

# **2010 BOARD OF DIRECTORS GUIDE**

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## INTRODUCTION

The current difficult business environment poses many challenges to boards of directors. Directors are facing intense public and political scrutiny as a result of the many questions raised by the worst economic crisis since the Great Depression of the 1930's. The recent well-publicized failures, excesses, and fraud in American business have led to numerous proposals for corporate governance reforms. Reform proposals include new and proposed federal legislation and regulations, Securities and Exchange Commission rule-making, and amendments to New York Stock Exchange and other stock exchange rules, as well as decisions from various courts, shareholder proposals, and policy recommendations from non-governmental organizations. These proposals include, among other things, reforms intended to improve the transparency of corporate transactions and financial statements, accountability of management to shareholders, and protection of the rights and interests of shareholders.

Because directors and their decisions and decision-making processes are currently subject to intense public and political scrutiny, there has been an increased focus by directors on the proper role and functioning of boards. Many commentators believe that prudent and thoughtful action by board members, rather than governmental or stock exchange oversight and regulation, is of paramount importance in improving board performance. The manner in which directors work with each other and with management to govern the company, shape its strategic vision, and oversee the implementation of that vision presents many complex issues that are often not susceptible of being effectively regulated by government. It is impossible to have a "one-size-fits-all" approach to effective functioning of boards of directors. Accordingly, each board of directors should develop structures, policies, and practices which are specifically tailored to the needs of each company.

Because of the changing landscape of corporate governance, it is more important than ever for each board member to have a firm understanding of the fundamentals relating to the board's core functions, its role and duties, its procedures and operations, and the key issues facing the board. This outline is intended to assist board members in understanding the proper role and functioning of the board in the new political and regulatory environment in which we live.

## **THE CORE FUNCTIONS OF THE BOARD**

Every director must understand his or her role generally, as well as the specific role a company will expect the individual to assume for the company. In general, the board of directors is responsible for overseeing the management of the business and affairs of the company. In this role, the board serves as a strategic and business advisor to management. The board has the fiduciary objective of long-term creation of value for the company and its shareholders. Each director must represent the interests of shareholders diligently by understanding the company's business, industry, operations and strategic plans, and by providing independent, honest, and prudent advice.

Directors owe fiduciary duties to the company and its shareholders. To satisfy these duties, each director must exercise his or her independent, informed, and good faith business judgment in the best interests of the company and its shareholders. The board of directors is responsible for approving the company's long-term strategy, selecting the company's chief executive officer ("CEO") and planning for the succession of the CEO, oversight of the management of the company, and monitoring compliance with applicable laws and regulations. The board is also responsible for setting of executive compensation in a manner which will attract and retain qualified individuals who will contribute to the long-term success of the company. In addition, although the function of the board is to provide informed oversight rather than to the actual day-to-day management of risk, which is the responsibility of management, there is increased scrutiny of the function of the board with respect to risk management. As the central mechanism for management oversight and accountability in our corporate governance system, the board of directors also has the responsibility to determine how the board should be organized, and how it should function. Each of these core functions will be discussed briefly below.

### **Approval of Long-Term Strategy**

A principal function of the board is to approve the long-term strategy of the company. The board serves as a strategic advisor to management. The company's long-term strategy should be initially formulated by management, and then approved through a process of discussion and dialogue between management and the board. The board should assist and advise management in formulating the strategic vision and long-term strategy of the company, which must be regularly reassessed as industry and economic conditions develop and change.

### **Selection of and Succession Planning for the CEO**

The board of directors bears the ultimate responsibility for selecting the company's CEO and planning for his or her succession. The integrity and performance of the CEO is critical to the management and success of the company, and there is no function of the board which is more important than selecting, evaluating, and if necessary, replacing the CEO.

## **Setting the “Tone at the Top”**

Because a company’s corporate culture is shaped by the attitude and values of the top management regarding integrity and performance, it is essential that the board of directors be aware of and help set the “tone at the top” of the company. The board of directors should work with the CEO and other senior management of the company to create and promote a corporate culture that sets high standards for ethical behavior. This corporate culture should emphasize the paramount importance of integrity, fair dealing, professionalism, and full compliance with legal requirements. The “tone at the top” helps form a corporate culture that positively affects its long-term reputation and success. The tone at the top permeates a company’s corporate culture and the company’s relationships with customers, suppliers, employees, investors, regulators, local communities, outside counsel and other advisors, and other constituencies. The vision of the board and top management for the company, including their commitment to high ethical standards and full legal and regulatory compliance, should be effectively communicated throughout the entire organization. A company’s code of conduct and conflicts of interest policies should be an integral part of its operations.

## **Monitoring of Management and Compliance**

The corporation laws of the various states explicitly provide that the business of the corporation is to be managed by or under the direction of the board of directors. However, the board’s function is not to actually manage the company, but instead to oversee and monitor the management of the company. The board of directors has the responsibility to fulfill the role of strategic and business advisor to management of the company. In addition, the board has the role of monitoring the performance of the company and management, including monitoring the performance of the company using customary economic metrics, and by overseeing compliance with applicable laws and regulations. While the board is not responsible for auditing or ferreting out compliance problems, it is responsible for determining that the company has an appropriate system of internal controls. The board should also monitor company policies and practices that address legal compliance, government relations, and matters affecting the public perception and reputation of the company. Every company should ensure that it conducts appropriate compliance training for employees and conducts regular compliance assessments. Furthermore, the board must take appropriate action if and when it becomes aware of a material problem that it believes management is not properly handling.

## **Setting Executive Compensation**

The board of directors has the primary responsibility for setting executive compensation. There is currently intense public and political scrutiny of executive compensation policies, and there are many varied reform proposals intended to limit “excessive” compensation and perceived inadequacies and abuses in compensation practices. Among other things, current proposals seek to require non-binding shareholder votes to approve executive compensation and “golden parachutes,” to limit or prohibit severance payments to officers terminated for poor performance, to require “clawbacks” of unearned performance-based pay, to strengthen independence standards for compensation consultants, and to require increased disclosure of compensation policies and their relationship to risk management.

However, it is important to remember that the primary goal of the board and its compensation committee is to attract and retain qualified management who will help build long-term value for the company and its shareholders. The compensation committee and the directors should make compensation decisions on an informed basis, in good faith, and not in their personal self interest. If they do so, they should be protected by the “business judgment rule,” discussed below, and they should not fear being second-guessed by the courts on their compensation decisions. This is particularly true when the compensation committee has the advice of legal counsel and an independent compensation consultant.

### **Overseeing Risk Management**

The success and survival of business organizations requires them to take risks, and those that are successful manage risks well. The recent breakdown of worldwide credit markets and the failure of large established financial institutions have led to an increased scrutiny of risk management by all companies. Recent actions by regulatory bodies and ratings agencies have also focused attention on the importance of effective risk management. For example, the Public Company Accounting Oversight Board (“PCAOB”) is guiding audit firms to examine more closely the level of risk associated with management processes. The PCAOB is encouraging auditors to modify audit plans to increase monitoring for high risk behavior, on the theory that management is likely to accept greater risks when economic pressures or compensation incentives drive decisions regarding risk-taking.

Additionally, the SEC has focused on the interplay between compensation policies and corporate risk-taking. The SEC has proposed Compensation Disclosure & Analysis (“CD&A”) amendments which would require disclosures regarding the relationship between compensation policies and risk management. The SEC has also focused on the board’s role in the oversight of risk management as a significant corporate governance policy matter, and has indicated a willingness to allow shareholder proposals regarding risk management to be included in company proxy materials. Other legislative proposals have suggested risk management reforms such as requiring companies to form a separate risk committee of independent directors to be responsible for establishing and evaluating risk management practices.

However, it is important to keep in mind that the proper function of the board is to provide informed oversight rather than direct management of risk. The board cannot and should not be involved in the day-to-day management of risk. Directors should satisfy themselves that the company’s management has designed and implemented risk management processes that are functioning properly and are adapted to the company’s strategic plan. They should also satisfy themselves that the necessary steps are being taken to establish a corporate culture of risk-adjusted decision-making, and that the risk management system will bring to the board’s attention the material risks to which the company and its business are subjected. The risk management system should also permit the board to understand how these risks affect the company, and how management assesses and deals with these risks. The function and role of the board in its oversight of risk management is to help create a corporate culture which is not overly risk averse, but which understands that risk assessment is an integral component of the company’s corporate strategy, culture, and generation of long-term value for shareholders.

## **Approving Major Transactions**

Major transactions such as acquisitions, mergers, spin-offs, debt and equity financings, and significant investments generally require board approval under applicable law and a company's charter and bylaws. The board must receive and review sufficient information to evaluate the proposed transaction and make an informed and reasoned decision regarding its approval. If a company has sufficient internal expertise to analyze and present sufficient information to enable the board to consider and assess the relative risks and rewards of the transaction and any alternatives, then the board is justified in relying on management's presentation as a basis for its decisions. However, it is often advisable for the board to retain experienced outside financial, accounting, legal and other advisors to assist with evaluation of major transactions in order to obtain objective third-party advice and guidance. This is especially true when a proposed transaction involves complicated legal, financial, accounting, tax, or other issues.

