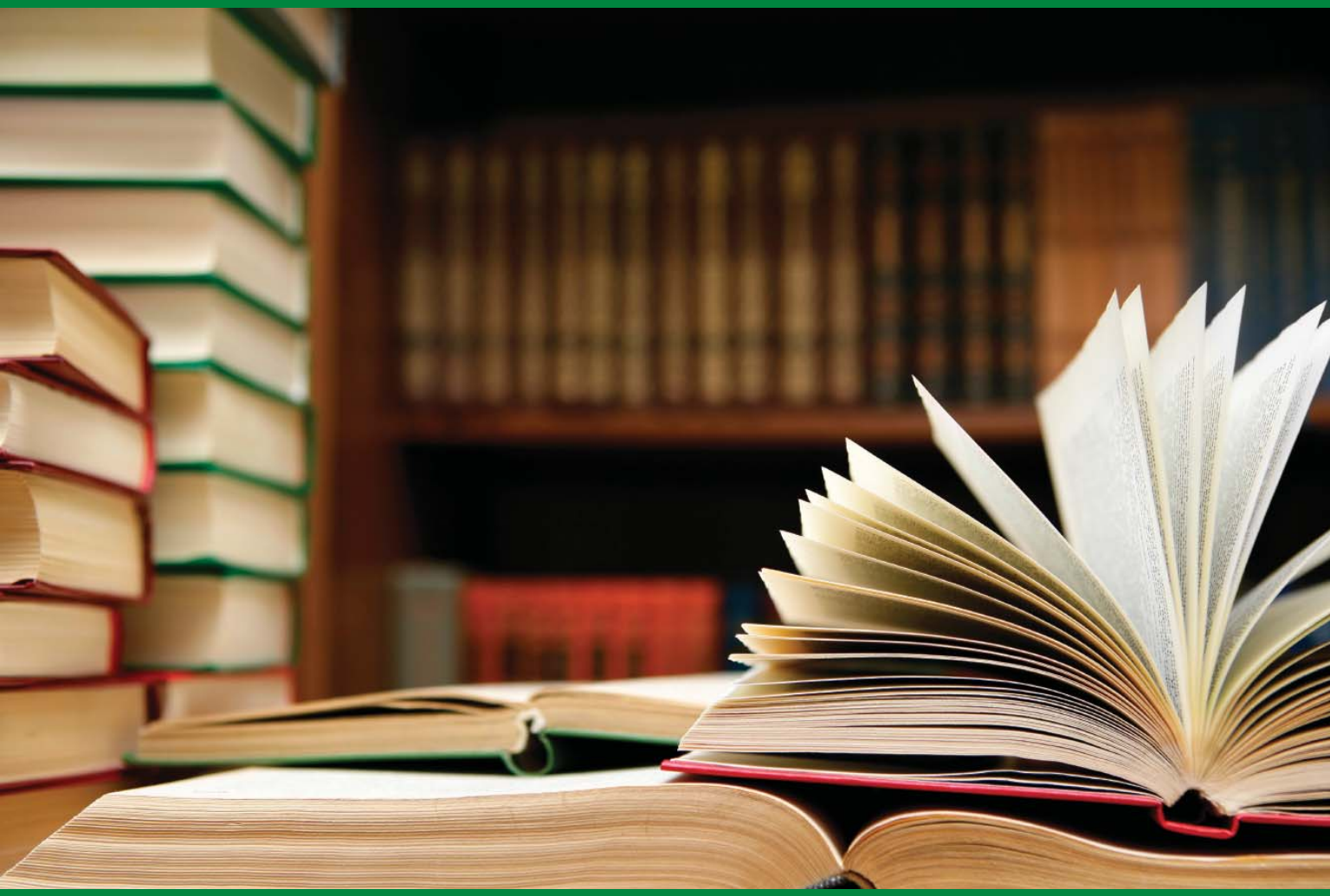
NEW YORK STATE BAR ASSOCIATION
Journal
JUNE 2010
VOL. 82 | NO. 5



I Don't Need Your Authority

The Use of Learned Treatises in New York State Courts

by Eric Dinnocenzo

Also in this Issue

Reprinted with permission from the New York State Bar Association *Journal*, June 2010, Vol. 82, No. 5,
published by the New York State Bar Association, One Elk Street, Albany, New York 12207.

