

# Fiduciary Duties of Board Members

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Board of Directors of the State Compensation Insurance Fund

Presented by Randall W. Keen

## State Fund is not a corporation

- A corporate board's duties are to the corporation's shareholders; not a factor here

While State Fund has not-for-profit status under a special provision of the Internal Revenue Code, it is not the type of non-profit corporation that is regulated by the Attorney General

State Fund is often referred to as a “quasi-public”, “quasi-private” or even “quasi-governmental” entity

State Fund is a “public enterprise fund”

The board of directors is hereby vested with full power, authority and jurisdiction over the State Compensation Insurance Fund. The board of directors may perform all acts necessary or convenient in the exercise of any power, authority or jurisdiction over the fund, either in the administration thereof or in connection with the insurance business to be carried on by it under the provisions of this chapter, as fully and completely as the governing body of a private insurance carrier. . . .

-Insurance Code section 11781

Board has “full power, authority and jurisdiction over” State Fund

May perform all acts “necessary or convenient”

“As fully and completely as the governing body of a private insurance carrier”

In short, while the traditional Duty of Loyalty and Duty of Care do not strictly apply to the Board because of State Fund's unique status, those duties (which apply to the governing body of a private insurance carrier) are instructive, and will help ensure compliance with the Board's business judgment rule.

Attend board meetings. “[N]o one should become a director without being reasonably certain that he or she will actively participate in the board’s work” (A.A. Sommer Jr., *ABA Journal*, June 1992).

Do your homework. Read the information that is reasonably available.

Be prepared and ask questions. The reliance on management and staff should be reasonable and fact-based.

Red flags. When the directors have been put on notice about an issue, they should be persistent in obtaining accurate and complete information.

Delegation: Board can delegate to the President or to a committee—but must still provide effective oversight

New directors should take reasonable steps to learn about the organization they are being asked to serve.

- Attend training
- Ask questions
- Educate self on industry, trends

### Duty of care = Duty of prudence

- Prudence requires *asking questions* and *understanding rationale* for actions before taking them
- Prudence requires *analyzing advice* and *recommendations* received from staff and experts, *not acting as a “rubber stamp”*
- Prudence requires *following applicable law* governing State Fund

## Primary Duty Rule

- Act loyally for State Fund's benefit
- Duty not to acquire a material benefit from a third party in connection with State Fund transactions
- Duty not to use or communicate confidential information for member's own purposes or those of a third party
- Similar and parallel to the statutory and common law conflict of interest laws



## Director's Loyalty to Organization – Not to Appointing Authority

- Under Insurance Code provisions, Board members do not serve at the appointing authority's pleasure (DIR position is the one exception by virtue of the ex officio appointment)
- Can only be removed by the appointing authority "if the member ceases to discharge the duties of his or her office for the period of three consecutive board meetings"

## Vulnerability

- Political pressure from Executive Branch and Legislature
- Threat of new legislation
- Conflict of interest and related state and federal rules applicable to individual board and staff members
- Refer inquiries from third parties to CEO or General Counsel for accuracy and consistency

## Courts have been clear:

- A private insurer is not a fiduciary to its insureds
- An insurer “may give its own interests consideration equal to that it gives the interests of its insured; it is not required to disregard the interests of its shareholders and other policyholders when evaluating claims; and it is not required to pay noncovered claims, even though payment would be in the best interests of its insured.” (*Love v. Fire Ins. Exchange* (1990) 221 Cal. App. 3d 1136).
- However, insurers have “special” duties such as good faith and fair dealing that “are akin to, and often resemble, duties which are also owed by fiduciaries . . . because of the unique nature of the insurance contract.” *Id.*

Directors have no liability in private capacity for “any act performed or obligation entered into in an official capacity, **when done in good faith, without intent to defraud** and in connection with the administration, management or conduct of the fund or affairs relating thereto.”

