Board Structure and Operations

Alan S. Gutterman

§1 Introduction

Corporate governance begins with the board of directors, regardless of the size of the corporation and any other rules to which the corporation may be subject due to its status as a “public company.” Reference should still be made to the basic rules for the size of the board of directors and the method of selecting directors that apply under the laws of the state in which the corporation has been incorporated. However, with regard to public companies, as well as larger privately held businesses that either have a large number of outside shareholders or may be looking to become a public company in the future, notice must be taken of the substantially increased role and authority of independent directors; the expanded responsibilities of various committees of the board of directors, notably the audit committee; and requirements relating to the financial expertise of board members, particularly those serving on the audit committee, and education and training of directors. The complexity of director activities has also led to substantial changes in practices regarding the conduct and documentation of board activities. Special consideration should be given to the composition of the board of directors and the processes implemented by the board to carry out its duties and responsibilities (see Table 1).

Table 1
Composition and Processes of Board of Directors

- The Sarbanes-Oxley Act, and the supporting rules and regulations of the exchanges, require that “independent directors” comprise a majority of the board; that provision must be made for regular meetings of the independent directors in executive session; and that the compensation of the CEO and other executive officers, as well as director nominations, must be approved by the independent directors.
- All companies with listed securities must make specified disclosures regarding the financial expertise of the members of their audit committee and must ensure that their audit committee members are all able to satisfy basic “financial literacy” requirements, including the ability to read and understand financial statements.
- Directors should be provided with education and training on all of the topics discussed during this program as well as managing the responsibilities of being an active and effective board member; evaluating outside consultants who may be asked to provide advice on various issues, including executive compensation and disclosure controls; emerging trends in shareholder proposals, including proper procedures for handling shareholder discontent and increasing involvement of institutional investors; crisis management, including investigation of potential corporate misconduct; and CEO succession issues, including termination of an under-performing CEO.
- Reporting companies remain subject to the same rules and practice pointers that apply to any corporation with respect to the conduct of board meetings and documentation of the results of the deliberations of the board; however, reporting companies should also review their procedures for board meetings to ensure that they are scheduled at times, and for periods, that will allow the board and its committees to satisfy its oversight obligations under the Sarbanes-Oxley Act and other SEC rules.

§2 Board structure and selection and removal of directors

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State corporation laws generally require that a corporation have a board of directors and that all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation be managed by or under the direction of, its board. Some statutes permit articles of incorporation or a shareholders’ agreement, or in some states bylaws, to do away with the requirement of a board of directors in certain instances; however, these provisions are only relevant to small closely-held corporations. State corporation laws include default rules relating to a number of basic issues with respect to structuring the board of directors including rules relating to the number and qualifications of directors, procedures for election of directors, terms of directors, resignation and removal of directors and the filling of vacancies on the board. Each of these issues will generally be addressed in the bylaws of the corporation although it is also possible to include relevant provisions in the articles of incorporation.

§3 — Number of directors

The Model Business Corporation Act and most state statutes provide that a board of directors must consist of one or more individuals, with the number specified in or fixed in accordance with the articles of incorporation or bylaws. New York and several other state statutes require a minimum of three directors. The Model Business Corporation Act and some state statutes provide that the number of directors may be increased or decreased from time to time by amendment to, or in the manner provided in, the articles of incorporation or the bylaws. The recommended size for a particular board depends on a variety of factors such as the composition of the shareholder group (and the corresponding need for representation of such groups on the board), the need to comply with applicable independence requirements and the desire to have members with specific technical and business backgrounds. Public companies in certain industries have a relatively large board, often 15 or more members, while others prefer to keep the number of directors to a more manageable size such as five or seven. Observers believe that the optimal board size for a public company is probably somewhere in the middle—seven to eleven members—and that the decision should be based primarily on making sure that each board member has the opportunity to make a meaningful contribution to deliberations by the full board and each of the committees upon which he or she serves. The need for public companies to have a relatively large number of committees, each with their own specific regulatory mandate, means that those companies must have enough directors to evenly and fairly distribute the required work.

5 See, e.g., N.Y. Bus. Corp. Law § 702.
§4 --Qualifications and characteristics of directors

The articles of incorporation or bylaws may prescribe qualifications for directors. Under the Model Business Corporation Act and most state corporations acts, a director need not be a resident of the state of incorporation or a shareholder of the corporation unless the articles of incorporation or bylaws so prescribe. While public companies generally do not have specific qualifications for service as a director included in their bylaws the charter of the governance and nominating committee will usually include a list of the characteristics that are sought when recruiting new directors and, of course, regulatory standards dictate that the composition of the board comply with “independence” requirements and that directors be familiar with financial reporting and accounting rules and procedures.

The board of directors, working as a group and through its governance and nominating committee, should develop a set of director qualifications that address the appropriate skills, perspectives, experiences, and characteristics required of board candidates, taking into account the company’s needs and the then-current make-up of the board. The qualifications should include knowledge and experience in areas critical to understanding the company and its business; technical, business and interpersonal skills; personal characteristics, such as integrity and judgment; and candidates’ commitments to the boards of other publicly-held companies and other outside activities. Each board member is expected to ensure that other existing and planned future commitments do not materially interfere with the member’s service as a director and that he or she devotes the time necessary to discharge his or her duties as a director.

The qualification guidelines should also address the overall goals and objectives regarding diversity and optimal size and composition of the board and its various committees and, of course, applicable requirements of the securities exchanges. A March 2014 study of board oversight of sustainability issues among S&P 500 companies commissioned by the IRRC Institute and authored by the Sustainable Investments Institute found that 9% of the companies had implemented some form of board oversight of the company’s positions and policies on workplace diversity and inclusion issues, in most cases allocating responsibility to one of the board committees such as corporate social responsibility or nominating and governance. Directors should not underestimate the important of diversity in the boardroom to institutional investors, many of which, such as BlackRock have made it clear that they intend to engage with their portfolio companies to better understand their progress on improving gender balance and hold the nominating and/or governance committees of the boards of those companies responsible for any apparent lack of commitment to board effectiveness.

8 P. DeSimone, Board Oversight of Sustainability Issues: A Study of the S&P 500 (IRRC Institute, March 2014), 1, 15.
The stakes surrounding boardroom diversity took an interesting turn on September 30, 2018 when California made history by becoming the first state to mandate a minimum numbers of women directors for publicly held corporations headquartered in the state. The controversial law added Section 301.3 to the California Corporations Code which requires that a domestic general corporation or foreign corporation that is a publicly held corporation (i.e., a corporation with outstanding shares listed on a major United States stock exchange) whose principal executive offices, according to the corporation’s Securities and Exchange Commission Form 10-K, are located in California must have a minimum of one female (defined as an individual who self-identifies her gender as a woman, without regard to the individual’s designed sex at birth) on its board of directors no later than December 31, 2019. The required minimum number of female directors increases as December 31, 2021 to 2 if the corporation has 5 directors or to 3 if the corporation has 6 or more directors. The California Secretary of State is required to publish various reports on its Internet Web site documenting, among other things, the number of corporations in compliance with the provisions. The California Secretary of State is authorized to impose fines for violations starting at $100,000 for the first violation and increasing to $300,000 for subsequent violations.

The statutory changes were accompanied by a number of interesting and compelling findings by the Legislature including the argument that having more women directors serving on boards of directors of publicly held corporations would boost the California economy, improve opportunities for women in the workplace, and protect California taxpayers, shareholders, and retirees (including retired California state employees and teachers whose pensions are managed by CalPERS and CalSTRS). The Legislature declared that absent a proactive approach it would take 40 to 50 years to achieve gender parity. The Legislature also pointed to independent studies that had concluded that publicly held companies performed better when women serve on their boards of directors and noted that other countries, many of them in Europe, had already addressed the lack of gender diversity on corporate boards by instituting quotas mandating 30 to 40 percent of seats to be held by women directors. A key factor in the way that the measure was drafted was the conclusions of several studies that having three women on the board, rather than just one or none, increased the effectiveness of boards.

The data on the dearth of women members on the boards of public companies based in California is clear: as of June 2017, one-fourth of California’s public companies in the Russell 3000 index had NO women on their boards of directors; and for the rest of the companies, women held only 15.5 percent of the board seats. Smaller companies were even more likely to lack female directors. Realizing that many of the public companies headquartered in California are actually formed and organized under the laws of a state other than California (e.g., Delaware or Nevada), the new law specifically extended coverage to these so-called “foreign corporations” by providing that Section 301.3 would apply to a foreign corporation that is a publicly held corporation to the exclusion of the law of the jurisdiction in which the foreign corporation is incorporated. This attempt to override the laws of other states has been the subject of numerous objections and many feel that it will not survive the inevitable court challenges. Among other things, the legislation has been loudly opposed by numerous business group that have argued not
that it violates existing laws and constitutional protections in that it would displace an existing member of the board of directors solely on the basis of gender. Others have criticized the bill for focusing exclusively on gender-related aspects of board composition while ignoring other forms of diversity.

Regardless of how effective the legislation proves to be in practice, the move is consistent with growing pressure from various groups, particularly institutional investors, to appoint more women to corporate boards. Other factors are also in play that may ultimately lead to changes regardless of the fate of the new California legislation. Studies indicate that companies are becoming increasingly concerned about their image and reputation and that taking aggressive and transparent steps to change the experiences, skill sets and life views is an important way to signal that attention is being paid to societal changes and expectations. Perceived failures in board oversight of corporate culture that has led to high profile disclosures of sexual harassment and other forms of discrimination in the workplace are also relevant. Another consideration is how decisions are actually made in boardrooms and what steps can be taken to improve decision making including incorporating the views of women and other groups that have traditionally not been part of those deliberations. Gender diversity in the boardroom and among executive teams will also be important for companies looking to become and remain more innovative, find ways to capitalize on new technologies and anticipate how technology and changes in societal values will impact the workforce.

Finally, the qualification guidelines should include a brief summary of the steps taken to identify, evaluate and select candidates for board membership, including a schedule or timetable to ensure that sufficient time is allocated for the important steps of assessing the needs of the board, identifying appropriate candidates and providing them with information regarding the company and the board and, ultimately, interviewing candidates in order to gather sufficient information for the board to make a decision regarding which candidates should be nominated for the board. The governance and nominating committee should be responsible for periodically reviewing and modifying, as appropriate, the qualification guidelines.

Table 2
Personal and Experiential Qualifications for Prospective Directors

In general, new board members will be sought who possess the particular skills, experience, expertise and diversity that will best complement board effectiveness at the time. In its evaluation of candidates for the board, the board’s governance and nominating committee should have regard to normally accepted nomination criteria, including honesty and integrity; the ability to exercise sound business judgment; appropriate experience and professional qualifications; absence of conflicts of interest or other legal impediments to serving on the Board; willingness to devote the required time; and availability to attend board and board committee meetings. In considering overall board balance, the committee should give due consideration to the value of a diversity of backgrounds and experiences among the members. When

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10 For public companies, the guidelines should also address the procedures to be followed for handling shareholder nominations. In some cases, procedures for orientation and training of new directors, as well as performance assessment, are included in the guidelines, although these topics are generally addressed separately in director development policies.
identifying candidates that can be recommended to the entire board for a position as a director, the
governance and nominating committee should seek persons who:

**Personal Qualifications**

1. Have a reputation for intelligence, strength of character, good judgment, and the highest personal and
   professional integrity;
2. Are committed to understanding the company and its industry and to spending the time necessary to
   function effectively as a director, including regularly attending and participating in meetings of the Board
   and its committees;
3. Have a working knowledge of corporate governance issues and comprehend the changing role of a
   public company director, particularly the fiduciary obligations owed to the company and its stockholders;
4. Have the independence necessary to make an unbiased evaluation of management performance and
   effectively carry out the responsibilities of oversight, and do not have, nor appear to have, a conflict of
   interest that would impair the candidate’s ability to represent the interests of all the company’s
   stockholders;
5. Are willing and able to recommend alternative solutions to problems;
6. Support the ideals of the company’s “Code of Conduct” and are not engaged in any activity adverse to,
or do not serve on the board of another company whose interests are in conflict with, the company’s
   interests;
7. Are not encumbered by existing directorships and other commitments that may have an adverse impact
   on their ability to fulfill the obligations of a member of the board and/or impair their ability to exercise an
   independent judgment; and
8. Are likely to work constructively with the existing directors and contribute to the overall effectiveness of
   the board.

**Experience**

9. Have held a generally recognized position of leadership and responsibility in an area of endeavor such as
   business, finance, law, public service, banking or academia;
10. Have demonstrated the business acumen, experience and ability to use sound judgment and to
    contribute to the effective oversight of the business and financial affairs of a large, multifaceted
    organization and are willing and able to contribute positively to the decision-making process of the
    company;
11. Assist in achieving a mix of board members with diverse professional backgrounds and a broad
    spectrum of knowledge, experience and capability;
12. Have experience working with basic financial statements and understand the financial issues that
    confront modern corporations; and
13. Have experience and skills in areas of particular importance to the company’s overall strategic plans.

§5  ---Independence requirements

The Sarbanes-Oxley Act, and the supporting rules and regulations of the exchanges, require that “independent directors” comprise a majority of the board and that provision must be made for regular meetings of the independent directors in executive session.\(^{11}\) In addition, the compensation of the CEO and other executive officers, as well as director
nominations, must be approved by the independent directors. Both the NYSE and Nasdaq
allow such approvals to be given by compensation committees composed solely of
independent directors and, in fact, the NYSE requires that companies have such

\(^{11}\) See generally NYSE Rules Section 303A.01, 303A.03 of the Listed Company Manual and Nasdaq Rule
5605(b).

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committees. Historically, Nasdaq also allowed for approval by a majority of all the independent directors and permitted one non-independent director to serve on a compensation committee composed of at least three members for a limited period of time in “exceptional and limited circumstances” if certain conditions were satisfied. However, the Nasdaq listing standards have been amended to remove this second alternative, which were actually rarely used, and thus Nasdaq-listed companies are required to have a standing compensation committee comprised of at least two members and all members of the compensation committee would need to be “independent directors” (as defined in the Nasdaq Listing Rules). The exception allowing for limited service by one non-independent director has been retained.

The definition of “independence” for purposes of the Sarbanes-Oxley Act means that a member must not have accepted any direct or indirect compensatory fee from the company or its subsidiaries, other than compensation for service as a director, and must not be an affiliated person of the company. The NYSE and Nasdaq have both adopted additional “independence” requirements that go beyond those included in the Sarbanes-Oxley Act. In the case of the NYSE, for a director to be deemed “independent” the board must affirmatively determine that the director has no “material relationship” with the company either directly or “as a partner, shareholder or officer of an organization that has a relationship with the company” and the basis for a board's determination that a relationship is not “material” should be disclosed in the company's proxy statement delivered to shareholders in connection with the annual meeting. Nasdaq rules define an “independent director” as a person who is not an officer or employee of the company or any of its subsidiaries or any individual having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

Both the NYSE and NASDAQ rules include a list of relationships that are likely to render a person ineligible for classification as an independent director, and the ineligibility will continue for a specified “cooling off” period following termination of the disqualifying relationship. The definitions that apply to these relationships are complex and should be

12 See NYSE Rules Section 303A.05 of the Listed Company Manual.
13 See generally NYSE Rules Section 303A.01, 303A.03 of the Listed Company Manual and Nasdaq Rule 5605(d).
14 Extensive definitions of “indirect compensation” and “affiliated person” are included in the SEC rules. In general, audit committee members cannot receive compensatory payments indirectly through spouses, minor children, or an entity with which the director is affiliated and which provides the issuer with accounting, consulting, legal, investment banking, financial or other advisory or similar services.
15 See generally 15 U.S.C.A. §78j-1(m) and SEC Rule 10A-3, 17 C.F.R. §240.10A-3; NYSE Rules Section 303A.02 of the Listed Company Manual and Nasdaq Rule 5605(a)(2). The definition of independent director is the same for all purposes throughout the relevant rules, except that additional restrictions must be taken into account with regard to audit committee membership (see, e.g., Nasdaq Rule 5605(c)). The existence of these “independence” requirements has the effect of forcing listed companies to designate some subgroup of the entire board to perform the functions of the audit committee, since “management” directors would not satisfy the applicable definition of “independent.”
16 See generally NYSE Rules Section 303A.02 of the Listed Company Manual and Nasdaq Rule 5605(a)(2).
carefully reviewed; however, obvious problems will arise in the case of:

- Employees of the company or any parent or subsidiary of the company, as well as their immediate family members;\(^\text{17}\)
- A person who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former auditor of the company;
- A person who accepts, or is an immediate family member of a person (other than an employee of the company or a parent or subsidiary of the company) who accepts, payments from the company or any of its affiliates in excess of an amount specified in the applicable rules during the current year or in the recent past; however, exceptions are normally made for payments relating to director compensation or for prior service if such payments are not contingent in any way on continued service;
- A person who is a partner in, or a controlling shareholder or an executive officer of (or whose immediate family member falls into one of these categories) any organization that is engaged in a significant business relationship with the company, either as a customer or a supplier;\(^\text{18}\) and
- A person or an immediate family member who has been part of an interlocking compensation committee arrangement.

