

# Preparing for the Challenges of Corporate Decision Making

William H. Venema

*Member*

Epstein Becker & Green PC



## **The Role of a Corporate Governance Lawyer**

My focus in the area of corporate governance is on advising the board of directors concerning the proper discharge of their duties to the corporation in connection with various matters. Specifically, my role includes helping the board implement procedures and systems to ensure that they are able to carry out their duties. Section 141 of the Delaware Corporate Code provides that the business and affairs of every corporation organized under the laws of the state of Delaware are to be managed by or under the direction of a board of directors. Most other state corporate codes have similar provisions. Recently, certain academics and activist shareholders have attempted to supplant the current director-centric governance structure with one that is shareholder-centric. Although these efforts have gained significant attention in the press, they are not law. Accordingly, the main focus of my corporate governance counseling remains on advising the board of directors.

## **Adding the Most Value for Clients**

I add the most value for clients by helping them anticipate potential problems and avoid them by the implementation of best practices. The areas on which I focus depend on the needs of the particular corporation. In general, I try to ensure that a corporation has implemented procedures and systems to ensure the timely distribution of relevant information to the board of directors, so that the directors are able to carry out their duties to the corporation. Although certain information systems are required by Sarbanes-Oxley and other laws, boards should go beyond what is required and take steps to foster a corporate culture that values open and honest communication. Good communication with management enables the board to act in a timely manner, so that they can solve problems before they become material. In addition, I help boards develop standard operating procedures that will assist them in addressing issues effectively and avoiding many problems altogether.

The most important service an attorney can render is to remain detached. It is easy for emotions to become inflamed when a director or an officer is accused of improperly attending to his or her duties. An objective review of the facts and circumstances of the situation is essential to the development of an appropriate course of action.

Obviously, it is also important for the attorney to stay abreast of recent court opinions that have elaborated on the meaning of the duties that the various players owe to the corporation under particular circumstances. Providing this information to the board clearly and concisely will assist them in determining the course of action that the corporation should pursue.

## **Corporate Governance Issues**

Although the fundamental issue of corporate governance currently seems to be the extent to which shareholders will usurp the role of the board of directors, that issue manifests itself in a variety of ways. These manifestations include shareholder initiatives with respect to a variety of issues, such as the process for selecting directors, setting executive compensation, and expanding the list of decisions that must be decided by a vote of the shareholders. I help boards ensure that their decisions and their decision-making processes cannot be successfully challenged by activist shareholders and others.

Many of the reforms resulting from the Enron fiasco have required corporations to adopt new procedures and structures. I try to help boards comply with these complex legal and regulatory requirements in a way

that does not interfere with the board's duty to guide the business strategy and performance of the corporation.

### **Components of Corporate Governance Law**

While the umbrella topic of corporate governance law could be divided into numerous components, most practitioners divide it into the following areas: executive compensation, director elections and board composition, director decision-making, and shareholder approval requirements.

For each of these areas, there are best practices that boards should consider. These best practices can be applied across the spectrum of issues with which boards are required to deal and include ensuring that directors:

- Minimize the informal communications that occur outside of meetings,
- Allow adequate time for deliberations,
- Review the documents and other materials that are pertinent to the decisions they are being called upon to make,
- Use an appropriate selection process when selecting experts to advise them,
- Understand they must act as a group, not individually, and that their authority should not be usurped by activist corporate executives, and
- Cause appropriate records of their deliberations to be maintained.

Although informal communications among directors outside the boardroom can help establish collegiality among the directors, such communications can also be the source of problems. Ultimately, these exchanges are not as helpful as consultations in the context of a formal board or committee meeting. Informal communications should never be a substitute for the full deliberation of the board or committee at a formal meeting. Communications outside of a formal meeting can cause the members of the board or committee to be unequally informed, thereby adversely affecting the ability of the board or committee to act collectively, which is the only manner in which such bodies are entitled to act. Finally, informal communications outside a formal meeting are rarely documented, resulting in a record that might be insufficient to establish that the board or committee acted with an appropriate level of care and deliberation.

