

CORPORATE GOVERNANCE AND THE LIABILITY OF BOARDS OF DIRECTORS

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I. ASSESSING THE RISKS OF BOARD SERVICE.

- Governance is Governance. It's different from management. It's about oversight. Proactive oversight. And its required by law.
- Governance Environment. It's important that the board and senior management understand governance, and create an environment which values excellent governance practices. Are they articulated in writing? Are they implemented? Does the board update itself on governance issues, best practices and conduct which results in litigation? Boards and directors opposed to continuing education on governance subjects (as endorsed by the New York Stock Exchange, Nasdaq, various business organizations, institutional investors such as TIAA-CREF and CALPERS, and the National Association of Corporate Directors) should be avoided. Good governance is about good practices, continuing education, execution and evaluation.
- Board Composition. Qualities such as honesty, intelligence, foresight, strategic, independent (in thought and action), receptive to input, willing to share knowledge, able to withstand pressure, analytical, collaborative, challenging, decisive, willing to speak out, willing to compromise are all qualities needed by directors. Find out whether the other board members have them. Think about the types of people needed by this particular board. How are directors selected? Does the board analyze the skills needed on the board as part of the selection process? Was the process organized by the board's independent directors, or was it controlled by a particular person or group? If management or a dominant shareholder group controls the board, ascertain their agenda, and be careful about serving.
- Board Organization and Leadership. How is the board organized? Does it have the necessary committees? How are the committee members selected? Who presides at board meetings and executive sessions of the board? Is there independent board and committee leadership? Does the leadership promote and observe good governance practices?
- Board/Management Relations. Directors need to be schizophrenic: proactive overseers on the one hand, effective collaborators with management on the other. It

must be clear that the CEO works for the board, not the other way around. Underlying many of the recent corporate scandals are boards which were overly deferential to aggressive, sometimes imperious, senior executives. If the CEO isn't committed to excellence in governance, if the board isn't clear in practice about its role vis-à-vis management or if the board is basically a rubber stamp for management proposals, avoid serving as a director.

- Missions/Values/Culture. Does the company have a well articulated mission and set of corporate values? Does the board support these values implicitly and explicitly, by its selection of directors, its CEO selection, the conduct it rewards, holding management accountable for building a culture of fairness, trust and high performance, and how it deals with issues and concerns brought forward by employees and lower level management. Does the board understand and take responsibility for the company's culture?

Constants in many of the high-profile corporate failures were highly-compensated senior management, tolerance or ignorance on the part of the board of highly-controlling, sometimes abusive, management behavior and a "me-first" culture. People who "rock the boat" weren't promoted or encouraged; they left or were terminated. Whistle blower protection was incorporated in the Sarbanes-Oxley legislation for a reason.

Great boards understand the attributes and benefits of a great corporate culture, and insist on the development of such a culture by their management. There are excellent organizational culture assessment tools for monitoring a company's culture. Even though it's becoming a cliché, the "tone at the top" starts with the board.

- Planning. Does the company have a plan that it follows? Read it. Does it reflect the mission and values of the organization? Is there an adequate assessment of the company's strengths, weaknesses, opportunities and threats? Does it adequately balance short and long term value creation and performance?
- Conflicts of Interest. Is the board truly sensitive to conflicts of interest and properly cautious in dealing with them? Independence and objectivity are important in discharging a director's duties. Personal relationships among directors, or between directors and management are closely examined by the media, investigators and litigants when problems arise. Be extremely cautious about an environment where relationships may in actuality or perception compromise board objectivity. These issues also arise when a director, or an organization with which he or she is associated, is a customer, supplier, controlling shareholder, beneficiary of corporate gifts, etc.
- Special Expertise. If an invitation to serve is occasioned by a person's special expertise, greater responsibility, and reliance on that expertise by other directors, may result. Make every effort to ascertain the consequences of accepting an appointment based on that expertise, and be sure that the board has other experienced directors

who have commensurate responsibilities, and that the governance environment on the board is conducive to the utilization of the special knowledge of the various directors.