Corporate Governance: An Expert Can Make a Difference in Litigation

By Sheryl L. Hopkins, H. Stephen Grace, Jr., and John E. Haupert

The current economic crisis has once again focused the spotlight on corporate governance issues. Past board and management actions are being scrutinized in the numerous securities fraud, breach of fiduciary duty, and ERISA actions that have been filed in the aftermath of the stock market decline in 2008 and 2009. Whether considering the propriety of board and management actions in consummating recent mergers and acquisitions, such as Bank of America's acquisition of Merrill Lynch, or considering the actions of the board in carrying out its responsibilities in the Countrywide securities fraud litigation, corporate governance issues are at the center of this litigation. This article will address how the testimony of corporate governance and management practices experts can be utilized in this and other litigation, and who is qualified to testify as a corporate governance expert.

Corporate Governance Practices Are at Issue in a Variety of Causes of Action

Roles, responsibilities, practices, and processes of both the board and management are at issue in a variety of causes of action. For example, breach of fiduciary duty actions against directors asserting that directors have failed to properly exercise their oversight or decision-making functions or have acted in bad faith or in their own self interest obviously require an understanding of how boards and management function and the standard business practices and processes of corporate governance that may be applicable. Similarly, securities violations claims may require an understanding of the roles and responsibilities of directors and individual corporate officers to determine whether fraudulent intent is present or whether a due diligence defense is available. And even common law fraud claims involving complex business decisions may

Sheryl L. Hopkins, J.D., MBA (shopkins@hsgraceco.com) is a member of the Board of Advisors of Grace & Co. Consultancy, Inc. and a former practicing attorney with Akin Gump and Vinson Elkins.
H. Stephen Grace, Jr., Ph.D. (hsgrace@hsgraceco.com) is president of Grace & Co. and former chair of Financial Executives International.
John E. Haupert (haupertd@bellsouth.net) is a member of the Board of Advisors of Grace & Co. and former treasurer of the Port Authority of New York and New Jersey [www.hsgraceco.com].

implicate corporate governance issues in explaining how and why decisions were made and what structures were in place to ensure good decision making to address issues of fraudulent intent and misrepresentation.

Corporate Governance Testimony Is Specialized Knowledge Which Can Be Helpful to Courts and Juries Under Fed. R. Evid. 702

In the context of these actions, courts and juries are increasingly asked to assess and evaluate complicated business decision-making and oversight decisions. Good business decisions sometimes have bad outcomes. To avoid having these types of cases tried by hindsight, it is important that the trier of fact understand the context in which business decisions are made as well as good corporate governance and management practices and processes for making decisions. Business mores and governance practices evolve over time. What steps should be taken, procedures followed, and information considered in making these and similar decisions? What are the roles and responsibilities of the individual officer and director in this process? These are complicated questions whose answers are important to the fact finder.

But executive compensation issues, provisions in mergers and acquisition agreements, financial decision-making issues, director oversight responsibilities, and disclosures in financial statements or SEC filings, to name a few, are not exactly everyday stuff within the common experience of most courts and jurors. Testimony explaining both the context in which the board or management acted and customary business practices, standards of conduct and procedures for boards or management can, therefore, be helpful to the court or the jury in deciding the case.

Federal Rule of Evidence 702 recognizes that expert testimony is admissible where "specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue." Courts have for some time recognized that complex corporate management process and practice issues are beyond common experience and may require expert clarification.[1]

The following three real-life examples, based on the experiences of the firm with which the authors are associated, demonstrate how attorneys can use corporate governance and management practices experts in breach of fiduciary duty, securities violations, fraud, bad faith claims and other cases.

