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Creating an effective board

Wilson Sonsini Goodrich & Rosati

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Creating an effective board

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Creating an effective board of directors in today's environment is not unlike building a championship baseball team. One must consider the particular needs of the company, the different personalities involved, the various legal requirements and the dynamics which will occur within the boardroom. The best board on paper is no guarantee that the board in fact will be effective, any more than buying the most expensive players guarantees a world championship (as any Enron shareholder or Yankees fan will know).

Just as there is no one recipe for creating a successful team, there is no one structure which guarantees that a board will be effective. Thus, on many of today's most controversial governance issues – including separation of the positions of chairman and chief executive officer (CEO), definition of an 'independent' director and even proper compensation of directors – no one solution is right for every company. Rather, the unique circumstances and special needs of each individual company must be considered so that an effective board can be created.

With this in mind, this chapter reviews certain issues that boards should consider when trying to create an effective board. The chapter is divided into three sections:

- legal requirements, including requirements of the exchanges and recent case law developments affecting the selection and function of directors and board committees;
- practical and business issues to consider when building a board, including which personal and functional characteristics to look for in a director; and
- some guidelines for creating effective meetings, including suggestions for building the type of dynamics that make meetings effective for both the directors and management.

Legal requirements affecting the selection of directors

Understanding the legal requirements for boards used to be a fairly straightforward exercise. As a general matter, such issues were left to state law, and that typically meant Delaware law. However, times have changed. Today, both the federal government and the exchanges have a multitude of rules which are layered atop the requirements of state law – itself the subject of considerable change. The result is that the company's counsel is often a first stop for those given the task of building an effective board.

Corporate governance rules of the exchanges

In response to the corporate governance scandals of the last few years, the New York Stock Exchange (NYSE), NASDAQ and the American Stock Exchange (AMEX) have all created new corporate governance rules designed to ensure greater board effectiveness, as well as to create a structure which will ensure that the board complies with its oversight responsibilities.

All of the exchanges have established new rules designed to create boards with a majority of independent directors. In addition to requiring the boards to make an affirmative determination that each independent director has no material relationship with the company, all of the exchanges have enumerated certain tests for determining independence. For example, under the NYSE rules, a director is not independent if he receives direct compensation from the company of over a certain amount per year or has received such compensation any time during the last three years, or if he is an officer or employee of another company that receives payments or services in an amount exceeding the greater of US$1 million or 2 per cent of such other company's gross revenues in any single fiscal year.

There are other restrictions as well, and NASDAQ and AMEX have largely similar rules for determining director independence. As it is now a requirement that all companies listed on either the NYSE or NASDAQ have a majority of independent directors (all but small companies on AMEX are subject to the same requirement), an initial question which anyone considering adding new directors must consider is whether these directors meet the tests for independence.

In addition to requiring that all boards be comprised of independent directors, the exchanges have given independent directors significant new responsibilities. For example, independent directors are now required to dominate several important board committees, including the audit, compensation and nomination/governance committees. The powers of these committees have also been significantly expanded. For example, the NYSE requires that the audit committee discuss the company's earnings press releases, as well as financial information and earnings guidance, and policies with respect to risk assessment and risk management. It must also meet separately and on a periodic basis with management, internal auditors and independent auditors to discuss any problems or difficulties with the company's controls or reports. The roles of the nomination/corporate governance committee and the compensation committee have also been significantly expanded; and while NASDAQ and AMEX do not require the creation of such committees, their rules have the practical effect of giving most of the authority for decisions involving the selection of new directors and management compensation to the independent directors.

The listing exchanges have thus established very significant and detailed rules on how a board operates and who is eligible to serve on a board. These issues are among the first to consider when creating a board: for while in one sense the standards can be considered a 'floor' for the board, they are sufficiently rigorous and detailed that, until recently, only a handful of companies at the forefront of the good governance movement would have met them.

The role of the federal government in the boardroom

Historically, the federal government played virtually no role in the boardroom, leaving governance and related issues to the states. However, with the enactment of the Sarbanes-Oxley Act, passed in response to the high-profile corporate scandals in 2002, the federal government became deeply involved with the operations of companies. This occurred in a number of ways, including requiring senior officers to certify the accuracy of the company's financial statements and a variety of other measures. With respect to board issues, Sarbanes-Oxley directed the Securities and Exchange Commission (SEC) to develop a number of rules for the audit committee, to ensure that it could operate independently and effectively. The final rules are set forth in Securities Exchange Act Rule 10A-3, and discussed in SEC Release 33-8220.