- Accountability. Does the board effectively evaluate management and itself? Does the board appropriately hold management accountable for corporate performance? Does the board have performance objectives for itself, and does it hold itself accountable for achieving those objectives? Are directors evaluated individually? Is evaluation and feedback embraced as a means of enhancing board and management performance, or is it avoided as a threat to collegiality and collaboration?
- Human Resources. Boards typically take responsibility for allocating and overseeing a company's financial resources. What about its human resources? Is the board holding management accountable for conduct and policies which are fair to the workforce as a whole? Is there is a comprehensive organizational philosophy which fairly allocates compensation, incentives, benefits, accountability and opportunities across the entire workforce? This is a key aspect of building a great culture.
- Board Duties. Does the board understand its legal duties of good faith, care, loyalty, compliance and oversight? How is the board educated regarding these duties? Are there procedures and processes in place to assure that it is properly performing its responsibilities? What committee is responsible for overseeing corporate compliance with laws, regulations, and the company's governing documents, key agreements and internal policies? Is the board regularly advised of issue which arise? Does the board have individual contact with the CFO, inside and outside legal counsel, internal audit, risk management, human resources, and do the individuals responsible for these functions have and use direct access to the board? Does the board seek special counsel on particularly sensitive issues when it needs to?
- Director Protection. Is the board and management sufficiently aware of the risks of director service? Are the risks openly discussed? Does the board have the resources needed to carry out its work? Is compensation appropriate given the skills, time required and risks involved in director service? Are resources provided for board education and orientation with respect to the industry in which the company competes, the business of the company and current governance developments? Are directors appropriately indemnified from, and insured against, liability?
- Governance Ratings. For public companies, one or more organizations will have published their assessment of the company's governance as a rating or score. These assessments may provide an informative "independent" view of the company's governance from the perspectives, and with the biases, of the particular ratings organizations, and should be reviewed.

II. WHY DO BOARDS FAIL?

- Poor risk assessment.

- Lack of real understanding of their oversight roles, and the tools needed to be effective overseers.
 - ❖ The directors may be good managers, but they aren't good overseers.
- Lack of understanding of what it means to be a fiduciary.
 - ❖ This is linked to the duty of loyalty.
 - ❖ The interests of the company come first.
- Intimidated by management; overly reliant on management; passive.
 - ❖ This was the case in Enron, WorldCom, Tyco, etc.
 - ❖ The board ended up working for management, not the other way around.
- Misplaced trust/too much reliance.
 - ❖ Blind faith in CEO and management team.
 - ❖ Belief that once they hire a well credentialed CEO, CFO, name accounting firm, law firm or investment banker, etc., they can rely without oversight or inquiry. That isn't the law.
 - ❖ Failure to probe management, lawyers, accountants.
 - ❖ Failure to get to know second and third tier employees.
- Failure to understand/monitor the corporate culture.
 - ❖ Result was in many cases a culture of "me first," arrogance, greed.
 - ❖ Result is a culture where people don't bring concerns about wrongdoing forward.
 - ❖ Tight control of information; development of information silos.
 - ❖ Discouraging dissent.
- Failure to appreciate the signals they send about the values and ethics of the organization.
 - ❖ Who they recruit for the board.
 - ❖ Who they hire as CEO.
 - ❖ How they compensate management versus how management compensates the employee base.

- ❖ What behaviors they reward. What behaviors they sanction (or fail to sanction).
- Failure to appreciate and use the oversight tools at their disposal.
 - ❖ CFO, controller, internal auditor, risk assessor, risk manager, internal counsel.
 - ❖ Independent counsel, independent auditor and other advisors.
- Failure to observe good governance practices.
 - ❖ What are the sources of good practices?
 - ❖ Board is passive, not a proactive overseer.
 - ❖ Board members lack energy, judgment, leadership, courage.
 - ❖ Board co-opted by pay, perks, relationships - i.e., not sufficiently independent or objective. Many of the directors were hand-picked by the CEO and were friends, had business relationships, served on each others' boards.
 - some interesting cases on independence.
 - ❖ Committee failures.
 - governance: re independence.
 - compensation: excessive amounts; perks; loans
 - audit: financial statements (these are the company's statements, not the auditors); compliance
- Failure to perform legal duties.
 - ❖ Oversight.
 - ❖ Good faith.
 - ❖ Care (informed judgment; appropriate process).
 - ❖ Loyalty.
 - ❖ Compliance.
- Board education.
 - ❖ Insufficient knowledge of the company and industry.
 - ❖ Insufficient knowledge about governance.