## **Ensuring Effective Functioning of the Board**

Although there are many governmental and regulatory reform proposals intended to improve board performance, many commentators believe that the key to good board performance is not government or regulatory action, but rather action taken by the board itself. As a result of the recent world-wide economic crisis, directors should be even more attuned to establishing and maintaining the effective functioning of the board. Many boards have been reassessing their proper role and functioning, as well as reviewing strategies and procedures to improve and optimize their effectiveness. Effective functioning of the board depends on carefully structured processes and procedures that are specifically tailored to the needs of each company. There is no checklist, "best practices," or standard "one size fits all" approach which will assure that a board will function effectively. Rather, the board of a company must carefully craft and calibrate its board policies, procedures, and manner of operating in order to achieve a proper balance between the board's advisory and monitoring functions, and between board oversight and a more direct "hands-on" engagement with the company's management.

Additionally, the board should periodically review and reevaluate its processes and procedures for directors working with each other and with management, to ensure an appropriate response to the specific challenges and circumstances at the time. Each board should develop its own structures, processes, and practices that are specifically tailored to the company's needs, while recognizing that these needs may change over time.

## **DIRECTORS' FIDUCIARY DUTIES AND LIABILITIES**

### **Overview of Fiduciary Duties of Directors**

Directors are primarily responsible for promoting the best interests of a company and its shareholders by providing general direction for the management of the company's business and affairs. The board of directors of a corporation has primary oversight responsibilities for: (i) setting corporate policies; (ii) selecting and delegating authority to management officers; (iii) making major corporate decisions; (iv) monitoring the affairs of the corporation; and (v) preventing corporate wrongdoing.

The basic relationship between the board of directors and management is expressed in state corporation statutes. Under these statutes and applicable case law, corporate directors have broad power to manage a corporation according to their discretion and best judgment, but that power is not unrestricted. Directors of corporations are fiduciaries and owe a duty of care and loyalty to the corporation and its shareholders. The duty of care requires directors to act on an informed basis, in good faith, and in the best interests of the corporation. The duty of loyalty requires directors to avoid conflicts of interest that benefit them to the detriment of the corporation or otherwise place their own interests above the interests of the corporation or its shareholders. The duty of care, the duty of loyalty, and the duty to act in good faith are the constant compass by which directors' actions should be guided.

If directors violate their fiduciary duties, they may be subject to personal liability. Perhaps the greatest fear directors have is that their personal assets may be at risk due to liability for monetary damages arising from a suit for breach of their fiduciary duties. Fortunately, directors have been largely insulated from liability for breach of their fiduciary duties under the "business judgment rule," discussed below, which is a concept well-established in case law. To determine whether the business judgment rule applies to a particular board action, the court reviews the process a board used to approve that action. In the absence of fraud, illegality, or conflicts of interest, courts have generally not "second guessed" the directors by substituting the court's judgment for the judgment of directors, provided that they were well-informed and followed a prudent deliberative process in their decision-making. If the board is free from conflicts of interest and makes a well-informed decision in good faith, after following a deliberate and thoughtful decision-making process, board members should not have any liability for their decisions, even if the decisions were, in hindsight, poor decisions that caused substantial loss or damages to the corporation and its shareholders.

### **Compliance with the Duty of Care**

The duty of care describes the level of competence that is expected of a director when carrying out his or her role. It is commonly expressed as "the care that an ordinarily prudent person would exercise under similar circumstances."

To fulfill the duty of care, directors must engage in informed decision-making. This means directors must inform themselves of all material information related to a business decision prior to making it. It also means that directors must be reasonably informed of the alternatives to a decision, keeping in mind that the more significant the decision, the greater is the requirement to probe and consider alternatives. After becoming sufficiently informed, directors are required to act with the level of due care appropriate to a particular situation. Specific action (or inaction) constitutes a breach of the duty of care only if a director is "grossly negligent." Thus, active diligence and participation in board decisions by a director is the best way to avoid personal liability for the breach of the duty of care.

Actions that show a director's diligence include, among other things: (i) becoming informed about and understanding the company's business, industry, operations, and strategic plans; (ii) attending board meetings regularly; (iii) taking time to review, digest, and evaluate relevant materials and information; (iv) taking reasonable steps to assure that all material

information bearing on a decision has been considered by the directors (or by those upon whom directors will rely); (v) actively participating in board deliberations, asking appropriate questions, and discussing each proposal's strengths and weaknesses; (vi) seeking the advice of legal counsel, financial advisors, and other professionals when appropriate; and (vii) taking sufficient time to reflect on decisions before making them.

When seeking to inform themselves with respect to a business decision, directors often rely on information prepared by employees, legal counsel, public accountants, and/or board committees of which he or she is not a member. Directors are typically protected in relying on such information, as long as they do so in good faith. Reliance in good faith means that directors do not have any awareness that the information they rely on is untrustworthy.

### **Compliance with the Duty of Loyalty**

The duty of loyalty requires directors to put the best interests of the corporation and its shareholders above their own. Stated otherwise, it is a standard of faithfulness. A director must give undivided allegiance to the corporation, particularly when there is a conflict between the interests of the director and the interests of the corporation. Some situations in which directors must be careful to maintain loyalty to the company include: (i) where directors are involved on both sides of a business transaction; (ii) where directors are involved in setting executive compensation; (iii) where there is an opportunity to misappropriate business opportunities that rightfully belong to the company; and (iv) where there is an opportunity to utilize corporate assets or information for personal gain.

“Interested director” transactions may include many different types of corporate transactions that are subject to the duty of loyalty. Some examples are: (i) contracts between the corporation and a director or an entity in which the director has a material interest; (ii) transactions that involve the use of corporate assets, or information for purposes that benefit the shareholder and are unrelated to the best interests of the corporation; (iii) competition by directors with the corporation; (iv) “usurpation of corporate opportunities” (a director with access to a business opportunity related to the business of the corporation should first make it available to the corporation before pursuing it for the director’s own benefit); (v) corporate acquisitions, including management buyouts, in which the interests of a controlling stockholder or management might diverge from that of other stockholders; (vi) “insider trading” in the company’s stock; and (vii) “management entrenchment” by actions that have the purpose or effect of perpetuating directors in office (*e.g.*, the rejection of a hostile takeover bid).

Directors can most easily fulfill their duty of loyalty by avoiding transactions in which they have a conflict of interest with the corporation. Because this is not always possible, a director should disclose all the relevant facts about his or her interest in the transaction to the company’s board. Such disclosure will allow the board to decide how to best ensure that the interests of the corporation and its shareholders are protected. If a majority of disinterested board members still authorizes the transaction in good faith, the disclosing director will have satisfied his or her duty of loyalty to the corporation. Alternatively, a director can disclose the transaction to the company’s shareholders and obtain approval of the transaction by the vote of shareholders holding a majority of the company’s shares.

## **Compliance with the Duty of Good Faith**

The duty of good faith is not a new concept in Delaware fiduciary law. The duty of good faith has been viewed by the Delaware courts as an integral component or a subsidiary element of the duties of care and loyalty. The duty of good faith, while not always stated as a separate fiduciary duty apart from the duties of care and loyalty, requires that directors act honestly, in the best interests of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy. Under the duty of care analysis, the court's review will likely focus on the process by which the board reached the decision under review. More recent case law, including *In re the Walt Disney Company Derivative Litigation*, seems to indicate that only fairly egregious conduct will be held to constitute a lack of good faith. Examples of conduct that may constitute a failure to act in good faith include: (i) a knowing and deliberate indifference to a potential risk of harm to the corporation; (ii) intentional acts with a purpose other than that of advancing the interests of the corporation; (iii) acts with the intent to violate applicable law; or (iv) the intentional failure to act in the face of a known duty to act, which demonstrates a "conscious disregard" for the director's fiduciary duties.

In *Dow Chemical*, discussed below, the court addressed, among other things, the plaintiffs' contention that the board had failed to act in good faith in considering a "bet the company" merger transaction. The court held that in the context of a business transaction, an "extreme set of facts" involving the complete and utter failure of the directors "to even attempt to meet their duties" would be required to support a claim that the directors did not act in good faith.

## **Personal Liability of Directors for Breach of Duty of Oversight**

There has been a recent flurry of lawsuits resulting from the financial losses incurred from investments in risky subprime mortgages, credit default swaps, and other complex derivatives. Certain of these suits have alleged that the huge financial losses of their companies were caused by breaches of fiduciary duties of directors due to their alleged failure to satisfy their duty of oversight, as part of their duty of care. Even in the face of the almost unprecedented losses incurred by some companies as a result of these investment activities, the Delaware courts have continued to confirm that they will protect informed business judgments made in good faith by directors.