The rules regarding “independence” of all directors are supplemented by additional requirements for service on audit and compensation committees. Specifically, when making the affirmative independence determination specifically for members of these committees the board should consider (i) all factors that are specifically relevant to determining whether a director has a relationship to the company that is material to that director’s ability to be independent from management in connection with the duties of a committee member, including the source of the director’s compensation, including any consulting, advisory or other compensatory fee paid by the company to the director; and (ii) whether or not the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

Many companies have integrated those rules and regulations into a set of director qualification guidelines that include not only “independence,” but also characteristics that the company believes are suitable for its directors. For example, these guidelines might

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\(^{17}\) The term “immediate family member” is used in the NYSE rules and includes a person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than employees) who shares such person's home. The comparable term under Nasdaq rules is “family member,” which is defined as a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home.

\(^{18}\) Significance is measured in relation to either the company or the other organization, depending on the circumstances. For example, under the NYSE rules, a director who is an executive officer or an employee, or whose immediate family member is an executive officer, of another company (a) that accounts for at least 2% of the listed company's consolidated gross revenues or $1 million of the company's revenue, whichever is greater, or (b) for which the listed company accounts for at least 2% of such other company's consolidated gross revenues or $1 million of such other company's revenue, whichever is greater, cannot be considered independent.
refer to strong management experience with a company of similar size and engaged in comparable activities, as well as proven knowledge and skills in accounting and finance, business judgment and strategy. A written definition of “independence” should also be incorporated into the qualification guidelines. The board of directors should make an annual determination regarding the independence of directors based on applicable criteria, such as the NYSE and Nasdaq rules, and prepare a report disclosing the basis for such determinations.

The independent directors should regularly convene separate meetings in executive session without management directors present. Such meetings should occur no less than two times annually, and perhaps more frequently, and information regarding the presiding director at such meetings and the method for contacting the presiding director or all of the non-management directors as a group should be disclosed in proxy materials for the annual meeting to facilitate communications between the independent directors and the employees and/or shareholders of the corporation.

§6 ----Financial expertise

All companies with listed securities, even those whose securities are not traded on the NYSE or Nasdaq, must make specified disclosures regarding the financial expertise of the members of their audit committee. In addition, companies with securities listed on one of the main exchanges must ensure that their audit committee members are all able to satisfy basic “financial literacy” requirements, including the ability to read and understand financial statements. Realizing the practical and public relations advantages of recruiting board members that are well versed in financial reporting and accounting issues, companies are beginning to adopt policies with respect to director qualifications that emphasize the need to find candidates with education and experience as a public accountant, auditor, principal financial officer, controller or principal accounting officer of a company, or a position involving similar functions; experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; or experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements.

§7 --Election of directors

Directors are elected at the first annual shareholders’ meeting and at each annual meeting thereafter unless their terms are staggered. 19 If the articles of incorporation authorize dividing the shares into classes, the articles may also authorize the election of all or a specified number of directors by the holders of one or more authorized classes of shares. 20 For example, holders of preferred stock may be given the right to elect one or more directors, either from the time that the shares are originally issued or following a

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default by the corporation on any obligation (e.g., payment of dividends or redemption of shares) to the preferred shareholders. In such cases, each class (or classes) of shares entitled to elect one or more directors is a separate voting group for purposes of the election of directors.

Plurality voting has long been the rule with respect to election of directors under state corporation laws and the Model Business Corporation Act. Plurality voting awards a board seat to the nominee with the most number of votes even if the nominee fails to receive a majority of the total votes cast in the election. Recently, however, public companies have been forced to confront mounting pressures to move away from plurality voting and embrace new procedures that would prevent nominees that win an election yet fail to receive a majority of the votes from taking office. Advocates of these so-called “majority voting” proposals argue that it will empower shareholders and provide them with a real say in the composition of the board of directors—an issue that has long been part of the corporate governance landscape for public companies since slates of director nominees are created by the board itself through its nominating/governance committee. Opponents of majority voting argue that it can be destabilizing and put too much power in investors that have only a short-term interest in the corporation and its affairs. Others have expressed concerns that majority voting may violate state corporation laws, federal securities laws and exchange listing requirements. For example, failure of one or more “independent directors” to receive a majority of the votes may cause a company to run afoul of rules mandating that companies have a specified minimum percentage of independent directors on their board. Some public companies have already voluntarily implemented some form of majority voting initiative and the drafters of the Model Business Corporations Act, as well as key states such as California and Delaware, are beginning to take affirmative action with respect to legislating procedures relating to majority voting.

In addition to majority voting provisions there are a number of other initiatives in process that are designed to increase shareholder input into the designation of candidates for the board of directors of public companies. For example, Delaware law has been amended to permit Delaware corporations to adopt bylaws that would allow shareholders to make their own nominations of directors on proxy materials circulated by the corporation and provide for reimbursement of shareholder expenses associated with their efforts to elect their own nominees. The SEC is also constantly weighing various proposals in this area and has recently floated the idea of mandating that large companies must allow shareholders holding at least 1% of the outstanding voting securities to have an opportunity to suggest board candidates on the company’s proxy materials. Finally, a sweeping legislative proposal introduced in May 2009—the Shareholder Bill of Rights (S 1074)—would require that directors receive a majority vote as a condition to election and

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21 For discussion of nominating/governance committee activities, see “Governance and Nominating Committee” in “Governance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
22 See, e.g. Del. Code Ann. tit. 8 § 112.

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would also provide shareholders with a right to vote on executive compensation and separate the positions of CEO and board chairman.

<table>
<thead>
<tr>
<th>The Business Roundtable on the Nominating Process and Governance Committees</th>
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<tr>
<td>The Business Roundtable proposed the following principles and best practices regarding the nominating process and corporate governance committees:</td>
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<tr>
<td>- The corporate governance committee, which should be composed entirely of independent directors, should play a leadership role in shaping a company's corporate governance and overseeing the composition, structure, operation and evaluation of the board and its committees.</td>
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<td>- The corporate governance committee should take responsibility for assuring that a substantial majority of the board meets appropriate standards of independence developed by the committee and approved by the board.</td>
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<td>- The corporate governance committee should develop and recommend to the board a set of corporate governance principles, which the corporation should make publicly available.</td>
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<td>- Director candidates should be identified, evaluated and recommended to the board by the corporate governance committee. The corporate governance committee should consider director candidates recommended by stockholders, as well as suggestions from directors, management and other sources.</td>
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<td>- The corporate governance committee should have an established process for evaluating the independence, contributions and effectiveness of incumbent directors when deciding whether to recommend those directors for re-nomination.</td>
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<td>- The corporate governance committee should be responsible for establishing and overseeing procedures for stockholder communications with directors if the full board or another committee does not do so.</td>
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<tr>
<td>- The corporate governance committee should assist the board in planning for CEO and senior management development and succession if another committee of independent directors does not do so.</td>
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**Sources:** The Nominating Process and Corporate Governance Committees: Principles and Commentary (Business Roundtable, April 2004).

§8 --Terms of directors

The Model Business Corporation Act and most state statutes provide that the terms of the initial directors of a corporation expire at the first shareholders' meeting at which directors are elected. The terms of all other directors expire at the next annual shareholders' meeting following their election unless their terms are staggered. Despite the expiration of a director's term, he or she continues to serve until his or her successor is elected and qualifies or until there is a decrease in the number of directors.

In a majority of jurisdictions, the term of a director elected to fill a vacancy expires at the next shareholders' meeting at which directors are elected. Most of the remaining

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jurisdictions provide that when a director is elected to fill a vacancy, that director serves
the remaining portion of the term of the vacancy being filled.\textsuperscript{26}

The Model Business Corporation Act provides that the articles of incorporation may
provide for staggering the terms of directors by dividing the total number of directors into
two or three groups, with each group containing one-half or one-third of the total, as near
as may be. In that event, the terms of directors in the first group expire at the first annual
shareholders' meeting after their election, the terms of the second group expire at the
second annual shareholders' meeting after their election, and the terms of the third group,
if any, expire at the third annual shareholders' meeting after their election. At each
annual shareholders' meeting held thereafter, directors will be chosen for a term of two
years or three years, as the case may be, to succeed those whose terms expire.\textsuperscript{27} State
statutes vary in the specifics of staggering of directors' terms.\textsuperscript{28}

The use of the "staggered board" procedure, which is popular among public companies,
serves a number of purposes. Most importantly, by providing that only a part of the
board of directors is up for reelection in any year, persons who acquire a controlling
interest in the corporation would be unable to assume control of the board of directors for
some period of time, thereby reducing the potential attractiveness of the acquisition. As
such, a staggered board is often considered to be an "antitakeover" measure. A staggered
board is also useful for providing continuity when it is anticipated that directors will only
serve a single term on the board, since there will always be some directors with current
familiarity with corporate affairs who can bring new members "up to speed."

\section*{§9 --Resignation of directors}

Under the Model Business Corporation Act and a majority of state statutes, a director
may resign at any time by delivering written notice to the board of directors, its chairman,
or to the corporation.\textsuperscript{29} A resignation is effective when the notice is delivered unless the
notice specifies a later effective date.\textsuperscript{30}

\section*{§10 --Removal of directors by shareholders}

Under the Model Business Corporation Act and many state statutes, the shareholders may
remove one or more directors with or without cause unless the articles of incorporation
provide that directors may be removed only for cause.\textsuperscript{31} The Model Business Corporation
Act and many state statutes provide that if a director is elected by a voting group of

\textsuperscript{26} See, e.g., Cal. Corp. Code § 301; Tex. Bus. Corp. Act Art. 2.34.
\textsuperscript{27} Model Bus. Corp. Act (1984) § 8.06. See generally Fletcher Cyc Corp § 334.1 (Perm Ed).
Code Ann. tit. 8 §§ 141(b), 223(d).<FNP>See generally Fletcher Cyc Corp § 345 et seq.
Code Ann. tit. 8 §§ 141(b), 223(d).

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shareholders, only the shareholders of that voting group may participate in the vote to remove him.\textsuperscript{32}

A director may be removed by the shareholders only at a meeting called for the purpose of removing him and the meeting notice must state that the purpose, or one of the purposes, of the meeting is removal of the director, according to the Model Business Corporation Act and some state statutes.\textsuperscript{33} If cumulative voting is authorized, a director may not be removed if the number of votes sufficient to elect him under cumulative voting is voted against his removal. If cumulative voting is not authorized, a director may be removed only if the number of votes cast to remove him exceeds the number of votes cast not to remove him.\textsuperscript{34}

\section*{§11 --Removal of directors by judicial proceeding}

Under the Model Business Corporation Act and many state statutes, the court of the county where a corporation's principal office (or, if none in that state, its registered office) is located may remove a director of the corporation from office in a proceeding commenced either by the corporation or by its shareholders holding at least 10 percent of the outstanding shares of any class if the court finds that (1) the director engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation and (2) removal is in the best interest of the corporation.\textsuperscript{35} Numerous other states provide for similar methods of removal of directors by judicial proceeding.\textsuperscript{36}

\section*{§12 --Vacancies}

The Model Business Corporation Act states that unless the articles of incorporation provide otherwise, if a vacancy occurs on a board of directors, including a vacancy resulting from an increase in the number of directors: (1) the shareholders may fill the vacancy; (2) the board of directors may fill the vacancy; or (3) if the directors remaining in office constitute fewer than a quorum of the board, they may fill the vacancy by the affirmative vote of a majority of all the directors remaining in office.\textsuperscript{37} If the vacant office was held by a director elected by a voting group of shareholders, only the holders of shares of that voting group are entitled to vote to fill the vacancy if it is filled by the shareholders.\textsuperscript{38} In contrast, some state statutes provide that such a vacancy may be filled by a vote of the remaining directors, even if the number of remaining directors does not

\begin{itemize}
  \item \textsuperscript{36} See, e.g., Cal. Corp. Code § 304; N.Y. Bus. Corp. Law § 706(d).
  \item \textsuperscript{37} Model Bus. Corp. Act (1984) § 8.10(a). See, e.g., Georgia Code § 14-2-810; Wash. Rev. Code § 23B.08.100. See also Fletcher Cyc Corp § 286 (Perm Ed).
  \item \textsuperscript{38} Model Bus. Corp. Act (1984) § 8.10(b).
\end{itemize}
constitute a quorum. Under the Model Business Corporation Act, a vacancy that will occur at a specific later date (by reasons of a resignation effective at a later date) may be filled before the vacancy occurs but the new director may not take office until the vacancy occurs.  

§13 Identification and selection of qualified directors

An effective board of directors should operate as a team and should be composed of members that, taken together, can contribute the requisite technical, operational, financial and managerial experience and talents to the deliberations of the board. The composition of the board of directors for a public company is dictated, to some extent, by the regulatory requirements and the listing standards of the national securities exchanges and this means that the director group for a public company must include independent directors and directors with appropriate credentials in specific areas such as accounting and financial reporting. While much attention has been paid to the selection and composition of board members for public companies, most of the same principles should apply when putting together a group of directors for even the smallest business. While the principals of a modestly-sized business with largely local operations may not have access to a large pool of qualified candidates, they should nonetheless take the time to go through each of the following steps when extending invitations to prospective board members when the corporation is first launched and whenever the growth of the business or other changes dictate adding or removed members from the board:

1. The first step, of course, is to review all applicable legal requirements relating to the composition of the board of directors and the manner of selection. While the attorney for the corporation should take the lead on this step, reference can also be made to various checklists and summaries prepared by law and accounting firms. In the case of public companies, the “independence” requirements imposed under the securities laws and various stock exchange rules will obviously be important.

2. Once the formal legal requirements have been identified, the background and experience of current directors and any other persons already designated as likely candidates should be reviewed. The purpose of this analysis is to see whether the group will allow the board as a whole to satisfy the applicable requirements. If there are any gaps, recruitment efforts must be launched to fill any open spots.

3. An analysis should be conducted of any actual or potential relationships between a director on the one hand and the corporation and/or any of its senior officers on the other hand. The goal is to identify any situation, such as a contract or familial relationship, which might impede the ability of a director to act independently with respect to his or her participation in board activities. While some isolated affiliations can generally be tolerated with smaller corporations, following full disclosure and abstention

from voting and discussions, it is a good practice to avoid those situations whenever possible. For public companies and larger private corporations, reference should be made to the tests for “independence” included in the rules the major securities exchanges.

(4) Consult with the key stakeholders of the corporation, including senior managers and major outside shareholders, regarding their preferences with respect to the composition of the board of directors. While independence is an important factor in imposing financing and business discipline on the management team, it is also necessary for the directors and managers to be able to communicate comfortably about how the corporation is operating and performing. In cases where an outside shareholder has the right to designate a board member, the shareholder should be encouraged to select a nominee that can work well with the management team and who brings experience and resources in areas that are useful to the business and not otherwise duplicated by other board members.

(5) With respect to each prospective candidate for membership on the board of directors, conduct a background check of the candidate’s prior experience as a member of a board, including work with non-profit organizations. The focus of the investigation is to verify, hopefully, that the candidate has been diligent in participation and preparation and has made a positive impact on the organization and the operation of the board.

(6) Understand the reasons that the candidate is interested in serving on the board of directors. Whenever possible, the candidate should be interviewed by several parties, including current directors, to determine how the candidate sees his or her role on the board and how service will fit within the director’s other activities. In many cases, a person will accept a board membership for the wrong reasons, or without a full understanding of the duties and obligations involved. In each case, the stage is set for conflict and disappointment at some point in the future.

(7) Finally, each candidate should be assessed to identify the unique skills and experience that he or she will be able to bring to the board of directors and to the business of the company as a whole. While the board should maintain its independence and distance from day-to-day management, members should be seen as part of the business team for the corporation and a wide array of opinions and strengths should be available for use as the business grows and changes.