- ❖ Insufficient knowledge of their duties and their liabilities.
- ❖ Insufficient knowledge of corporate strategy.
- ❖ Insufficient appreciation of business risks and vulnerabilities.
- Poor appreciation of conflicts of interest.
 - ❖ The Enron example.
 - ❖ The Bear Stearns example.
 - ❖ Providers on the board.

III. PROTECTING BOARDS AND DIRECTORS.

- Due diligence in assessing risks and addressing those risks.
- Boards and management well educated and experienced with respect to governance.
- Exculpation clauses in Articles of Incorporation.
- No limitations on full indemnification in the Articles or Bylaws, but protect the company by permitting company to assume defense of claims.
- D&O insurance.
 - ❖ Assess exclusions.
 - ❖ Negotiate coverage terms.
 - ❖ Structure coverage.
- Director agreements.

IV. HOW CAN BOARDS USE GOVERNANCE TO REDUCE CORPORATE AND BOARD/DIRECTOR, LIABILITY/EXPOSURE, AND BUILD ORGANIZATIONAL VALUE?

- **Governance is a discipline different from management. It's about proactive, vigorous oversight.** Who populates boards? Often it's people who have excelled at management. The challenge is developing excellence at governance.
- **Integrity is everything.** It is the root of stakeholder and public confidence in a company. Organizational integrity starts at the top, i.e., the Board of Directors and senior management.

- **Corporate culture and board/management leadership is critical.** Boards must take more responsibility for ensuring that the board and management have appropriate leadership, and that leadership is held accountable. The board must actively monitor the culture of the organization to assure that it reflects ethical values and trustworthiness, and must require management to do its utmost to build/maintain an ethical culture.
- **Boards must take more responsibility for compensation, perks and incentives.** The media and several institutional shareholders have flogged this subject for years. And it's critical that boards do a better job. Recent disclosures of compensation levels and perks paid to senior management of organizations have incensed the public and their political representatives. Compensation plans for senior executives and other managers must be reviewed to assure improper behavior is not incentivized.

Boards must realize that excessive director and executive compensation reflects poorly on their independence, integrity and judgment. Some business groups have started to address the issue; see the September 17, 2002, Conference Board Blue Ribbon Commission report on executive compensation.

Boards must also be aware of the corrosive effect on the corporate culture, particularly with respect to trust and fairness, which can result from poor compensation practices at the board and management level.

- **Boards must carefully assess actual and perceived conflicts of interest.** Conflicts of interest in general, but particularly involving directors, senior management and key advisors, must be carefully assessed, and independent advice sought where necessary. Like the compensation issues, unresolved or poorly resolved conflicts of interest reflect badly on boards' independence, integrity and judgment.
- **Boards must pay more attention to the organization's human capital.** Boards have always accepted responsibility for the organization's financial capital. They must devote equal attention to the organization's human capital.
- **Directors must pay close attention to their core duties: care, loyalty, good faith, compliance and oversight.**
 - **Care in every decision.** Be informed. Directors shouldn't approve matters they don't understand. Real or perceived pressures shouldn't overshadow the duty to make an informed judgment.
 - **Loyalty.** The interests of the organization always come first. Directors shouldn't use their position or the confidential information they gain for their or others' benefit. Boards must avoid being compromised by compensation or benefits which could actually, or be perceived in hindsight to, compromise their judgment.

