

The Role of Boards

WWU MBA Corporate Governance Seminar

How Corporations Are Run

- In general-
Shareholders (owners) have the right to prudent stewardship of the entity, but their rights to insert themselves into management are very limited. A fundamental right of shareholders is to elect the board of directors (or similar governing board).
Board of directors elects the **officers** (senior executives) of corporation-CEO, CFO, etc. They lead the management of the enterprise.
Corporate officers have specific powers delineated in the company's bylaws (to enter into agreements, employ people, manage money and property, keep official books and records, etc.).

Q—How democratic is the current scheme of corporate governance. Is this good or bad?

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The Role of Boards

- Required by law (usually state laws)
- "The Corporation shall be managed under the direction of a board of directors."
- Limited liability companies have "managers" (unless directly managed by owner/members).
- Partnerships have "limited" or "general" or "managing" partners.
- Non-profit corporations have directors.
- Elected by owners/members pursuant to articles of incorporation and bylaws (or LLC operating agreement) and applicable laws
- Publicly-traded companies are subject to additional layers of state, federal, and/or stock exchange regulations.

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The Role of Boards

- Certain powers are *only* vested in the Board (non-delegable)-
 - Sell all or substantially all of entity
 - Declare dividends
 - Declare bankruptcy
 - Elect senior officers

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The Role of Boards

- Paramount duty is to foster long-term success of the entity consistent with-
 - Fiduciary duties to shareholders
 - Compliance with law and regulations
 - Compliance with corporate articles and bylaws

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Oversight vs. Management

- Directors *ensure* good management; they don't normally *provide* it
- Oversight and management are different
- Exceptions-
 - Management crisis
 - Big holes in management abilities and resources
 - Matters involving management breaches of integrity or involving board liability

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Board Responsibilities

- Boards can delegate almost any function to management, except as limited by law.
- Boards usually reserve to themselves final approval (with advice of management) of major policy or strategies such as-
 - mission/vision, code of ethics
 - employment and compensation of CEO and senior leaders ("C-level executives").
 - shaping strategic plan in collaboration with CEO leadership
 - management's operating plans and financial goals
 - approval of incentive compensation plans

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Board Responsibilities

- Powers typically reserved by boards (cont.)-
 - Approve major or unusual transactions
 - informal advice to management (in or outside of meetings)
 - Ensuring systems for monitoring of legal and ethical compliance
 - Selecting, compensating, and evaluating their own members
 - Selecting their own leaders
 - Setting their own rules
 - Evaluating their own performance

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Fiduciary Duties in Corporate Governance

- **Shareholders** are generally not fiduciaries and are free to pursue self-interest
- **Directors and officers** are fiduciaries who owe an undivided loyalty to the entity
- Corporations are managed **under the direction** of the board of directors, not by the board itself ("Noses in; fingers out.")

Q – Can there be conflicts between desires of shareholders and fiduciary duties of directors?
 Q - Where is the line between appropriate board oversight and meddling in management's affairs?

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Governance Fiduciary Principles

- Established mostly in state laws, with Delaware setting the pattern.
- Directors and officers owe to the corporation and its shareholders the **duties of loyalty** and **care** in the conduct of their affairs.
- From these two duties flow such consequent and subsidiary duties as those of confidentiality of corporate secrets, candor with shareholders, corporate opportunity, and the avoidance of conflicts of interest.

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Governance Fiduciary Principles

- Laws also require that directors discharge their duties –
- **In good faith** (honestly)
- With the **care** of an ordinary person in like position under similar circumstances (prudently)
- In a manner reasonably believed to be in **interests of corporation** (rational and loyal)

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Governance Fiduciary Principles

- Directors are indemnified by corporation and not liable for their actions if they have met these duties—even if they are wrong or make an error of judgment ("**business judgment rule**" widely adopted by courts).
- Peter Drucker: "A decision is a judgment. It is a choice between alternatives. It is rarely a choice between right and wrong. It is at best a choice between 'almost right' and 'probably wrong'-but much more often a choice between two courses of action neither of which is provably more nearly right than the other." (From *The Effective Executive*)
- **Business judgment rule** recognizes **risk** inherent to business
- Companies purchase director and officer liability insurance

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Discussion Question

- Given the broad and somewhat vague nature of the fiduciary duties of *care* and *loyalty*, how does one judge the behavior of directors?
- Is the *business judgment rule* unfair to shareholders?