Insurance Code section 11772 (emphasis added)

**BEWARE:** Business Judgment Rule’s requirements that action be taken “in good faith, without intent to defraud” and “in connection with administration of . . . the fund . . .” mean that its protection may not be available if:

- Conflict of interest exists.
- Action violates other applicable law or key State Fund policy.

If in doubt, ask legal counsel.

- First stop: Board/Fund counsel -- State Fund’s General Counsel.
- Note: Attorney-client privilege is held by the Board; no individual board or staff member can assert the privilege to prevent Board counsel from communicating anything said to him or her by the individual board or staff member to the Board.
- If personal legal concern, consult own legal counsel at own expense.

Combination of statutes and common law

Public officials must make decisions in the public interest, not in their own financial interest.

Public officials must avoid even the appearance of acting in their self interest

Laws are minimum standards. The press often questions conduct that is legal and allowed.

- “Doesn't he realize the appearance is terrible?” said Bob Stern, president of the Center for Governmental Studies. ‘When you're taking gifts from strangers, there's only one reason. They only give gifts because they want something.’” *Baca Has Raked in \$120,000 in Gifts Since Becoming Sheriff*, Los Angeles Times, April 30, 2011.

General Rule: No public official may make, participate in making or use his or her official position to influence the making of a governmental decision at any stage, in which the official or his or her immediate family has a financial interest.

You have a conflict of interest with respect to a government decision if it is sufficiently likely that the outcome of the decision will have an important impact on your economic interests

## Involved in the decision?

- Make → includes voting
- Participate → advise, recommend
- Influence → communicate

## Are your economic interests involved in the decision? (Self or immediate family)

- Investment  $\geq$  \$2,000 (exceptions for time deposits, insurance and mutual funds, et al.)
- Employment
- Real property  $\geq$  \$2,000 FMV + in jdx, plus 2 miles
- Income source  $\geq$  \$500 in last 12 months (promised or provided) (several exceptions)
- Gifts  $\geq$  \$420 in 12-month period (increases biannually)
- Personal financial effect → if own or family's finances will be impacted at all

# Do You Have an Economic Conflict under the PRA? 8 Step Analysis (cont.)

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If you get this far, stop and ask for advice from legal counsel



## Board member: Disqualified from voting or participating

- Must publicly declare the specific interest
- Refrain from participating as board member and leave the room unless public participant

## Employees:

- Should disclose the interest to management; President should disclose his own conflict to Board
- Cannot participate in any manner

Could be charged with misdemeanor  
(conviction precludes public office for four years)

Civil fines up to \$5,000 per occurrence

Board decision rendered within four year statute of limitations  
period may be voided

Different than PRA – limited to financial interest in a government contract

A public officer or employee may not make or participate in the process of making contracts in which he or she is financially interested.

Board members are assumed to be involved in contract decisions, even if the Board has delegated its duty and does not vote to approve a contract.

Public officer or employee?

Is there a contract? Broadly defined

Involved in making a contract?

- Developing, negotiating, modifying and soliciting bids

Financial Interest?

- Direct or indirect, positive or negative.

Does an Exception Apply?

- Non-Interest
- Remote Interest

Rule of Necessity? For essential services

## Non-Interest: List of statutory exceptions

- e.g., public services generally provided on same terms and conditions; governmental salary unless contract is with your department (still requires disclosure and notation in minutes)

## Remote Interest: List of statutory exceptions

- e.g., salary exception and follow certain procedures; prior long term relationship as supplier to contractor

# No Recusal for Board Members

Board members presumed to be involved in all contracts under Board's jurisdiction—disqualification not allowed, and Board cannot act.

Unless an exception applies to permit the Board to act, Board member can only avoid a potential conflict by, in some case, irrevocably renouncing interest, or by resigning from the Board.

Staff members with potential conflict must be screened from all actions on the contract (including Board action) (and/or, irrevocably renounce interest)

Violation of Section 1090 can be prosecuted as a felony, result in imprisonment of the public official, fines, restitution, and a void contract.

# QUESTIONS?

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