Boardroom Readiness & Governance 101

Presented by Linda Iannone
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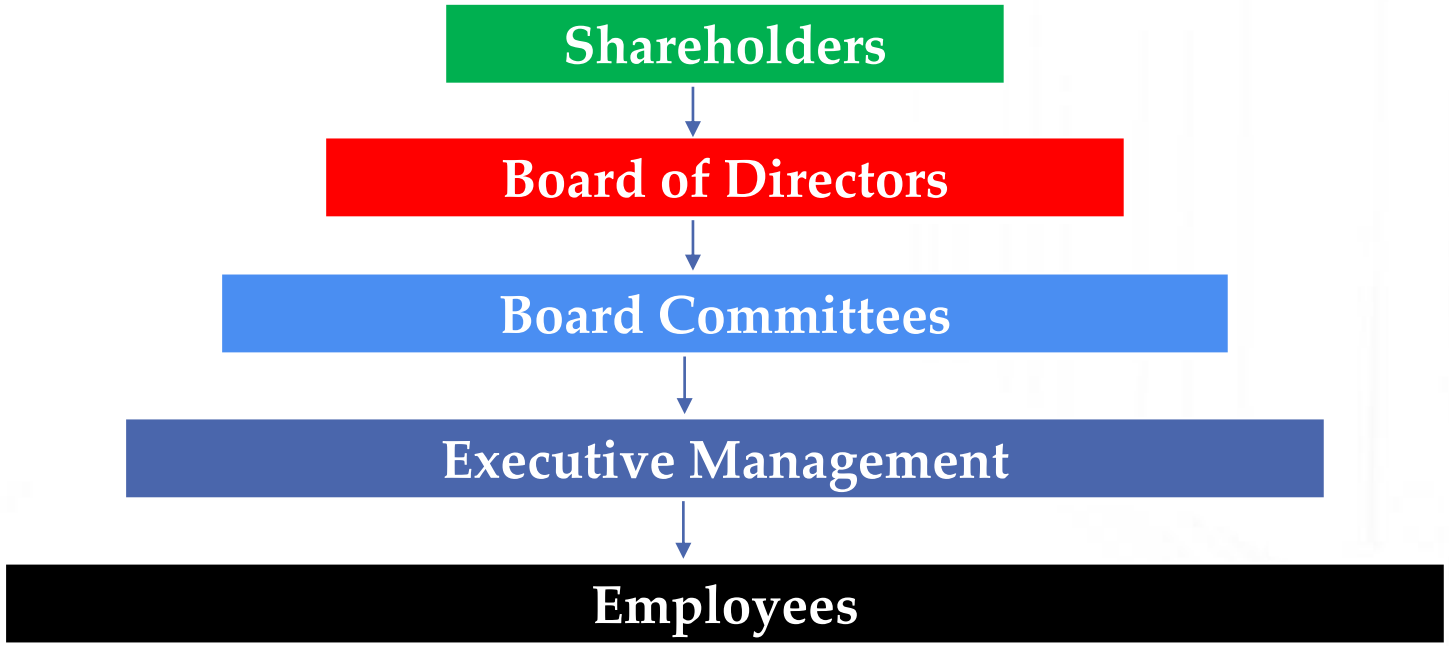
What is Board Governance?

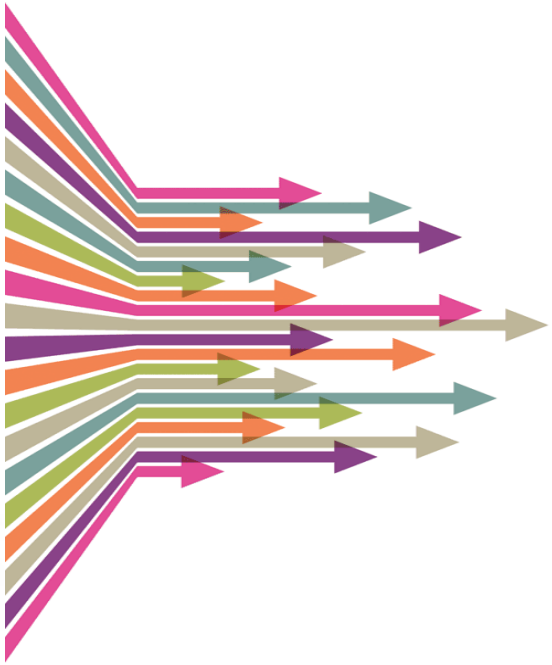
- The acts, processes and authorities that govern an organization
- A structure of relationships and processes to direct and control an organization designed to achieve the organization's goals
- Oversight, insight and foresight