- ❑ **Good Faith.** Directors must act in good faith. In Minnesota, directors may not be indemnified by the organization if their act or failure to act was not in good faith.
 - ❑ **Compliance.** Pay attention to the company's governing documents, policies and agreements, and the laws and regulations to which the company is subject. It is difficult to enforce a company's code of conduct and standards of legal compliance if the message of compliance doesn't start with the board and senior management, both in terms of emphasis and conduct.
 - ❑ **Oversight.** A board's job isn't to manage; it's to vigorously oversee and evaluate management. The CEO reports to the board, not the other way around. An adversarial relationship with management is counterproductive. Collaboration is essential. But personal relationships and compensation can't be allowed to obscure the need for vigilant oversight.
- **Boards must strive to understand risks, pay attention to warnings and confront problems promptly and forthrightly.** Policies and procedures for assessing and monitoring risks are essential, and directors must assure that they are in place and functioning well. Warnings need to be heeded and promptly investigated. Investigation means a thorough effort to obtain all relevant information, using independent resources where necessary to assure objectivity. History provides ample lessons of the disastrous consequences of cover-ups. A cautionary note: When conducting an investigation pay close attention to issues of attorney-client privilege.
- **Boards must use the tools at their disposal to effectively execute their oversight responsibilities.**
 - ❑ Selection of capable directors, knowledgeable about governance and oversight, who have the time, energy, knowledge, judgment, leadership and courage to effectively discharge their responsibilities.
 - ❑ Selection of a CEO who is experienced and committed to building a corporate culture that is ethical and compliant, and holding the CEO accountable for the development of that culture.
 - ❑ Selection of independent board leadership with the knowledge and skills to assist the board in meeting its responsibilities.
 - ❑ Insistence on periodic independent assessments of the company's culture, ethics, values and compliance.
 - ❑ Oversight over the evaluation, hiring, firing and compensation of employees who are key to assessing and shaping the corporation's financial reporting, human resources, risk assessment, ethical and legal compliance environment. *E.g.*, CFO, controller, internal auditor, risk manager, internal counsel. Periodic one-on-one interviews with the responsible individuals are an essential check.

- ❑ Independent contact with key corporate advisors: outside counsel, independent auditors, various consultants.
 - ❑ Engagement of the independent auditors and compensation consultants; oversight over the engagement of outside legal counsel and other key advisors to assure that the loyalty of these advisors is to the company and not the personnel at the company who engaged them.
 - ❑ Engagement of independent counsel and consultants to advise the board, or board committees, on matters with respect to which the board requires a “second opinion” or advice from a service provider who is not regularly engaged to serve the company under management’s direction.
 - ❑ Use of tools such as business intelligence and balanced scorecard software to assist with monitoring.
 - ❑ Use of assessment tools and organizations to gain knowledge of the corporate culture, ethics and compliance environment deep within the organization.
 - ❑ Use of corporate and outside investigatory and research resources to scan backgrounds of key people and organizations.
 - ❑ Use of search firms to assist with the identification and screening of director and CEO candidates.
- **Transparency is good; obscuring reality is bad.** Transactions, schemes or practices which make it difficult for those who rely on the company’s financial information to clearly understand that information will be questioned. Boards need to be increasingly aware that if third parties’ decisions are made based on potentially misleading omissions or information, litigation and government investigations may ensue.
 - **Targets are good; quarterly earnings obsessions are bad.** Agreed that plans, targets and accountability are good. But not when the targets are unrealistic or the pressures or incentives to achieve them so great as to result in deliberate distortions, or the use of “cutting edge” accounting or business practices. A survey by *CFO Magazine* found that 17% of CFOs, many from the nation’s largest companies, had been pressured by CEOs one or more times in the last five years to misrepresent financial results. Directors need to be aggressive about investigating and ending that pressure.
 - **Monitor corporate disclosures.** Boards are increasingly aware of the organization’s responsibility for accurate, complete disclosure to banks, creditors, insurance companies, government tax and regulatory authorities, and others who rely on or require the organization’s business and financial information. Boards must also be aware of the many ways in which the corporation provides information, e.g., public comments by management, management conduct, media interviews, press releases,

websites, broadcast or directed email, regulatory agency filings and a multitude of forms and applications for other third parties.

- **Boards must be extremely conscious of the signals they send to the organizations they govern:** signals which come from their own conduct, who they nominate as directors, who they hire as the CEO, what conduct they endorse, what values they espouse directly and indirectly, how they deal with behavior which is antithetical to those values, and situations which test those values – it's about the culture of the organization for which they are ultimately responsible.
- **Directors need to be schizophrenic:** vigilant overseers, on the one hand, and effective, constructive collaborators on the other.
- **Boards must focus on reputational value: reputations take years to build; moments to lose.** For most organizations their reputations and goodwill are among their most valuable assets. Boards must be alert to individual and organizational conduct which may compromise a company's reputation for integrity and trustworthiness with its various stakeholders. As we've seen the consequences of a breach of trust can be brutal.
- **Good governance practices.** Good governance in actuality, not just in appearance. The boards of many organizations now in the news are populated with individuals who have excellent credentials. Often the appropriate governance documents and board structures are in place. However, good governance is about organization, process, education and **EXECUTION**. And finally **EVALUATION** -- evaluation of management, principally the CEO, evaluation of the board, and evaluation of directors.

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