In the 2009 case *In re Citigroup, Inc. Shareholder Derivative Litigation*, the plaintiffs alleged that current and former directors of Citigroup had breached their fiduciary duties by failing to properly monitor and oversee management of risks that Citigroup undertook as a result of its investments in subprime mortgages and other securities. The plaintiffs alleged, among other things, that the directors had ignored the significance of press releases and news reports that indicated deterioration in the credit and subprime mortgage markets. The Delaware Supreme Court dismissed these claims, holding that directors' duties of oversight under Delaware are not designed to subject directors to personal liability "for failure to predict the future and to properly evaluate business risk." The court held that only a "sustained or systemic failure" to exercise oversight would establish the lack of good faith that is a necessary prerequisite to any finding of personal liability of directors. The court also noted the important

distinction between potential liability for failure to exercise oversight of business risks, and potential liability for failure to exercise oversight of illegal conduct. The court emphasized that it will not hold directors personally liable for making good faith business decisions that, “judged in hindsight, turned out poorly.”

In early 2010, the plaintiffs in the case *In re the Dow Chemical Company Derivative Litigation* challenged an acquisition by Dow of another chemical company for approximately \$18.8 billion. The plaintiffs attempted unsuccessfully to distinguish *Citigroup* primarily on the theory that a “bet the company” transaction, potentially affecting the future of the company as a going concern, should be subject to a higher standard. The court made it clear that Delaware law does not support such a distinction when it stated that “[a] business decision made by a majority of disinterested, independent board members is entitled to the deferential business judgment rule regardless of whether it is an isolated transaction or a part of a larger transformative strategy. The interplay among transactions is a decision vested in the board, not the judiciary.”

### **The Business Judgment Rule**

Delaware courts recognize that few would serve on a board of directors if directors were held personally liable for losses caused by what, judged with hindsight, was negligence. Even disinterested, well-intentioned, informed directors can make decisions that, in hindsight, were improvident. Recognizing that business decisions frequently entail risks and uncertainties, courts sought a means of encouraging directors to enter into transactions that, although risky, have a potential for profit. Delaware courts felt that if a director’s liability were determined using traditional fiduciary principles, a court would be substituting its judgment for that of the directors, which was not intended by the corporation statutes. Courts have long recognized that, in the uncertain environment of business, boards of directors need to be free to take risks without the fear of being sued for their business decisions. While corporate directors are expected to use their business judgment to advance the interests of a corporation and its shareholders, they are not expected to insure corporate success.

Consequently, directors’ business decisions generally qualify for protection by the “business judgment rule.” Under the business judgment rule, courts presume that disinterested directors making business decisions acted on an informed basis, in good faith, and with the honest belief that the action taken was in the best interests of the corporation. In suits against directors brought by shareholders, either for themselves or derivatively on behalf of the corporation, courts applying the business judgment rule will determine only whether the directors making the decision (i) were free from conflicts of interest, (ii) appropriately informed themselves before taking the action, and (iii) acted after due consideration of all relevant information that was reasonably available. Under the Delaware business judgment rule, the board’s action will not subject board members to liability if the action or decision of the directors can be attributed to any rational business purpose. Directors that meet the criteria of the business judgment rule do not have to worry about having their business decisions second-guessed by a court, even where their decisions result in corporate losses.

In order ensure protection from liability for business decisions with bad results, however, directors must use certain processes when making those decisions. The most important action a

director can take when faced with a business decision is to be actively engaged in the decision-making process. It is when directors take little or no action that they risk losing the protection of the business judgment rule. Directors that implement policies and procedures to ensure that the requirements of the business judgment rule are met will generally be protected from liability for their business decisions. When entering into significant transactions, boards of directors seeking to ensure such protection should implement certain processes in order to build a record that shows they satisfied the above criteria. Directors should, among other things, adhere to processes which allow them to become informed in accordance with the duty of care requirements (as described above), and document the board's good faith efforts to properly exercise its business judgment. In addition, under appropriate circumstances, the board may (i) form a committee of independent directors to act on behalf of the board; (ii) hire an investment bank or financial advisor to provide a fairness opinion or company valuation; or (iii) hire outside counsel (or other professionals, as necessary) to advise the board.

An important exception to the protection of the business judgment rule is the failure to satisfy the duty of oversight by failing to prevent corporate wrongdoing. The business judgment rule does not usually apply to "failure to protect and prevent" cases since they are not a challenge to a decision or action of the board, but are instead a claim based on the failure of the board of directors to take action. Failure of directors to prevent misstatements in financial statements, failure to prevent back-dating of stock options, and failure to prevent Foreign Corrupt Practice Act violations are examples of failures to act (rather than decisions or actions by the board), which, depending on the facts, may not be covered by the business judgment rule. The key in these situations is that the directors have a "good faith" duty to consciously satisfy themselves that the company has in place effective internal monitoring and reporting systems specifically designed to detect and prevent wrongful conduct.

### **Indemnification, Exculpation, and D&O Insurance**

Applicable corporate laws generally provide additional means for protecting directors from personal liability. These provisions are designed to allow corporations to attract and retain qualified independent directors. The primary mechanisms that protect directors from personal liability include: (i) statutes that allow exculpatory "charter option" provisions to be included in the corporation's certificate of incorporation to limit or eliminate a director's liability for monetary damages for breaches of his or her fiduciary duty of care; (ii) broad indemnification provisions (within allowable limits) which are based on bylaws provisions or an indemnification agreement between each director and the company; and (iii) comprehensive insurance for directors and officers ("D&O insurance").

All directors should be indemnified by the company to the maximum extent allowed by law, pursuant to bylaws provisions and indemnification agreements between each director and the company. These bylaw provisions and indemnification agreements should be reviewed regularly to make sure that they provide the full coverage permitted by applicable law.

The company should purchase a reasonable amount of D&O insurance to protect the directors against the risk of personal liability for their services as directors of the company. D&O insurance is important because it can cover certain claims for which indemnification is not

permitted, and it also provides a third-party source to fund the coverage. This is particularly important in the case of insolvent or financially distressed companies, which may not have the financial ability to satisfy their reimbursement obligations to directors. Because of the risk of litigation, directors should review not only the amount of D&O insurance coverage, but the terms and conditions which govern the coverage of the company's D&O insurance policy. The directors should make sure that the D&O policy provides for reimbursement of defense costs as they are incurred (rather than at the end of the proceeding).

Directors should also pay close attention to retentions, the definitions of "loss," "claim," "wrongful acts," and "defense costs," and to other policy provisions relating to exclusions, severability, and rescission. For example, some policies may include the right of the insurance company to rescind the policy based on assertions that a company's financial statements were materially inaccurate when the policy was issued. Because of the potential impact of bankruptcy of the company on the availability of insurance, many companies purchase separate supplemental insurance policies covering just the directors and officers individually (this is often referred to as "side-A" coverage). This coverage is in addition to the normal D&O insurance coverage that covers both the company and the directors and officers individually, and is designed to provide protection to the directors and officers in the event of exhaustion of the company's primary insurance coverage, or depending on the language of the policy, the bankruptcy of the company. Another potential concern is that a policy's definition of "claim" may not include demands for nonmonetary relief or governmental investigations.

## **DIRECTORS' FIDUCIARY DUTIES IN M&A TRANSACTIONS**

### **Change of Control Transactions - "Revlon Duties"**

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the Delaware Supreme Court considered the validity of a board's decision in the context of a change of control contest in which the stockholders were being "cashed out" (i.e., paid cash in exchange for their shares). The court held that directors in this situation have a duty to maximize the (cash) price for the stockholders. Since the *Revlon* decision, it has been recognized that in certain circumstances a board may have a duty to conduct an auction for the company or at least a functional substitute for an auction. For example, a number of decisions have validated the use of a post-signing "market check" in lieu of an auction.

However, the *Revlon* case may sometimes be misunderstood to require that the board conduct an auction for the company in *any* merger or change of control situation. Delaware courts have stated clearly since *Revlon* that the duty to conduct an auction arises only in certain limited circumstances. These circumstances include but are not limited to instances in which a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company or when, in response to a bidder's offer, a target company abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company. Thus, the courts tend to draw a distinction between the decision to negotiate and enter into a friendly stock merger agreement and the decision to initiate an active bidding process. This is because, unlike *Revlon*, where the stockholders were being cashed out, stockholders in a friendly negotiated stock-for-stock merger will have a continuing equity interest in the merged company.

Directors should also understand that they have no absolute legal duty to discuss or negotiate with a potential acquirer, accept a bid, or explore an offer to acquire the company. This is true even if the proposal offers the company's shareholders a substantial premium over market price. In many circumstances, the directors of the company may reasonably conclude that the institution's long-term prospects are more valuable to shareholders than the offer by the potential acquirer. They may also conclude that the offer should be opposed for other valid or legal business reasons, including potential violations of law or regulations. Under this right, nicknamed the "Just Say No Defense," directors have been justified in deterring attempted acquisitions when the corporation has a reasonable business strategy that may ultimately result in shareholders receiving a higher value than the consideration offered in the acquisition.

Directors that utilize the "Just Say No Defense" in response to unsolicited acquisition proposals are simply making it clear that they believe that it is in the company's best interest to reject the proposal, and that the company is not for sale. Target directors usually give two reasons for rejecting an offer, or refusing to engage in discussions or to give serious consideration to an unsolicited proposal: (1) the price is inadequate, because the company is currently worth more; or (2) the proposal is not in the best long-term interests of shareholders, because management has a business plan which it believes will likely result in a higher future value for the company. While the specific facts and circumstances of the Just Say No Defense cases vary, the common factor is that the target corporation has a reasonable plan to achieve a value for shareholders that may be higher than the value of the acquisition proposal.

