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Looking Before You Leap . . . Into the Boardroom

By Mitch Bryan

The private hedge fund you started 15 years ago currently manages assets of $200 million and is flourishing. Your kids are in college, and your term in office on the local school board has expired. Years of hard work on the golf course have finally lowered your handicap below your shoe size. So isn't it time you accepted that flattering and tempting invitation to become a director of your largest investor's family-owned national restaurant chain to help prepare it for a possible IPO? Well, maybe. But first you should take a close look at the expectations and risks of serving as a corporate director today, and also of the qualifications of those currently sitting on the board you've been invited to join.

The Brave New World of Corporate Boards

In the current business and legal environment, courts, lawmakers and shareholders (as well as their lawyers) are keenly focused on faithful performance of directors' obligations in conformity with their fiduciary and regulatory duties. Unlike a decade ago, corporate directors are no longer seen or expected to act merely as advisors to a company's chief executive officer, or as a rubber-stamp for management actions. Once mainly thought of as a coveted honor, serving on a corporate board today is anything but the high-stature, low-stress reward it used to be for rising to the top as a stellar business executive at one or more successful companies. Nor are a well-known name in the business community and a golf course friendship with the CEO any longer sufficient qualifications for serving on a corporate board.

Management Oversight and Strategic Input

Beyond selecting, setting compensation for, and advising the CEO, to quote the Corporate Govern-ance Guidelines of Apple Computer, Inc., the overarching obligation of a company's board of directors is "to oversee the

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CEO and other senior management in the competent and ethical operation of the Company on a day-to-day basis and to assure that the long-term interests of the shareholders are being served." In other words, a company's directors must actively monitor the CEO's and senior management's performance and methods, and also provide strategic input into periodic goal setting and the internal and external processes by which the company plans to reach its chosen goals. Equally important, once the directors and management have jointly shaped the company's strategic direction, whenever possible, the directors should consider the company's strategic plan as a core factor in their decision-making on all board-level issues.

Company and Industry Orientation

New directors must receive and study introductory materials about the company and its industry, and be offered other educational opportunities to increase their awareness of the company's business model, competition, and strategic risks. Throughout their term, board members should occasionally visit the company's facilities and meet with its employees to gain a clearer understanding of day-to-day operations. Attendance at accredited director education programs is also often required as a condition of serving on a corporate board.

Regular Meeting Participation

Today's director must prepare for, attend and participate in most or all board meetings, as well as meetings of one or more board committees to which he or she is appointed by a majority of other board members. "Participation" at board and committee meetings means not merely casting one's vote after listening to questions, views and analyses by others. It requires active, robust and sometimes even heated— while mutually respectful— debate among all directors on the merits of board actions and decisions on which they are to vote. In addition to reviewing the agenda for each meeting, all directors must obtain and thoroughly study in advance written materials and data needed for an understanding of business to be conducted at the meeting.

Yet directors are not expected to be experts on every subject they must consider on behalf of the company. When making decisions involving complex issues and data, they are permitted and encouraged to consult and rely on opinions and advice from outside attorneys, industry experts, accountants, compensation consultants, and other specialized advisors. If issues at hand touch upon the CEO's or senior management's credibility, it is appropriate for individual directors to meet or otherwise communicate with one or more information sources within the company—such as members of its accounting department or middle management in particular operations of the company.

Board Committees and Independence

Corporate boards and most nonprofit entities typically form committees to address certain key board functions. More and more frequently, board committees—particularly the audit committee—are guided by their own individual charters and engage their own legal, accounting, and other advisors to assist in analyzing and responding to specific issues and problems. In the case of public companies, the Sarbanes-Oxley Act of 2002 requires that all board committee members be "independent" within criteria prescribed by NASDAQ "independence" standards. Similarly, it is common and considered best practice for boards to appoint at least a majority of "independent" directors to all board committees. It also is considered best practice for each committee, at the beginning of each year, to establish a schedule of agenda subjects to be discussed during the course of the year.