To properly conduct their deliberations, directors must have adequate time at scheduled board or committee meetings to consider the matters addressed at the meetings. Chancellor William Chandler, author of the opinion in the recent landmark case concerning the hiring and termination of Michael Ovitz as the Walt Disney Company's president, noted that the Disney compensation committee met for only one hour to consider the Ovitz employment agreement. Although Chancellor Chandler ultimately held that the directors were not liable, he expressed concern over the board's failure to spend any significant time deliberating Ovitz's employment agreement, even though it included a severance package worth over \$140,000,000, which Ovitz received in exchange for serving as president for less than fifteen months.

In conducting their deliberations, whether in the board meeting or in a committee meeting, directors should have the opportunity to review all pertinent documents and other written materials concerning any important matter before them. If the documents are too voluminous to review, the directors should receive and review detailed written summaries of the material terms contained in the documents. Such summaries could be prepared by the corporation's staff or by outside counsel. Boards should not give wide latitude to corporate officers to make changes in documents after they have been approved by the board, although this practice is,

regrettably, rather common.

Directors are charged with exercising their business judgment and acting in a manner they reasonably believe to be in the best interest of the corporation and its shareholders. In carrying out these duties, directors are entitled to rely on the corporation's employees as well as outside experts. Nevertheless, when directors use experts and advisors to assist them in making decisions, they should ensure that the procedures used to select them are appropriate in light of the specific matter they are being asked to consider. Directors should document the extent to which they relied on the advice of experts or outside counsel in making their decisions. Further, the manner in which the board of directors selected the experts and advisors should be properly documented in the record of the meeting. A written report of the expert's advice should also be included in the record of the action. Finally, if directors are going to rely on an expert in making an important decision, it is wise to have the expert make a formal presentation at the meeting so the directors can ask questions and ensure that they understand the expert's recommendation.

If the board includes among its members energetic chief executive officers, including one from the corporation itself, the directors might need to be reminded that the board takes action as a group. Moreover, corporate executives should be admonished never to take action with respect to a material matter before obtaining the formal authorization of the board. In the aforementioned Disney case, Chancellor Chandler noted that, even though the execution of an employment letter agreement with Ovitz was not legally binding upon the corporation, such action, coupled with the public announcement of the hiring of Ovitz, could be construed as putting inappropriate pressure on the board to approve the action.

The minutes of the meetings of the board and its committees are usually the principal defense evidence when a decision of the directors is challenged. Like Chancellor Chandler, courts often rely heavily on the minutes of the meetings of the board and its committees. The minutes should record what was discussed, how long the discussions lasted, whether directors asked questions, and the nature of the advice they received. For example, Chancellor Chandler expressed frustration over the difficulty in determining the length of a committee meeting and the amount of time that was devoted to discussing Ovitz's employment agreement. If directors have engaged in informal communications outside of a formal meeting, the meeting minutes should reference those communications, including their substance.

In preparing the minutes, the corporate secretary should consider their principal purposes and potential audiences. Minutes have three principal purposes. First, they are the primary evidence that there was proper corporate authority for a particular action that requires board approval. Consequently, the minutes need to record the substance of what was approved, as well as the facts necessary to establish that the action was properly approved (e.g., the proper convening of the meeting, the existence of a quorum, the approval of the action by the required number of votes). Second, minutes help demonstrate that the directors discharged their fiduciary duties appropriately. If the minutes reflect—either accurately or inaccurately—that the board failed to reasonably exercise its business judgment, they could create serious issues for the board in any subsequent litigation. Although minutes cannot correct a board's failure to act properly, they can (and should) accurately reflect when a board does act properly. Finally, minutes are part of the "institutional memory" of the board and its committees, because they establish a written record of the subjects considered, when they were considered, and what action (if any) the board took or what recommendation the committee made.

When preparing minutes, the corporate secretary should keep in mind that there are several potential audiences, including the directors themselves, shareholders, regulators, potential purchasers of the

corporation, and (potentially) the opposing party in a lawsuit. These audiences—of which the directors are well aware—affect what should be included in the minutes.