Including protective devices like a stock option in the merger agreement does not necessarily mean that the board is putting the company up for sale. Accordingly, the use of a "lockup agreement", a "no-shop clause", or other structural devices intended to slow or discourage unsolicited offers from third party bidders, absent egregious circumstances, is generally insufficient to invoke *Revlon* duties. The courts may decline to extend *Revlon's* application to corporate M&A transactions simply because they might be construed as putting a corporation either "in play" or "up for sale." The adoption of structural safety devices alone as part of a merger agreement does not necessarily trigger *Revlon* duties.

### **Directors' Duties in Responding to Takeover Bids; Enhanced Scrutiny under *Unocal***

The Delaware Supreme Court's *Paramount v. Time Warner* decision makes it clear that a target's directors have broad discretion to consider various factors in responding to a takeover bid. The court also stated that, unless the company initiates an active bidding or auction process or a transaction which would constitute a change in control of the company, the basic obligations of the board in responding to a takeover bid are unchanged. Thus, to qualify for protection under the business judgment rule in the context of a takeover, directors must make reasonable, good faith judgments as to whether the best interests of the company would be served by either accepting or rejecting the proposed takeover bid. When considering how to respond to unsolicited acquisition proposals, a board of directors may conclude that the corporation should remain independent or should be acquired only at a higher price or on terms more favorable than those offered initially by the bidder. Directors who act in bad faith, over-reach, are fraudulent, or act out of a debilitating self-interest will generally not qualify for protection under the business judgment rule.

In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court held that the board’s duty in cases involving the use of defensive measures to deter takeovers is “enhanced” by the possibility that the board may be acting primarily in its own interests, rather than those of the corporation and its shareholders. The *Unocal* court articulated a test which places the initial burden on the directors to satisfy two requirements:

- (1) that the board of directors had *reasonable grounds* for believing that corporate policy and effectiveness were in danger, and
- (2) that the board of directors’ defensive response was *proportional* in relation to the threat posed.

When the *Unocal* Test applies, the members of the board of directors have the burden of proving that the relevant factors have been satisfied, prior to obtaining the protection of the business judgment rule. In *Unocal*, the Court explained that each takeover response must be examined in light of the facts of each case to determine the applicability of the “business judgment rule.”

When discussing the second part of the *Unocal* test, the Court described the need to balance a particular defensive measure against the threat posed to the corporation to determine if it is “reasonable in relation to the threat posed.” This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on “constituencies” other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of non-consummation, and the quality of securities being offered in the exchange.

### **FIDUCIARY DUTIES IN THE ZONE OF INSOLVENCY**

Particularly in difficult economic times, directors should be aware of the unique considerations and risks that arise when a company is insolvent or in the ill-defined “zone of insolvency,” when a company is on the brink of becoming insolvent. The directors of an insolvent or nearly insolvent company face increased risks of litigation from shareholders, creditors, and others when loss of money by them is threatened or even unavoidable. Directors may also face greater risks of litigation for matters such as potential personal liability for dividends that allegedly render the company insolvent.

As discussed above, directors generally have a statutory duty to oversee and direct the management of the business and affairs of the corporation. The conduct of directors of corporations which are insolvent or in the zone of insolvency continues to be reviewed under the business judgment rule. This requires directors to be fully engaged and to ensure that they follow the proper process when making their decisions. Directors that make decisions through careful, informed, and good faith processes when their company is insolvent or in the zone of insolvency will generally be protected from liability for their decisions by the business judgment rule.

However, when a corporation becomes insolvent (and potentially when it is nearly insolvent), its creditors become the residual beneficiaries of the value of the company and are also harmed by any breaches of fiduciary duties by directors that diminish the value of the company. Because of this situation, Delaware courts have held that creditors of an insolvent company have standing to bring a derivative suit (i.e., a suit on behalf of the company) for breaches of fiduciary duties by the company's board of directors. Although the directors of an insolvent corporation do not owe fiduciary duties to creditors, they continue to owe these duties to the corporation, and the creditors have standing to pursue fiduciary duty claims on behalf of the enterprise.

Under Delaware law a corporation is generally considered to be insolvent when (1) there is a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof; or (2) it is unable to pay its debts as they come due. Even where a corporation is deemed insolvent, directors are still presumed, under the "business judgment" rule, to be acting in good faith, independently, and with due care. As long as directors act on an informed basis, in good faith, and in the best interests of the corporation they will be shielded from liability.

Unfortunately, whether a company is solvent, insolvent, or in the "zone of insolvency" is often difficult to determine, and the financial condition and solvency of a corporation can deteriorate rapidly. The courts have not yet defined precisely what the "zone of insolvency" means, and this creates additional issues for directors who are seeking guidance in their actions as directors of a financially troubled company. However, if a company is not able to raise sufficient funds to pay its debts, is unable to borrow money at all or can only borrow on unreasonable terms, or cannot pay its obligations on a current basis, then the company may be operating in the zone of insolvency.

To avoid the pitfalls associated with determining insolvency and the potentially attendant shift in fiduciary duties, directors should stay attuned to financial indicators which may signal a company's slide towards insolvency. Directors may do so by implementing policies designed to monitor relevant data and metrics, and by requiring disclosure by management to the board of important shifts or changes in the company's financial condition.

The law in this area is unsettled, but it is clear that when a company is approaching insolvency, directors must make their decisions with a view to how those decisions will affect the interests of creditors, in addition to the interests of shareholders and the company. Turnaround strategies and other actions designed to shore up the finances of a financially troubled company are subject to many uncertainties. Because of the many potential financial and legal issues relating to determinations of solvency, and fiduciary obligations to insolvent companies or companies nearing insolvency, directors should consult independent legal counsel and financial advisors for advice when a company is insolvent or operating in the zone of insolvency.

## **KEY ISSUES FOR THE BOARD IN 2010**

The uncertain economy has had a reverberating effect in America's board rooms, and has resulted in calls from some legislators, regulators and shareholders for more transparency and accountability in corporate governance. With so many cooks in the kitchen, today's boards of directors are faced with increased responsibilities and new challenges. Some of the key issues facing directors of public companies in 2010 are discussed below

### **Risk Management**

Risk management will continue to be a high priority for directors in 2010. The economic crisis has brought a renewed focus on risk management from shareholders, regulators, and Congress. The SEC adopted rule changes effective in February 2010 requiring companies to describe in their proxy statements the board's role in risk oversight, as well as how a company's compensation policies may affect risk-taking by management and employees where those risks are reasonably likely to have a material adverse effect on the company. The SEC has also created the new Division of Risk, Strategy, and Financial Innovation to help identify developing risks and trends in the financial markets. In addition, the SEC has taken the position that the board's role in overseeing risk management constitutes a significant policy issue that can be addressed in shareholder resolutions in proxy statements.

Although Delaware courts will generally not second-guess directors in assessing and taking business risks on behalf of a company, directors should take an active role in monitoring their company's business risks. Diligent risk management is not merely a "best practice," but a necessary practice to ensure the success and survival of the business of the company. Effective oversight of risk management entails not merely the legal and financial risks that have traditionally been overseen by audit committees, but the full range of material risks that a company may encounter. Enterprise risk management ("ERM") is a term often applied to a global approach to risk management applied throughout the organization. ERM addresses all of the risks of a business enterprise, including operational, financial, strategic, compliance and reputational risks, across the entire enterprise, rather than a more traditional "silo" approach in which each operating function or division managed risk independently. ERM involves not only risk reduction, but an assessment of both "upside" as well as "downside" risks, as part of the strategic planning process. There are several frameworks available to assist companies in implementing ERM, including the ERM framework adopted by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), and "Effective Enterprise Risk Oversight, The Role of the Board of Directors 2009," published by the National Association of Corporate Directors ("NACD").

Accordingly, today's board of directors must take steps to monitor the company's risk management from a "big picture" standpoint. Boards of directors of all companies should evaluate the adequacy of their risk management oversight procedures in light of the heightened scrutiny resulting from the financial crisis, and the requirements of the new SEC disclosure rules. This involves understanding what the company's material risks are and how management addresses those risks, reviewing the company's risk management profile on a regular basis and, determining the best structure for overseeing risk management. The board should evaluate the

manner in which it oversees risk management. Depending on the size of the company and the size of the board and how well it functions, a board may decide to retain overall authority for risk management oversight at the board level. Some boards have chosen to form special committees or subcommittees of the board to specifically oversee risk. Directors should also address the reporting processes, in order to ensure that they are obtaining the relevant information that they need to understand the company's risks, as well as management's assessment of those risks. In addition, directors should address director education, to allow all directors to have a good understanding of their company's business and the major risks it faces.