Breach of Fiduciary Duty Claim Against Independent Directors

In breach of fiduciary duty actions against directors and officers, the court or the jury must determine whether directors and officers acted in an informed manner with the best interests of the corporation in mind and in good faith. To help make these determinations, expert testimony is useful to explain both the context in which the directors or officers acted and customary business practices, standards of conduct and processes considering the specific circumstances. The following breach of fiduciary duty action against the independent directors of a bankrupt corporation illustrates how corporate governance and management practice testimony can be used in these types of cases.

In this case, the liquidating trustee of a creditor trust established in connection with a Chapter 11 plan of reorganization sued the independent directors of a twice–bankrupt energy company asserting: (1) the independent directors elected after the corporation first emerged from Chapter 11 had breached their fiduciary duties by pursuing business strategies that were excessively risky and not in the corporation's best interests; and (2) the directors knew these risky strategies represented a material conflict of interest between the CEO and the corporation, since these strategies offered the CEO the only opportunity to regain control of the corporation. Specifically, the plaintiff alleged that the independent directors had abdicated their corporate governance responsibilities, approved the expenditure of large sums of money in high-risk oil and gas exploration ventures, and engaged in self-dealing.

Courts have recognized that complex corporate management process and practice issues are beyond common experience and may require expert clarification.

The corporate governance expert reviewed the allegations and addressed each allegation to determine if customary business practices and processes were followed. The expert found that the independent directors had acted appropriately for the following reasons:

- The oil and gas industry is inherently a risky business and risk sharing is a business judgment.
- The directors were independent and were not excessively compensated; there was no self-dealing.
- The independent directors were well informed and appropriately interacted with and relied on management and exercised experienced and reasonable judgment in addressing their responsibilities in an effort to make the reorganized entity a success.
- Certain senior creditors in the first bankruptcy proceeding, operating as a bondholder committee, negotiated the CEO's employment agreement and incentives and were directly involved in the selection of the independent directors. The company's strategy was developed and put in place by the bondholder committee as part of the Plan of

Reorganization, which was approved by the court. The strategy was based on the bondholder committee members' experience with the CEO and on their belief that he was a talented natural resources finder.

- The CEO would never have regained control of the corporation under the employment agreement negotiated by the bondholder committee, even if the plan had been successful. These senior creditors, regardless of the success of the reorganized firm, would have retained control. In fact, the employment contract anticipated the bondholder committee members would replace the CEO if the plan was successful.
- The damages claimed by the plaintiff in the form of loss of value were speculative and not based on any evidence; the actions of the independent director did not cause any damages.

This analysis helped explain the context in which the independent directors had acted, to show that they had acted in an informed manner with the best interests of the corporation in mind and in good faith. The case was ultimately dismissed on the defendant's motion for summary judgment.

Good Faith and Bad Faith Claims

Corporate governance and management practices experts may also offer helpful testimony in other types of complex commercial litigation. The following embezzlement case, in which the plaintiff claimed direct and consequential damages of almost $19 million against the defendant bank, again shows how testimony on corporate governance and management practices can be used effectively.

Two of the plaintiff's employees embezzled almost $1 million over several years from their employer by setting up a fictitious bank account at the defendant bank. The embezzlement resulted in the plaintiff company's insolvency. The company sued the bank asserting that the bank was negligent, acted in bad faith, and failed to follow reasonable commercial standards of fair dealing by opening the account and accepting checks and wire transfers into the fictitious account without proper endorsement. After reviewing the evidence in the case, the corporate governance expert, testifying on both liability and damage issues, refuted the plaintiff's claims, as follows:

- The two employees had commenced their embezzlement scheme several years before the fictitious account at the defendant bank was opened, a fact unknown to the plaintiff at the time it filed the initial petition. In fact, the employees had employed fictitious accounts at three other banks prior to opening the account at the defendant bank and had embezzled a total of almost $2 million through the fictitious accounts at multiple banks.
- The embezzlement resulted from both a lack of and failure of internal controls at the plaintiff's company and from a highly unusual and inappropriate delegation of responsibilities by the company's owner.
- Significant problems with the timely and accurate production of financial statements by the plaintiff also contributed to the lax environment, which allowed the two employees to undertake and continue the embezzlement scheme for several years.
- The plaintiff company's damage claims were not supported by the evidence.