Depending on the size of the company, consideration should be given to periodically engaging an outside consultant to conduct an independent evaluation of the operations and efficiency of the board of directors. Consultants can survey current members of the board without triggering conflicts and should also be able to advise the members about best practices from interactions with other companies. This evaluation process can also be used to identify weaknesses in the composition of the board that should then be addressed in the recruitment and selection process.
The primary responsibility for board structure and operations is typically vested in a board-level governance and nominating committee and the duties and responsibilities of the committee typically highlighted in the committee’s charter include:

- Recommending to the board candidates for election or reelection to the board at each annual meeting of shareowners of the company including assessment of contribution of board members being considered for reelection
- Recommending to the board candidates for election by the board to fill vacancies occurring on the board
- Considering shareowner nominees for board seats
- Monitoring the independence of the board
- Making recommendations to the board concerning the selection criteria to be used by the committee in seeking nominees for election to the board including procedures for review of candidate qualifications and potential conflicts of interest
- Aiding in attracting qualified candidates to serve on the board
- Making recommendations to the board concerning the structure, composition and functioning of the board and all board committees including the membership and scope of activities of specific committees
- Reviewing board meeting procedures, including the appropriateness, adequacy and timeliness of the information supplied to directors prior to and during board meetings
- Establishing policies and procedures for reviewing related party transactions
- Evaluating or providing for evaluation of board and board committee performance and the performance of individual directors
- Reviewing and recommending retirement policies for directors
- Reviewing any outside directorships in other public companies held by senior company officials
- Periodically receiving and considering recommendations from the CEO regarding succession at the CEO and other senior officer levels
- Developing and recommending a set of corporate governance principles to the board
- Making reports and recommendations to the board within the scope of its functions

A Global Compact publication [The Essential Role of the Corporate Secretary to Enhance Board Sustainability Oversight: A Best Practices Guide (United Nations Global Compact, September 2016)] recommended that the specific duties and responsibilities of the governance and nomination committee should also include the following:

- Ensuring the board demonstrates best practice in corporate sustainability governance and effectiveness and that a periodic review is conducted to ensure board practices continue to align with best practices in corporate sustainability governance
- Developing, maintaining, evaluating and updating a corporate sustainability governance framework which describes the corporate sustainability governance processes in the organization
- Ensuring that processes for identifying, recruiting, appointing, and providing ongoing development for directors reflect best corporate sustainability governance practices
- Assessing the effectiveness of the board nomination process at furthering the company’s sustainability objectives
- Considering the board’s operating practices and ensuring they adhere to best practices with respect to sustainability impacts (e.g. green meeting standards, travel, accommodations, etc.)
- Implementing and executing long-term board composition plans and nomination criteria that reference sustainability competencies, skills, strengths, experience, background and knowledge and reference the board’s commitment and approach to sustainability and diversity
- Developing a skills matrix/competencies grid and criteria for board membership that includes sustainability, diversity and values alignment
- Ensuring that annual report/disclosure on governance practices describes the board’s corporate sustainability governance practices in accordance with the Global Reporting Initiative guidelines or
other recognized standard

- Facilitating the integration of sustainability into orientation of new directors and ongoing training and education for the overall board and individual directors and ensuring that the sustainability skills, experience and contribution of the overall board and individual directors is incorporated into the board’s evaluation processes

Evaluations of board and management performance should be conducted no less frequently than annually by the governance and nominating committee and the committee should have the sole authority, supported by adequate funding, to retain and dismiss outside advisors that may provide consulting services in connection with the committee’s responsibilities, such as search firms used to identify board and management candidates.

For further discussion of governance and nominating committees, see “Governance and Nominating Committee” in “Governance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

Recruitment and selection of new board members has traditionally been left either to the chief executive officer or to a group of directors on a nominating committee who meet only during that period of the year when the bylaws require that directors be nominated and put before the shareholders for election. The preferred approach is for the board to take the time to adopt guidelines to be followed in order establish and maintain an orderly process for recruiting and selecting new members for its board of directors. The center piece of those guidelines should be the establishment a permanent committee that is committed to working year-round on board development including not only the traditional recruiting and selection activities but also mapping out a long-term strategy for the composition of the board and ensuring that current board members are informed about “best practices” for being knowledgeable and effective board members. The board development committee should begin by drafting a comprehensive policy that spells out in detail the procedures to be followed with respect to recruitment, evaluation, selection and orientation of new board members. The topics covered by the policy are all important and include the process of identifying, selecting and vetting potential nominees for the board; qualifications for selection, both personal and professional; procedures for handling shareholder nominations, which are particularly relevant for public companies subject to specific statutory requirements relating to such nominations; election and orientation; performance assessment and re-election.

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<td><strong>Checklist for Selection of New Candidates for the Board of Directors</strong></td>
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The following is a high-level checklist of the main steps in identifying and selecting new candidates for service on the board of directors:

- The chairperson of the board, the chief executive officer, the governance and nominating committee, or other board members identify a need to fill vacancies or add newly created directorships.
- A consensus is reached regarding the need to fill vacancies or add newly created directorships and the criteria that should be used to identify appropriate candidates taking into account the desire of the board to ensure that there is a range of skills and diversity of backgrounds represented on the board.
- The chairperson of the governance and nominating committee initiates a search, working with company staff support and seeking input from the board members and senior management, and hiring a
search firm or obtaining advice from legal or other advisors, if necessary.

- Candidates, including any candidates proposed by shareholders, that satisfy the criteria in any policies adopted by the governance and nomination committee or otherwise qualify for membership on the board, are identified and presented to the committee.
- A determination is made as to who among the committee members, board members or senior management have a basis to initiate contact with preferred candidates, or if appropriate, a search firm is utilized to initiate contact.
- The chairperson of the board or the chief executive officer and at least one member of the governance and nominating committee interviews prospective candidate(s). If the candidate is being recruited based on his or her specific qualifications for a particular board committee an interview with one of the current members of that committee should also be conducted.
- The full board is kept informed of progress.
- The governance and nominating committee meets to consider and approve final candidate(s) and conduct interviews as necessary.
- The governance and nominating committee will propose to the full board candidates for board membership to fill vacancies or to stand for election at the next annual meeting of shareholders.

Once the policy is in place, the real work begins including the following steps:

- Reviewing the charter documents of the company (i.e., articles of incorporation and bylaws) to ensure that the requirements regarding election of directors and composition of the board are appropriate for the company.
- Develop procedures for ensuring that recruitment practices and priorities are linked to the strategic plans established by the board and senior management including recruitment and selection of board members with experience in the areas that are considered to be most crucial for the strategic success of the company. In other words, each board member should be able to make a unique and meaningful contribution to the advance of the company’s strategic plans.
- Create a board director position description that can be used as a basis for identifying and evaluating prospective director candidates and informing them of their proposed duties and responsibilities. In addition, the committee should develop director qualification guidelines for use in evaluating prospective candidates and other appropriate policies and procedures (e.g., for public companies, a specific and formal definition of “director independence”).
- Create a board recruitment grid that lists and describes the skills, experience, diversity and other qualities that should be represented on the board of directors and facilitates identification of gaps that need to be filled during the recruitment process. The grid should begin with the current board members and once their attributes have been categorized the committee can focus on missing pieces as a means for developing recruiting priorities and determining what topics might be added to ongoing board training initiatives.
- Create an explicit diversity policy with respect to the composition of the candidate pool for membership on the board and the composition of the board of directors itself and establish procedures for assessing the effectiveness of the policy and the alignment of diversity at the board level with the company’s employee base.
• Create and maintain an up-to-date list of potential board candidates that includes specific information on the particular skills and experience they can bring to the board.

• Develop an application form for prospective new board members that can be used to collect, in a uniform and consistent fashion, all of the required information about potential new board members.

• Develop a package of materials to be sent to prospective members including a brief description of the recruitment and nominations process, a copy of the board director position description and additional material regarding the company and the specific activities of the board and its committees.

• Develop a schedule for the recruiting, interviewing and selection process that tracks the requirements of the company’s charter documents (i.e., articles of incorporation and bylaws) and includes setting up meetings between prospective candidates and one or more current board members, holding such meetings and providing candidates with information regarding board membership, identifying potential conflicts of interest, offering candidates an opportunity to attend a board meeting, voting on prospective candidates and advising them of the decision and providing successful candidates with a formal orientation program.

• Develop an agenda and materials for an orientation session for prospective board members that should be conducted before interviews to provide all candidates with an opportunity to ask questions about the duties and responsibilities of directors and hear presentations from members of the board development committee and representatives of senior management regarding the expectations for board members. Attendance at this orientation should be mandatory and the failure of a prospective board member to attend should be taken as an indication that he/she does not have the necessary level of interest or commitment required for contributing board members.

• Develop an interview checklist that can be used during meetings between prospective board members, designated current members of the board and the company’s chief executive officer.

• Establish procedures for formal review of applications of prospective candidates by the nominating committee and the full board of directors and procedures for informing shareholders of background of candidates that the board decides to recommend for election to the board.

• Establish curriculum for orientation and training of new directors, including samples of board materials and schedules of meetings of the full board and board committees.

• Create and administer any agreements that should be required of directors including acknowledge of corporate governance policies and procedures, indemnification agreements and, if offered, equity compensation agreements.

Many of the steps above are designed to develop the best and clearest picture of the interest and qualifications of prospective directors. At the end of the board’s due diligence process, it is time to ask several fundamental questions regarding each candidate: (1) does the candidate appear to be genuinely committed to the goals and purposes of the company; (2) is it realistic to expect that the candidate will be able to contribute the time and effort necessary in order to be an effective board member; (3)
Relevance of Prior Experience in Selecting Board Members

Experience in comparable situations is certainly a relevant factor in identifying and assessing potential board members. Maman investigated the factors that were likely to influence whether a director who already had a seat on the board of directors of a large Israeli company would be invited to sit on additional boards during a period that ran from 1974 through 1988 and found strong support for the hypothesis that a combination of the structure of the national economy and the human and social capital of individual directors determines whether a director will be asked to join additional boards. Specifically, Maman found that the availability of additional board memberships for a director depended on the position of his or her organization within the overall structure of the Israeli economy as well as the director’s position within his or her organization; the director’s affiliation with political organizations; and the director’s personal social networks. Maman looked at the backgrounds of Israeli directors who had been successful in accumulating multiple directorships and found that the directors who were invited to sit on more boards had served for longer periods on boards of directors, held high positions on these boards, had better professional credentials, were appointed from inside rather than outside the company, had large social networks, held central positions on interlocking networks, and already sat on boards of companies that were part of large business groups.


Table 4
Scheduling Tips for Recruitment and Selection of New Board Members

The following list describes the key activities for a schedule to be used in connection with the recruitment and selection of new members of the board of directors:

- Establish a committee that will focus exclusively on recruitment, selection and orientation of new board members and education and assessment of the members of the board once they have assumed their positions;
- Reference the requirements included in the company’s charter documents (i.e., articles of incorporation and bylaws) with regard to election of directors including the number of members that are up for election at the next shareholders’ meeting and requirements regarding notice of nominees to shareholders;
- Board members should convene a strategic planning session to discuss, among other things, the key strategic goals for the company in the future and the need to identify prospective candidate for board membership with the skills necessary to support achievement of the strategic goals;
- Develop a profile of the current board according to various relevant criteria such as age, race, ethnicity, specific skills and experience, community contacts, etc.;
- Reference should be made to the list of potential board candidates that should be maintained on a continuous basis to identify the most suitable candidate in light of the current and proposed composition of the board;
- Suitable candidates should be contacted about their interest in being formally considered for the board at that time and asked to complete an application form (or update any application form they may have completed in the past). Candidates should also be given information about the recruitment and nominations process and information about the activities of the company and the board and its committees;
• Once the application process has been completed, prospective candidates should be invited to an orientation session during which they members of the board development committee, as well as representatives of senior management, provide an overview of the duties and responsibilities of directors, the current and future activities of the company and specific expectations of new directors regarding time commitment and outreach activities on behalf of the company. Attendees should also have an opportunity to pose questions about board membership and, following the meeting, affirmatively confirm their interest in proceeding to the interview stage;

• Once the orientation session has been completed, candidates should meet with designated current members of the board, as well as with the company’s chief executive officer, to go through all of the items on an interview checklist including reviewing the information on the candidate’s application, going over the duties and responsibilities of board members, relaying information to the candidate about the current and projected activities of the company and answering any other questions that the candidate might have;

• Compliance with applicable policies and requirements (e.g., conflicts-of-interest and independence requirements) should be verified;

• Suitable candidates that have successfully completed the interview process should be invited to attend a board meeting and current board members should be informed in advance of the attendance and the agenda should be supplemented with introductions of candidates and opportunities for them to ask questions during the meeting;

• After the candidate has attended a board meeting and complete all other steps in the application process, the nominating committee should convene to formally consider the candidate’s application and make a recommendation to the full board which should then take a formal vote on whether or not the candidate should be presented to the shareholders of the company as an approved nominee of the board;

• All prospective candidates should be informed about the decision of the board regarding their applications and those candidates who have been endorsed by the board, and are willing to serve, should be placed before the shareholders for a vote as required under the company’s charter documents and applicable laws;

• Once candidates have been approved and elected by the shareholders they should be notified, invited to attend the next meeting, scheduled for orientation and provided with copies of any agreements required of directors.

§14 --Voting arrangements among shareholders

The power to select the board of directors is held by the shareholders of a corporation, and the power to select all or a majority of the directors is held by those shareholders who own a majority of the outstanding stock of the corporation. Voting arrangements among shareholders may take a variety of forms, particularly as they pertain to the election of directors. For example, a voting agreement, which is often referred to as a "pooling" agreement, is often entered into by two or more shareholders to provide for the manner in which each of them will vote their shares. Alternatively, one or more shareholders may create a voting trust, conferring on a trustee the right to vote or otherwise act for them, by signing an agreement that sets out the provisions of the trust (which may include anything consistent with its purposes) and transferring their shares to the trustee. Finally, voting arrangements may also arise from the grant of an irrevocable proxy.

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41 For a discussion of control devices generally see O'Neal & Thompson, O'Neal's Close Corp Ch. 5 (3d Ed).
arrangements may be used with, or in lieu of, other mechanisms for allocating control in
the corporation (e.g., different shareholder groups may be provided with the ability to
elect directors by issuing various classes of stock or the same effect as a contractual
voting arrangement can be achieved by issuing one class of stock with full voting rights
and another class of stock with no voting rights).

§15 --Board observers

Some investors in privately-held companies, particular corporate partners, may negotiate
for “observation rights” which would allow one of their representatives to attend
meetings of the board of directors and committees thereof and receive most of the
materials (i.e., notices, minutes, consents and business and financial reports) regularly
provided to directors of the company in their directorial capacities. Observers do not
have the legal status of a director and thus do not have the specific duties of a director nor
do they have the right to vote on matters that come before the board. They should,
however, be required to sign an agreement that obligates them to maintain the
confidentiality of any information received in their observer role. The level of
participation in discussions available to the observer should be determined among the
board members and the company’s agreement with the investor regarding the observer
rights should include the right to exclude the observer from access to materials and
meetings if the company believes that such exclusion is reasonably necessary to preserve
the attorney-client privilege or to protect highly confidential proprietary information.
The agreement with observers typically includes additional rights such as the right to
consult with management of the company on significant business issues, including
management’s proposed operating plans; the right to meet regularly with manager during
each year at mutually agreeable times for such consultation and to review progress in
achieving operating plans; and the right to examine the books and records of the company
and inspect its facilities and request information about the financial status of the
company, subject once again to the company’s right to exclude the observer from access
to highly confidential proprietary information and facilities.

§16 Evaluation factors for prospective directors

It is generally an honor for someone to be asked to join the board of director of a
company, regardless of its size and whether or not it is a public company or privately-
held. Board membership provides an opportunity for involvement in setting the strategy
for the business and interacting with talented individuals with interesting backgrounds
and experiences. If the company is successful and builds a strong reputation in the
marketplace and in the general community its directors will share in the glow. However,
prospective directors must also consider the duties, responsibilities and potential
liabilities associated with serving as a director. These include not only the legal duties of
care and loyalty discussed elsewhere in this Library, but also the commitment of time and
effort that must be made in order for the director to properly discharge his or her duties
and adequately protect the interests of the shareholders. Prospective directors should first
take a close look at their own lives to see if they are in a position to take on the extra
responsibilities. The next step is to collect and review basic information about the
company, its business, its management team, the other directors and its professional advisors in order to assess how it might be to actually serve on the board.

With regard to the personal side of the decision to pursue a directorship, the Corporate Director’s Guidebook (Fifth Edition) suggests that candidates should consider the following basic questions:\n
- Whether the opportunity to serve on the board is sufficiently compelling to engage the candidate’s serious interest and attention in light of any competing commitments;
- Whether the candidate has (i) sufficient time and flexibility to perform diligently the required duties for a director of that company, especially if a corporate crisis or major transaction should arise; (ii) scheduling conflicts that would unduly interfere with the board’s normal meeting schedule; (iii) the requisite skills and experience to participate meaningfully as a director of that company; and (iv) any present, foreseeable, or perceived conflicts of interest with the company, its business, or its senior management (e.g., material relationships with competitors, potential acquisition targets, or potential acquirers);
- Whether the candidate has or can develop a sufficient depth of understanding of the company’s business and business model to be an effective director; and
- Whether the candidate believes that senior management of the company and its board of directors has the requisite level of integrity and conduct themselves in an honest and ethical manner.

