Five Essential Corporate Governance Duties and Even More Takeaways To Avoid Violating Them

Welcome to this comprehensive article on the fundamentals of corporate governance and best practices takeaways for board members, counsel to the board, and board advisors. Designed as a resource, it provides guidance to directors, officers, inside counsel, outside counsel, shareholders, employees, and experts across various fields including crypto, cyber security, and economics.

Within these pages, you will find a concise description of the most important generally accepted principles of corporate governance as well as takeaways to help board members and others to avoid violating corporate governance principles. While corporate governance covers a broad spectrum of topics, this article focuses primarily on the principal duties of directors and officers generally understood in the United States.

1. The Board of Directors has broad discretion to make decisions for and act on behalf of a corporation.

A board of directors generally has the ultimate authority to make decisions for a corporation unless a majority of the board lacks independence on an issue or the majority of the board has conflicts of interest on an issue, or certain authority has been delegated by the board to senior management or a board committee. In general delegation of authority is permitted if it is reasonable under the circumstances to delegate the topic pursuant to a well-defined and described scope of delegated authority in a board resolution and the delegation is done in good faith.

Decisions by independent directors which are consistent with their fiduciary duties of care and loyalty and oversight are usually protected by the business judgment rule as long as the board members are independent on the issue in question, they do not have a conflict of interest, the voting board members have been adequately informed of the relevant facts, and they act reasonably and in good faith. See below for a detailed description of the business judgment rule.

Claims that are most often brought against corporate directors and officers for wrongdoing are for alleged failures to observe their duties of care, loyalty and oversight and include breach of fiduciary duty, failure of oversight, usurpation of corporate opportunities and waste of corporate assets.

Subject To Certain Exceptions, Directors Are Responsible For:

- Making all major decisions on behalf of the corporation which have not been properly delegated to management or a committee.
- Determining overall business goals and objectives.
- Overseeing utilization of resources and budgeting expenses.
- Overseeing management of the business and deciding who will manage its daily operations.
- Seeing to it that the company has set up reasonable compliance and risk oversight systems that give regular reports to the board, particularly where the information involved is significant for the board and officers to be knowledgeable about, in order to properly meet their respective duties and obligations. Such systems should be set up with reasonable care and with a reasonable expectation that they will keep board members and depending on the circumstances some officers, reasonably informed.
- The most serious risk and exception occurs when a board member has a conflict of interest. If a majority of the board is not independent or is conflicted, the board will lose its decision making authority on the issue in question.

2. Fiduciary Duties of Officers are narrower and less stringent than the board

Fiduciary duties of officers of a corporation are similar to those of the Board of Directors but the breadth of the obligations and authority are narrower and in some cases less stringent than those that apply to the board. Clearly Officers are expected to carry out the duties entailed in their employment and there is a great deal officers are expected to do and not to do. Of most relevance in this description of corporate governance as it applies to corporate officers are the previously described instances where a board delegates responsibilities to an officer or officers. Clearly officers are expected to carry out any such duties with care and loyalty to the corporation. Self-dealing and letting personal interests outweigh the interests of the corporation will expose officers to liability for breach of the duty of loyalty. Negligence with respect to duties assigned to an officer is a breach of the duties of care and loyalty and possibly depending on the circumstances, the duty of oversight. Recently there have been morecases filed by shareholder plaintiffs including derivative claims against individual officers who fail to carry out their duties with care and loyalty to the corporation's interests.

3. Oversight Duties of Directors and Officers

Under the emerging law on oversight duties of directors and officers, it is important for directors and officers to be vigilant with respect to the important business issues and material risks a company faces so as to identify areas where it is necessary or may become necessary to take preventative measures. This is particularly the case where it might be possible to avoid losses and minimize risks to the company and to take corrective action where called for and to minimize actual damages. By keeping themselves informed of developments and emerging problems, directors and officers are meeting their fiduciary duty to the corporation to stay reasonably informed on the major issues (sometimes referred to as mission critical issues by courts) and significant risks to the company of all sorts. Such risks if not addressed may cause a company to be injured in its business from a financial perspective but also there may be injury to shareholders and other stakeholders, employees, its long term business prospects, its reputation and its brand.

Directors' and Officers' Fiduciary Duties to the Corporation and Shareholders:

- Duty of Care
  Directors must act in good faith and with care in making decisions and in taking necessary actions so as to make informed, thoughtful and educated decisions on behalf of the corporation.