Governance Structure of a Corporation



Benefits of an Effective Governance Framework

- Improves performance and investor confidence
- Minimizes fraud and mismanagement
- Enhances sustainability
- Lowers cost of capital
- Improves decision making and accountability
- Enhances risk management and control environment
- Assists in attracting qualified and talented directors
- Increases retention of management and employees



Board Fiduciary Duties

- **Duty of Care**—requires a director to:

  - Act in good faith

  - In a manner the director reasonably believes to be in the best interests of the corporation and its shareholders

  - With the care, including reasonable inquiry, that a prudent person in a like position would exercise under similar circumstances

- **Duty of Loyalty**—requires a director to place the interests of the corporation above his or her own interests

  - No self-dealing

  - No conflicts of interest

  - No usurpation of corporate opportunities

Business Judgment Rule

- Standard of judicial review
- Presumes that a director acted with due care (even if a decision later turns out to be unwise or a mistake) if the director:

  - Was disinterested

  - Acted on an informed basis (including reliance on outside experts where appropriate)

  - Acted in good faith and with an honest belief that the decision was in the best interests of the corporation and its shareholders

Examples of Business Judgment Rule in Action

Unocal v. Mesa Petroleum (business judgment applied)

- Unocal Board approved an exchange offer to thwart an unwanted takeover bid by Mesa
- In approving exchange offer, Board met for 9 hours, received detailed presentations by legal counsel and investment bankers and concluded that Mesa tender offer was coercive and inadequate
- Court held that Board acted reasonably, in view of the threat posed to corporate policy and effectiveness, after a reasonable investigation, in good faith and with an honest belief that the action taken was in the best interests of the company
- Under these circumstances, the court will not substitute its judgment for that of the board

Examples of Business Judgment Rule in Action (cont.)

Smith v. Van Gorkom (business judgment rule not applied)

- Board approved a merger agreement at a two hour board meeting, called on one-day's notice without any supporting written materials about the agreement, the adequacy of the price or the existence of a crisis or emergency
- Price included a substantial premium over the market price of the company's shares
- Court held that, despite the premium, the board failed to inform itself adequately of the intrinsic value of the company and, therefore, was grossly negligent in approving the merger

Heightened Fiduciary Duties

Under certain circumstances, courts will impose a heightened degree of fiduciary duties on boards of directors:

- Sale of company—when board decides to sell company, directors are obligated to obtain the best price reasonably available for the shareholders (Revlon v. McAndrews & Forbes Holdings, Inc.)
- Entire fairness standard—when board cannot avail itself of business judgment rule (due to breach of duty of care or loyalty), courts will evaluate entire fairness of transaction, including price, terms and process (Mills Acquisition Co. v. Macmillan, Inc.)

Consideration of Environmental, Social & Governance Issue

ESG debate among shareholders, academics, policymakers, lawyers and jurists:

- To what extent can boards consider stakeholder interests other than shareholder interests?

  --Climate change/environmental responsibility
  --Wage growth
  --Income inequality
  --Job creation
  --Consumer fairness

- To date, courts have generally held that board decisions must further the best interests of shareholders

- Some corporations ("B" corporations) choose to formally embed public benefits with the mission to enhance shareholder value

Challenge Question #1

What are the board's fiduciary duties?

a. Duty of transparency and duty of integrity

b. Duty of care and duty of loyalty

c. Duty of disclosure and duty of accountability

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Board Responsibilities

In enhancing shareholder value, the Board of Directors has a dual mandate:

- Directional/Advisory: direct and advise management regarding strategic, operational and reputational position of the company

- Oversight: monitor company performance, oversee risk management and hold management accountable

Responsibilities of the board are separate and distinct from those of management. The board does not manage the company but has ultimate responsibility for its actions.