After an extensive trial, the jury found that the plaintiff had direct damages of only $120,000. The jury further found that the plaintiff itself was responsible for 95% of this $120,000 in damages and that the defendant bank was responsible for only 5% of the damages or $6,000. The jury also found there were no consequential damages.

Securities Violations Claims

Claims for violations of the 1933 Securities Act and the 1934 Securities Exchange Act against companies, directors and officers frequently require an understanding of the roles and responsibilities of directors and individual corporate officers to determine whether fraudulent intent is present or whether a due diligence defense is available. The following Rule 10b-5 claim by the SEC against a CEO demonstrates the types of issues where corporate governance testimony may assist the fact finder.

The SEC sued the defendant CEO of a software company claiming that the CEO had intentionally orchestrated the misstatement of the company's financial statements through an accounting fraud, which ultimately resulted in a restatement. The SEC further asserted that the CEO's certification of the restated financial statements was an admission of wrongdoing. While at first glance, this case might appear to have called exclusively for accounting expert testimony, the real issue in the case was not whether the accounting was right or wrong, but whether the non-accountant CEO had exercised appropriate judgment in addressing the accounting issues and in relying on accounting professionals.

The defendant's corporate governance expert evaluated the allegations and explained how companies are organized and what the CEO's role and duties were in this situation as follows:

- All companies must rely on a division of labor to operate.
- By necessity the CEO must rely on the expertise of others within the company to fulfill the duties and obligations in his or her role in the overall management of the company.
- The proper accounting for transactions under generally accepted accounting principles (GAAP) is not always a black-and-white issue and requires accounting expertise.

- The CEO was not an expert in accounting and had the right, in this instance which involved complicated accounting issues not fully resolved by the accounting rules, to rely on the accounting judgment of both internal and external accounting professionals as to the proper way to account for the transactions in question.
- The CEO had not ignored his duties, but rather had diligently performed those duties by seeking the advice of experts in an effort to fulfill his obligations.

This analysis was helpful in establishing that the CEO had acted appropriately without fraudulent intent. The case was settled for a nominal five-figure sum after the judge stated at a pre-trial hearing that he did not believe a fraud charge could be supported at trial.

Who Is Qualified to Testify as a Corporate Governance Expert?

Once it is determined that the testimony of a corporate governance expert would be helpful to the trier of fact to understand the evidence, the next question is, Who is qualified to testify as a corporate governance expert? Courts, in the exercise of their gatekeeper role under Federal Rule of Evidence 702, must decide at the outset who is qualified to testify as a corporate governance expert. Under Federal Rule of Evidence 702, a witness can be qualified as an expert "by knowledge, skill, experience, training, or education." Courts reviewing academic credentials have qualified practicing attorneys, law school professors, MBAs, microeconomists, and CPAs as corporate governance experts. But not every attorney, MBA, accountant or economist is qualified to testify as a corporate governance expert. Thus, the need to clarify what other qualifications should be expected of those who represent themselves as qualified corporate governance experts.

The Advisory Committee notes to Federal Rule of Evidence 702 (2000 amendments) recognize that in some fields experience may be the "predominant, if not sole basis, for a great deal of reliable expert testimony." Courts must look beyond a proposed expert's academic or technical training credentials when determining whether that expert is qualified to render an opinion in a given area. They must also examine the full range of the expert's practical experience.[2] Experience may trump academics in many situations. For example, a Ph.D. in food science qualified by education may be able to explain what pathogens contaminate food, but if the question at issue is customary safety practices and processes used in a kitchen to avoid food contamination, a chef with years of experience in preparing food is more qualified than the food scientist to answer this question. Similarly, a mechanical engineer may be able to explain the forces at play on a racehorse's legs in running a race, but if the issue is what to do to avoid injury in running a race, a jockey qualified by years of practical experience in riding horses in races can more credibly answer the question than the mechanical engineer.