- Duty of Loyalty
  Directors must act in the best interest of the corporation and its shareholders. Corporate interests should take precedence over any personal interest of a director, officer or controlling shareholder

- Duty to Disclose/Candor
  When the board decides to ask shareholders to vote on an issue or a vote is required, directors must oversee efforts to fully disclose all material and relevant information within their knowledge after reasonably inquiry.

- Duty of Oversight
  The duty of oversight has been the subject of a number of cases recently which apply to oversight by both directors and officers. With respect to directors, the Marchand case has clarified the duty of oversight and of loyalty and clarified the earlier Caremark opinion in assessing whether directors have met their fiduciary obligations. That case puts emphasis on the need for directors to pay careful attention to establishing a system to keep the Board informed of material issues and risks and measures taken to deal with them. Recently cases have also confirmed that officers have similar obligations.

4. Board Members Should Acquire a Reasonable Level of Understanding and Can Rely on Experts

A board member is not required to be an expert in every field that is relevant to potential risks to the company and is not required to have detailed technical knowledge of all that goes on in a corporation. Such a requirement would be asking the impossible in most companies. In order to fulfil his or her duties to a company a board member should take reasonable steps to see that assignments of qualified individuals are made as to various aspects of management who then report up the line, ultimately to the board.

While board members should acquire a reasonable level of understanding of the company's business and its health as well as its level of exposure to risks that can be identified, including, for example, oversight risk, they may rely on advice from those individuals in management or outside experts that they reasonably believe do have the expertise necessary to evaluate the company's business issues and risks. The board may rely on such advice in deciding reasonably how to protect against various types of risks.

Decision making based on thoughtful and reasonable reliance on the expertise of others will likely justify application of the business judgment rule for directors and officers who are independent and not conflicted. The Business Judgment Rule is discussed in detail in a later section. Where it applies it will likely protect the company and directors and officers from a claim of breach of oversight.

Notethat if directors have information that contradicts the information provided by a third party advisor, reliance on the third party's statements may be considered unreasonable. Facts and circumstances concerning the reliability of the person providing advice should be considered with reasonable care by a director in reaching a conclusion on a course of action.

5. A Board Can Delegate Authority

A board can delegate, where it is reasonable to do so, some of its responsibilities on certain issues, but it generally is not required to delegate that authority to others if the board has reasonably adequate resources to address the issues and risks with reasonable care and have no conflicts of interest. A board in its entirety can chose to retain authority to address issues where a majority of the board is independent.

Often though, a board will give some authority to a committee or officer to make a recommendation on decisions with respect to identified issues (and in some cases giving the committee decision making authority). In recent years, boards have fairly frequently delegated, for example, topics like mergers and acquisition issues and how to address cyber risks to an audit committee, a risk committee, a technology committee or a special committee. It is ideal, but not necessary, if the committee or some of its members have some facility for understanding a particular topic then at issue. If a committee has a member or members with such expertise on a topic, that can be helpful, but it is not required to have such a person.

The board should ensure that there are reasonable and adequate reporting structures in place to keep the board, and/or a relevant committee adequately informed of any significant topic/issue or risk. See Caremark and Marchand cases from Delaware Courts.

Key Takeaways to Avoid Violating Corporate Governance Duties

1. The Business Judgment Rule Protects Corporate Directors

The business judgment rule is a legal presumption which largely protects corporate directors who have no personal interest in the outcome of specific board issues and who, while reasonably informed, act in good faith and with an honest belief that they are acting with the lawful and legitimate interests of the corporation and shareholders in mind from liability for breaches of fiduciary duty

This doctrine is grounded in the belief that courts are ill equipped and infrequently called upon to make business judgments on how corporations should be run. Judges generally recognize that Boards of corporations are more familiar with and better informed of what is best for business operations than judges.

Courts will accordingly afford great deference to board actions taken by independent directors who are reasonably informed on the issue in question and act in good faith in accordance with duties of care, loyalty and oversight.

The application of the business judgment rule presumption is rebuttable and may be rebutted by evidence that the directors breached a fiduciary duty by engaging in self-dealing, making decisions tainted by conflicts of interests, acting fraudulently, dishonestly or in bad faith or failing to act with reasonable diligence in informing themselves of relevant facts and circumstances.

2. Assess Board Composition and Qualifications

As part of its duty of care, the board should periodically evaluate its composition and the corporate structure and charter of the company to determine whether there is sufficient experience and expertise on the board to carry out its duties. It should also consider whether there is adequate diversity on the board in its judgment and also to comply with its duties under the entities' corporate purpose, and any claims made by the corporation as to its policy on diversity to shareholders, stakeholders or investors. The review should also assure that there is an absence of conflicts of interests with the company on the part of any board members. It should also consider if there is domination by a controlling person and whether that control is not being used improperly. The duty of loyalty requires that directors always keep the best interests of the corporation and its shareholders (and of other stakeholders if consistent with its corporate purpose) as its primary goal when assessing options in decision-making.