Board Responsibilities

- **Set the tone at the top**
- **Approve corporate strategy**
- Identify risk areas, set risk tolerances and risk appetite
- **Hire and evaluate chief executive**
- **Perform succession planning**
- Design executive compensation packages
- **Ensure integrity of financial statements**
- Approve major corporate transactions, such as asset purchases, acquisitions and divestitures
- **Protect company assets and reputation**
- **Represent the interest of stockholders**
- **Ensure compliance with laws, regulations and ethical standards**

Challenge Question #2

Which of the following would not be an appropriate board action?

a. Approving corporate strategy

b. Succession planning

c. Setting performance goals for middle management

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Independence

- Boards are expected to be independent:

  - Act solely in the interest of the corporation and its shareholders

  - Free from conflicts that compromise judgment

  - Able to effectively challenge management and take positions in opposition to management

- Independence is defined according to governing regulatory standards

- Determination of independence requires careful evaluation of director's biography, experience, business and family relationships, financial holdings and relation to management

NYSE Independence Definition

No material relationship with company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the company. Disqualifying factors include:

- Director has been an employee of the company during last 3 years
- Director has received (or whose immediate family member has received) more than $120,000 in compensation from the company (not including director fees)
- Director or an immediate family member is a current partner of company's internal or external auditor
- Director is a current employee, or an immediate family member is a current executive officer, of an organization that has made to or received from the company payments for property or services in an amount which, in any of the last three years, exceeds greater of 2% of such other company's consolidated gross revenues or $1 million

Challenge Question #3

Which of the following statements are true?

a. Directors are expected to exercise independent judgment, free from conflicts of interest

b. A director may be considered independent if he or she also serves as CEO

c. Directors are expected to act in the best interests of the corporation and its shareholders

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Board Committees

Boards may delegate certain duties to committees, including

- Audit Committee
- Compensation Committee
- Nominating and Governance Committee

For public companies, these committees are required and each member must be independent. Audit Committees have the most stringent set of independence requirements.

Board Committees (cont.)

- Delegated duties defined in committee charters
- Committee decisions and deliberations reported to full board
- Besides audit, compensation and nominating/governance, committees may include risk management, technology, corporate responsibility, credit, and asset liability management, depending on industry
- Special committees may also be formed for significant events or transactions, such as mergers and acquisitions, leveraged buyouts, high level investigations and litigation

Board Committees (cont.)

Under **California law**, boards may **NOT** delegate:

- Any action requiring shareholder approval (also under Delaware law)
- Filling of board vacancies
- Fixing of director compensation
- Amending bylaws (also under Delaware law)
- Declaring dividends or other distributions on company shares

Audit Committee Responsibilities

- Oversee financial reporting and disclosure
- Approve and oversee external auditor
- Oversee internal audit program and system of internal controls (SOX)
- Monitor accounting policies and practices
- Establish procedures for whistleblower complaints
- Oversee regulatory compliance
- Oversee risk management
- Hire consultants as necessary

Compensation Committee Responsibilities

- Set compensation for the CEO
- Establish performance goals for CEO
- Monitor performance of CEO relative to goals
- Advise CEO on compensation for other executives
- Determine structure of executive compensation, including cash, bonus programs and equity awards
- Hire consultants as necessary

Nominating and Governance Committee Responsibilities

- Identify individuals qualified for board service
- Recommend director nominees to be elected at annual shareholders' meeting
- Determine corporate governance guidelines
- Manage board evaluation process
- Review shareholder recommendations for board members

Corporate Governance Guidelines

Topics typically covered:

- Director qualifications (integrity, time commitment, industry expertise)
- Term limits or age restrictions
- Independence standards
- Diversity
- Optimal size of board
- Executive sessions
- Board self-evaluation
- Board compensation philosophy
- Access to independent advisors
- Ethical standards

Challenge Question #4

True or False?

For public companies, Board members who are not independent may serve on the Compensation Committee.

Challenge Question #4

True or False?

For public companies, Board members who are NOT independent may serve on the Compensation Committee.

Board Processes and Governance

- Operation of the board prescribed in governing documents, primarily Articles of Incorporation and Bylaws
- Board is overseen by the chair who
  - sets the agenda,
  - schedules meetings, and
  - presides at the meetings
- At meetings, majority rule governs
- Minutes maintained and approved by board
- Periodically, independent directors meet in executive session outside presence of management (required for public companies)

Board Processes and Governance (cont.)

