# Boards of directors: the past, present and the future.

# This article originally was published by NEW ENGLAND INHOUSE LAWYER.

**By Stephen M. Honig of Duane Morris.**

Decades ago, the functions of public boards of directors were easily articulated: boards evaluated management, used best judgment, did not self-deal, and discharged the duties of care and loyalty. The primary role was overseeing strategy.

Disinterested directors were protected by the business judgment rule; if you were well-informed and rationally believed that you were acting in the best interest of the company, you were doing your job and could not be sued.

**Evolution of duties**

Several developments began to erode that picture. Delaware courts, reviewing acquisition transactions, imposed duties of process and substance, duties so complex that boards must now navigate a matrix of procedures. What committees should be established? Must “entire fairness” be applied? Do you have the “Revlon duties” to shop your company?

Delaware jurisprudence continues to evolve, while the law in other jurisdictions is unclear. Certain jurisdictions (such as Nevada) expressly disavowed imposition of such duties.

In 1996, Delaware courts in the *Caremark* case established the duty to “oversee” performance of corporate functions. How granular was this obligation?

In August, in the *Melbourne Municipal Firefighters* case, the Delaware Chancery Court admitted that proving a *Caremark* violation is extraordinarily difficult; boards suffer liability only where they either willfully or through gross negligence ignore major "red flags" in failing to monitor.

After the financial 2008 meltdown, Congress passed the Dodd-Frank Act and the Sarbanes-Oxley Act, establishing board obligations with respect to both process and substance.

Boards spent much attention implementing these obligations, resulting in a counter-reaction wherein boards attempted to take regulatory burdens off their agendas (leaving them to management and advisors) so as to return to their proper role of overseeing strategy.

But, in addition to SEC and self-regulatory organization requirements, significant other issues developed: "deputization" of a director representing a particular shareholder conflicted by owing fiduciary duties to all shareholders; growing emphasis on documenting board process since courts began reviewing actions with focus on procedure as evidence of diligence; emphasis in federal government sentencing guidelines aimed at individuals; and focus on whether the board had instilled an ethical "tone at the top."

The board also must deal with the Dodd-Frank requirement that shareholders have an advisory vote on executive compensation; majority voting having become the de facto standard for most public companies; and the fact that that since broker discretionary voting has been eliminated, the vote of institution shareholders, and the power of proxy advisory firms and activist shareholders, have increased.

**Boards today**

What are the guiding principles for boards today, arising under the interaction of state law, federal law, regulatory organizations, institutional investors, activist investors, third-party proxy advisory firms and the courts?

In October 2015, addressing a New York Stock Exchange-sponsored conference, then-SEC Commissioner Luis Aguilar noted that directors had "significant oversight responsibilities with respect to executive management and for the overall direction of the company," must set the "tone at the top," and were "guardians of the company's assets."

He identified three "themes of corporate governance": effective engagement with the shareholders, ensuring company resiliency with focus on crisis and risk management, and looking to the future in times of rapid change.

Aguilar observed that enterprise risk oversight, topical after the 2008 meltdown, had expanded to cover all risks, not just ensuring that accounting was accurate; calibrating enterprise risk had become a required preoccupation of boards (the most recent iteration of this risk preoccupation is cyber security); directors must "engag[e] in long-strategic planning ahead of management" so as to make sure management does not fall asleep; directors must police board membership so that people possessing requisite skills are included; and boards must reflect "our nation's changing demographics," and include women and minorities.

How can a board fulfill those numerous obligations?

First, boards are working harder, meeting more often and for longer sessions, and placing more emphasis on executive sessions to permit full discussion.

Second, boards have focused on their own composition, eschewing the older model of boards as cronies, attempting to staff specific skill sets and to self-evaluate.

Third, director education has become a major focus. In September, the National Association of Corporate Directors (NACD) issued a "first-ever standard for corporate director education," a framework outlining areas of director knowledge and competency that boards must possess.

Substantive areas of competency include not only financial and managerial decision-making, but also overseeing corporate talent, risk oversight and shareholder engagement and addressing "emerging issues — perspectives on the horizon."

NACD promises it will make its framework "available to all organizations that provide corporate governance education" so as to elevate director standards, although such a generous offer also can be viewed as attempting to "own the space."