Once the candidate is satisfied that he or she can commit the time necessary for effective service and that he or she has a real interest in the operations of the company and the markets in the company competes, it is time to conduct a more detailed evaluation of the company’s business and its procedures with respect to corporate governance generally and the conduct of board activities specifically. The detailed evaluation, which includes meets with members of the board and the senior management team, also provides the candidate with a chance to test the truth of his or her initial assessment of the integrity and business ethics of the persons with whom the candidate would be working while serving on the board. The Corporate Director’s Guidebook (Fifth Edition) lists a number of steps that can be taken including the following:\n
- Meet with the nominating/corporate governance committee chair or other board representative who extended the invitation to consider joining the board, and with the CEO and perhaps other senior members of management, to discuss the principal issues facing the company, board organization and procedures, and the committee memberships contemplated for the candidate;
- Review the company’s recent public disclosure documents (e.g., SEC filings, press releases and investor presentations) to learn more about the nature of the company’s business, its financial condition, the stability of its current business activities and its future prospects; and

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\[^{44}\] See 62 Business Lawyer 1479, 1488 (2007).
• Gather information about the company’s reputation in the investment community and in the business world generally, by reviewing press and analyst reports and conducting Internet and other searches.

These steps provide an opportunity for the candidate to assess the attitude of the CEO and other members of the executive team about the role that directors should play in setting and monitor the business strategies of the company. The candidate should also determine whether any additional information received from this process changes his or her expectations about the level of commitment required for the position. For example, if closer scrutiny of the financial condition of the company uncovers problems with respect to liquidity the amount of time and effort associated with director service may increase dramatically to the point where the candidate cannot take the position in light of his or her other obligations.

If the candidate is still interested, he or she should take a close look at the specific policies and procedures that apply to the activities of the board and its committees and the protections that are made available to directors to reduce their potential liability for serving on the board. Among other things, the candidate should review the company’s corporate governance principles or guidelines and committee charters; review the audit committee’s membership and procedures and meet with the chair of the audit committee to discuss any recent or current critical financial or accounting issues, the procedures for reviewing public disclosures, internal controls and management reporting systems, compliance programs and risk assessment procedures; review recent examples of the “meeting book” provided to directors in advance of meetings and other information regularly provided to the directors; and gain an understanding, based on appropriate professional advice, of the company’s directors’ and officers’ liability insurance and the provisions in the company’s organizational documents and contracts relating to indemnification of directors and advancement of litigation expenses. Other issues to consider include the skills and level of participation of the company’s outside legal and financial advisors, the terms of any employment agreements and benefit packages provided to senior executives, the nature of any third-party claims or similar obligations against the company and the compensation package being offered for serving as a director. Finally, if possible, the candidate should meet with as many other directors as possible to determine whether there might be any impediments to building and maintaining a culture of collaboration and mutual respect that is necessary for effective deliberations and making good decisions.

§17 Indemnification and insurance

Prospective directors should understand the basis for potential liability as a director, particular in any subsequent securities transaction and become familiar with any right he or she might have to indemnification and to insurance coverage under applicable state law. Prospective directors should ask their counsel to verify whether the company’s state of incorporation permits indemnification of directors and, if so, whether any required

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indemnification language has been included in the company's charter documents. For example, if the company is incorporated in Delaware, the company's certificate of incorporation should include language to the effect that directors shall, to the full extent permitted by the Del. Code Ann., not be liable to the company or its stockholders for monetary damages for breach of fiduciary duty as a director. If the indemnification available to directors in the particular state is not considered to be sufficient, the prospective director should raise the possibility of changing the state of incorporation, either before he or she joins the board or within a fixed period thereafter. In addition, prospective directors should request an indemnification agreement from the company which would cover the circumstances under which the director would be entitled to indemnification and reimbursement of expenses based on actions brought against the director in that capacity. The indemnification agreement should be drafted as permitted under applicable state law and prospective directors should engage their own counsel to review the proposed terms and conditions before executing the agreement. The potential liabilities for directors, as well as the availability and scope of indemnification and insurance coverage, are discussed in greater detail elsewhere in this Library.

§18 --Time commitment

Prospective directors need to consider whether they have sufficient time to serve as a director. Directors should limit the number of boards on which they serve and be prepared to invest a substantial amount of time each year to preparing for and attending meetings of the board and its committees and participating in informal discussions with other directors, senior managers and professional advisors to the company. Add on the time required to review the company’s financial statements, business plans, forecasts, and similar documents and reports and it is not surprising that knowledgeable observers counsel prospective directors that they should be prepared to invest at least 250 hours a year to be an effective director of a public company. If the company runs into a corporate crisis or other urgent event, such as financial distress or a change-in-control transaction, the burden on directors in terms of time will grow even higher.

§19 --Frequency and conduct of meetings

Prospective directors need to ensure that board meetings are conducted on a frequent basis, that reports are obtained at each meeting from each of the key functional departments of the company (i.e., finance, engineering, marketing, research, and human

47 However, in Delaware, a director's liability for breaches of fiduciary duty cannot be eliminated or limited for: (1) any breach of the director's duty of loyalty to the corporation or its stockholders, (2) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (3) violation of Del. Code Ann. tit. 8 § 174 relating to unlawful dividends and similar matters, or (4) any transaction from which the director derived an improper personal benefit. See Del. Code Ann. tit. 8 §§ 102(b)(7) and 145. California permits the liability of directors for monetary damages for a breach of a director's duty of care to be eliminated or limited, subject to various exceptions (e.g., intentional misconduct, absence of good faith, or improper personal benefits). See Cal. Corp. Code § 204(a)(10)(A).


resources), and that accounting representatives are present at each such meeting or at meetings of the audit committee. Public companies must have an audit committee, and it’s probably a good idea for mature private companies to create an audit committee that regularly interviews the company’s public accountants and reviews the accounting procedures of the company.

§20 --Internal controls and management reporting procedures

Prospective directors should carefully review copies of the issuer’s financial statements, business plans and forecasts in order to ensure that the company has a set of internal controls that guarantee that the directors will receive timely and accurate information regarding the financial status of the company. In many cases, he or she should speak with the company’s outside accountants regarding the company’s accounting systems. Prospective directors should also understand management reporting procedures and ensure that they will be able to maintain contact with representatives of management and company counsel in order to keep informed about the company’s business.

§21 --Independence of board

Prospective directors should make sure that the board has a heavy majority of outside directors, each of whom would be independent of the day-to-day managers of the business. Independent directors, a concept discussed in more detail elsewhere in this chapter, should conduct regular meetings in executive session to discuss the performance of the CEO and other senior managers and review the performance of the entire board in relation to its governance responsibilities. While “independence” is defined in the listing standards promulgated by the national securities exchanges, prospective directors should meet with other outside directors before accepting a position on the board to determine whether they truly have an independent attitude about their role as a director and a willingness to critically evaluate and, if necessary, challenge the proposals made by the CEO and the other executive in appropriate situations.

§22 --Employment agreements and benefits

Prospective directors should review and understand any employment agreements or employee benefit plans which might be applicable to the CEO and the other senior executives. This is a good way to gauge the personal incentives of the members of the management team and identify specific areas of company performance that might be of greatest interest to such managers. Notice should be taken of the growing pressure, particularly among public companies, to restructure compensation arrangements of the senior managers, particularly the CEO and chief financial officer, to reduce the emphasis on short-term milestones and goals that raise temptations to manipulate financial reporting methods. Directors may be subject to harsh, and very public, criticism if the CEO and other executives receive large bonuses at a time when the company’s business and financial performance has been poor and shareholders have seen the value to their investment shrink.
§23 Third-party claims and obligations

Prospective directors should carefully review the circumstances surrounding each potential claim against the company, as well as all significant obligations that the company has to third parties. The existence of a large potential liability to a third party can provide clues to possible problems with the internal controls of the company and also allows the prospective director to predict, to some extent, how the CEO and other senior executives will be spending their time in the short- and medium-term. Depending on the stage of development for the company, particular types of claims (e.g., claims by larger competitors that company technology is infringing on the rights of the claimant) can substantially reduce the likelihood that the company will survive and prosper. If necessary, prospective directors should discuss each claim or obligation with company counsel and should consider obtaining another assessment from independent counsel selected by the prospective director.

§24 Organizational matters

After a corporation is legally in existence, it is still necessary to organize it to do business. Statutes in most states require a corporation’s initial directors to hold an organizational meeting after incorporation. This meeting is generally used to take various steps to complete the organization of the corporation. The organizational meeting usually must be called by a majority of the initial directors. Many states permit action the organizational matters to be taken without a meeting, where there is written consent of all the directors describing the action taken. However, it is generally recommended that the directors meet in persons to complete the following steps that are normally required for a new corporation to be properly organized:

- Adopting bylaws;
- Appointing officers and establishing their duties and responsibilities;
- Ratifying prior acts of the incorporators, promoters, and shareholders;
- Issuing shares of stock, including determining the consideration to be received in exchange for the shares, allocating the consideration between “capital” and “paid in surplus” if required by state law;
- Accepting share subscriptions;
- Establishing and maintaining appropriate corporate records, including share books, share transfer ledger, minute book and books of account;
- Approving the opening of bank accounts;
- Signing bank account authorization cards;
- Negotiating the general terms and contents of loan and security agreements;

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51 See, e.g., Del. Code Ann. tit. 8 § 108(a); 805 Ill. Comp. Stat. § 5/2.20(a); Texas Civil Statutes Article 3.06. See also Model Bus. Corp. Act (1984) § 2.05.
• Approving loans obtained from financial institutions or shareholders and signing promissory notes;
• Setting the compensation of directors and officers;
• Approving various contracts and agreements;
• Establishing benefit plans for officers and employees;
• Electing to tax treatment under subchapter S;
• Designating an attorney and accountant for the corporation; and
• Qualifying to transact business in foreign jurisdictions.

Minutes of the organizational meeting should be drafted and retained in the minute book. Such a record can be particularly important in avoiding any challenge from shareholders, creditors or taxing authorities that the corporation was not validly organized and, as such, the entity must be treated as a partnership.

§25 --Corporate governance guidelines

In addition to the various activities that are normally completed in connection with the organization of the board of directors, consideration should be given to adoption of corporate governance guidelines lay out the common expectations of the board members regarding participation in meetings and supervision of corporate activities. Once adopted, the guidelines should be revisited on a regular basis, particularly when new members are elected to the board. Corporate governance guidelines are particularly important for public companies after the enactment of the Sarbanes-Oxley Act and can cover a wide range of matters. For example, in light of the pressure imposed on public companies to embrace majority voting procedures for the election of directors, public companies should consider adopting a corporate governance policy on the subject. The policy should specify the procedures that will be followed in the event one or more directors fails to receive a majority of the votes cast in any election in which the director is running unopposed, including a summary of the factors that will be taken into account when determining if a mandatory offer of resignation must be accepted. The policy should be summarized or included in each proxy statement relating to the election of directors.

§26 --Service and compensation agreements

The duties and obligations of corporate directors are generally defined by statute, applicable case law, and the bylaws of the corporation. In some cases, however, the corporation may enter into a separate service or compensation agreement with one or more non-employee directors with regard to any special rights or privileges afforded to the director. Any such arrangement would need to be approved by a majority of the disinterested directors of the corporation and should also be fully disclosed to the shareholders. One example of such an agreement might be an arrangement between a corporation and non-employee serving as the chairman of the board. The agreement should set forth the duties and obligations of the chairman, particularly when it is anticipated that significant amounts of time will be expended in providing consultation services to senior management and attending board and committee meetings. The terms
of any directors’ fees and incentive compensation (e.g., stock options) should also be fully covered in the agreement.

§27 Meetings and actions of board of directors

Board actions are required whenever the directors exercise any of the specific statutory powers of the board with regard to organizational matters. In addition, formal board action is usually prudent when adopting a stock purchase or option plan; entering into major contracts; authorizing significant borrowings on behalf of the corporation; entering into employment contracts with key employees; adopting employee benefit plans; entering into major leases; forming subsidiaries; designating committees of the board and the powers of the committees; and adopting corporate policies.

The actions of the board of directors are generally taken in meetings at which a quorum is present. Many state laws provide that meetings may be conducted by telephone, if all parties can hear each other in a conference call. Meetings may be either regular meetings or special meetings. Regular meetings are typically established in the bylaws or are fixed by the board and generally require no call or notice; however, the formal records of the corporation may include a direction to the secretary to provide notice to the directors of a regular meeting otherwise provided for in the bylaws, and a written notice from the secretary to the directors reminding them of a scheduled meeting of the board. Special meetings, which always require notice, typically may be called by the corporate secretary, the chairman of the board, the president or other authorized people described in the bylaws. In cases where insufficient notice of a meeting has been given, the directors may waive notice and consent to the conduct of the meeting.

In addition, actions by the board of directors are often taken by unanimous written consent of all members of the board. Most state statutes provide that unless the articles of incorporation or bylaws provide otherwise, action required or permitted to be taken at a board of directors’ meeting may be taken without a meeting if the action is taken by all members of the board.

Reporting companies remain subject to the same rules and practice pointers that apply to any corporation with respect to the conduct of board meetings and documentation of the results of the deliberations of the board. In addition, however, reporting companies should review their procedures for board meetings to ensure that they are scheduled at times, and for periods, that will allow the board and its committees to satisfy its oversight obligations under the Sarbanes-Oxley Act and other SEC rules. For example, meeting schedules should be set so as to ensure that the board meets well in advance of all earnings releases and filing of periodic reports with financial information. It is also advisable for board committees to meet for all or a large part of the day prior to the full board meeting to be sure they have sufficient time to fulfill all of their responsibilities.

§28 --Regular and special meetings of board of directors
The board of directors may hold regular or special meetings in or out of the state in which the corporation is incorporated.\(^{53}\) Unless the articles of incorporation or bylaws provide otherwise, the board of directors may permit any or all directors to participate in a regular or special meeting by, or conduct the meeting through the use of, any means of communication by which all directors participating may simultaneously hear each other during the meeting.\(^{54}\) A director participating in a meeting by this means is deemed to be present in person at the meeting.\(^{55}\)

\section*{\textit{\textbf{§29}} ----Notice requirements}

The Model Business Corporation Act and some state laws state that unless the articles of incorporation or bylaws provide otherwise, regular meetings of the board of directors may be held without notice of the date, time, place, or purpose of the meeting.\(^{56}\) Some state statutes provide that a regular meeting of the board of directors may be held with or without notice, as prescribed in the bylaws.\(^{57}\)

Under the Model Business Corporation Act and the corporations statutes of some states, unless the articles of incorporation or bylaws provide for a longer or shorter period, special meetings of the board of directors must be preceded by at least two days' notice of the date, time, and place of the meeting.\(^{58}\) In contrast, state statutes simply provide that notice of special meetings must be as set out in the corporation's bylaws.\(^{59}\) Under the Model Business Corporation Act, the notice need not describe the purpose of the special meeting unless provided by the articles of incorporation or bylaws.\(^{60}\)

The Model Business Corporation Act and nearly all state corporations laws allow a director to waive any required notice before or after the date and time stated in the notice.\(^{61}\) The waiver must be in writing, signed by the director entitled to the notice, and filed with the minutes or corporate records. Alternatively, a director's attendance at or participation in a meeting waives any required notice to him of the meeting unless the director at the beginning of the meeting (or promptly upon his arrival) objects to holding the meeting or transacting business at the meeting. The Model Business Corporation Act

\begin{footnotes}
\footnoterefs{57}{See, e.g., Michigan Compiled Laws § 450.1521(2); Pennsylvania Statutes Title 15, § 1703; Tex. Bus. Corp. Act Art. 2.37(B).}
\footnoterefs{60}{Model Bus. Corp. Act (1984) § 8.22(b).}
\end{footnotes}
prohibits a director who is protesting notice from voting for or assenting to action taken at the meeting; however, some state statutes make no reference to such a prohibition.

§30 ----Quorum and voting requirements

Unless the articles of incorporation or bylaws require a greater number, a quorum of a board of directors consists of: (1) a majority of the fixed number of directors if the corporation has a fixed board size; or (2) a majority of the number of directors prescribed, or if no number is prescribed the number in office immediately before the meeting begins, if the corporation has a variable-range size board. Under the Model Business Corporation Act and some state statutes, the articles of incorporation or bylaws may authorize a quorum of a board of directors to consist of no fewer than one-third of the fixed or prescribed number of directors. The Model Business Corporation Act and most state corporation laws provide that, if a quorum is present when a vote is taken, the affirmative vote of a majority of directors present is the act of the board of directors unless the articles of incorporation or bylaws require the vote of a greater number of directors.

§31 ----Director's assent to board actions

A director who is present at a meeting of the board of directors or a committee of the board of directors when corporate action is taken is deemed to have assented to the action taken unless he objects at the beginning of the meeting (or promptly upon his arrival) to holding it or transacting business at the meeting; his dissent or abstention from the action taken is entered in the minutes of the meeting; or he delivers written notice of his dissent or abstention to the presiding officer of the meeting before its adjournment or to the corporation immediately after adjournment of the meeting. The right of dissent or abstention is not available to a director who votes in favor of the action taken.