Among the more significant aspects of these rules, as a matter of federal law the audit committee is now required to have direct responsibility for the appointment, compensation, retention and oversight of the work of the company's independent auditor. In addition, the audit committee is given the right to retain such other experts and advisers as it deems necessary, and to have the company pay for these advisers. The audit committee is also responsible for establishing procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, as well as for establishing appropriate procedures to handle any anonymous employee complaints about questionable accounting or auditing issues.

These same rules also require that all members of the audit committee be independent, and provide a definition of 'independence' which differs from that of the exchanges. Under these rules, an audit committee member may not accept, directly or indirectly, any consulting, advisory or other compensatory fee from the company other than in his capacity as a board member. There is no *de minimus* exception to this rule, while the term 'indirectly' is broadly defined to include any family member as well as any entity in which the audit committee member is a partner, member or officer.

State law applicable to director selection and conduct

Traditionally, in order to determine the appropriate standards for director conduct, one reviewed the corporate law of the company's state of incorporation. As the vast majority of US companies are incorporated in Delaware, this meant reviewing Delaware law. Delaware law is based largely on common law, with case law providing the most significant body of law.

There are numerous, multi-volume books discussing the appropriate standards for directors under Delaware law, and we cannot begin to discuss the details of Delaware law in these few pages. Instead, we set forth some basic principles relevant to building an effective board, as well as briefly summarising some potential legal issues facing directors of Delaware companies.

First, as a general matter, Delaware gives wide latitude to boards and management in the selection of directors. While shareholders have the ultimate choice over who gets to be a director, there are no specific requirements under Delaware law concerning, for example, whether a board has a majority of independent directors or what types of committees a board must have. Similarly, Delaware has no statute or legislation specifying the qualifications that directors must hold, the frequency with which the board must meet or the topics to be covered at board meetings. Rather, as a general matter Delaware defers to boards the general decision-making authority about how best to operate and oversee the company's operations.

However, this general grant of authority has several important limitations. For example, under Delaware law a director is required to satisfy a duty of care and a duty of loyalty in all matters relating to the corporation. The duty of care requires that directors make a reasonable effort to ascertain and consider all information necessary to make an informed decision about what is in the best interests of the corporation. The duty of loyalty requires that a director act in good faith, in a manner which the director believes to be in the best interests of the corporation and its shareholders. Only if the director satisfies both of these obligations is the director's decision protected by the business judgement rule.

Delaware law also places a premium on actions taken by independent directors, particularly where there is a possibility that the non-independent directors could have some type of structural or other conflict as a result of their positions in management. Yet Delaware courts have no firm rule for what makes a director independent in a particular circumstance. Rather, consistent with Delaware's common law tradition, Delaware courts review all the facts and circumstances of a particular situation to determine whether, with regard to that specific situation, the director can be considered independent.

Perhaps an even more significant limitation on director conduct in Delaware is the concept of equity. Under this concept, even permissible behaviour under a particular statute may be prohibited if it violates equitable principles. Thus a director who acts in a way which is inconsistent with his position may be enjoined from such behaviour even if, as a general matter, the action at issue is permitted by a specific statute. Thus, in the recent case of *Hollinger Int'l, Inc v Conrad Black*, the Delaware court reaffirmed the principle that inequitable conduct does not become permissible simply because it is legally possible, and enjoined the adoption of bylaws approved by a majority stockholder.

Again, it is not possible here to discuss even a fraction of the parameters and cases governing director conduct under Delaware (or any other state's) law. What is important to note, however, is that despite the dramatically increased role of the exchanges, and even the intrusion of the federal government, state law remains the most important body of law governing director conduct in the United States, and the state with the most established body of law is Delaware. This law continually evolves and changes (in part in response to current events, as well as other developments), and thus a good place to begin when considering the legal obligations and requirements on directors is with a review of Delaware law.