### **Shareholder Proposals**

One powerful way activist shareholders can promote their agendas is through the shareholder proposal process. By introducing a shareholder proposal for inclusion in a company's proxy statement, shareholders gain management's immediate attention. While there are certain situations in which the SEC will permit companies to exclude shareholder proposals from their proxy statements, the SEC has been trending toward giving the proposing shareholder the benefit of the doubt. If this trend continues, companies are likely to be faced with more and more shareholder proposals each proxy season on matters as diverse as management performance, corporate governance, and social and political issues that shareholder activists hope to influence. Each proxy season generates several "hot topics," such as Y2K in the late 1990s, current "global warming" issues, and majority voting and other topics discussed below.

How a company deals with shareholder proposals can have a significant effect on the company's public image. Shareholder proponents often post on their websites running tallies of their proposals, the companies they were submitted to, and the resultant votes. In addition, proxy advisory firms publicly monitor company responses to shareholder proposals.

In considering how to respond to shareholder proposals, directors should consider what effect they might have on the company. In some cases shareholder proposals can be accepted without significant difficulty or harm to the company. In other cases, it may be more appropriate to seek exclusion of the proposals from the proxy statement. In both situations, shareholder proponents are seeking dialogue with the company, and the board should consider carefully how to respond.

### **Executive Compensation and "Say on Pay"**

Over the last several years, executive compensation has become a highly charged subject. This is particularly true where companies have not met performance expectations and executives nonetheless receive bonuses. Banks, financial institutions and others participating in the Troubled Asset Relief Program, or "TARP," have already been subjected to compensation reforms. Legislation has been introduced on a broader scale that would give shareholders a non-binding "say-on-pay" vote on executive compensation packages and golden parachute arrangements, impose restrictions on severance compensation, and impose mandatory "clawback" provisions requiring executives to return performance-based compensation if subsequent events demonstrate that the performance goals were not met. Some companies (for

example, Verizon Communications, Microsoft Corp. and Apple, among others) have voluntarily adopted say-on-pay policies, in an effort to enhance shareholder relations.

Another area of focus is the relationship between compensation policies and risk management, particularly whether a company's compensation policies might encourage excessive risk taking. New SEC rules went into effect February 28, 2010, which require the CD&A section of company proxy statements to include an analysis of the relationship between employee compensation policies and risk management.

Against this backdrop, it may be difficult for boards and compensation committees to remain focused on the goal of executive compensation: to attract and retain qualified individuals who can best execute the company's business strategy. Boards and their compensation committees need to establish a clear link between pay and performance in order to minimize second-guessing by shareholders, courts, or others. A board can best do this by carefully documenting its compensation analysis and conclusions, acting in good faith and on an informed basis, and consulting with independent compensation consultants as necessary.

### **CEO Spotlight: Succession Planning and Separation of Chairman and CEO Positions**

Another corporate governance area receiving enhanced scrutiny in 2010 has been CEO succession planning. Difficult market conditions have put the spotlight on CEOs and caused higher than normal turnover at the CEO level. Shareholders want to know that their directors have a policy in place to manage succession issues. It is noteworthy that the SEC issued guidance in November 2009 stating that because CEO succession planning is a significant policy issue, shareholder proposals on this topic generally cannot be excluded from proxy statements.

Because a lack of continuity in leadership can undermine public confidence as well as interfere with a company's long-term and short-term strategies, boards should ensure their company has succession plans in place. These plans should be reviewed on a regular basis and as changes in circumstances dictate. By having a succession plan in place, companies can pre-empt shareholder questions and proposals on this issue and provide themselves, as well as the shareholders, a measure of comfort.

Another focus of shareholder activism has been the issue of the separation of the CEO and chairman functions. For instance, a shareholder proposal passed in April 2009 required Bank of America to separate its CEO and chairman positions. In addition, an activist shareholder led Sara Lee Corporation to amend its corporate governance guidelines and bylaws to provide that it would select an independent chairman when its current CEO's tenure ended. In 2010, shareholder proposals advocating the separation of the CEO and chairman roles have continued to gain ground. Various legislative proposals have been introduced on this topic as well. The SEC's disclosure reforms effective in 2010 require companies to include information about their leadership structure, including whether and why they have chosen to combine or separate the CEO and chairman positions.

Proponents of the separation of the CEO and chairman functions argue that separation enhances the accountability of the CEO to the board and helps ensure the board's independence from management. Opponents argue that a company's benefits from having a chairman with extensive and intimate knowledge of a company's business. Board members in 2010 should actively discuss which structure will best serve the interests of their company, after consideration of all relevant factors. Companies that do not separate the CEO and chairman positions should consider appointing a lead or presiding director to supplement the chairman's role.

### **Majority Voting**

For the last several years, activist shareholders have been seeking to gain more control in the board room through majority voting provisions. Consequently, a growing number of companies have replaced plurality voting with majority voting, a trend that looks like it may well continue.

The amendment to NYSE Rule 452, effective in 2010, which eliminates discretionary voting by brokers in uncontested director elections, has also exacerbated the situation by potentially making it more difficult to obtain a majority vote. Prior to this amendment, brokers who hadn't received voting instructions from beneficial owners could vote in uncontested director elections in their discretion. Because broker votes comprise a substantial portion of the votes cast, this rule change is expected to significantly increase the voting power of institutional shareholders and proxy firms and could have significant effects on companies that have adopted a majority voting standard. Note that Rule 452 applies to companies listed on NASDAQ and other exchanges, as well as the NYSE.

### **Shareholder Communications**

Another current trend in corporate governance is the push by activist shareholders for more direct communications with the companies in which they invest. While management should be the primary spokesperson for the company, in some cases directors may be asked to take a more active role in communications with shareholders, which ultimately may appease the shareholders and avoid the shareholder proposal process and proxy fights.

Regulation FD prohibits the selective disclosure of material non-public information. Because the determinations of "materiality" can be ambiguous, the SEC is considering providing guidance concerning such disclosures, particularly with respect to a company's communications with its shareholders.

### **Takeover Defense**

The recent precarious state of the economy has left some corporations financially weak while others, in a "wait-and-see" mode, have been stockpiling cash. As the economy gains stability, this disparity may lead to a rise in acquisitions, some of which could be hostile. Additionally, reforms such as increased proxy access for shareholders, elimination of broker discretionary voting and majority voting could leave some companies more vulnerable to attack.

Accordingly, boards should consider reviewing their company's takeover exposure, if they have not done so recently.

## **BOARD SELECTION, COMPOSITION AND STRUCTURE**

With the rise in shareholder activism and increased public and political scrutiny of board actions over the past few years, board selection, composition and structure have become “hot buttons” in corporate governance issues. Matters such as director independence and qualification have become top priorities and have made the task of selecting directors more difficult than ever before. When considering the composition of a board of directors, it is important to focus on creating a board that can effectively oversee and maintain a strong working relationship with senior management. These considerations are discussed briefly below.

### **Director Independence**

Companies and their boards of directors have recently come under increased scrutiny due to the worldwide economic recession. As a result, there has been increased advocacy by certain shareholders, financial institutions, shareholder advisory services, and activist groups for boards to be composed almost exclusively of independent directors. Some have also called for more stringent standards for deciding which directors qualify as independent. Many of the proposed reforms call for the elimination of directors with any current or past relationship between the director and the company, between the director and other directors, and between the director and other organizations that have business or other relationships with the company.

The purpose of the various requirements that directors be “independent” of a public company is to ensure that the directors are free from conflicts of interest and that they can act in the best interests of the stockholders. Accordingly, one of the most important considerations regarding the composition of a public company board of directors is director independence. All companies listed on the New York Stock Exchange are required to have a majority of directors who meet certain criteria for independence. It generally is considered best practice to have a supermajority of independent directors, with a significant number of public companies adopting a model of having only independent directors except for the chief executive officer. As board policy, it is best to say that the board will have “at a minimum” a majority of independent directors in order to allow for flexibility in board composition as directors leave and join the board and as the board and management contemplate succession issues.

The primary emphasis of director selection should be to create a board of directors who work well together and with management to serve as an advisor to management in setting the strategic course of the company. Individuals who are selected to be directors should be persons who possess sufficient intelligence, experience, integrity, and character to allow them to make sound business judgments that are free from bias based on personal considerations. If too much emphasis is based on “independence,” the boards risk having directors who are strangers to the company and its industry, and who may serve better as an overseer for the discipline of management, rather than as a strategic advisor to the company.

Companies now operate in increasingly more complex business and volatile market conditions, making it even more difficult for directors to make prudent and intelligent strategic and business decisions. As the requirements for director independence become more stringent, businesses may be forced to go outside their industry to find directors who qualify as independent. Because of this, some independent directors may be relatively inexperienced in the company's business, and lack the sophisticated expertise and understanding of relevant industries and markets. The result of these increased standards for director independence may be that boards are forced to rely more than ever on management to inform their decisions.

Independent status nonetheless continues to be an increasingly important issue when determining the make-up of a board of directors. A company must be extremely careful that any potential issues with respect to independence, such as a business relationship with the company or a related entity, are fully disclosed. Any of these potential issues that are considered in connection with determining a director's independent status must be reported to the SEC at the time a director is identified as independent. Tenuous or remote relationships that may have been overlooked in the past, such as a director's involvement with a nonprofit organization that is supported by the company, may now present a question of independence, especially in hindsight after problems have occurred in the business. A practical way to limit exposure with respect to decisions on independent director status is to consider delegating the responsibility to a committee of directors who are free from any suspect relationships.