§32 ----Ratification of board actions by absent directors

While every effort should be made to have all of the directors present and participating at board meetings, either in person or as part of a conference call, there are situations where action must be taken by less than all of the directors. While the action will be effective

provided that the required vote is obtained and timely notice has otherwise been given to all directors, it is useful to obtain a written acknowledgement from absent directors of their assent or ratification of actions taken in their absence. A copy of the ratification should be placed with the other corporate minutes and actions by written consent, and the ratification should be noted in the minutes of the next subsequent board meeting.

§33 ----Board leadership

It is customary to designate one of the members of the board of directors to serve as the chairperson who formally presides over meetings of the board and is responsible for parliamentary decisions regarding the processes followed by the board during its deliberations. For small privately-held corporations without outside investors the president typically assumes the role of board chairperson although it is also common for this title to be given to another member of the founding group. As companies grow, however, the board chair may be one of the independent directors, the CEO or an “executive chair” (such as a former CEO of the company). Privately-held corporations and not-for-profit organizations tend to prefer separation of the chairperson and CEO roles and it is recommended for those organizations as a good approach to encouraging independence and facilitating succession planning. Public companies are almost evenly divided on the issue with larger companies more likely to follow the combined role and smaller companies generally preferring a separation of duties. 69

Having the CEO also serve as the chairperson of the board of directors has long been a traditional practice among public companies, particularly larger firms, in the US and the argument in favor of this approach has been that it makes it perfectly clear who is in charge of setting the direction for the company and executing the strategies established by the CEO and the executive team with the advice and consent of the other directors. However, the recent trend has moved toward separation of the roles largely in response to what appear to have been excessive abuses of power and authority by the CEO including appointment of independent directors unable or unwilling to meaningfully challenge the CEO and the way he or she was running the business. When the chairperson is someone other than the CEO the goal should be for the chairperson to facilitate communication between the CEO and the other board members and provide helpful support to the CEO in building relationships with board members and overseeing the executive team. In situations where the CEO also acts as chairperson the independent directors may organize among themselves and designate their own lead, or “presiding,” director to work with the CEO on setting the agenda for board meetings and deciding which materials need to be circulated to directors in advance of the meeting. The lead independent director, who typically serves as the chair of the nominating/corporate governance committee of the board, will also preside over the “executive session” meetings of non-management directors and will serve as the principal liaison between the CEO and the independent directors. The lead independent director will also be the person who coordinates the

annual evaluation of CEO performance and delivers the initial report on the evaluation to the CEO before it is discussed by the entire board.\textsuperscript{70}

\section*{§34 \textit{----Board meeting agenda}}

As discussed above, the chairperson of the board is primarily responsible for setting the agenda for each board meeting; however, each director has the right to request that a particular issue be presented to all of the directors for discussion and, if appropriate, formal action. While the CEO traditionally took the lead in establishing the agenda the current practice is for the CEO and lead independent director to work together on putting a list of topics together and collecting the necessary materials for the directors to review in advance of the meeting. Obviously each meeting should include time to discuss specific issues that are of current importance to the company; however, over the course of the year the directors should be sure that the following items receive continuous attention\textsuperscript{71}:

\begin{itemize}
  \item Achievement (as well as periodic reexamination and updating) of operational and financial plans;
  \item Evaluation of the performance of the CEO and other members of executive management;
  \item Evaluation of board and committee performance, and the adequacy and appropriateness of corporate systems and controls that address legal compliance;
  \item Risk management;
  \item Corporate policy supervision;
  \item Financial and internal controls, and
  \item Timely and accurate financial reporting and other disclosures.
\end{itemize}

\section*{§35 \textit{----Executive sessions}}

The listing requirements of the national securities exchanges require that the independent directors periodically convene their own meetings in “executive session” without management directors present. While no formal board actions can be taken during executive session the meeting provides the participants with an opportunity to float ideas, and bring up issues and concerns, that they may not be comfortable discussing in front of the entire board. It is also a good time and place for candid discussions regarding the performance of the CEO and other members of the executive team. In order to control the already large time commitments of outside directors to their board responsibilities, executive sessions are generally scheduled to coincide with regular board meetings. The lead independent director, discussed above, presides over the executive sessions and should be responsible for setting the agenda in advance by polling the other independent directors to identify issues that they would like to discuss. If appropriate, the lead independent director should invite special outside advisors, such as independent special counsel, to attend the meetings to provide input on sensitive and complex issues such as

\textsuperscript{70} For further discussion, see Report of the NACD Blue Ribbon Commission on Board Leadership.

\textsuperscript{71} See 62 Business Lawyer 1479, 1508-1509 (2007).
problems with the CEO or other members of the executive team. The lead independent
director should be responsible for briefing the CEO on the issues discussed during the
executive session including any recommendations for further action by the entire board.
Since executive sessions are not formal board meetings a detailed record of the
discussions, such as minutes, should be not be created; however, notice that the meetings
have been held, along with a brief summary of the topics discussed, should be included in
the regular board minutes.

§36 ----Meeting planning

In organizing the activities associated with calling and conducting an organizational or
annual meeting of the board of directors, the following checklist may be helpful:

(1) Arrange for use of desired site for the meeting;
(2) In the case of an organizational meeting, insure that all steps have been taken to
complete formation of the corporation, including appointment of initial directors in the
articles of incorporation or by action of the incorporator(s);
(3) In the case of an annual meeting, insure that all necessary steps have been taken
relating to calling and conducting the annual meeting of shareholders and the election of
directors;
(4) Consult appropriate statutes, charter documents, and any shareholders’ agreement
to ascertain the requirements with regard to election of directors and actions by the board;
(5) In the case of an annual meeting, insure that all required reports regarding the
business and finances of the corporation will be prepared on a timely basis;
(6) Prepare informational materials and drafts of all agreements (e.g., form of
indemnity agreement) which are to be reviewed and considered at the meeting;
(7) If appropriate, take steps required to formally call the meeting, transmit notice of
meeting, and copies of materials and other items referred to in (6) above, to directors in
the manner permitted by the bylaws, and prepare affidavit of delivery of notice regarding
same;
(8) Review agenda of meeting, prepare the order of procedure for the meeting, and
confirm that any persons other than the directors who may be called upon to participate in
the meeting (e.g., non-director officers, accountants, shareholders with observer rights)
will be available;
(9) Visit meeting site and confirm arrangements for seating, audio visual, meals, etc.;
and
(10) Conduct meeting, prepare resolutions describing the actions taken by the
directors, prepare minutes of the meeting and circulate same to directors for approval,
and include a copy of the approved minutes in the minute book.

§37 --Actions without meeting

While this checklist is primarily for use in preparing for the organizational meeting of the directors, and
for regular meetings following the annual shareholders’ meeting, it can also be adapted for use in
connection with other periodic meetings of the board of directors.
Under the Model Business Corporation Act and nearly all state corporation laws, unless the articles of incorporation or bylaws provide otherwise, action required or permitted to be taken at a board of directors’ meeting may be taken without a meeting if each director signs a consent describing the action to be taken and delivers it to the corporation.\(^73\) The action is deemed to be the act of the board of directors when one or more consents signed by all the directors are delivered to the corporation. The consent may specify the time at which the action taken thereunder is effective. A director’s consent may be withdrawn by a revocation signed by the director and delivered to the corporation prior to delivery to the corporation of unrevoked written consents signed by all the directors.\(^74\) Action taken by written consent has the effect of action taken at a meeting of the board of directors and may be described as such in any document.\(^75\)

§38 — Unauthorized actions

One of the first steps that counsel who has inherited a corporate client should take is to look for board actions which are inconsistent with the corporation’s articles and bylaws and the applicable state corporation law. A board of directors will, on occasion, take action inconsistent with the corporation’s articles of incorporation or bylaws, or may take action purporting to amend articles or bylaws but, which in fact and law, do not. Examples include authorizing the selling of shares in excess of the total authorized capital; electing directors in excess of the authorized number; changing the corporate name or using a name different from the name reflected in the articles; stock splits or stock dividends without first amending the articles; and adopting stock option plans where the number of shares under the plan, when added to already issued shares, exceeds the total number of shares authorized in the articles.

Consideration needs to be given as to whether the articles or bylaws should, and can, be amended to deal with inconsistent actions. Since articles are only amended when the certificate of amendment is filed in the office of the secretary of state, no retroactive effect can be achieved. Where a corporation has acted (1) as if its articles had been amended, or (2) in a manner lawful only if its articles had been amended, counsel has very little room within which to maneuver. First, counsel should evaluate whether the action in question can be undone either with the consent of all concerned or without economic harm to third persons. Second, counsel should determine if the action in question is needed for the future and what can be done to cure the unauthorized acts. Depending on the answers to these questions, counsel and the corporation can proceed with amending of the articles in the usual fashion.

Bylaw amendments, on the other hand, are more susceptible to retroactive correction since they do not involve the intervention of a public official. The failure to amend bylaws to increase the authorized number of directors to reflect the actual number of


directors elected can be repaired in retroactive effect by having the directors and/or shareholders (depending on who had the power to change the number of directors) taking contemporaneous action which amends the bylaws effective as of the prior date, and having the board and shareholders take contemporaneous action ratifying all actions taken by the board subsequent to the unauthorized increase in the number of directors. Alternatively, if the directors and shareholders have remained the same throughout, there is no reason not to have them take the necessary action as of the prior date, using that date, since they were always authorized to do so.

§39 --Minutes and minute book

Actions taken by the directors at meetings should be memorialized in minutes which are maintained in the corporate minute book. The minutes should not only include the actual resolutions approved by the board members and the reports presented to the board of directors by officers and agents, but should also reflect the following procedural items:

- That notice of the meeting was given in accordance with the procedures in the bylaws or, if notice was not properly given, a waiver of notice was obtained from each of the directors and attached to the minutes for the meeting;
- That each of the directors has received a copy of minutes from the prior meeting, read and reviewed them and that approval was obtained;
- That role was taken and that the members of the board present are listed in the minutes;
- That the chair made a determination that a quorum was present at the meeting; and
- The names of the directors who made and seconded motions before the meeting, as well as an actual tally of the vote taken on all motions.

The content of the minutes will, of course, vary depending on the type and purpose of the meeting. For example, minutes of a regular annual meeting of the board will include resolutions relating to the election of officers and generally will reference the president's report on the business and financial performance of the corporation since the date of the last regular annual meeting. In contrast, the minutes of a special meeting will focus on the action(s) for which the meeting was called, such as filling vacancies created by the resignation of directors or officers and/or approving specified contracts or transactions which may require consideration prior to the date of the next scheduled regular meeting of the board. When items of business come up for action by the directors, they may simply appear in the minutes in the form of a motion or a resolution without introductory matter. It makes the minutes more informative, however, if the recital of the action taken is preceded by some kind of statement regarding the background for the proposal and how the matter came before the meeting. Counsel may refer to various form books and collections of examples of resolutions in drafting the minutes; however, in using forms and templates it is important that the illustrative language be carefully edited to cover all the legal requirements relevant to the matter being considered. For example, in the case of the issuance of shares, the minutes should reflect that the board considered the fair
market value of the consideration to be received for the shares, as well the fair market value of the shares for purposes of determining the purchase price.

Minutes for directors' and shareholders' meetings should always be filed in an organized fashion in the minute book of the corporation, which should be maintained at the corporation's principal office by the person acting as the corporate secretary. A duplication copy should also be maintained at an off-site location, such as the offices of the corporation's regular outside law firm. The minutes should be filed in chronological order along with any reports or other similar materials presented to the meeting and referred to in the minutes. The minute book should also include copies of the corporation's charter documents, including the latest version of the corporate bylaws certified by the secretary. A good standing certificate as of a recent date from the secretary of state of the state where the corporation is incorporated should also be included in the minute book.

§40  Board committees

Every state corporation law allows the board of directors to form committees of directors. The Model Business Corporation Act provides that, unless the articles of incorporation or bylaws provide otherwise, a board of directors may create one or more committees and appoint one or more members of the board of directors to serve on them, while other state corporation laws provide that the board of directors may designate an executive committee and one or more other committees if the articles of incorporation or bylaws provide for such committees. While many state corporation laws require each committee to have two or more members, who serve at the pleasure of the board of directors, a number of state laws make no reference to a minimum number of members required to form a committee. Other jurisdictions require committees to contain at least three directors, while some require a minimum of one director per committee.

When the board of directors reaches a certain size, and the company has received capital from outside investors, it is customary to create one or more formal and permanent committees of the board to focus on specific corporate governance issues such as accounting and financial reporting practices (i.e., the audit committee, which has attracted the greatest attention among commentators on corporate governance for public companies), evaluation of executive performance and recommendation of compensation arrangements for executives (i.e., the compensation committee) and selection of directors and oversight of corporate governance policies and procedures (i.e., the

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81 See, e.g., N.Y. Bus. Corp. Law § 712.
82 See, e.g., Tex. Bus. Corp. Act Art. 2.36.
nominating/corporate governance committee). Other permanent committees, which are often referred to as “standing” committees, may include an executive committee, which is an administrative committee of a board with a large number of directors that may be created to approve certain actions that do not require consideration by the full board; a finance committee; a litigation committee; and a corporate responsibility committee. There is no typical menu of committees that fit every company and board members should be flexible in designing the committee structure to suit their needs and ensure that key issues confronting the company and its industry are given the requisite attention. For example, nominations and corporate governance may be combined into a single committee and the committee overseeing compensation may also have additional tasks, such as leadership development, included in its title and charter.

The EY Center for Board Matters issued a report in December 2016 on how board committees among S&P 500 companies have evolved to address new challenges including heightened regulatory requirements, shifting investor expectations and transformative global changes. EY found five significant trends that emerged between 2013 and 2016 for these larger companies:

- More boards were adding additional committees due to changing board priorities and pressures, boardroom needs and company circumstances.
- Executive committees, which tended to handle certain board-level responsibilities when the board is not in session, were the most common type of additional committee, and finance, compliance and risk committees were also growing more common.
- Cyber, digital transformation and information technology were not only for the audit committee and companies were assigning various aspects of these topics to a variety of other committees including the compliance, risk, finance and technology committees.
- Compliance, risk and technology committees saw the most growth, a trend that might be explained by the likelihood that boards realized the need for greater breadth and depth of focus in these complex business areas.
- Sector matters when it comes to additional committees and in six of ten industry sectors surveyed over 75% of the companies had at least one additional committee, presumably in response to certain unique compliance, risk and operational challenges in those sectors. Utilities companies were the higher user of additional committees, followed by financial services at a distant second.

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83 For further discussion of the specific roles and responsibilities of various committees of the board of directors of public companies, see “Board Committees” in “Governance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).


85 The most common functions of additional committees, ranked by the percentage of companies adding such committees, were as follows: Executive 37%, Finance 31%, Compliance 12%, Risk 11%, Corporate Social Responsibility 7%, Technology 6%, Public Policy and Regulatory Affairs 5%, Strategy and Planning 5%, Research and Development 3% and Mergers and Acquisitions 2%.
Among smaller companies included in the S&P SmallCap 600 46% of them had at least one additional board committee, with most popular choices being executive, risk, finance, strategy and compliance.

The board of directors also has the right, and in many cases an obligation, to create a special temporary committee composed of members drawn from its pool of independent directors to consider issues and transactions that fall outside of the ordinary day-to-day matters that occupy the time and resources of board members. For example, special committees may be formed to consider transactions that involve a potential conflict of interest between the company and one or more its directors, officers and/or principal shareholders. A special committee is also commonly used when the board is considering a potential takeover bid from another party and may also be appropriate in times of stress for the company such as when there have been allegations of wrongdoing among members of the executive team or the company is facing potentially disabling litigation or financial distress. Given the sensitive and complex subject matter that generally triggers formation of a special committee it is common for the members of the committee to given the authority to engage their own independent legal counsel and any other professional advisors deemed appropriate by the committee. A special committee may be given authority to take action on behalf of the company on its own; however, the more likely scenario is that the committee will make recommendations for consideration by the entire board of directors.

### Board of Directors Capacity for Startups: A Lean Approach

During the startup stage founders are primarily focused on what is immediately in front of them and have little time or patience for considering what might need to be done to build capacity among the members of the board of directors. While this is not surprising, founders should be aware of the following key areas where the board can, and should be expect to, make a valuable contribution to the success of the organization:

**Accounting and Legal.** While founders are often more interested in identifying board members with “industry” experience, it is important not to ignore accounting and legal considerations. One or more of the board members should be assigned audit and legal responsibilities and should be expected to focus on several key areas including accounting policies, internal controls, financial reporting practices, legal and regulatory compliance and the company’s policies and procedures for ethical business conduct. The members should oversee the employment of the company’s independent accountants and the preparation and audit of the company’s financial statements; provide oversight on the external reporting process and the adequacy of the company’s internal controls; and review the scope of the other activities of the independent accountants and the activities of the company’s internal auditors. In discharging their duties, the board members should develop and maintain a regular line of communication with the company’s financial management and internal and external auditors. None of the board members involved with audit-related activities or issues should be an officer or employee of the company.

