciary duty growing out of a "going private" transaction,\textsuperscript{111} Justice Jack Jacobs (sitting in Chancery, by designation) held that a director/committee member with specialized expertise (here, financial expertise) could not defend simply by asserting he had relied on an opinion of the committee's investment bankers.\textsuperscript{112} Justice Jacobs first noted the director's substantial financial experience, which he found to be equivalent, if not superior, to that of the banker, and then rejected the director's reliance argument as implausible.\textsuperscript{113} That determination, in turn, led Jacobs to conclude the director knew or should have known the purchase price was unfair.\textsuperscript{114} Jacobs found that by voting to approve the transaction nonetheless, the director had acted for personal motives, which violated his duty of loyalty and good faith, for which he was personally liable.\textsuperscript{115}

5. \textit{The Continued Importance of the Business Judgment Rule}

As to those responsibilities where the audit committee acts by making decisions, assuming the decision is a business judgment, the business judgment rule should apply. Examples would include committee decisions to hire an auditor, approving audit services, preparing audit committee reports, and deciding how to respond to deficiencies in the internal controls or elsewhere in the audit oversight area, including those revealed by CEO and CFO certifications.\textsuperscript{116} Where the audit committee has responsibilities, but does not exercise business judgment, the business judgment rule is inapplicable. Examples may include supervision of the auditor and reviewing information prepared by management or by the independent auditor. Fiduciary duties continue to govern conduct by the audit committee in these areas.

\begin{itemize}
  \item [111.] \textit{Id.} at *1.
  \item [112.] \textit{Id.} at 39–40.
  \item [113.] \textit{Id.}
  \item [114.] \textit{Id.}
  \item [115.] \textit{Id.}
\end{itemize}
6. *Little Current Case Law on Audit Committee Member Liability or Access to Corporate Investigations; the Dynamic Nature of Fiduciary Duties*

There is relatively little case law on the liability of audit committee members; much of that law, moreover, deals with liability under the federal securities laws.\(^\text{117}\)

The Delaware Chancery Court has considered whether a plaintiff can use section 220 of the Delaware corporate statute (the "books and records" statute)\(^\text{118}\) to obtain the results of an audit committee’s investigation into possible wrongdoing, where the committee used legal counsel and asserted attorney-client privilege and work product protection. In *Chinn v. Endocare, Inc.*, the chancery court held that a forensic accounting report prepared for the audit committee at the direction of the committee’s legal counsel was not protected because it was shared with the outside accounting firm that was under investigation.\(^\text{119}\) In *Saito v. McKesson HBOC, Inc.*, disclosure under section 220 was denied as to materials given to the SEC under a confidentiality agreement.\(^\text{120}\)

Although currently undeveloped, it can reasonably be expected that case law will grow as state law fiduciary duties are reinterpreted in light of recent federal and SRO changes and altered expectations of directors and audit committee members. Along this line, it is worth recalling both an obscure, but telling, comment in the ALI's Principles of Corporate Governance and a more prominent statement by Vice Chancellor Strine. The ALI comment states: "[T]he ‘duty’ . . . component[] of duty of care provisions [is] . . . flexible and dynamic . . . [O]bligations may change over time to reflect new conditions or revised business practices or mores. Duty of care provisions should be interpreted in the light of contemporary conditions."\(^\text{121}\) Vice Chancellor Strine stated: "Enron might exert pressure

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118. DEL. CODE ANN. tit. 8, § 220 (Supp. 2004).


121. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a) cmt. b (1994); see also Paul H. Dawes, Caremark and the Duty of Care, in SECURITIES LITIGATION 2000, 219, 225 (PLI Corp. Law & Practice, Course
on courts to look more carefully at whether directors have made a good faith effort to accomplish their duties.”

VII. MISCELLANEOUS STATE LAW CHANGES

States have responded to concerns about corporate corruption in a variety of ways. For example, a couple of states now follow Sarbanes-Oxley in regulating loans. Colorado, for example, prohibits loans to members of the board of directors. Ohio law now provides that issuers filing registration statements with the division of securities must require that any outstanding loan to an officer, director, five percent shareholders, managers, trustee or general partner must be repaid within six months of offering securities. Any future loan to those persons must be for a bona fide business purpose and must be approved by a majority of disinterested directors, managers, trustees or general partners. Under Connecticut law, the CEO and CFO of each publicly held corporation must certify financial statements. Illinois makes interfering with an audit a violation of state securities law.