3. Determine What Topics to Delegate Authority

The board should determine what topics or issues it should reasonably delegate to a special committee, to another committee of the board, or to management. In making these determinations, the board should consider the skills, commitment and expertise of any likely candidate or candidates for committee appointment and, in particular, make sure of the absence of any conflict of interest and of any domination of the candidate by a controlling party. Other factors to consider in selecting committee members for a board committee include that the board member have sufficient time in her schedule to devote to meet her duty of care, a firm and plausible commitment to the assignment, experience as a board or committee member, some knowledge or expertise on the relevant issue and, importantly, a history of using good balanced judgment. Decisions of the board on such appointments should be made by a majority of the independent, unconflicted members of the board. It is often the case that such board decisions can best be made with the advice of inside or outside counsel

4. Engage Experts

A board obviously cannot be expected to be an expert on every conceivable issue related to a corporation and the basics of corporate governance do not require that of the board or it members. The board is not required to be expert on all issues. Instead the board after reasonably looking into and identifying mission critical issues or risks may rely on individuals who are employees that the board reasonably believes have the required expertise or it may engage third-parties and/or external advisors to obtain needed guidance, advice and technological expertise to help make good decisions, consistent with corporate goals. As a example, one area but not the only one, in which expert assistance is frequently needed is Cyber Security. Before hiring outside experts, the board should consider the materiality of the issue, the cost and the level of expertise of the person or entity, the risk associated with possible leaking of information outside the company, and other factors.

5. Ensure Reasonable Flow of Information to Comply with Duty of Oversight

In order to comply with its duty of oversight, as described in the leading cases on this subject, the Caremark and Marchand cases from Delaware, the board must arrange for an adequate and predictable information flow to reach it in order to meet its fiduciary duties of care, oversight and loyalty. In doing so, the board must carefully consider what information it needs to properly oversee risks and mission critical business issues that the company faces, as well as how it will receive that information in time to make it useful in their decision-making process. This is a developing area of the law, but Delaware Courts have made it crystal clear that the board cannot simply sit on its hands with its eyes closed. The board and board members must ensure that it makes a good faith effort to create an adequate information flow on business issues and risks to believe the board will be kept reasonably informed. Addressing these fiduciary duties by ensuring a reasonable information flow on important business issues and risks and responding reasonably to such information will likely cause independent members of the board proceeding in good faith, to get the benefit of the business judgement rule if claims against them arise later. These practices also will help in some circumstances by allowing action by the board before it is too late to cure certain problems.

6. Create and Review Internal controls

The board should ensure that an adequate system of internal controls exists with respect to accounting procedures and records, protection of corporate assets and protection against creation of unnecessary liabilities. It is important that such a system of adequate controls be determined to be in place or if not in place the board should promptly create such a modern system of controls. Internal controls are policies and procedures implemented by an organization to ensure their financial reports are reliable and cover required issues, that operations are efficient, and corporate activities are compliant with applicable laws and regulations. Publicly traded companies are required to have robust internal controls and validate this in their annual statement on form 10-K. Sufficient internal monitoring of compliance with company policies and government laws and regulations must be in place. The board should perform assessments of these internal controls and regularly get the report of a person expert in such controls employed by or consulting with the company and having the expertise needed to compare the companies' performance with industry standards. Large accounting firms have experts on internal controls and will normally assess them as part of an audit.

7. Understand How Management is Engaging Shareholders

The board should understand significant company policies and procedures and understand how management is engaging the corporation's shareholders. They should also keep in mind the corporate purpose adopted by the company. In 2019 the Business Roundtable which is composed of senior executives of substantial companies, adopted, in a vote and by a large margin, a resolution that corporations should adopt a statement of corporate purpose that did not only include maximizing value for shareholders, but instead, the board should also consider the interests of and treatment of other stakeholders such as employees, investors, customers, business partners, suppliers, the environment, the value of diversity, and other factors in its decision making. This version of corporate purpose is not required by existing statute for the most part. However, ignoring corporate purpose as it has been described by the company to shareholders, may lead to securities or other litigation against the board and/or the company in certain circumstances. Not surprisingly, the statements of corporate purpose vary from corporation to corporation.

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