**Compensation and Benefits.** Another important, and often sensitive area, for founders is compensation, their own and the salary and other benefits that will need to be offered to put together the talent necessary for the startup to succeed with its business model. Board members assigned responsibility for compensation matters should focus on establishing executive compensation policies that are consistent with corporate objectives and strategies and recommending to the board compensation for the CEO and other members of the executive team. These members should also work with the executive team regarding recommendations
for grants to managers and employees under the company’s stock compensation plans and should also be involved in discussion regarding modifications and additions to the company’s compensation plans taking into account market conditions and actions by competitors. One of the most important, albeit delicate, roles of the board members working on compensation issues is reviewing the performance of the CEO and other executives. None of the board members working on compensation issues should be an officer or employee of the company.

Management Development. While there are certainly founders of startups with substantial management experience, management development is an important area in which board members, particularly those who have their own careers as CEOs, can contribute. Board members focusing on management development, who logically may be the same members responsible for compensation matters, should be involved in the design and implementation of organizational management development programs and the review of recommendations for changes in the senior manager positions. In addition, members should work with the CEO on recruiting and organizational culture programs that will bring and maintain appropriate diversity into the company’s mission and workplace.

Governance. While the founders will certainly want to retain a voice on the board, if not outright control, inevitably there will be a need for outside directors, either because investors demand it or the skill sets of the founders are simply too limited to fill all of the areas in which directors must be versed in. One or more members should focus on governance, which includes making recommendations regarding nominees for election to the board and various committees of the board based on established guidelines and appropriate and necessary policies and procedures to ensure that the board operates efficiently and effectively. These board members should also take the lead in educating new board members and ensuring that there is a process in place to measure the performance of board members on a regular basis.

Sustainability and Social Responsibility. Every board member should be prioritizing the strategies and activities necessary to create sustainable business; however, given that every corporation, regardless of sustainability, needs to have board members specializing in other areas, it makes sense to have some of the members invest their time on sustainability and social responsibility issues to ensure that the company is developing and implementing appropriate policies and procedures that provide support for the company’s sustainable growth mission. These members should have experience in key areas such as stakeholder engagement and sustainability reporting and bring a network of connections to experts who can guide the corporation in setting up the appropriate governance structure for sustainability.

Strategy and Technology. Several members of the board should focus on strategy and technology and should be involved in regular reviews of the company’s strategic direction in its major business segments and the impact that new technologies is likely to have on the company. With regard to technology, board members should have a solid understanding of the company’s technical relationships, including relationships with academic institutions and public sector research facilities, and the adequacy of the company’s technical resources (including its human resources). These activities are key to success and companies are advised to recruit board members with appropriate technical education and experience.

Finance. Board members focusing on finance should be involved in regular reviews of the company’s financial posture including utilization of funds, capital structure and outside financing proposals. Finance is always important; however, for a startup it is absolutely mission critical to keep a close watch on cash flow and to make sure that the company becomes and remains well positioned to seek capital from investors and/or commercial lenders. Finance responsibilities may be taken on by the board members handling accounting and legal.

While larger companies often have an executive committee at the board level that is given limited authority to act for the board between meetings on matters already approved in principle by the board, startup boards should not rely too heavily on smaller groups because all of the issues at that stage are important and require input from the entire board. Exceptions may be made for specific matters assigned by the full board from time to time. The immediacy of so many issues for a startup means that board members must be prepared to commit substantial time to their various roles, particularly when there are gaps in experience.
among the founders and other members of the executive team.

Many startups prefer to operate with small boards, often no more than three members. This is understandable and startups may fill in experience and skills gaps among board members with advisors that can provide talent in some of the areas mentioned above. If an advisor is brought on for a relatively narrow and time-limited project, such as helping the founders nurture specific customer relationships, the activities of that advisor should nonetheless be placed within one of the topical areas mentioned above such as strategy and technology so that there is an orderly understanding of what the company is doing with respect to key strategic issues such as customer development, research and development, production, and sales and marketing. It is important for at least one of the non-employee directors to have an understanding of the roles of the various advisors since advisors are often recruited from the founders’ networks. In turn, if an advisor is recommended by a non-employee director, that director should take responsibility for ensuring that a good working relationship develops between the advisor and the relevant members of the executive team.

§41 Selection and oversight of executive team

While the board of directors has the statutory responsibility for exercising all of the powers of the corporation and for managing the business and affairs of the corporation, the real day-to-day work is carried out by the members of the executive team selected by the directors. The CEO is obviously the more important player on the executive team and he or she will certainly be approved by the entire board before assuming office. The CEO will typically be given some latitude to fill the other positions on the executive team; however, the directors should insist on the right to evaluate, and sometimes interview, candidates who are to assume responsibility for key functional activities such as finance, product development, sales and marketing and manufacturing. The CEO is responsible for setting and executing the company’s long- and short-term goals and objectives and the board should establish procedures for continuously evaluating the performance of the CEO and deciding if and when it might be appropriate to make a change in the leadership of the company due to the failure of the CEO to achieve the performance goals and/or new developments in the company’s external environment that might require a new direction in the management approach. The nominating/corporate governance committee generally focuses on succession planning and executive team evaluation while the compensation committee is responsible for reviewing and approving corporate goals and objectives that will be taken into account when establishing the compensation arrangements for the CEO and other senior executives and for reviewing the performance of the executive team against those goals and objectives.86

§42 Compliance programs and internal controls

The board of directors should assume responsibility for ensuring the integrity of the company’s accounting and financial reporting systems, including the independent audit, and making sure that appropriate systems of control are in place, in particular, systems

86 For further discussion of compensation strategies for the CEO and other senior executives, see “The Chief Executive Officer” and “The Executive Team” in “Governance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
for risk management, financial and operational control, and compliance with the law and relevant standards.\textsuperscript{87} For public companies the primary responsibility for compliance programs and internal controls is vested in the audit committee of the board of directors; however, some boards have created a corporate governance committee to support the audit committee and focus on compliance issues and risk management. It is imperative for all directors to insist upon regular reports regarding the operations, business and financial affairs of the company in general and on specific measures that have been taken in the compliance area. Rather than relying on the CEO for oversight of compliance issues the board may require that the company appoint a chief compliance officer that reports directly to the audit and/or corporate governance committee.\textsuperscript{88} With regard to internal controls, the audit committee should work closely with the company’s CFO and other members of the accounting and finance team to understand the accounting policies that are most critical to the company and its operations and evaluate the experience, expertise and integrity of the CFO and others primarily involved in the preparation of the company’s financial statements and related reports.

### Role of Directors in Developing and Overseeing Compliance Programs

When companies run afoul of laws and regulations the publicity can be intense and the adverse reputational and financial consequences to the company are generally quite significant. The post-mortem brings the board of directors to “center stage” and judges, regulators, investors and pundits in the financial press will all be asking whether the directors were paying attention, asking the right questions, adopting and enforcing appropriate policies and procedures, and making it clear that “compliance matters” when setting goals and allocating rewards. Simply put, while directors are not expected to fend off every act of misconduct by executives, employees and agents of their companies, they are responsible for effectively discharging their own duties and responsibilities relating to compliance and ethics programs.

The core elements of directors’ compliance-related duties and responsibilities come from several sources:

- The Federal Sentencing Guidelines for Organizations require that the governing authority of the organization (e.g., the board of directors of a corporation) be knowledgeable about the content and operation of the compliance and ethics program; exercise reasonable oversight with respect to the implementation and effectiveness of the program; exercise due diligence to prevent and detect criminal conduct, and promote an organizational culture which encourages compliance with the law.
- Courts have recognized that directors have a fiduciary obligation to make a good faith effort to assure that an adequate compliance program exists and to take affirmative steps to ensure that appropriate information regarding compliance with applicable laws reaches the board in a regular and timely manner.
- The listing requirements of the major securities exchanges include compliance-related elements such as mandating implementation of reporting procedures, adoption of codes of conduct and business ethics and independence of board and audit committee members.
- Regulators focusing on a range of industries have articulated their preferences regarding the role of the board of directors in compliance activities by conditioning settlement agreements on undertakings by

\textsuperscript{87} See Organisation for Economic Co-Operation and Development (OECD) Principles of Corporate Governance. For further discussion, see “Compliance and Risk Management: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).

\textsuperscript{88} For further discussion of oversight and management of compliance programs, see “Compliance and Risk Management: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
the company that its board will retain independent individuals or entities with compliance expertise and regulatory guidelines consistently mention that directors must be knowledgeable about, and involved with, the compliance programs of their companies.

While attention to compliance problems is generally most intense for larger publicly-owned companies, directors of firms of all sizes, including privately-owned companies, should consider “compliance” to be a significant part of their jobs. All directors have a fiduciary duty to their corporations and to the stockholders who are actual owners of the corporation and that duty will almost certainly be breached if directors fail to act with care in developing and implementing compliance and ethics programs and as a result the corporation and/or its agents are found to be culpable of misconduct and/or unlawful activity. In order to be sure that the board and its members understand their role in developing and overseeing an effective compliance and ethics program the following questions should be carefully considered:

- Is each prospective member of the board advised prior to appointment that he or she will be expected to achieve and maintain an adequate level of knowledge and skills relating to their duties with respect to overseeing the company’s compliance and ethics program and is prior compliance experience a factor in vetting new board members?
- Has each new member of the board completed an orientation program that includes information on the sources of a director’s duties and obligations with respect to oversight of the company’s compliance and ethics program and illustrative case studies of how courts and regulators have interpreted and enforced such duties and obligations?
- Are the members of the board sufficiently knowledgeable about the operations and structure of the company to understand internal reporting procedures and lines of authority and identify the activities that present the highest level of compliance risk?
- Are the members of the board sufficiently knowledgeable about the legal environment for the company’s specific business activities so that they can readily understand the statutes and regulatory guidelines that are most relevant to decisions about how to design the compliance and ethics program?
- Has the board ensured the compliance and ethics program is appropriate for the specific activities of the company by undertaking a detailed risk assessment that identifies and ranks risk areas and issues that have raised compliance problems in the past and must be specifically addressed in the program?
- Has the board conducted a “cost-benefit” analysis regarding the scope of the company’s compliance and ethics program to ensure that the company’s limited resources for compliance infrastructure have been efficiently allocated to the areas that present the most significant potential risks and liabilities for the company?
- Has the board fulfilled its overriding obligation to be knowledgeable about the content and operation of the company’s compliance and ethics program by overseeing the development of the program and formally reviewing and approving the overall program and specific policies and procedures within the program (e.g., code of conduct, policies regarding conflicts of interest, “hot line” or other policies for reporting misconduct and policies that address the company’s highest risk areas such as employment laws, antitrust laws and/or products liability laws) before implementation?
- Has the board formally approved the creation of an independent team with compliance expertise within the company’s organizational structure that includes (1) a chief compliance officer (“CCO”) who reports directly to the board (or audit or compliance committee of the board), (2) a compliance department overseen by the CCO, (3) a corporate compliance committee (“CCC”) with members from all the company’s functional departments charged with implementing compliance policies and procedures, and (4) an internal controls/security department charged with implementing internal controls and detecting and reporting actual misconduct and suspicious activities?
- Has the board formally given the CCO and the compliance department the authority to audit the activities of the company’s legal department and provide direct guidance and assistance to members of the board regarding fulfillment of their oversight responsibilities relating to compliance activities?
- Has the board formally reviewed and approved the charter of the CCC to ensure that it addresses key activities such as the development and implementation of codes of conduct and other compliance policies and procedures, development and administration of compliance and ethics training programs, risk assessments, annual audits of compliance and internal controls programs and remedial actions and
employee discipline in the case of compliance issues or other misconduct?

- Does the board (or the audit or compliance committee of the board) receive regular reports from the CCO regarding the involvement of managerial leaders from other departments (e.g., human resources, legal, finance, business development etc.) in the activities of the CCC and the actions they have taken to implement relevant aspects of the compliance and ethics program within their departments?
- Has the board required that the CCO develop objective performance metrics for the compliance and ethics program that have been formally approved by the board and set aside time at each meeting of the board (or audit or compliance committee of the board) to receive reports on the operations of the compliance department and progress toward satisfying the program’s goals and objectives and ask compliance-related questions of the CCO and members of the senior management team?
- Has the board allocated sufficient human, financial and technological resources to the compliance and ethics program (including funding for the CCC and retention of outside advisors (e.g., lawyers, accountants and consultants)) and invested the board’s own time in continuously considering compliance-related issues?
- Has the board provided for the “express authority” and “direct reporting obligation” for those persons with day-to-day responsibility for compliance activities (e.g., the CCO) to have direct access to members of the board and/or the committee of the board to which compliance matters have been delegated (i.e., audit or compliance committee) without having to report to the CEO, other members of the senior management team or the legal department?
- Has the board acted in a manner that sets the appropriate “tone at the top” with respect to promotion of an organizational culture of ethical conduct throughout the company and encouraging compliance through the use of appropriate incentives and disciplinary measures and proactive involvement in the development and approval of the compliance and ethics program in the manner described above?
- Has the board properly aligned the incentives for members of the management team and employees by ensuring that the company’s performance evaluation and incentive compensation processes take into account not only traditional financial metrics but also compliance and ethics-related objectives such as product/services quality, safety and customer satisfaction?
- Have all of the members of the board, as well as officers and employees of the company, completed adequate training to ensure that they are aware of the content and purposes of the company’s compliance and ethics program and how issues are identified and remediated?
- Has the board provided for continuous training of board members and senior management on the impact of changes in the legal and regulatory environment of the company that will impact the company’s compliance requirements?
- Have all of the members of the board been provided with suggestions on how they can educate themselves about how to carry out their compliance oversight activities such as by accessing information, guidelines and educational programs available through government websites (e.g., Office of Inspector General)?
- Does the board oversee regular reviews of the compliance and ethics program, no less than annually, to determine if changes are necessary in light of objective metrics of the efficacy of the procedures included in the program and changes in applicable laws and regulatory enforcement initiatives?
- Does the board oversee regular reviews of the company’s internal controls and risk management policies and procedures, no less than annually?
- Does the board ensure that reports or findings of compliance problems or other acts of misconduct are promptly reviewed and that responses are made in a timely fashion?

§43 Governance codes and policy statements

In order for the disclosure controls and procedures to be effective, companies must establish and maintain the appropriate “control environment.” The term refers to the mindset and philosophy that drives decisions and attitudes throughout the organization. The environment must be established at the top of the organization hierarchy, beginning
with the board of directors and its audit committee as well as with senior management. Then it needs to be reinforced throughout the company by employee training and the values that are rewarded with respect to the behavior and performance of employees.

One of the first steps in establishing the appropriate control environment is the adoption and dissemination of appropriate corporate governance policies and procedures. Written policies and procedures are not only important in making sure that the corporate governance program is properly implemented and monitored, they can also serve as a useful public relations tool. Documents, and the associated publication strategies, fall into several different categories and distribution will depend on whether or not the company is subject to the Exchange Act’s reporting requirements. For example, some documents are internal company documents and will only be published internally. Other documents, or a description thereof, will be published in the company’s periodic Exchange Act reports and also posted on the company’s web site. Publication on the web site allows them to be viewed by the investment community, thereby providing investors with some degree of comfort regarding the company’s commitment to corporate governance. In fact, the SEC and the major exchanges have adopted a number of rules that allow public companies to distribute information to investors via the Internet in lieu of the traditional paper copies of required reports. Examples of documents that might be posted on the company’s web site include corporate governance guidelines; director qualifications and selection procedures and definition of independence; committee charters; code of ethics for senior financial officers; CEO and CFO certification of financial statements (through links to actual filings of periodic reports containing such certifications); procedures for selection of outside auditors and rotation of audit partners; description of compensation policies for senior executives; corporate code of conduct; methods for contacting company officials; and description of board, committee and officer evaluation process.\(^9\)

Obviously, each of the above-listed documents will be reviewed and approved by the board of directors and incorporated into the procedures for administration of board activities. In addition, the following documents should also be vetted by the board, although they are usually not disclosed to the public in their entirety: letter of appointment for independent directors; directors’ handbook; risk management policies; and internal compliance and control systems.\(^10\) Companies will also usually post their contract review and signatory authority policy and securities trading policy on the internal Intranet network for viewing and consultation by all of the officers and employees of the company.

