Confidentiality Obligations for Directors and Officers in a Firm

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Confidentiality Obligations

• Introduction
  – Duty of confidentiality of a director and officer raises many sensitive legal and prudential issues
  – Week does not go by without situation raising a legal issue related to confidentiality
  – Must, therefore, be of major concern to corporate counsel and corporate legal advisors
• Introduction (cont’d)
• Outline of presentation
  – Legal and equitable foundations for duty of confidentiality
    • With several hypotheticals or examples of violations
  – Practical consequences of breach of duty
  – Conclude with general guidance on recommended company training and policies on the duty
• Legal and equitable foundations of the duty
  – Primary foundation is corporate law duty of loyalty (based on agency law)
    • Includes duty not to use corporate property (including information) for personal gain
      – Model Business Corporation Act § 8.31(a)(2)(v) (oblique reference to this use)
      – Would cover the use of confidential corporate information
    • There are easy and difficult cases
• Legal and equitable foundations of the duty (cont’d)
  – Duty of loyalty (cont’d)
    • Cases
      – What if an executive and a director, without knowledge of the board, engaged in exploratory discussions with a private equity firm interested in acquiring the company? Would it matter that they expected to be retained if the private equity firm succeeded in acquiring the company?
        » Recent situation at Dow Chemical (which dismissed director and officer and sued them for breach of fiduciary duties)
Legal and equitable foundations (cont’d)

– Duty of loyalty

• Cases

– What if a director, with the tacit knowledge of several other directors, regularly speaks with an industry reporter about viewpoints expressed in the boardroom? It is not obvious that this director personally gains from the discussion (other than to be cited in the press) or that the corporation suffers from the media articles that result.

» Hewlett-Packard: a similar situation was the catalyst behind the “scandal” at HP, with its illegal investigation of the boardroom “leak.”
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• Legal and equitable foundations (cont’d)
  – Duty of good faith
    • A duty that has received more jurisprudence lately
    • Avoid “intentional dereliction of duty, a conscious disregard for one’s responsibilities,” In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 66 (Del. 2006)
    • Considered to be part of duty of loyalty, see Stone v. Ritter, 911 A.2d 362 (Del. 2006)
    • But does not require a personal benefit
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• Legal and equitable foundations (cont’d)
  – Duty of good faith (cont’d)
    • Serious consequences, as in all duty of loyalty violations
      – Not a duty of care violation
      – No relief from damages, no indemnification, insurance (unless settlement)
    • What if a director or officer, without any purpose of personal gain, reveals confidential information about the firm at a dinner party? Does this rise to the level of conscious disregard of duty?
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• The “minefields” of the federal securities laws—second legal area of concern
  – Insider trading
    • Prohibition under Section 10(b) of the Exchange Act and Rule 10b-5 for using material inside information in connection with securities trading
      – Of course, such use may also give rise to corporate law claim
    • Reaches both direct and indirect trading
      – Passing along the information (“tipping”) in return for a benefit, which may be intangible
• Federal securities laws (cont’d)
  – Insider trading
    • Is it worthwhile for a director/officer to test the reach of the prohibition on insider trading?
      – What if a Chair/CEO reveals material inside information about his firm’s declining prospects to his wife, but only if she pledges to keep it confidential? She passes it along to her brother for his trading purposes, but only after telling her director/husband (but on New Year’s Eve) that she plans to do so.
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• Federal securities laws (cont’d)
  – Insider trading (cont’d)
    • Cases (cont’d)
      – SEC v. Rocklage, 470 F.3d 1 (1st Cir. 2006)
        » Interesting case that tests the reach of misappropriation theory, i.e., can you deceive someone if you tell them that you are breaking confidentiality?
      – Nonetheless, director suffers reputation harm
        » But wife and tippee brother are targets of SEC enforcement under misappropriation theory
• Federal securities laws (cont’d)
  – Insider trading (cont’d)
    • Cases (cont’d)
      – What if a director of Company A learns from the CEO that another public firm, Company B, in which Company A has invested, is the target of a buyout offer? The director then purchases call options in the stock of Company B. Has director traded on inside information in violation of Section 10(b)?
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• Federal securities laws (cont’d)
  – Insider trading (cont’d)
    • Cases (cont’d)
      – Under federal law director owes no duty of confidentiality, United States v. O’Hagan, 521 U.S. 642 (1997), to Company B, or not without other facts, such as that Company A entered into a confidentiality agreement with it
        » Perhaps a corporate law violation, given director’s use of information “belonging” to, or obtained while working for, Company A
• Federal securities laws (cont’d)
  – Under agency law, as well as federal securities law, company is liable for material misstatements or omissions of its directors/officers or other agents
    • Basic v. Levenson, 485 U.S. 224 (1998) (i.e., “we know of no merger”)
  – What if a director reveals confidential information about a company’s strategic plans (not for personal benefit), but it is distorted as it makes its way into the market (i.e., coming out more positive than intended)?
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• Federal securities laws (cont’d)
  – Regulation Fair Disclosure
    • No intentional selective disclosure to securities professionals or securities holders without simultaneous public disclosure of the same information
    • 17 C.F.R. §§ 243.100-.103 (2007); enforced by SEC, with full range of sanctions against director or officer
    • Thus, side conversations by a director or officer with analysts or large investors have to be discouraged
  – Other securities laws are relevant for confidentiality
    • E.g., Rule 14e-3 (prohibiting director and officer, among others, of a target or bidder in a tender offer from disclosing material nonpublic information about the offer)
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• Privacy law concerns
  – Unlikely to be directly implicated in most situations
    • But remember Hewlett-Packard, which involved violations of Calif. Penal Code when HP agents obtained personal identifying information for the leak investigation
  – Moreover, customer nonpublic personal information is subject to protection from retransmission, and to safekeeping
  – Confidentiality obligations are thus enhanced for this kind of information
    • In the financial institution setting: broker brings customer nonpublic personal information to his or her new firm
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• Practical considerations for confidentiality
  – Damage to board/executive team collegiality and effectiveness from a breach
    • Free expression in boardroom is needed for board members to offer guidance, counsel to CEO
      – We forget that the board is not simply a monitor
    • Leak of discussions can undermine this expression and create suspicion
• Practical considerations (cont’d)
  – Damage to collegiality (cont’d)
    – What if the remarks of a director, who was acting as a “devil’s advocate” during a meeting of independent directors, are leaked into public domain and taken out of context, or simply disclosed within the firm to the CEO?
      » At a minimum, damage to director/CEO relationship
      » Free expression is checked; reputation harm to firm (i.e., known as a place of in-fighting)
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• Practical guidance
  – Confidentiality must be part of firm’s code of ethics
    • Disclosure of code is required under Sarbanes and SEC Rule, 17 C.F.R. § 229.406; code is required by NYSE and Nasdaq
      – NYSE specifically requires confidentiality policies in the code
  – Code should have clear penalties for intentional and inadvertent violations of duty
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• Practical guidance (cont’d)
  – Must be subject for new director/officer/employee training
    • Enhanced training in public company
    • Confidentiality commitments/agreements from directors/officers/employees
  – Continuing education for new developments
    • E.g., Hewlett-Packard as case study
    • Developments in privacy law
  – One spokesperson for the company
• Comments, questions?
  – Are there other areas implicated by a breach of confidentiality?
    • E.g., Provisions in employment agreements regarding post-termination conduct

• Wrap-up