In general, the level of detail in the minutes should be proportional to the importance of the matter at hand. Nevertheless, minutes should reflect that a discussion of a particular issue took place and not simply record the discussion. Too much detail in the minutes can chill the willingness of directors to discuss issues candidly. Detail would be required, however, if a particular director wanted to “go on the record” with his or her dissent to a particular course of action. In that case, the minutes would need to reflect not only the director’s dissent, but also the reasons why the majority of directors reached a contrary conclusion.

Because of the many potential audiences for board and committee minutes, the sensitivity of a matter being discussed should also affect how it is discussed in the minutes. For example, special care must be taken when dealing with privileged information in order to avoid losing the privilege. If the board desires to make a record of a privileged matter, such as legal advice provided by outside counsel, it might be appropriate to have outside counsel confirm the advice in a letter or memorandum to the corporate secretary or in-house counsel and avoid putting the substance of the advice in the minutes. With respect to other sensitive matters where no board action is being taken, the minutes might include a simple statement, such as, “The president reported on various personnel matters.” Such statements record that the board was made aware of a particular matter and, therefore, performed its oversight responsibility. Executive sessions are, by definition, sensitive. If the board wants to preserve the content of such a session to establish that it exercised its duty of care, it could direct that a confidential memorandum be prepared and kept in a confidential file that is separate from the minutes. Having the general counsel prepare the memorandum might enable the corporation to claim the record is privileged.

### **The Financial Implications of Corporate Governance Law**

It is always easier, and usually cheaper, to prevent problems from occurring, rather than solving them after they occur. The best way to avoid expensive corporate governance problems is to have effective procedures in place, such as the best practices discussed above. Implementing the best practices discussed above will not only help the board of directors function properly, but will also enable the board to prove that it has done so.

### **Achieving Success as a Corporate Governance Lawyer**

Unfortunately, clients rarely appreciate the value of the work an attorney does to help them avoid problems. Nevertheless, these preventative measures are often the most valuable services a lawyer can provide. The most common way directors get themselves into trouble is by failing to document properly the manner in which they deliberated and decided on a particular issue. Thus, my basic strategy for providing value to a client in a corporate governance matter is to assist the board in adopting standard operating procedures based on best practices. These procedures would, of course, include a protocol for having thorough and proper deliberations and documenting decisions.

Additionally, to be successful in this role, it is critical for a corporate governance lawyer to stay abreast of developments in the field. Personally, I routinely read pertinent articles and law reviews, and I attend continuing legal education programs on corporate governance topics.

## **The Main Function of the Board of Directors**

The main function of the board of directors is to guide the business strategy of the corporation. In addition, the board should monitor the legal and regulatory compliance of the corporation. Although the board does not have a duty to search continuously for compliance problems, it should implement appropriate procedures and systems to monitor the corporation's legal and regulatory compliance. If the board becomes aware of a problem, it should take appropriate action to rectify it. The board of directors should meet regularly in executive session with the corporation's general counsel to discuss the operations of the corporation, with particular attention given to the adequacy of the corporation's compliance and governance programs and its information and reporting systems. If outside counsel is handling an investigation or significant litigation, that counsel should also routinely report to the board as well.

These functions are important because, first and foremost, they ensure that the corporation operates properly. In addition, the federal sentencing guidelines also promote comprehensive compliance procedures and careful monitoring by requiring directors to be knowledgeable of the corporation's compliance programs, to be informed by those who have day-to-day responsibility for compliance matters, and to participate in compliance training. The guidelines further provide that an effective compliance program that is monitored by the board can be a mitigating factor in a prosecutor's decision of whether to charge a corporation with misconduct.

## **Challenges Faced by the Board**

The biggest challenge a board will face is dealing with a crisis. If a board has been proactive in establishing effective procedures and systems for obtaining information and monitoring corporate performance and compliance, it should be prepared when a crisis arises.