### **Director Recruitment**

The number one concern when considering a prospective director should be whether the candidate is qualified to make prudent decisions and give sound advice to management of the company. Prospective directors should have a firm grasp of the business concepts and industry knowledge required to be a contributing member of the board. The SEC has proposed new proxy reforms that would require a company to disclose on its annual proxy statement the experience, qualifications, attributes, and skills that qualify each director and nominee for director to serve on the company's board. Banking institutions have been instructed by the Department of the Treasury, Federal Reserve, FDIC, and the Comptroller of the Currency to review their existing boards to ensure that the firm leadership has sufficient expertise and ability to both manage risks and maintain sufficient levels of equity. Unfortunately, these enhanced restrictions on independence make finding qualified directors increasingly difficult. It is important that when evaluating candidates for board positions, the push for independence does not overshadow the ultimate goal of creating an effective board of directors.

Another important question a board should always be considering when evaluating a potential new board member is whether the prospect is capable of working in a collegial way with the other members of the board. A board of directors cannot be expected to function at its full potential unless the members of the board have a strong, collegial working relationship. Thus, while intelligent and independent directors are essential to the proper functioning of the board, it is also important that the directors have a strong sense of collegiality, significant industry and business knowledge and experience, and a sense of common purpose. The board should also seek to maintain a diversity of experience and backgrounds among the directors, in order to enhance the breadth of boardroom discussions. If the board selects nominees for

director with these criteria in mind, they will be well on their way to securing a board of directors that will provide good strategic direction and management oversight, and also create an effective working relationship with the company's management.

## **BOARD COMMITTEES**

### **Overview of Board Committees**

The New York Stock Exchange ("NYSE") requires every company listed on the NYSE to have an audit committee, a compensation committee, and a nominating and governance committee, each composed solely of independent directors. SEC regulations require disclosures regarding the financial expertise of directors who serve on the audit committee, as well as disclosures designed to prohibit "interlocking" compensation committees between public companies. The board of directors of every company should consider carefully which individual directors best satisfy the requirements for service on board committees. In some circumstances, it may be good practice to document both the independence and qualifications of each director at least annually by using director questionnaires.

Although these committees are composed of independent directors, it is important that they have a good working relationship with the CEO and other management. The CEO ordinarily plays a significant role in discussions of compensation matters and governance matters, including selection of new directors. In addition, the board committees should have the authority under their committee charters to retain consultants to assist them in their decision-making, being always mindful that it is the committee's responsibility to exercise its own independent judgment on all matters. It is also important for these committees to have a close working relationship with the general counsel and CFO of the company. Because of their deep knowledge and understanding of the company and its business, these important officers of the company often provide more pertinent and informed advice than outside consultants.

The board may also appoint other standing committees to handle specific matters, such as a disclosure committee to handle SEC disclosure matters, or a risk management committee to oversee risk management (although risk management may also be handled by the board or by the audit committee). Boards often establish special committees from time to time to handle specific matters such as conflict of interest transactions, major shareholder litigation, hostile takeover bids, or specific major corporate events, investigations, or special projects.

The board and board committees should work closely with the general counsel and senior management to set their agendas for the year and for each meeting. Although it is the responsibility of management to initiate the company's business and strategic agenda, the board of directors should take an active role in establishing a clear understanding between management and the board regarding the board's responsibilities and role in oversight. The board and committee agendas should reflect the appropriate division of responsibilities between management and the board, and should be provided to the board sufficiently in advance of the meetings to provide adequate time to prepare for the meeting. Board and committee meetings should be regularly scheduled and should allow sufficient time during the meeting for full discussion of the matters on the agenda.

## **Audit Committee**

The audit committee is the primary means by which the board of directors monitors and oversees the company's financial statements, financial reporting and disclosure, and the relationship with the company's independent auditors. The audit committee must be composed solely of directors who meet the listing standards for director independence of the company's particular securities market, as well as the audit committee independence requirements under applicable SEC rules.

In addition, audit committee members are subject to certain financial literacy and financial expertise requirements. Audit committees should be comprised of persons with sufficient understanding of accounting and corporate finance concepts and terminology to enable them to act to effectively oversee the integrity of the company's financial reporting process and its financial statements. The NYSE and other major securities exchanges require that each member of the audit committee be able to read and understand fundamental financial statements (or must become financially literate within a reasonable time after being appointed to the audit committee). At least one member of the audit committee should qualify as an "audit committee financial expert" within the meaning of SEC rules. The financial expertise requirement is generally fulfilled by a committee member with a background in finance or accounting that permits the board to conclude in good faith that the director is capable of understanding the most complex issues of accounting and finance that are likely to be encountered in the course of the company's business. The NYSE permits a board to presume that a person who is an "audit committee financial expert" with the meaning of the SEC's rule has the requisite accounting or related financial management expertise to satisfy the NYSE's listing standards.

The board should receive regular reports from the audit committee, and the directors should satisfy themselves that the audit committee, management, and the independent auditors are satisfied that the financial condition and results of operations of the company are fairly presented. The audit committee should also get regular reports from management and the internal auditor to provide reasonable assurance that the internal control systems of the company are adequately structured and implemented to (a) allow the company to prepare its financial statements in accordance with generally accepted accounting principles ("GAAP"), and (b) give reasonable assurance of accuracy in financial reports. In addition, the audit committee should oversee management's design and implementation of policies and practices to manage and control compliance risks.

The NYSE rules require that the audit committee "discuss guidelines and policies to govern the process by which risk assessment and management is undertaken." Because of this requirement, many companies may elect to have the audit committee oversee risk management. However, it is important not to overburden the audit committee with too many responsibilities. The audit committee has a critical role in overseeing risk management related to financial reporting and financial controls. Beyond that role, the board as a whole has a responsibility to understand and oversee risk, so that it can provide good judgment in everything that it does. There are some risks, such as compensation risks, and risks related to choosing management and delegating authority to management, which must be the responsibility of the full board. Further, it must be kept in mind that risk is ultimately the responsibility of management, and risk must be

evaluated and managed at the management level. The plan for delegation of responsibility for various areas of risk should be fully designed and implemented in a manner which allows the full board to be actively involved in understanding the process.

Where risk management is particularly complex, a board may create a separate risk management committee, which oversees risk management, subject to the general review and oversight of the audit committee. If the company retains the risk management function in the audit committee, the audit committee should schedule appropriate meeting times for a periodic review of risk management apart from its role of reviewing financial statements and accounting compliance.

### **Compensation Committee**

Executive compensation is one of the most controversial issues in corporate governance today. There is intense political and public scrutiny of executive compensation policies and practices, and frequent public condemnation by politicians, regulators, investors, and other commentators of excessive executive compensation. Numerous legislative and regulatory reform proposals affecting compensation of public companies have been advocated recently. One such proposal is a requirement that any outside compensation consultant hired to advise the compensation committee be independent of the company, its directors, and its executives. Additionally, the proposal would also require that the consultants must report directly only to the board or board committee responsible for setting executive compensation. The SEC has also proposed proxy disclosure amendments that would impose specific and detailed disclosure requirements concerning consultants who provide executive compensation advice and other services to the company.

### **Nominating and Governance Committee**

The nominating and governance committee should establish and implement a formal and transparent process for nominating qualified directors. This process should ensure that the directors who are selected have the background, skills, industry knowledge, experience, integrity, and character necessary to create a board that can effectively oversee management of the company's business.

Recent reform proposals may soon complicate the nominating and governance committee's work. As discussed above, increased proxy access by shareholders allows them much more freedom to nominate directors. Similarly, the elimination of discretionary broker voting, majority voting for directors, and declassification of boards affects the director nomination and election process. If shareholder activism creates a practical necessity of communicating with shareholders regarding director nominations, the nominating and governance committee will play an important role in the process.

## **BOARD FUNCTIONING AND PROCEDURES**

### **Minutes**

It is important to keep careful and thoughtful minutes of all board and board committee meetings. Board minutes should indicate not only the time, date, and place of the meetings, but who was in attendance and the matters for which they were present and voted on, or were recused. Minutes serve as an official record of the deliberations of the board, and should accurately reflect the substance of the meetings and all material decisions made at the meeting. The minutes should provide adequate support to help the directors recall what transpired at a meeting.

Taking corporate minutes is an art rather than a science, and the goal should be to reflect the discussions and the time spent on significant issues. At the extremes, there are two types of minutes. The long or narrative form of minutes contains detailed, and sometimes almost verbatim, descriptions of discussions and actions. The short or abbreviated form reports only the actions taken or includes only a short description of the discussions at the meeting. In practice, most minutes fall somewhere in between these two extremes. The relative importance of the matter and the need for confidentiality of certain information may often influence both the length and content of the discussion in the minutes. The secretary and counsel for the company should work with the directors to prepare minutes which accurately and appropriately reflect the substance of board and committee meetings.