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Governance Fiduciary Principles

- Protection of directors from liability applies to duty of *care*, not duty of *loyalty*.
- Conflicts of interest** can cause breach of fiduciary duty for which a director is not shielded from liability. [Example]
- Directors have obligation to place interests of entity above personal interests.

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Duty of Loyalty/Conflicts of Interest

- Directors are expected to be independent of influences that may conflict with corporate director role.
- Publicly-traded companies are subject to federal rules defining what constitutes director "independence".
 - Must publicly declare which directors are independent.
 - Can only populate three required committees with independent directors - -audit, compensation, governance.

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Duty of Loyalty/Conflicts of Interest

- Conflicts can arise from transactions, dealings or relationships that have the potential to place the personal and the corporate interest at odds with one another.
- Can be financial, familial, relational, or social in nature, requiring fact-specific analysis.
- Interlocking directorships are increasingly frowned upon. Public company CEOs are not allowed to serve on one another's compensation committees.
- Directors have a duty to disclose potential conflicts of interest.
- Not a conflict if director will share benefit in common with shareholders.

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Duty of Loyalty/Conflicts of Interest

- Practical tests:
 - “The Front Page Test”
 - “The Smell Test”
 - “The Appearance Test”

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Duty of Loyalty/Conflicts of Interest

Directors can have conflicts of interest, but must-

- disclose them
- not try to take unfair advantage
- have any transactions approved by disinterested directors pursuant to corporate bylaws

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Duty of Loyalty/Conflicts of Interest

- Conflict of interest transaction (e.g. land swap) can be voided by the board of directors if-
 - proper board approval process not followed

and

 - transaction deemed not in interests of company.

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Duty of Loyalty/Conflicts of Interest

Discussion Question – Are the standards of what constitutes a conflict of interest different for large public and small privately owned companies?

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Duty of Care

- Directors must act with the diligence and competence of a reasonably prudent person in like position and circumstance.
- Must avail themselves of information and material reasonably available to them.
- Must give adequate consideration to topic.
- Have the right to rely on the advice of management, expert consultants, and committees.
- Cannot delegate fiduciary roles to others.
- U.S Sentencing Guidelines impose duties on public corporate boards and officers to put into place compliance programs to detect and report law violations and to take remedial action.

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Challenges to Duties of Care and Loyalty

Care--Challenges to board actions will examine process adequacy-

- number and length of board and committee meetings to consider topic(s)
- use of experts
- management and committee reports
- board minutes
- materials and information reviewed

Loyalty-- *Conscious and intentional disregard of duties can lead to finding of bad faith- -and personal liability for directors.*

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Challenges to Duties of Care and Loyalty

- The Walt Disney Company Case-shareholder action involving the termination of Michael Ovitz as President after less than one year with severance package around \$140 million.
- Delaware court reviewed decision-making process and found negligence on part of board, but not gross enough to violate duties of care or loyalty
- The court encouraged best governance practices, but said that liability does not require adherence to "...the aspirational ideal of best practices".

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Challenges to Duties of Care and Loyalty

- Disney case-Failure to act in **good faith** (violating duty of **loyalty**) when directors-
 - intentionally* act with purpose other than best interests of corporation in mind
 - intentionally* fail to act in face of known duty to act in conscious disregard of duties
 - act with intent to violate law.

Q – Is this the right standard, in your opinion?

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Challenges to Duties of Care and Loyalty

- Courts apply presumption of the **business judgment rule** that directors acted in an informed and good faith manner and in the belief that action was in best interests of company.
- Court will not substitute its judgment for that of the board, as long as any rational business purpose is being served.
- Burden of proof is on challenging party (shareholder) to prove breaches of duties of loyalty and care- -it's an intentionally high bar.

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Challenges to Duties of Care and Loyalty

- Can be spurred by M&A and takeover activity.
- Interests of short-term shareholders and long-term "**shareowners**" (such as institutional investors) may be different.
- Consideration of non-owner "stakeholder" interests allowed in most states by law-not WA.
- Directors are under no obligation to enter into talks about a sale or takeover ("**just say no**" defense) or to maximize shareholder value at any point in time.
- Exception: when they have put the company on the market- - then must be prudent in seeking to (1) capture best value reasonably available for shareholders and (2) exclude consideration of extraneous factors (such as what happens to employees).

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Challenges to Duties of Care and Loyalty

Discussion Questions – How do directors know when it's the right time to maximize value by selling the company? What avenues of inquiry would be prudent on the part of the board?

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