Fourth, the 2016 KPMG study titled “Building a Great Board,” a survey of 2,300 directors and senior executives in 46 countries, suggests these takeaways: directors must understand the competitive environment, given the pace of technological change; finding directors who combine general business experience and specific expertise is a problem that must be overcome to resist “status quo thinking”; boards need formal succession plans as only 31 percent report such a process; board self-evaluations are an essential tool in removing under-performing directors; and board succession planning is integral to long-term strategy.

Fifth, law firm websites bristle with board-education materials, various organizations and universities hold seminars exploring governance, and publications are replete with advice columns attempting to guide directors.

In addition to being sensitive to the broad themes identified above, directors today need to be informed by all business and legal developments, some of which are difficult to monitor. Below are some recent examples.

Congress, New York City’s comptroller and major investors criticized Wells Fargo’s board in failing to prevent Wells Fargo’s cross-selling efforts, but also in failing promptly to claw back executive compensation (CEO claw back finally occurred in early October, followed thereafter by the CEO’s resignation).

A Delaware Supreme Court decision in June (*CDX Holdings*) reminds boards of their obligation to fulfill contractual undertakings. In *CDX Holdings*, the stock option plan required the board to determine fair market value of shares where options were being cancelled in a merger; the board was found to have breached its fiduciary duty when it rubber-stamped a materially deficient management valuation. The board relied in part on an outside expert opinion (under the Delaware statute, boards are expressly permitted to rely on third-party advice in fulfilling fiduciary duties), but the board was not saved by that provision due to other inadequate processes.

Another thorny situation arises when companies approach the “Zone of Insolvency.” Boards are asked to fulfill seemingly unclear fiduciary obligations. Assume a company has just enough money to pay its creditors, but suffers continuing operational losses. In Delaware, so long as directors make business decisions designed to benefit the company and shareholders, directors will not incur liability should their decisions lead to company failure.

While some future egregious case — where, if the company had ceased operating all the creditors could have been paid, but the directors kept operating until bankrupt — may yet redefine the standard based on the alleged unreasonableness of the board’s strategic decisions, *Hopkins v. Nakamoto* (Idaho Bankruptcy Court applying Delaware law) in August denied director liability in an $8 million asset case with $1.3 billion in liabilities.

The fiduciary duty is owed to the corporation and to its shareholders, but upon insolvency creditors have the right to bring a derivative action to claim breach of duty. While the power of creditors to assert the claim does not make creditors the recipient of the duties, there may be a tendency to view the non-fulfillment of duty from the vantage point of the creditors even though the duty was not owed to them.

Note that the result also may be different for limited liability companies, which have the statutory authority to void fiduciary duties within their operating agreements, while nonetheless there also exists bankruptcy court authority for ignoring Delaware corporate law while protecting creditors’ rights.

Finally, in the approaching proxy season, one major firm has admonished boards to pay careful attention to their own compensation by hiring an outside consultant, assuring that compensation is compared with appropriate peers, assuring that the compensation committee charter specifies how the committee sets non-employee director compensation, and clarifying its right to retain an independent consultant.

**The future board**

A couple of years ago, the Delaware Business Law Forum discussed whether director-centric governance would remain the rule, or whether boards would become shareholder-centric. Consensus was that future boards would be “hybrid” with a mix of activist directors. Some boards will take their companies private or will avoid going public in the first instance (a few larger tech companies have developed liquid trading markets without undertaking SEC registration).

Some predicted greater use of dual class voting (notwithstanding that such structures are often subject to criticism). There was general agreement that shareholder engagement would continue to expand, with “heightened attention” on how directors are chosen and how boards are refreshed.

A trend of professionalization of boards was predicted, although there was fear that such professionalization might reduce the number of directors with industry knowledge.

Whatever happens, public directorship also will, over time and as applicable, find its way into the boards of better-run private companies.

Board-centric governance, rooted in current corporate law, will survive, but will be pressured by increased shareholder involvement, which carries the risk of emphasis on short-term performance.

The bottom line? Sitting on a board is not going to get any easier.

*Stephen M. Honig is a partner at Duane Morris in Boston. He can be reached at 857-488-4239*