In a time of crisis, it is important for a board to carry out its supervisory role and avoid overreacting. Recent crises have provided examples of both good and bad board behavior. The boards that functioned well were those that followed these steps:

- Carefully assess the situation with which you are presented.
- Establish procedures for obtaining any information about the crisis that was not being provided by means of existing procedures.
- Develop appropriate responses to the crisis.
- Correct any management, disclosure, or compliance deficiencies.

The boards that failed to perform well either overreacted, and made the situation worse, or delegated everything to outside counsel, accountants, and other experts, and thereby lost control of the situation and abdicated their responsibilities. Indeed, the boards that failed to perform well were often, to some extent, responsible for their respective crises, because they had failed to have procedures and systems in place that would have alerted them to the impending crisis.

A fundamental question for dealing with any crisis is whether the board should direct the CEO to lead the corporation through the crisis, or whether the chairperson of the board or some other person should take the lead. If the CEO has caused the problem by failing to perform properly or is otherwise compromised, someone else should take the leadership role. Alternatively, if the CEO is not the source of the problem and is not compromised, the CEO is in the best position to lead the corporation's response to the crisis under the

guidance of the board. Furthermore, directors should never cede their role to outside counsel, accountants, or other experts. Although such advisors can be very useful, they are, in the final analysis, advisors to the board. They should never supplant the board. It is up to the board to exercise its collective judgment and oversee the crisis resolution process.

### **Key Players Who Drive Corporate Governance and Compliance Cases**

The key players driving any matter in corporate governance and compliance cases are activist shareholders, the board of directors, corporate executives, and outside legal counsel and auditors. Of these players, the board of directors is the most important. The board of directors is the organization that is statutorily charged with being responsible for the business and affairs of the corporation. Corporate officers, employees, outside advisors, and others assisting the corporation ultimately answer to the board. Accordingly, it is up to the board to evaluate their performance. The hierarchy of each of these players is as follows:

- The board of directors comes first because of its statutory and regulatory responsibilities.
- The chief executive officer (CEO), chief financial officer, and general counsel are of the second highest importance because of the knowledge they derive from daily involvement with corporate issues, their responsibility for molding the culture of the corporation, and their statutory and legal responsibilities.
- Third in this hierarchy would be outside counsel, because they often advise the board and the executives of the corporation and comment on the work of the auditors.
- Outside auditors would be ranked fourth because of their regulatory responsibilities under various regulations of the Securities and Exchange Commission.

As mentioned, the role of the board is the most important. In recent years, that role has changed from one of advising management to one of monitoring management. Although the board has always performed these two roles, the reaction to corporate scandals such as Enron has caused regulators and activist shareholders to demand that boards focus on the role of monitoring the corporation's compliance with legal and accounting rules. Unfortunately, this emphasis on monitoring has come at the expense of attention to the board's role of advising management.

To carry out its duties effectively, a board must have timely and current information that is relevant to the important issues before it. It is essential for the board to have such information before a crisis arises. If the board is properly informed, it is up to the board to use that information appropriately and with judgment.

It is impossible for the board to stay informed if it is at odds with the senior executives of the corporation, because a board must have the assistance of management in order to stay properly informed. If the board tries to micromanage everything management does, it could cause management to provide only the information it is absolutely required to provide. Wise directors set strategy and general policies for the corporation and then delegate the details and execution of that strategy to management. That kind of relationship engenders management's trust and will make management more likely to keep the board informed. Intelligent managers recognize that keeping the board well informed is in their best interest as well, because an ill-informed board is more likely to overreact in the event of a crisis, and such a reaction is rarely a good thing for incumbent management.

In addition to its important responsibilities of keeping the board of directors properly informed and executing the strategic plans approved by the board, the senior executives of the corporation play a critical

operational role in molding the culture of the corporation. The corporation's culture affects the corporation's relationships with investors, employees, customers, suppliers, and other constituents. If the CEO and other senior executives fail to adhere to high ethical standards and fail to comply with legal requirements, it will be virtually impossible for the board to carry out its duties properly.