### **Executive Sessions**

NYSE rules require listed companies to hold regular executive sessions of non-management directors where no members of management are present. Executive sessions of the board provide an opportunity for confidential review of the performance of management and succession planning, as well as a confidential forum for discussing sensitive issues and problems. The NYSE rules also recommend that boards schedule at least annually an executive session of independent directors only. The trend seems to be toward scheduling regular executive sessions at every board meeting.

### **Director Education**

Boards should consider director education programs to help directors deal more effectively with certain important issues facing a company. These programs may include tutorials or seminars, as a supplement to board and committee meetings, or even formal classes at a college or university. Continuing director education may serve as a valuable tool to help keep directors informed as to current industry and company developments as well as certain specialized issues relevant to the company's business. Boards should also consider holding annual board retreats for board members, senior executives, and when appropriate, outside advisors to discuss and review strategy and long-range plans and financial and disclosure issues. Boards should also provide education for new directors, a major portion of which could be furnished at an annual board retreat. The training of new directors should include specific training to allow the new director to quickly gain a good understanding of the company's business and its risk profile.

## **Committee Charters and Codes**

The SEC and NYSE require companies (1) to adopt charters for audit, compensation, and nominating committees, and (2) to adopt or disclose a code of ethics, corporate governance guidelines, and policies and procedures for reviewing related party transactions. These should all be tailored to the specific needs and circumstances of each company, and carefully reviewed and updated each year to take out unnecessary or ineffective procedures and to add any items that may help directors in discharging their duties. The board should be careful to limit any requirements to those items that are necessary and feasible to accomplish in everyday practice, since failure to follow a designated policy, code, or procedure may be considered evidence of a failure to exercise due care.

One area which should be reviewed carefully in light of recent developments is an expansion of corporate compliance policies to prohibit not only bribery of foreign government officials, but also bribery of foreign private individuals. The recent prosecution by the U.S. Department of Justice (“DOJ”) of a case of foreign commercial bribery pursuant to the Travel Act may signal a new effort by the DOJ to wage a campaign against foreign commercial bribery in a manner similar to the anti-bribery campaign waged by the DOJ under the Foreign Corrupt Practices Act.

## **Confidentiality and Communications by Directors**

Directors generally owe a duty of confidentiality to the corporation concerning material non-public information they learn about the corporation in their role as directors. The preservation of this confidentiality is imperative to protect the effective functioning of the board and the interests of the company and its stockholders. In addition, the board should function as a collegial body, and all discussions in the boardroom should be considered confidential and that confidentiality should be preserved. The preservation of confidentiality is also important for the protection of individual directors against liability for any misleading statements attributable to them. Directors should respect the role of the CEO as the chief spokesman for the company. Unless specifically authorized by the board, individual directors should generally not engage in discussions with investors or other outsiders concerning the corporation’s business. If the board determines that it is advantageous for the board to have discussions with investors or others, it is advisable to consider appointing one director as the board’s official spokesperson. If there is a non-executive chairman or a lead director, it may be appropriate for that person to speak on certain matters on behalf of the company, but all such matters should be handled in close consultation with the CEO in order to avoid confusion in the company’s public statements.

## **Board, Committee and CEO Evaluations**

NYSE rules require that the board as a whole, as well as the audit, compensation, and nominating and governance committees, conduct annual self-evaluations to determine whether they are functioning effectively. In addition, the board should evaluate at least annually the CEO and other senior management. Because documents or minutes created in this evaluation process are not privileged, it is important to avoid creating documents that could damage the collegiality of the board or that may be used against the company and the board in litigation.

## **Director Compensation**

The compensation committee or the nominating and governance committee should determine or recommend to the board the form and amount of director compensation. This compensation should be “benchmarked” against that of peers or comparable companies, either using information readily available to the board, or relying on advice and analysis from compensation consultants. It is appropriate and customary for basic directors’ fees to be supplemented by additional amounts to committee chairpersons, or to members of committees that meet more frequently or require a greater time commitment than other committees. The SEC’s proxy disclosure rules call for specific tabular and narrative disclosure of all director compensation, including cash payments, stock options, restricted stock, or other equity awards, and any deferred or other compensation.

Although there has been a recent trend to use stock-based programs for director compensation, it is important to be sure that such programs do not create inappropriate incentives for directors. Restricted stock grants may currently be more desirable as a form of director compensation than stock options, for example, due to the desire to avoid the perception that option grants may encourage directors to support more aggressive risk-taking on the part of management in order to maximize the value of their stock options. County club memberships, use of corporate aircraft, charitable donations to nonprofit organizations with which a director is affiliated, and other similar “perks” should be avoided or carefully scrutinized to avoid adversely affecting a director’s independence or creating the appearance of impropriety.

## **Whistle-Blower Policies**

Boards and audit committees are required to establish “whistle-blower” policies and procedures to enable employees to submit concerns, on a confidential and anonymous basis, as to the company’s accounting, internal controls, or auditing matters. Companies are also subject to potential civil and criminal liabilities if it is proven that they have taken retaliatory action against a whistle-blower who is an employee. Boards should ensure that the company establishes an anonymous whistle-blower hotline and a well-documented policy for evaluating whistle-blower complaints, to identify those that merit investigation, in order to weed out frivolous complaints.

## **Major Transactions**

Major corporate transactions such as mergers, acquisitions, spin-offs, major investments, and debt or equity financings generally require board approval. The board’s consideration of these transactions should be based on full disclosure of all material facts to the board to aid them in their deliberations. If the company has the internal expertise to analyze the transaction and assess the relative risks and rewards, as well as alternative transactions, the board is justified in relying on management’s presentation without the advice of outside consultants. In many instances, however, it may be advisable to retain outside financial, legal, and accounting advisors to assist with evaluation of major transactions, particularly where there are complicated legal, financial, or accounting issues to be considered.

There is generally no need for the board to create a special committee of the board to handle major transactions, absent conflicts of interest or other circumstances that make the use of the full board problematic. Management should build a strong business, legal, and financial basis to support its actions with respect to any major transaction, including an appropriately documented “due diligence” file. Unless it is impractical for good reasons readily explainable to investors and others, the board should spend ample time in considering the approval of each major transaction.

For complicated transactions and complex agreements, it may be advisable for the board to meet at least twice when considering whether to approve or disapprove of the transaction. During the first meeting, the board would receive an initial presentation regarding the transaction, and the board would deliberate about and reflect on the relative risks and merits of the proposed transaction. The board would then adjourn for a second meeting at a later time to consider any additional information and to determine whether to approve or disapprove the proposed transaction with the actual approval, if any, coming at the second meeting, after the board has had additional time for deliberation, reflection, investigation, and questions.

### **Related Party Transactions**

Related party transactions present special issues with conflicts of interest, and are generally avoided today by most public company boards. However, there is no inherent impropriety in transactions between a corporation and its officers, directors, or major shareholders. Such transactions, if in the best interests of the corporation, may be approved by a fully-informed board through the action of its disinterested directors. The board should give careful attention to and monitor potential conflicts of interest of management, directors, shareholders, external advisors and service providers. The company should also comply scrupulously with all proxy, periodic reporting, and financial statement footnote requirements pertaining to related party transactions.

## **DIRECTORS OF NONPROFIT CORPORATIONS**

### **Overview of Nonprofit Organizations**

There are a great variety of nonprofit organizations such as churches, art museums, health care providers, civic organizations, social clubs, foundations, trade associations, and homeowner associations, among others. These organizations are often formed as nonprofit corporations, although they can also take other organizational forms. Most of these organizations are organized and maintained under a single state statute, and are managed by a board of directors (for a nonprofit corporation) or some other single governing body, for non-corporate entities. Although the size of the organizations, their budgets and resources, and their mission statements vary widely, the fundamental responsibilities of the directors of these organizations are generally the same. The legal analysis of the duties of directors of nonprofit corporations often draws upon the law and the lessons learned from the law applicable to for-profit businesses. However, in some circumstances state and federal law may impose additional or different duties on directors of nonprofit organizations, especially tax-exempt corporations and corporations deemed to be public charities.

## **Selection of Directors**

A significant difference between profit and not-for-profit corporations is the manner in which directors are selected. Some nonprofit corporations have members. In these corporations, the members elect directors in much the same way as stockholders elect directors in a for-profit corporation. Many nonprofit corporations have no members or shareholders, and the corporation is governed, and new directors are elected, by the board of directors, which is self-perpetuating. Some directors may be elected by status, such as by virtue of holding another position, such as the chief executive officer of an affiliate organization or constituency group.

### **Defining the Mission Statement; Defining to Whom Duties are Owed**

Defining, understanding, and adhering to the mission of the nonprofit organization are the duty of every director of every nonprofit corporation. The nonprofit corporation's mission statement determines the corporation's purpose, and the constituency that it serves. The overarching consideration in determining to whom the duties of the directors are owed is the mission of the organization.