Similarly, those with practical experience in corporate governance are generally better able to explain good corporate governance practices than those simply qualified by academics. Courts, for example, have focused on experience in both corporate law and securities law in qualifying attorneys as corporate governance experts. Lawyers testifying on corporate governance issues, however, may have their testimony excluded, or at least limited, based on the well-recognized principle that experts cannot testify about legal issues. In court, there is only one legal expert – the judge.[3]

In the management area those with actual, real-world upper-level management or board experience are qualified to testify on corporate governance practice issues. Those who have sat on or advised boards and been involved in making key decisions understand the process and the structures necessary to govern an organization effectively and fairly. General knowledge of the primary activity areas within companies, i.e. production, marketing, finance and accounting, legal, research and development, human resources, external relations, and IT is required, as well as an understanding of both formal and informal organizational structure.

Those with practical experience in corporate governance are generally better able to explain good corporate governance practices than those simply qualified by academics.

Experience with external financial reporting processes and other corporate communications, including annual filings, interim filings, proxy statements, other SEC filings and SOX requirements, is frequently important. Knowledge of how oversight and control systems and checks and balances, both formal and informal, actually work within an organization is key. Such systems go well beyond review of the income statement and balance sheet and must focus on operating cash flows, capital expenditures and other key value drivers. Familiarity with the functioning and structure of board committees such as the audit committee, the compensation committee, the

nominating/governance committee, and the evolving risk management committee can also be useful.[4] The ability to explain the uncertainties involved in making business decisions and the processes, practices, and information necessary to make good decisions may best reside in those who have made these decisions.

Conclusion

The testimony of a corporate governance expert can be helpful to the jury in a variety of causes of action, especially where complex business decision-making practices and processes are at issue. Breach of fiduciary duty cases, securities violations claims and, frequently, fraud and bad-faith claims all include issues that implicate the management decision-making process and actions. Understanding the roles and responsibilities of officers, directors and others with decision-making authority and the processes and structures in place in a business entity to ensure good decision making is important in these cases to help the trier of fact place the decision in the proper context of what was known at the time the decision was made. Practicing attorneys, law school professors, microeconomists, MBAs and CPAs have all been qualified as corporate governance experts by the courts, but education in law, economics, or management is not alone sufficient to qualify one as an expert in corporate governance. A corporate governance expert should also have practical experience in dealing with corporate governance issues – both to qualify as an expert and to enhance his or her credibility with the trier of fact. ■

1. *See, e.g.*, *Bauman v. Centex Corp.*, 611 F.2d 1115, 1120–21 (5th Cir. 1980) (corporate management issues may be complex and require expert testimony; the court admitted expert testimony of management consultant on corporate finance issues)

2. *United States v. Parra*, 402 F.3d 752, 758 (7th Cir. 2005).

3. *See, e.g.*, *Askanase v. Fatjo*, 130 F.3d 657, 673 (5th Cir. 1997).

4. *See* H. Stephen Grace, Jr. & John E. Haupert, *Corporate Governance Consultants: The Issue of Qualifications*, NACD – Directors' Monthly (May 2007).

H.S. Grace & Company, Inc.

H. Stephen Grace, Jr., Ph.D., President
Steve Grace, Director of Operations

H.S. Grace & Company, Inc. specializes in helping clients solve complex business challenges. Our team of senior executives offers unparalleled depth and breadth of experience to comprehensively analyze issues and identify optimal resolutions.

Our consulting falls into four broad areas: corporate governance; litigation; financial advisory services; and business consulting.