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\(^10\) For further discussion of designing and implementing internal compliance and control systems, see “Compliance and Risk Management: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
The content of certain governance-related codes and policies is often driven by regulatory requirements. For example, the Sarbanes-Oxley Act provides that periodic reports filed with the SEC must disclose whether or not (and if not, why not) the company has adopted a code of ethics for senior financial officers (i.e., CFO and principal accounting officer or controller).\(^\text{91}\) The code should include standards that are reasonably necessary to promote honest and ethical conduct, including the handling of actual or apparent conflicts of interest between personal and company interests; full, fair, accurate, timely and understandable disclosures in SEC periodic reports; and compliance with applicable government rules. Any change or waiver of the code would need to be disclosed on Form 8-K.\(^\text{92}\) Both the NYSE and Nasdaq have embraced the requirements of the Sarbanes-Oxley Act in their listing standards and have actually expanded the scope of coverage beyond senior executive and financial officers to include all directors, officers and employees. Nasdaq provides that companies must adopt a code of conduct for all directors, officers and employees that is publicly available and includes the elements necessary to meet the code of ethics requirements of § 406 of the Sarbanes-Oxley Act and that companies must provide Nasdaq with prompt notification after an executive officer of a company becomes aware of any material noncompliance by the company with these Nasdaq requirements.\(^\text{93}\) The NYSE provides a little more detail in its requirement that companies adopt and disclose a code of business conduct and ethics for directors, officers and employees that addresses conflicts of interest; corporate opportunities; confidentiality; fair dealing; protection and proper use of company assets; compliance with laws, rules and regulations (including insider trading laws); and encouraging the reporting of any illegal or unethical behavior.\(^\text{94}\)

In addition, many companies are now adopting corporate governance guidelines, which are actually required for NYSE-listed companies.\(^\text{95}\) Among other things, the principles should cover director qualification standards; director responsibilities; director access to management and, as necessary and appropriate, to the outside auditors; director compensation and related-party transactions; director orientation and continuing education; management succession; and procedures for annual review and assessment of directors, committees and senior managers. Responsibility for preparation, recommendation and oversight of these guidelines would be vested in the nominating/corporate governance committee of the board. Even in the absence of guidelines, directors of Nasdaq-listed companies are subject to continuing education and training requirements.

Many companies have also adopted an extensive code of business conduct that addresses many aspects of the day-to-day activities of the company and each of its employees. The code of business conduct will often be supplemented by specific corporate policies relating to compliance areas. Companies should also be mindful of the public relations value associated with the publication of the code for viewing by business partners and the

\(^{93}\) Nasdaq Rule 5610.
\(^{94}\) NYSE Rules Section 303A.10 of the Listed Company Manual.
\(^{95}\) See NYSE Rules Section 303A.09 of the Listed Company Manual.
investment community. Each of the codes and policy statements should be drafted by in-house and outside counsel, reviewed by the audit committee, and ultimately approved by formal action of the entire board of directors. Each code or policy statement should be distributed to employees, perhaps by posting on the company’s Intranet, and it is essential that the procedures be regularly reviewed at the company’s employee training sessions.\footnote{For further discussion, see “Compliance and Risk Management: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).}

Not surprisingly, there is an extensive library of examples of codes of conduct that companies and their counsel can and should review when drafting and/or revising their own codes. One impressive effort at compiling illustrations in one place and in a form that is easily accessible is the Ethisphere Institute’s Code of Conduct Dataset that can be accessed at http://ethisphere.com/code-dataset/. It is recommended that companies review their codes of conduct no less frequently than annually and carefully monitor specific concerns of those regulatory agencies that have jurisdiction over their operational activities.

§44 Procedures for employee complaints

The Sarbanes-Oxley Act requires that public companies must establish a “hotline” to allow employees to report to the audit committee, on a confidential and anonymous basis, alleged problems relating to the company’s accounting practices. Specifically, the audit committee must establish procedures with respect to handling complaints relating to the company’s accounting, internal accounting controls or auditing matters, including implementing a system that allows employees to submit, on a confidential and anonymous basis, concerns regarding auditing matters or questionable accounting practices. Protection for employees who lawfully provide information regarding auditing and accounting matters is provided under § 806 of the Sarbanes-Oxley Act\footnote{18 U.S.C.A. § 1514A.}, which prohibits companies from discharging, demoting, threatening, harassing or otherwise discriminating in the terms and conditions of employment against any such employee. In setting up the necessary procedures the audit committee must address several key issues to make sure that the system is effective and also provides the necessary level of protection to the participants.

A fundamental question that is hotly debated is whether the company should rely on one of the many third-party vendors that are offering “universal turnkey” solutions for the establishment and maintenance of the hotline system. If an outside vendor is selected, calls would be diverted to a call center where employees of the provider, rather than the public company, would intake information from the complainant. While this type of system appears to reduce the time and effort associated with setting up the system, as well as costs of training company employees, it does have several disadvantages: the attorney-client privilege may be lost with respect to information disclosed during the process of handling the complaint; uncertainty regarding the response of the third-party vendor and its employees when asked to deliver records or provide testimony in the
course of a subsequent investigation or in litigation; the vendor’s employees may fail to collect valuable information from the complainant due to their lack of understanding of the operations and business of the company; and the information-collection process may be incomplete, possibly leading to a document trail that looks worse than it really is due to the lack of supplemental information that creates proper context.

Given the risks described above, and the lack of industry experience in the nature of complaints and the manner in which they are disclosed, a number of commentators are suggesting that companies forego outside providers in favor of a system that relies on internal staff and counsel. They suggest that companies look for how other firms have handled long-standing hotline situations, including programs that allow employees to report illegal payments and fraud under the Foreign Corrupt Practice Act and the hotline systems that have been used for a number of years by defense contractors and government agencies. When establishing an internal hotline system, careful consideration should be given to the following steps in the process:

- The procedures for screening and processing the complaints to determine, at the outset, whether the complainant and the information merit additional scrutiny. As a rule, more attention should be paid to tips that are accompanied by specific information, rather than merely general comments that lack detail.
- Counsel should be involved at an early stage in reviewing and evaluating complaints that pass through the initial screening process. This increases the likelihood that the attorney-client privilege will apply and also bolsters the audit committee’s argument that it acted with appropriate diligence in handling complaints.
- Management should understand that counsel responding to hotline complaints is acting on behalf of the audit committee and, as such, will report directly to the committee and not to management. In cases where this will create potential conflicts of interest or the complaint reaches to higher levels of management, it may be appropriate to engage outside counsel.

Regardless of how the hotline is staffed, companies should prepare a written notice of the methods that employees can use to report complaints about the company’s accounting or internal controls, or any other matter of concern to the employee. The notice should include detailed policies and procedures regarding receipt, retention and treatment of reports of financial fraud, a step that is mandated by the Sarbanes-Oxley Act. The notice should be posted on the company’s web site and included as part of the collection of employee information materials. The reporting system should also be supported by a company policy statement that affirms that employees that report violations in “good faith” will not be subject to retaliation or retribution by other employees since employees that believe they are being subjected to retaliation for reporting instances of a company's financial fraud are given the right to sue their employer and recover compensatory damages under the “whistleblower” protection provision in § 806 of the Sarbanes-Oxley Act.98 In fact, it is now common practice for companies to include language in their

98 18 U.S.C.A. § 1514A. As part of their “whistleblower” policies and procedures, companies are expected to make a clear statement that they will not discharge, demote, suspend, threaten, harass or in any manner

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general codes of business conduct and ethics that encourages all employees to promptly discuss with or disclose to their supervisor, senior corporate officers or audit committee members any information regarding acts or events of a questionable, fraudulent or illegal nature.

Under the Sarbanes-Oxley Act provision, an employee can start an action by filing a complaint with Occupational Safety and Health Administration, a division of the Department of Labor. The department has 180 days to issue a final decision. If a report is not issued within that time period, an employee can file a suit in federal court. While public companies must clearly establish whistleblower procedures, given that several administrative law opinions have imposed the provisions on non-public subsidiaries of public companies, it seems that the number of companies that may be subject to the regulations may be quite large. Given the substantial adverse impact that a whistleblower suit can have on the company’s reputation in the financial community, including a sudden and steep decline in the company’s stock price, the need to enforce protections available to whistleblowers should be taken seriously. One important cautionary note for companies is that they should not assume that an employee must show that a violation of law actually took place. In one administrative law opinion, the judge held that an employee needs to show only that he or she had a "reasonable belief" that a company violated the law when making a whistleblower claim permitted under Sarbanes-Oxley.

Further, mere proximity in time between a protected activity and the adverse action is itself sufficient to create an inference of unlawful discrimination. Thus, it is particularly important for companies to exercise additional caution to document their reasons for termination if it is necessary to terminate an employee on or near the date that the employee files a report. In light of the “whistleblower” protections in § 806 of the Sarbanes-Oxley Act, as well as parallel state law protections, it is recommended that labor counsel be involved in personnel decisions made with respect to any employees known to have provided information regarding potential problems with respect to accounting and audit procedures and policies.

A public company’s “whistleblower” policies and procedures must also take into account the potential impact of Section 21F of the Securities Exchange Act of 1934 entitled “Securities Whistleblower Incentives and Protection.”, which was adopted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). Among other things, Dodd-Frank established a whistleblower program that requires the Securities

and Exchange Commission ("SEC") to pay an award, under regulations prescribed by the SEC and subject to certain limitations, to eligible whistleblowers who voluntarily provide the SEC with "original information" derived from the independent knowledge or analysis of the whistleblower about a violation of the federal securities laws that leads to the successful enforcement of a covered judicial or administrative action, or a related action. Dodd-Frank provides for bounties of 10% to 30% of the monetary sanctions exceeding $1 million resulting from an SEC enforcement action, or several enforcement actions rising out of the same set of facts. Dodd-Frank also prohibits retaliation by employers against individuals who provide the SEC with information about possible securities violations.

On May 25, 2011, the SEC voted to approve the Final Rules implementing the whistleblower provisions of Dodd-Frank and, importantly, the SEC did not require a whistleblower to first exhaust a company’s internal compliance procedures before taking their information to the SEC although the fact that a whistleblower voluntarily participated in a company’s internal compliance and reporting system can become the basis for increasing the amount of any award eventually paid to the whistleblower. If a whistleblower reports to the company first, the SEC will consider that the information was provided to it as of the date of that internal report provided that such information is actually delivered to the SEC within 120 days of the internal report. The Final Rules identify several types of potential "whistleblowers" who would not be eligible for rewards including, but not limited to, people with a pre-existing legal or contractual duty to report their information to the SEC, attorneys, people who obtain the information illegally and officials of an entity who receive information from another person (e.g., an employee) of allegations of misconduct or learn of such information through the entity’s procedure’s for reporting misconduct.

The Dodd-Frank provisions change the prior landscape in Sarbanes-Oxley did not provide a reward for whistleblowers and the reward provisions in the Exchange Act applied only to insider trading. Commentators note that the whistleblower incentives can be expected to alter the enforcement landscape in several key areas, notably accounting fraud and violations of the Foreign Corrupt Practices Act. Further information on Dodd-Frank "whistleblower" provisions can be obtained at the SEC’s Office of the Whistleblower website.

§45 Special obligations of public company directors

Directors of public companies have the same fundamental duties and responsibilities as directors of any other company (e.g., duties of loyalty, care and disclosure). In addition, however, the deliberations of public company boards and their committees must meet the applicable legal and regulatory standards including the listing requirements of the national securities exchanges and individual directors must understand and comply with the following duties and responsibilities including within the federal securities laws:

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• Directors should establish procedures to satisfy themselves that the disclosures made in response to SEC reporting requirements (e.g., annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K) are complete and accurate and must be comfortable that there are disclosure controls and procedures in place reasonably designed to achieve the timeliness, accuracy, and completeness of all required reports.

• Directors should take diligent steps to assure the accuracy of their corporation’s registration statements filed with the SEC in connection with any offering (including in a merger or acquisition) of the corporation’s securities to the public. In order to avoid personal liability for material inaccuracies or omissions in the registration statement, a director must show that, after reasonable investigation, he or she had reasonable grounds to believe and did believe that the registration statement did not contain any materially false or misleading statements or any material omissions that made the registration statement misleading (the so-called “due diligence” standard).

• Directors are among the group of corporate insiders who are required to comply with prohibitions on “insider trading” in the federal securities laws including the prohibitions on purchasing or selling the corporation’s securities, either in the open market or in private transactions, when they possess material, nonpublic information about the corporation. A related requirement is the need for director to report share ownership and transactions, and disgorge short-swing profits, under Section 16 of the Exchange Act.

• Since directors are considered to be “controlling persons” of the corporation they are restricted in their ability to offer or sell their securities of the corporation to the public absent registration or the availability of specific exemptions (e.g., SEC Rule 144).

• Directors should be familiar with the procedures used to prepare the proxy statements used by the corporation to solicit proxies for shareholder votes and should review such statements before they are distributed to ensure that all information relating to them personally and to the activities of the board with which they are familiar is complete and accurate. A related issue is the responsibility of directors to make sure that all applicable laws and regulation are followed by the corporation with respect to shareholder actions including election contests.

• Directors should refrain from taking any action that would lead to a violation of SEC Regulation FD, which provides that material information about a public company may not be disclosed on a selective basis by the corporation or its agents to marketplace participants, such as analysts, brokers, investment advisors, and shareholders who may act on the information and have not agreed to keep the information confidential.

• Directors, particularly those serving as members of the audit committee, should ensure that effective compliance programs are established that address each of the key duties and responsibilities listed above including insider trading and disclosures, as
Best Practices for Boards and Directors of Listed Companies

The law firm Wachtell Lipton, which has established a reputation as one of the premiere governance counselors to directors of corporations with shares listed on public securities exchanges, provided the following list of what boards and individual directors will be expected to do in the coming years to meet the demands of institutional investors and the company’s other stakeholders:

- Oversee corporate strategy and the communication of that strategy to investors;
- Set the tone at the top to create a corporate culture that gives priority to ethical standards, professionalism, integrity and compliance in setting and implementing strategic goals;
- Choose the CEO, monitor the CEO’s and management’s performance and develop a succession plan;
- Determine the agendas for board and committee meetings and work with management to assure appropriate information and sufficient time are available for full consideration of all matters;
- Determine the appropriate level of executive compensation and incentive structures, with awareness of the potential impact of compensation structures on business priorities and risk-taking, as well as investor and proxy advisor views on compensation;
- Develop a working partnership with the CEO and management and serve as a resource for management in charting the appropriate course for the corporation;
- Oversee and understand the corporation’s risk management and compliance efforts, and how risk is taken into account in the corporation’s business decision-making; respond to red flags when and if they arise;
- Monitor and participate, as appropriate, in shareholder engagement efforts, evaluate potential corporate governance proposals and anticipate possible activist attacks in order to be able to address them more effectively;
- Evaluate the board’s performance on a regular basis and consider the optimal board and committee composition and structure, including board refreshment, expertise and skill sets, independence and diversity, as well as the best way to communicate with investors regarding these issues;
- Review corporate governance guidelines and committee charters and tailor them to promote effective board functioning;
- Be prepared to deal with crises; and
- Be prepared to take an active role in matters where the CEO may have a real or perceived conflict, including takeovers and attacks by activist hedge funds focused on the CEO.


§46 Investors’ participation in management of emerging companies

One of the most common funding methods for emerging companies is raising capital from venture capital investors. One of the principal differences between a venture
capital investment and other investments is the desire of the investors to actively participate in the management of the company through representation on the company’s board of directors. The degree of participation will vary depending upon the circumstances. For example, the investors may be content to elect a minority of the members of the board. In other cases, the investors may insist upon the right to name a majority of the directors. Another common scheme is to provide that both the investor group and the company's founders and managers will have equal representation on the board, perhaps with the added option of allowing the designated directors to appoint additional independent board members.

There are a number of pros and cons to be considered by management with respect to the degree of control which will be given to the investor group. Certainly, investor participation on the board provides a good method for insuring that the investors are kept apprised of corporate activities and for building a strong consensus on appropriate business strategies. Also, the investor members may be to provide assistance in recruiting independent members of the board who can bring additional expertise or business relationships to the company. On the other hand, management may believe that investor control of the board will impair their ability to make key strategic decisions.

Several researchers have argued that founder CEOs may be more prone to non-value maximizing decisions because they are less objective about the prospects of the firm and more reluctant to approve and implement decisions and strategies that might reduce their ability to retain control over the resources of the firm and corporate affairs. In order to address this concern, outside investors, such as venture capitalists, may insist that they have effective control over the board of directors so that they are in a position to monitor and control the activities of management and, if necessary, replace a founder CEO prior to the company’s initial public offering if there are genuine concerns regarding the objectivity, motivations and skills of the founder CEO and his or her ability to effectively manage the difficult transition from private to public company. However, while independent directors may be better able to implement regulation and control processes they may not be able to provide the CEO with the guidance regarding strategic direction that is necessary in fast growing industries. In fact, researchers have observed that “inside” board members may be better equipped than outsiders to assist the CEO in developing an appropriate innovative firm strategy due to their direct knowledge of the firm’s operational activities and their day-to-day exposure to the competitive and technological environment in which the firm operates.

