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Directors' Fundamental Responsibilities Are Not Changed By SEC Enforcement Action in Chancellor Corp.

The theme of our June 17, 2003 memo that the business judgment rule is alive and well is not affected by the SEC proceeding against an outside director of Chancellor Corp., even as explicated by SEC Director of Enforcement Stephen Cutler. Directors who are reasonably diligent and who do not ignore red flags will not be faulted under state law or the federal securities laws. But the Chancellor enforcement action does emphasize the need to exercise due care in monitoring compliance, corporate performance and disclosure.

In Chancellor, the SEC found that an outside director of the company, who also served on the company's audit committee, "recklessly ignored signs pointing to improper accounting treatment, thereby allowing Chancellor's management to orchestrate a fraudulent financial reporting scheme." According to the cease and desist order, the outside director never reviewed the company's accounting procedures or internal controls, and exhibited a total deference to the company's CEO, who was perpetrating a fraud on the company. The SEC concluded that the director exercised no care to ensure that the company had appropriate internal controls and that its financial records were accurate. The director acquiesced in the CEO's complete control of accounting decisions, including those relating to payments to the CEO's own companies. Mr. Cutler stated that the Chancellor enforcement action reflects the Commission's willingness to pursue cases against outside directors who were "**reckless in their oversight of management and asleep at the switch**." The SEC charged that this outside director, "completely neglected his duties as a director and an audit committee member. As an outside director with fiduciary responsibilities, [the director] ignored clear warning signs that financial improprieties were ongoing."

The fundamental responsibilities of directors of public companies remain to exercise common sense business judgment. This requires skepticism, diligence and a willingness to ask tough questions, while insisting that the answers received are understandable. It requires a level of prudence in making sure that a corporation does not take on an undue level of risk and a level of vigilance in making sure that any compliance criticisms or identified audit or control deficiencies are quickly rectified. Finally, it requires diligence in ensuring that the company makes full, fair, accurate, timely and understandable disclosures. These are not difficult standards to meet and there is no need to fear that even though they are met, directors will be subject to enforcement actions or liability in a derivative lawsuit. The business judgment rule is alive and well.

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