Building an effective board

Building an effective board is a difficult task for any company, and the needs and skills required will change from one board to the next. Nonetheless, there are a few common elements which should be borne in mind in the quest to create an effective board.

First, the company must go beyond the traditional search parameters for directors. Directors in today's environment need a variety of skills, and while ideally a board would have some members with CEO experience, there are other skills which may also be critical to the establishment of a board which meets the needs of the corporation. What we advise is that rather than thinking of the director's prior experience, consider the skills and qualities that would make a good director. In addition, the board should think strategically about the mix of people on the board. If, for example, the board already has three directors who were CEOs of large, public companies, and two other directors with technical or financial expertise, perhaps it is worth looking for another director with a different background – for example in the community or marketing – rather than another 'big name' former CEO. Similarly, the board will want to consider whether the director has sufficient time to perform his duties, the geographical location of the director, and other practical factors. (For more on these issues, we recommend the recent book by Jay Lorsch and Colin Carter entitled *Back to the Drawing Board: Designing Corporate Boards for a Complex World*.)

The board should also consider the issue of director education, both specifically and generally. To be an effective director, one must have a clear understanding of the company's business and of the duties of a director of a public company. A number of director education programmes have proliferated in the last few years, many of which offer an excellent opportunity for directors to get a broad exposure to issues facing directors today. Alternatively, a number of companies have brought this type of educational programme in-house, by hiring some combination of outside counsel and governance experts with the aim of educating the directors on a variety of governance issues.

Perhaps of even greater importance is company-specific education. Companies should have an orientation programme for new directors, to give them an opportunity to gain a true understanding of the business as well as to meet some additional members of management. Thereafter, the company should have some type of annual or periodic retreat, preferably at the company or one of its important locations, to discuss and understand the key drivers in the company's business and allow the directors to meet on a less formal basis with members of management. It may also make sense to ensure the directors have sufficient technical and other skills to allow for easy communication between them, particularly between meeting times and in the event of a crisis.

Running an effective board meeting

Having built an effective board, the next task for the directors is to create a structure which allows them to focus on the issues they wish to focus on. This is particularly difficult in today's environment, where boards often find much of their time taken up with regulatory issues or details which were traditionally the province of management. However, the board must remember that its primary functions are strategic direction and oversight, and not get distracted from these tasks.

One way to ensure that directors will be able to do their job effectively is to send them the materials to be considered at the board meeting sufficiently far in advance to allow their review prior to the meeting. In today's electronic age, it is remarkably easy to send directors the relevant information quickly. Companies should work with directors to take advantage of technology to make the board process more efficient. This will ensure that time spent in the boardroom can be used efficiently, rather than just going over material which could have been reviewed independently.

A board should also have a regular review of its own members and procedures, to ensure the directors feel that their colleagues are doing the job that is required. Historically, this has been a difficult subject, and sometimes directors stayed on past their effectiveness. Creating an effective board evaluation programme is one of the most difficult tasks for any board, and the specifics of the programme will differ depending on the board and company. Yet it is particularly necessary in today's environment: serving on a board is difficult enough when all members are contributing, but when one or more are not, this leads to bad governance and creates unnecessary risks for the company and the board.

Finally, it is important to remember the significance of dissent within the boardroom. Historically, the dissenter in the boardroom has not always been a welcome presence. However, in today's environment there is special need for a dissenter to make sure that the board has considered the various points of view, particularly on significant issues. As a general matter, directors are not liable for making the wrong decision; but they can be liable for not giving enough care or attention to a matter. A dissenter within the boardroom helps to ensure that all angles are considered, obviously within the context of confidentiality and cordiality necessary for a well-functioning board. (Yale professors Ian Ayers and Barry Nalebuff discuss the role of the dissenter in the boardroom in their recent book *Why Not? How to Use Everyday Ingenuity to Solve Problems Big and Small*.)

Conclusion

This chapter has set forth a few guidelines which may apply to building an effective board. Yet perhaps the most important principle to take away is that there is no one solution for building an effective board. Rather, in today's environment this is a team exercise which requires the participation of management, counsel and other advisers, as well as the directors. It is worth the effort, however, as a board which is chosen with the needs and business of the company in mind, which puts in the necessary hours, has efficient meetings and understands its obligations to shareholders and the company's other constituencies, is a clear winner.

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