Other researchers have argued that the presence of a large number of insiders on the board can actually temper any undue optimism of the CEO and support objective decisions based on the ready

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availability and analysis of high quality firm-specific information continuously provided by the insiders.\textsuperscript{110}

\section*{§47 --Contractual or charter restrictions}

In those instances where the investor group does not control the board of directors following the investment, the investors will typically seek covenants or charter provisions limiting the issuer's right to take certain actions without the consent of a majority of the investor group. The prohibited actions may include mergers, acquisitions, liquidation, stock issuance which would dilute the interest of the investor group, redemption or repurchase of outstanding securities, and, in rare cases, the decision to initiate a public offering. In addition, the investors may insist upon the right to elect a majority of the issuer's board of directors if the issuer defaults on material provisions of the stock purchase agreement or provisions of its organizational documents. Material events may include a failure to make mandatory dividend or redemption payments to the investor group, default under the stock purchase agreement, or, in rare cases, failure to meet certain agreed-upon performance criteria.

\section*{§48 --Procedures for facilitating management participation by investors}

The procedures for providing for investor representation on the board will vary depending upon the form of instrument used in the transaction and the voting rights otherwise available to the investors under applicable law. If the investment takes the form of common stock or debt, a separate voting agreement will be used among the investors and the principal non-investor shareholders of the company. When investors are purchasing preferred stock, the articles of incorporation may provide for class voting, allocating to the preferred stock the right to elect a specified number of directors. This may also require a separate voting agreement among the various investors to specify which of them will be entitled to designate the directors of the investor group.

\section*{§49 --Observer rights}

If an investor is not to be represented on the board, the investor still may be given the right to attend board meetings as a non-voting "observer" and to receive notice of meetings and any written materials distributed to the directors. Since the members of the board, including investor designees, generally seek to limit the number of persons at meetings, observer rights are usually only granted when the investors has a significant position in a specific round of financing. When creating observer rights consideration must be given to implementation of procedures by the company to preserve confidentiality of its proprietary information.

\section*{§50 --Considerations for investors' board representatives}

In most cases, the representatives of venture capital and other outside investors that join the board of directors following the closing of an investment will have a substantial amount of experience in serving as directors of rapidly growing private companies and, in fact, it is the willingness of these seasoned business people to become actively involved in the management of the company which tends to distinguish venture capital investments from other types of private placement financings. However, service as a member of the board of directors while continuing to manage a sizable investment in the company can present the venture capitalist with a variety of potential conflicts, as can the fact that a director may be selected by a group of investors, not all of which may have the same goals and objectives. Moreover, the investor-director will become exposed to potential personal liabilities and, as such, should consider the various issues described above that are of concern to all prospective directors.

While investors’ board representatives are not members of the management team and thus do bring a relatively independent mindset to deliberations regarding the company and its strategic direction, they do bring their obligations to their own investment fund into the board room and must be mindful of potential conflicts of interest between what is best for their fund and what is appropriate to protect the interests of all shareholders. In addition, representatives of venture capital investors are expected, perhaps more so than truly independent directors, to contribute their time and effort mentoring members of the management team and making introductions to potential business partners who can support the efforts of the management team to rapidly grow the business in the manner expected by the venture capitalists. In light of the special position and role of an investor board representative, he or she should carefully consider the following issues before joining the board of a portfolio company:111

- Does the representative understand the company’s competitive position and have access to the information necessary in order to maintain awareness of new developments in the relevant industry sector? Larger venture capital funds actually have specialists that focus solely on particular industries and, as such, they are able to provide representatives who have substantial industry background and an extensive network of contacts that can provide information that can be shared with the management team.
- Is the representative willing and able to provide support to the sale function of the company in locating new prospects and closing new business? Landing one or more key customers is essential for emerging company success and venture capitalist should be able and willing to use their contacts to open doors for the company’s sales team to gain access to the appropriate decision makers at prime customer targets.
- Does the representative have the time and temperament to serve as a sounding board for the CEO and, in some cases, mentor the CEO? The representative should build a strong, yet professional, relationship with the CEO and encourage the CEO to share his or her concerns and problems before they grow out of control.

111 Based on the advice regarding minimum expectations of board service for venture capital directors included in “A Simple Guide to The Basic Responsibilities of VC-Backed Company Directors”, a White Paper Written by the Working Group on Director Accountability and Board Effectiveness (October 2007).
• Is the representative prepared to proactively share relevant knowledge from their portfolio experience with their fellow board members? Representatives bring a wealth of experience in board service to their portfolio companies and likely have already seen many of the same problems that the board is wrestling with at any given time. A good representative can offer solutions that can be used to keep the company on track—an important consideration for emerging companies competing in an environment where speed is paramount and delays can cost the company its competitive advantage.

• Does the representative have the time to be available for informal consultation with management and the board outside of the normal board schedule? Board service requires a real commitment of time and effort, including informal face-to-face meetings and phone conversations between board meetings, and the representative must manage his or her other obligations to ensure that he or she is available when necessary. This is particularly important for emerging companies since they often find themselves in a crisis mode due to unforeseen issues with a customer or supplier, all of which are “key relationships” when the company is small.

• Are the representative and his or her fund prepared to assume and accept a lead role in financing the company? A lead venture capital investor not only contributes the large portion of any financing round it also assumes a large amount of responsibility for filling out the “syndicate” and finding other venture capital investors to provide financial support to the company. Since most venture-backed companies need two or more rounds of financing to get to a “liquidity event,” the lead investor must be prepared to provide additional capital on its own and assist the management team in identifying and landing other investors for subsequent rounds.

• Is the representative prepared to contribute his or her knowledge and experience during liquidity events (i.e., initial public offering or sale of the company to another party)? Venture capitalists invest in companies with the anticipation of a liquidity event within three to five years and bring substantial experience in the “nuts and bolts” of the underlying transactions associated with these events. Representative should be able to provide introductions to investment banks and other advisors who can guide the company and its management team through the process.

• Is the representative able to understand and respect the different responsibilities the representative has to his or her investment fund on the one hand and to the other shareholders as a director on the other hand? Once the representative joins the board he or she owes fiduciary duties to all of the shareholders and must avoid conflicts of interest such as pressing the other directors to make decisions that would unfairly benefit the representative’s investment fund at the expense of other shareholders.

• Is the representative prepared to invite and respect input from non-venture capital directors, even when those non-venture capital directors with relatively small ownership stakes by comparison to their own? Unfortunately, venture capitalists sometimes have a reputation for being arrogant and impatient with the opinions of others and it is important for the representative to take the time to listen to the views of other board members and create a collegial climate in the board room that encourages everyone to freely speak their mind about particular concerns.
§51 Directors’ education and performance assessment

Accepted notions of good corporate governance dictate the implementation of director education programs and regular assessments of the performance of the board of directors. In fact, the NYSE requires that the boards of its listed companies adopt and disclose corporate governance guidelines that address, among other things, continuing education and orientation of directors and annual performance evaluations of the board.

§52 --Orientation of new directors

Once the decision has been made to join the board, new directors should move quickly to gain a clear understanding of the board's rights and obligations in general and the company's specific policies with respect to board and committee meetings and the authority of individual officers. New directors also need to study and understand the nature of the business of the company, the industries in which the company competes, and the operational procedures and business strategies of the company. In addition, new directors will need to take the time to keep up with changing business standards and trends which may have an impact on the company. One way this can be accomplished is to have senior managers provide directors, on a regular basis, with a package of materials that includes industry publications and other reports and briefings on new business, technology, and legal developments.

As part of their orientation, new directors should obtain from the company copies of:

- Articles of incorporation, bylaws, and minutes of recent board meetings;
- Financial statements;
- Annual and periodic reports to shareholders;
- In the case of public companies, 10-K, 10-Q, and 8-K reports and registration statements;
- Documents relating to board procedures, organization, and schedules;
- Organization charts and biographies of management;
- Summaries of management compensation and copies of employment contracts and employee benefit plans;
- Product brochures and documents describing the company's business, technology, facilities, and markets;
- Important internal management and financial reports;
- The most recent management letter from auditors;
- The general and outside counsel's response to the auditor's request for information;
- Memoranda or "codes of conduct" explaining the company's policies with respect to ethical conduct, insider trading, questionable payments, conflicts of interest, antitrust compliance, and other legal compliance programs; and
- Business plans and strategic summaries.

In addition, new directors should meet with other directors to obtain their views on the company and management and to ascertain the amount of time it will take to serve as a
director. New directors should also meet personally with top managers to learn for themselves about the problems and prospects of the company, new trends in the industry, and the quality of the company's internal systems and controls. Another useful idea for easing the transition for a new director is to ask a more experienced member of the board to serve in an informal mentoring relationship for the first few months after the new director has assumed his or her position.

§53 --Continuing education of directors

The fiduciary duties and other legal obligations associated with service as a director have turned the position into something akin to a true and separate profession and, as is the case with other professionals such lawyers and accountants, directors must continuously educate themselves about the wide range of topics that are relevant to serving as an effective and informed board member. The explosion of new rules and potential liabilities during the 2000s led to increased demand for director education and training. The major exchanges began offering training and courses for new directors and directors now have a number of opportunities to attend educational and training programs and institutes sponsored by commercial legal publishers, the American Management Association and the National Association of Corporate Directors. A variety of topics are discussed at these programs including recent court decisions interpreting the duties of directors of public companies and their rights with respect to indemnification for actions taken during the course of their activities as a corporate director; managing the responsibilities of being an active and effective board member, including information and time requirements; evaluating outside consultants who may be asked to provide advice on various issues, including executive compensation and disclosure controls; emerging trends in shareholder proposals, including proper procedures for handling shareholder discontent and the increasing involvement of institutional investors; dealing with officers and employees that provide evidence of fraud; crisis management, including investigation of potential corporate misconduct; and CEO succession issues, including termination of an under-performing CEO.

While each director should establish his or her own routine for staying informed about the company and new developments of interest to anyone serving as a director, companies should also establish formal continuing education programs for their directors. Best practices for continuing education of directors are still emerging; however, the following elements should be considered when designing a program for the board of a public company:

- Companies should put together a comprehensive, permanent, collection of materials regarding the background of the company; its organizational structure, including key personnel, departments and divisions; the company’s position within the industry, and the company’s strategic plan. These materials can be used during director orientation and then should be continuously available to directors throughout their term. The materials should be updated from time to time as necessary to ensure the information contained therein remains current and notice of updates should be sent to all directors.
• At least annually, in connection with a regularly scheduled board meeting, directors will be offered a seminar on topics relevant to corporate governance and the responsibilities of directors of public companies. Appropriate topics would include the role of the board in the oversight of management, board performance evaluations, succession planning, responding to shareholder proposals, mechanisms to protect shareholder rights, financial literacy, transparency, drafting and disclosing board guidelines and executive and director compensation.

• Companies should recommend external seminars and conferences for the use of their directors in meeting their continuing education objectives. Recommendations can be made following input from outside counsel, independent auditors and other outside experts with expertise in corporate governance matters. Directors should be strongly encouraged to attend, preferably with other company directors to encourage discussion of relevant topics, one recommended external seminar or conference per year and the company should offer to reimburse a director’s reasonable expenses relating to attendance at such seminars and conferences. Directors should be required to share insights and observations derived from participating in any seminar or conference.

• The company should cause to be prepared and distributed to directors a quarterly update on significant issues, trends, and changes relating to the corporate governance of public companies and other relevant topics. In addition, the company should provide directors with copies of alerts, updates and other materials pertaining to corporate governance matters that the company may receive from outside law firms, accounting firms, regulatory agencies and other organizations.

• The company should require that directors establish and maintain a membership in the National Association of Corporate Directors (“NACD”) and cover the costs of such membership. The NACD provides a number of forums and other activities that allow directors to interact with their peers and increase their knowledge of corporate governance topics.

• Companies should arrange for directors to have regular interaction with managers and employees outside of the executive team and should schedule site visits to business operations and informal meetings with representatives to key departments and divisions to receive updates on the strategic activities of those business units and the concerns of those responsible for achieving specific strategic goals and objectives.

A continuing education program for directors will only be effective if someone is asked to take ownership of the process and the board itself sets aside adequate resources to fund the process and ensures that educational activities are a regular feature on the agenda for director meetings. Responsibility for education should be vested in the Nominating/Corporate Governance Committee and the adequacy of the educational

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112 Institutional Shareholders Services (“ISS”) has developed a process for vetting the content of director education programs and it is generally recommended that directors seek out ISS accredited programs to fulfill their continuing education requirements. Lists of ISS accredited program are readily available. Formal director education programs are also offered by several prestigious business schools including Harvard, Stanford, Wharton and Northwestern.

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program should be evaluated as part of the regular board performance assessment process described below.

§54 --Performance assessment

Boards of public companies must, as a matter of good practice and in accordance with specific legal and regulatory requirements, conduct regular evaluations of the performance of the board as a whole as well as each of the individual directors. NYSE-listed companies must include annual performance evaluations of the board in their corporate governance guidelines. In addition, the NYSE requires that its listed companies establish an independent nominating/governance committee that will be responsible for overseeing the evaluation of the board and management. Evaluation activities are not limited to the board of directors as a whole but must also be conducted with respect to activities of key board committees. The NYSE requires that each audit committee must have a charter specifying duties of the committee, including evaluating the audit committee on a "regular basis" (presumably at least annually). Similar requirements for an annual performance evaluation apply to the compensation and nominating/governance committees of NYSE-listed companies. As for NASDAQ-listed companies, they must "certify" that they have adopted a formal written audit committee charter, and that the audit committee has reviewed and reassessed the adequacy of that charter annually. In addition, the charters of the audit committees of NASDAQ-listed companies generally call for annual review and assessment of the performance and effectiveness of the committee.

Board evaluation is a relatively new phenomenon and standards are still emerging on the right questions to ask and how assessments should be conducted. Moreover, in order for the evaluation and assessment to be meaningful there needs to be some understanding as to just what is meant by the term “effective board”. One report on board evaluation advised that in order for the board to be effective it must have the right people, the right culture, the right issues, the right information, the right process and the right follow-through. 113 Each of these elements can be explained briefly as follows:

- The board should have a substantial majority of independent directors with a wide range of talents, expertise, and occupational and personal backgrounds as well as an independent-minded spirit to act courageously for the best interests of the corporation and its shareholders.
- The board should develop and encourage an internal culture that promotes candid communication and a rigorous approach to collecting and evaluating information and making difficult decisions regarding issues that are appropriate for the board.
- The board should focus its attention and activities on the design, implementation and assessment of corporate strategy and should be actively involved, in conjunction with management, on all issues that are materially relevant to maximization of long-term shareholder value.

• Directors must have access to, and carefully review, all relevant information necessary for them to make informed decisions; however, when requesting information directors must make reasonable demands that allow management to provide prompt and thorough replies.

• The board should establish a formal evaluation process that begins with developing a description of the specific duties, goals, and objectives of the board as a whole and each of the directors individually, and then deploying the tools necessary to measure actual performance against those responsibilities.

• Once the evaluation is completed the results should be shared with the full board as well as each individual director and action plans should be developed in order to address areas in which improvement is necessary.

Boards of public companies typically delegate the evaluation and assessment process to an independent committee, generally the nominating/governance committee. The members of that committee should be versed in the methods and tools that have been developed to make the assessment process more efficient and objective including the use of questionnaires and interviews. Individual evaluation of directors can be carried out in a variety of ways including self-evaluation, peer evaluation, a combination of self-evaluation and peer evaluation, evaluation by the nominating/governance committee and evaluation by an outside consultant. Hopefully one of the byproducts of the evaluation and assessment process is that the directors gain a fuller appreciation of their value to the company and the important role that they can play in setting and executing company strategy and supporting the activities of the management team that they are overseeing. The results of the evaluation should be taken seriously and the board should formally accept recommendations for improvement and require progress reports on remedial actions as a regular part of the board agenda.

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114 See Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness (2001/2005) for examples of sample forms that can be used for board evaluation and the evaluation of individual directors.
About the Author

This chapter was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, *Business Transactions Solution*, is an online-only product available and featured on Thomson Reuters’ Westlaw, the world’s largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 90 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan is currently a partner of GCA Law Partners LLP in Mountain View CA (www.gcalaw.com) and has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph. D. from the University of Cambridge. For more information about Alan and his activities, and the services he provides through GCA Law Partners LLP, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his website at alangutterman.com.

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) was launched by Alan Gutterman to teach and support individuals and companies, both startups and mature firms, seeking to create and build sustainable businesses based on purpose, innovation, shared value and respect for people and planet. The Project is a California nonprofit public benefit corporation with tax exempt status under section 501(c)(3) of the Internal Revenue Code dedicated to furthering and promoting sustainable entrepreneurship through education and awareness and supporting entrepreneurs in their efforts to launch and scale innovative sustainable enterprises that will have a material positive environmental or social impact on society as a whole.

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