VIII. RETHINKING THE LEGAL AND ETHICAL ROLES OF CORPORATE LAWYERS IN CORPORATE GOVERNANCE

A. Audit Committee Reform and the Corporate Lawyer’s Ethical Role

Audit committee reforms—whether from Sarbanes-Oxley, SEC rules or SRO rules—reflect a perception that our corporate governance system broke down in the late 1990s. These reforms reflect a sharp break from the longstanding belief that boards of directors—given wide latitude under state

Handbook Series No. B-1199, 2000) (“That directors owe their organizations a duty of due care is a venerated standard of business law, widely if not universally accepted by the legal and financial community. The understanding of what that duty entails, however, has changed significantly over time.” (emphasis added)); JEREMY BACON & JAMES K. BROWN, CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD 75 (1975) (discussing a director’s duty of care and stating that “due care is flexible”; that “circumstances which may be relevant in any particular case” in determining the obligations imposed by the duty of care, including “the general customs or ways of doing things in the particular type of business”).

122. Strine, supra note 41, at 1373.
125. Id. § 1707.131(C)(2)(b).
The law—will, for the most part, eventually adopt healthy governance practices. These reforms wrest from the boards and senior officers some of their long-held discretion over the audit function. The audit function, essentially, is about developing well-functioning processes for generating full, reliable company information—information about financial and compliance matters. By specifying the composition and certain functions of audit committees, federal law and SRO rules hone in on audit committees as a central mechanism in this vital information generating function.

This development parallels the new focus on the lawyer's role in corporate governance. Just as reformers feared “capture” of auditors by senior management, so they feared capture of corporate counsel. Section 307 of Sarbanes-Oxley and the SEC reporting up rule seek to reemphasize the lawyer's legal role as counsel to the corporation, and redirect the norms of lawyer behavior and professional self-identity away from representing senior management and toward representing the corporate enterprise itself. Thus, lawyers with “evidence” of wrongdoing—key corporate information—must, if lacking an appropriate response by the CEO or CLO, take that information to the audit committee or board of directors. How audit committees and boards at large numbers of companies respond to reports of wrongdoing will likely influence whether the SEC adopts a further rule requiring that lawyers “report out” those misdeeds. For now, lawyers are charged with transmitting one particular kind of internal corporate information to the all important audit committee—evidence of legal wrongdoing. That the audit committee itself is permitted to retain its own separate legal counsel simultaneously reflects lingering concern over the allegiance of corporate counsel and underscores the audit committee’s pivotal role in corporate decision-making and, hence, its need for independent counsel.

These legal rules—controversial within the business bar—can be expected, over time, to influence how lawyers perceive their own professional roles. It is likely that lawyers not only will more self-consciously identify themselves as lawyers for “the board” or “the audit committee”—rather than “management”—but also that, over time, corporate lawyers, unlike litigators, will, as to internal governance matters, develop stronger identities as “gatekeepers” and not purely “advocates.” Those lawyers desiring to retain as their professional identity the more traditional role of advocate, may more sharply identify themselves as advocates for the enterprise, not for senior officers who may, at times, act at odds with corporate interests.
B. Corporate Lawyers and the Limits of Ethical Rules

In his insightful new book on the fall of Milbank, Tweed bankruptcy lawyer John Gellene, Professor Milton C. Regan, Jr.128 explores reasons why corporate/transactional lawyers may tolerate conflicts of interest in corporate representation. He identifies three chief reasons why, historically, conflicts may be considered less urgent by corporate lawyers than by litigators.129 First, professional rules speak more explicitly and clearly to litigation than to corporate work;130 second, transactional clients tend to be more tolerant of conflicts;131 and third, transactional lawyers work closely with investment bankers who have tended to be lenient about conflicts.132

In the past, corporate lawyers might have found murkier constraints as to their responsibilities in professional rules, drawing instead on widespread conventions and practices; clients might have tolerated conflicts to lower transaction costs and to gain a reputational intermediary with extensive contacts who could enhance trust and cooperation and ease the task of finding common ground in negotiated transactions. Lawyer and client beliefs about professional responsibilities are now undergoing fundamental rethinking.133

129. See id. at 314–21.
130. See id. at 314.
131. See id. at 316–17.
132. See id. at 317–21.
APPENDIX


§ 141. Board of directors; powers; number, qualifications, terms and quorum; committees; classes of directors; nonprofit corporations; reliance upon books; action without meeting; removal.

(e) A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.


Art. 2.41. Liability of Directors and Shareholders in Certain Cases

D. In the discharge of any duty imposed or power conferred upon a director, including as a member of a committee, the director, may in good faith and with ordinary care, rely on information, opinions, reports, or statements, including financial statements and other financial data, concerning the corporation or another person, that were prepared or presented by:

(1) one or more officers or employees of the corporation;
(2) legal counsel, public accountants, investment bankers, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
(3) a committee of the board of directors of which the director is not a member.

A director is not relying in good faith within the meaning of this Section if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by this Section unwarranted.