H.S. Grace & Company, Inc. clients draw upon the talents of founder Dr. H. Stephen Grace, Jr. and more than 30 current and former executive officers and board members of major public and private corporations. Together we offer more than 1,000 years of executive leadership experience across a broad range of industries.

We can help diagnose and resolve the complex issues companies face to enhance shareholder value, protect reputation and long-term ability to succeed, manage litigation, and successfully navigate major changes such as mergers and acquisitions or bankruptcies. H.S. Grace & Company, Inc. brings unparalleled experience, a comprehensive approach and valuable insights to the table.

Grace & Co. Consultancy, Inc., Board of Advisors

Holly A. Borkin
Vice President of Investor Relations (Ret.), Grand Metropolitan PLC (now Diageo); Board of Directors (Ret.), NYC Partnership

James N. Clark
Board of Directors, and Executive Vice President and CFO (Ret.), Western & Southern Life Insurance Company; Former Chairman, Financial Executives International

George Cox
Managing General Partner (Ret.), Park Central Ltd.

Jeffrey E. Curtiss
Director and Audit Committee Chairman of KBR, Inc.; Former CFO, Service Corporation International and Browning-Ferris Industries; Current Secretary, CFA Society of Houston; Former Secretary, Financial Executives International

R. Hartwell Gardner
Board of Directors, Pioneer Natural Resources; Treasurer (Ret.), Mobil Corporation; Former Chairman, Financial Executives International

Edward A. Grun
Director, Gensler Worldwide

John E. Haupert
Treasurer (Ret.), The Port Authority of New York and New Jersey

Sheryl L. Hopkins
Former Practicing Attorney, Akin Gump, Vinson & Elkins, Locke Lord (f/k/a Locke Purnell), Gordon Arata (Management Committee)

Peter Howell
Direktor, Credit Risk Management (Ret.), Deutsche Bank A.G.

Steven B. Lilien
Weinstein Professor of Accounting and Former Chairman of the Stan Ross Department of Accounting at Zicklin School of Business, Baruch College; Director of Center for Financial Integrity, Baruch College

Nicholas J. Lomonte
Vice President Finance (Ret.), ABB Lummus Global Inc.

Martin G. Mand
Executive Vice President & CFO (Ret.), Nortel Networks; Vice President & Treasurer (Ret.), DuPont Company; Former Chairman, Financial Executives Research Foundation, Inc.

Khalid S. Masood
Finance Director (Ret.), Hub Power Co., Karachi, Pakistan

S. Lawrence Prendergast
Executive Vice President of Finance & Director (Ret.), LaBranche & Co. Inc.; Chairman & CEO (Ret.) and Director, AT&T Investment Management Corp.; Former Chairman, Financial Executives Research Foundation, Inc.

Francis C. Regnier
Former CEO, Montaigne Diffusion (LACOSTE), Paris, France

Robert S. Roath
Board of Directors and Audit Committee Chair, InterDigital Communications Corporation; Chairman of Advisory Board, L.E.K. Consulting; Former CFO, RJR Nabisco

The Honorable William M. Schultz
Former United States Bankruptcy Judge, Southern District of Texas

Ronald H. Wilcomes
Vice President and Investment Counsel (Ret.), MetLife Insurance Co.

Alfred L. Williams
Former CFO of Tenneco Gas, Arcadian Corp., Moorman Manufacturing, Global Industrial Technologies, Inc.; Director of Audit Worldwide for Tenneco, Inc.

Walter C. Wilson
Former Senior Vice President and CFO, EOG Resources, Inc.; Trustee, Financial Executives Research Foundation, Inc.

www.hsgraceco.com

Houston: 4615 Southwest Freeway, Suite 625 • Houston, TX 77027
(713) 572-6800 • Fax (713) 572-6806

New York: 300 East 57th Street, #18A • New York, NY 10022
(212) 644-8620 • Fax (212) 813-1779
Email: hsgraceco@hsgraceco.com