- Board action may be taken at meetings at which a quorum is present or by unanimous written consent
- Calling of meetings, both regular and special, and required prior notice governed by state corporate law and bylaws
- If notice is given in less time than bylaws require, directors must execute waiver of notice; if all directors attend meeting, then waiver of notice not required
- Meetings conducted with parliamentary procedures, including quorums, motions, voting (ayes and nays) and adjournment

Board Processes and Governance (cont.)

Minutes

- Memorialize deliberations and decisions made by board
- Drafters need to strike a balance between too much, and not enough detail
- Minutes should not be a verbatim recitation of the dialogue among directors at the meeting
- Minutes should reflect the information provided to the board as the basis of decision making and provide sufficient evidence that, prior to reaching a decision, the matter was appropriately discussed and considered
- Minutes often play an important role in litigation, which could be years after the events occurred when memories have faded
- Depending on industry, minutes may be reviewed closely by regulatory agencies as part of examination process

Challenge Question #5

If insufficient notice of a board meeting is given,

a. The meeting cannot be held

b. Action taken at the meeting is still legitimate

c. The meeting can be held and action can be taken if all directors sign a waiver of notice

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Director Elections

- **<u>Two main election regimes:</u>**

1. **Annual election**—All directors elected annually by the shareholders for one-year terms

2. **Staggered terms**—Directors elected to three-year terms, with one-third of board standing for election each year

- Staggered boards provide continuity and can serve as an anti-takeover device

- Activist shareholders oppose staggered boards since they can have the effect of entrenching the board and management

Director Elections (cont.)

- In most companies, directors are elected on a one-share, one-vote basis
- Shareholders may withhold votes but not vote against a nominee
- Four main voting methods determined by state corporate law or bylaws:

  -- Plurality: directors who receive most votes are elected, even without a majority

  -- Majority: directors must achieve majority

  -- Cumulative: shareholders can pool votes and apply to candidates (either all to one candidate or distributed among more than one)

  -- Dual class: different classes of shares carry different voting rights

Director Vacancies and Appointments

- Vacancies may be filled by a vote of the directors then in office
- Additions to the board may be approved by the existing board, if the number of directors remains within the range established by the Bylaws
- If the board is already at its maximum size, the Bylaws must be amended which will sometimes require a vote of the shareholders

Director Removal from Office

- Directors may be removed from office <u>without cause</u> if approved by the outstanding shares
- If cumulative voting applies, no director may be removed if the votes cast against removal would be sufficient to elect the director if cumulatively voted
- <u>Shareholders may petition court</u> for removal of a director in the case of fraudulent or dishonest acts or gross abuse of authority

Challenge Question #6

True or False?

In his or her own discretion, the Chair of the Board may remove a director with or without cause.

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Director liability

- Directors can be held <u>personally liable for breaches of their fiduciary duties</u> (Enron, WorldCom), though relatively uncommon

- Statistics relating to litigation involving M&A transactions:*

  -- 95% of transactions result in litigation

  -- Each transaction resulted on average in 4 lawsuits

  -- Most litigation settles without any personal liability for directors with median attorneys' fee awards per settlement of $555,000

*Study by Matthew D. Cain and Steven Davidoff Solomon (2014)

Director indemnification and insurance

Protections available for directors:

- Exculpatory provisions in charter documents (unintentional negligent acts)
- Indemnification provisions in charter documents
- Individual agreements (acting in good faith)
- Directors & officers liability insurance

Preventive Measures to Avoid Liability

- Establishing well-defined and conservative standards of independence
- **Appointing directors with diverse skills and backgrounds**
- **Training directors in fiduciary duty standards and governance principles**
- **Adhering to a code of conduct and ethics**
- Developing active compliance monitoring systems
- Staying informed about corporate developments, disclosures and financial condition
- Evaluating board effectiveness
- **Establishing strict controls over related party transactions**
- **Maintaining effective internal reporting systems for fraudulent acts or wrongdoing**
- **Initiating open and regular shareholder communications**

Board Readiness

Questions to ask yourself:

- Do I have the time to devote to board service?
- Will my employer allow me to serve on a board?
- Do I have an understanding of the role of the board and corporate governance principles?
- Am I comfortable with the company's business model, financial statements, budgets, and generally how the company makes money?
- Am I a team player and able to work in a consensus-driven environment?
- What is my value proposition for board service?

Challenge Question #7

After this session, are you still interested in serving on a board?

Yes ___

No ___

Questions?

Contact me via E-mail → **lindaiannone35@gmail.com**