The role of the corporation's outside counsel and auditors is also extremely important. Unfortunately, the nature of their roles has become clouded, as the demands of regulators, activist shareholders, and the media have led to a proliferation of special investigation committees, each with its own counsel and advisors. In addition, some risk-averse auditors, attempting to adhere to ever-tightening standards of the Securities and Exchange Commission, also demand investigations. Despite the absence of compelling evidence, it has somehow become axiomatic that independent investigations lead to better corporate governance. These investigations are time-consuming, they distract directors from their advisory role, and they cause senior executives to spend more time interacting with outside counsel and advisors and less time interacting with the board of directors. Nevertheless, they are a fact of life in modern-day corporate America, although boards should use them more sparingly than they are currently. Special investigation committees should be used when needed, but they should not be seen as the answer to every problem that arises.

### **The Strongest Motivation Driving a Plaintiff**

It is difficult to say what the strongest motivation driving a plaintiff is. One factor that impacts motivation is that shareholder actions are very profitable for plaintiffs' law firms. Nevertheless, the pressures on boards of directors are coming from a variety of sources, not just plaintiffs' law firms. These sources include hedge funds, institutional shareholders, academics, and shareholder advisory organizations like the Council of Institutional Investors and Institutional Shareholder Services.

One unfortunate motivation these shareholders and groups seem to have in common is that they have little interest in long-term value creation for the corporation. Consequently, they put tremendous pressure on boards to manage for short-term results, often at the expense of the corporations' relationships with their employees, customers, and suppliers, and at the expense of the corporations' investments in projects that are critical to their success in the long term, even though they fail to yield a return in the short term. This pressure exists because few investors, whether individual or institutional, focus on the long term. The more a corporation's shares are held by funds and institutions with a short-term perspective, the more pressure the board will feel to achieve short-term results. Unfortunately, short-term results often come at the expense of the steps the corporation should take to achieve long-term goals, such as engaging in research and product development activities.

### **Settlement versus Litigation**

Settlement and litigation are opposite sides of the same coin. If one chooses to litigate, settlement has been abandoned, and if one is unable to settle, litigation is often assured. It is always difficult to determine when to litigate and when to settle. And it is virtually impossible to assess the motivations of one's opponent when it comes to litigation versus settlement.

Clearly, if one's legal position is solid (that is, the evidence can clearly establish that the corporation in general, and the board in particular, acted properly), settling such a lawsuit—for any price—could very well invite other frivolous lawsuits. Alternatively, if the corporation or the board have acted improperly, or if the corporation has failed to maintain records sufficient to establish that it acted properly, it might be prudent for

the corporation to settle a lawsuit. A middle ground of these two extremes is a situation where the corporation has a strong case but does not want to incur the expense or suffer the distraction of defending it. In that case, settling the case might be the prudent, albeit distasteful, thing to do.

## **Conclusion**

Ben Franklin's *Poor Richard's Almanac* reminded early Americans of an ancient proverb that is particularly apropos to the discussion of corporate governance: "An ounce of prevention is worth a pound of cure." The media and court cases tend to focus on the way in which corporations and their boards of directors have reacted to crises. That focus can divert attention from a far more important and useful pursuit: addressing issues proactively with plans and procedures that enable corporations to avoid problems and to respond effectively and efficiently when frivolous complaints and claims arise.

*William H. Venema is an experienced business lawyer who represents entrepreneurs and start-ups, as well as Fortune 100 companies. His law practice focuses on mergers and acquisitions, venture capital, securities offerings, licensing, joint ventures, and commercial transactions. He is a member of Epstein, Becker & Green, P.C. and is the managing partner of the firm's Dallas office.*

*In addition to representing clients in a variety of business transactions, Mr. Venema is the author of The Strategic Guide to Selling Your Software Company: Essential Advice from a Veteran Deal Warrior, as well as numerous articles on mergers and acquisitions and other business law topics. He also created The Venema Report, an e-newsletter and Web site devoted to helping entrepreneurs manage their businesses better.*

*Mr. Venema is a distinguished graduate of the U.S. Military Academy, where he earned a B.S. in engineering and was selected for membership in the honor society Phi Kappa Phi. In addition, he earned an M.B.A. from Georgia State University and a J.D. from the University of Virginia School of Law.*