Fiduciary and Regulatory Duties

In discharging their obligations of overseeing management and making decisions on major company issues, common law and regulatory duties abound. In general, each director owes the corporation fiduciary duties of care, loyalty, and candor. The duty of care requires a director to act with the care an ordinarily prudent person in a like position would exercise under similar circumstances—i.e., to make informed decisions based on all information reasonably available, and to do so in a manner he or she reasonably believes to be in the best interest of the corporation and its shareholders. The duty of loyalty requires a director to act in a manner he or she reasonably believes to be in the best interests of the company and without regard for the director's personal interests. In almost all jurisdictions, a director of a company on the brink of insolvency owes

a duty to the corporation's creditors to guide the CEO and senior management in a manner that takes into account interests of creditors and is geared toward preserving corporate assets for possible liquidation to pay the company's debts.

A director's duty of candor requires truthful communication to shareholders and disclosure of any and all conflicts of interest. Directors of a nonprofit also owe to their organization a duty of obedience to the specific charitable, educational, special interest group, or other public purpose of the organization as stated in its corporate charter. In connection with the sale or purchase of stock, warrants, or other securities, under Securities Exchange Commission Rule 10b-5 and state Blue Sky laws, a company's directors and officers owe buying or selling shareholders a duty not to make any false or misleading statements nor to omit material facts. And the list of regulatory duties goes on—particularly for directors of public companies under Sarbanes-Oxley and related SEC regulations.

Director Liability

A director's breach of any of his fiduciary duties to the company or its creditors, or of regulatory duties to shareholders, will expose him or her to liability—and sometimes punitive damages, penalties or other sanctions—for resulting loss to injured persons or entities. In addition to protection afforded by liability limitation and indemnity provisions in the company's corporate by-laws, the "business judgment rule" ordinarily will shield directors from liability for negligent acts and omissions committed in the course of performing their duties.

The business judgment rule insulates a director from liability, however, only if the director is disinterested (i.e., has not breached the duty of loyalty) in respect to the action or inaction involved. The director also must actually exercise judgment—rather than passively acquiesce, and do so on an informed basis with a good faith belief that her conduct is in the best interests of the company. One or more of several recognized defenses for a director's breach of regulatory duties may be available in any given case.

D&O Liability Insurance

To protect a director's personal assets from potential liability for negligence or other wrongful acts, the company must have adequate director and officer liability insurance coverage. The types of available D&O insurance, most common exclusions, and other grounds for denial of coverage are beyond the scope of this article. As a general rule of thumb, independent directors should insist that the company provide D&O insurance with separate coverage limits for themselves either individually or as a group. Before accepting a seat on the board, a newly elected director should have legal counsel review and advise regarding adequacy of coverage.

Best Practices Are the Best Defense

Needless to say, following best practices in the boardroom is the most reliable form of insurance for insulating a director from personal liability. A few quick thoughts on best practices directors should follow to minimize liability exposure. First, maintain independence, vigilantly guard against any conflicts between your personal or family interests and interests of the company, and promptly disclose any conflict that may arise. Second, hire and rely on genuinely qualified experts when analysis is necessary for a board decision beyond your knowledge and expertise. Third, retain copies of meeting agendas and minutes identifying all attendees and noting topics discussed and votes taken, and copies of materials and expert advice on which you and your fellow board members relied in making decisions.

Do You Have What It Takes?

By carefully considering the responsibilities and risks involved in serving as a corporate director, you will be better prepared for deciding whether to do so. In making your decision, keep in mind your hedge fund's major investor invited you to sit on his company's board because he knows you to be an individual possessing the highest personal and professional ethics, integrity, and values. Don't be timid; after all, you didn't become a highly successful business executive by faintness of heart in the past. But be sure to consider whether your business relationship with your major investor might impair your independence and thereby your qualification to serve as a member of his company's board. Above all, in any decision you make as a prospective or sitting board member, let good faith be your guide.

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