Although nonprofit organizations are generally free to run themselves, they have a very real, although not always clearly defined, degree of responsibility toward their constituencies or stakeholders. In various ways, nonprofit organizations must answer to their supporters and donors, including individual contributors, foundations, corporations, government agencies, and other nonprofit organizations which support or collaborate with the nonprofit organization. They must also answer to their members, if they have members (this includes organizations such as professional or trade organizations and labor unions).

Nonprofit organizations must also answer to their beneficiaries, who are the recipients of the services an organization provides. These beneficiaries may include readily definable groups such as students, hospital patients, the homeless, abandoned children, theater and museum attendees, or battered persons. Some beneficiaries, such as the general public, who may benefit from advocacy for good government or the environment, or from scientific or policy research, can be so large, diffuse, and ill-defined that it is difficult to achieve any direct accountability. Staff and volunteers are also stakeholders of the nonprofit organization, and their interests should be considered by the board, as well. All of the above constituencies have a right to some degree to know how the money contributed to the organization is spent, and to receive information and reports on the activities and management of the organization.

All directors are accountable to defined classes of persons or entities, although some classes of persons do not have the right to question the director's conduct, or bring him or her into court. For example, in a public charity, there may be a class of beneficiaries of a charitable nonprofit corporation (for example, the poor of a parish) who do not appoint the directors. Generally, these persons do not have the power or legal authority to enforce the obligations of the directors. In the United States, this role is filled by the state, generally represented by the state attorney general. In effect, the attorney general becomes the representative of the constituency for whom a charitable organization was formed.

## **Composition of the Nonprofit Board**

A nonprofit board should include people of various backgrounds, experience, and expertise to provide a pool of talent for board activities and bring the collective judgment of the board to bear on important issues. The board should be an active board, which meets regularly, and among other things, evaluates reports from the head of each major committee, as well as the executive director. The executive director should generally not be a voting member of the board of directors.

## **Functions and Responsibilities of the Nonprofit Board**

The board of directors of a nonprofit corporation serves several important functions and shares certain responsibilities, including, among others: (i) preparing the job description of the executive director; (ii) selecting, advising, evaluating and, if need be, replacing the executive director; (iii) establishing and reviewing the corporation's strategic direction and approving specific corporate objectives; (iv) assuring, to the extent possible, that adequate financial and other resources needed to accomplish the corporation's objectives are furnished to the organization; (v) monitoring the performance of the executive director (and other management personnel, if any); (vi) ensuring that the organization operates in a socially responsible, ethical, and effective manner; (vii) establishing and carrying out an effective system of governance at the board level; (viii) ensuring that the organization's activities are consistent with its mission statement and its long-term goals and objectives; (ix) preserving and protecting the assets of the organization for use in furthering the mission statement and long-term goals and objectives of the organization; and (x) leading and facilitating development and fund-raising efforts for the organization.

Because most nonprofit organizations solicit contributed funds, they are subject to certain legal requirements related to the charitable gifts they receive. To satisfy those requirements, they must be careful to exercise control over staff, volunteers, consultants, and contractors to ensure that the donor intent or donor designations of any donors regarding the purposes to which the donors' gifts are to be used are scrupulously honored. The board should exercise oversight in these matters, and should also take reasonable steps to ensure that fund-raising expenses are reasonable and reports made available to the public on request.

## **Fiduciary Duties of Nonprofit Directors**

The directors of a nonprofit corporation have fiduciary duties that are similar to those of the directors of a for-profit corporation. The board must understand and fulfill these fiduciary duties. Nonprofit directors and officers have three commonly recognized duties to the organizations they serve: the duty of care, the duty of loyalty, and the duty of obedience. The duty of care and the duty of loyalty are much the same as those applicable to for-profit business organizations. The duty of obedience requires that a director act with fidelity, within the bounds of the law, to the organization's mission, as expressed in its articles, bylaws, and mission statement. These duties also apply to board committee members fulfilling committee functions.

To satisfy the duty of care, board members should recognize and appreciate the need to be well-informed, and the value of collegial decision making. The board should meet regularly, and insist on good attendance and participation by all board members. There should be frequent meetings of focused committees. In order for the board to function well, the board and its various committees must work together well, with clearly defined roles for each. Reliance on outside counsel and advisors may also be appropriate for more complex matters such as tax and legal issues.

The duty of loyalty requires that a director must not use a nonprofit organization position for his or her individual personal advantage. Much like the for-profit corporation, the duty of loyalty relates primarily to conflicts of interest, corporate opportunity, and confidentiality.

If conflicts of interest do arise, many state nonprofit corporation laws provide that the conflict will not be deemed to breach the director's duty of loyalty or render void the transaction under which the conflict arose, if the corporation and the director can show that either the transaction was approved by a disinterested majority of the board, after full disclosure by the director of the material facts giving rise to the conflict, or that the transaction was fair to the corporation at the time it was entered into.

State law may provide directors, officers, trustees, and other volunteers of charitable organizations with immunity for certain actions. Frequently, volunteers are immune from liability, provided they are acting in the course and scope of their duties or functions. Charitable organizations and their employees are generally provided a somewhat more limited immunity, if they are given any immunity at all. Nonprofit governing documents often provide broad indemnification for the corporation's directors, officers, employees, and agents, and most nonprofits purchase directors' and officers' liability insurance ("D&O Insurance") coverage for their directors and officers.

### **Understanding the Tax Status of the Nonprofit Organization**

A director should also have a good understanding of the tax status of the nonprofit corporation. A director should not assume that because the corporation is nonprofit that it is exempt from federal or state income taxes or other taxes. The federal tax-exempt status is a privilege conferred under the Internal Revenue Code (the "Code"), which requires that the organization meet throughout its existence certain requirements set forth in the Code. A director should also understand that exemption from federal income tax does not necessarily permit donors to the corporation to deduct the value of their contributions from their taxable income, as a charitable contribution. The Internal Revenue Service ("IRS") permits donors to deduct gifts to a tax-exempt organization only if the organization qualifies under Section 501(c)(3) of the Code. Most public benefit and religious organizations, and any other organization wishing to provide deductibility of gifts as charitable donations, will seek exemption under Section 501(c)(3).

Generally, a 501(c)(3) organization should meet the following requirements to retain its tax-exempt status: (1) the organization should be organized and operated exclusively for one or more of the charitable, educational, religious, or similar purposes which are specified as

“exempt” purposes under the Code; (2) no part of the organization’s net earnings may inure to the benefit of private shareholders or individuals; (3) the organization may not, except as an insubstantial part of its activities, attempt to influence legislation (unless it elects to come under the provisions allowing certain lobbying expenditures) or participate to any extent in a political campaign for or against any candidate for public office; and (4) the organization may not be organized or operated for the benefit of private interests, such as those of the founder, the founder’s family, employees, or members (if any) of the organization.

## **Compliance**

Although nonprofit directors are not responsible for the day-to-day compliance with federal and state requirements, directors should be aware of the requirement for filing an annual report with the IRS. The annual report on Form 990 (or Form 990-PF for a private foundation) requires detailed information regarding: (1) source of funds; (2) contributions made to the organization during the year; (3) the names of individuals or organizations who are “substantial contributors;” (4) the recipients of distributions from the organization; (5) the relationship of such recipients to the organization or individuals connected with the organization; and (6) the purpose of each distribution. There are also required disclosures regarding directors and certain matters related to governance of the organization.

To document a tax exempt organization’s proper exempt activities, the organization should keep detailed records regarding contributions, expenses, and the relationship of donors to beneficiaries.

Taxation and legal compliance by nonprofit organizations is an extremely technical field, and a director’s obligations do not require a detailed knowledge of applicable provisions of the Code and other tax statutes and regulations. Most nonprofit corporations have their tax reporting and tax compliance issues handled by outside accountants or attorneys. The board has the responsibility to oversee these professionals, as a part of the board’s general duty of oversight. Directors should periodically evaluate whether the corporation is fulfilling its mission, and should also periodically review with the organization’s accountants or attorneys its on-going compliance and qualification as a nonprofit and, if applicable, tax-exempt organization.

## **Audited Financials; Audit Committee**

A well-managed nonprofit organization should also have audited financial statements. The organization should have an audit or finance committee to oversee the finances and financial statements of the organization. Much like a for-profit corporation, the audit committee of a nonprofit is concerned with overseeing both the organization’s financial statement audits and the organization’s internal controls. However, because no statute or regulation specifies the role of the nonprofit organization’s audit committee or who should be a member of the audit committee, the exact composition and duties of the audit committee will vary considerably from one organization to another. Accordingly, the best source of guidance regarding best practices for audit committees for nonprofit corporations are the rules and practices of audit committees of publicly-held companies, as discussed above.

## **Conflict of Interest Policies and Procedures for Nonprofit Organizations**

Conflict of interest issues in nonprofit organizations have become increasingly important in recent years. There is a strong trend to hold nonprofit organizations, and their directors and officers, to more demanding standards of accountability and public scrutiny. The IRS now requires nonprofit organizations to have in place a conflict of interest policy. A conflict of interest policy generally deals with the identification and disclosure of conflicts of interest, and the actions taken after disclosure. Broadly speaking, conflict of interest policies and their guiding principles are designed to prevent persons with decision-making authority in the organization, who have the obligations of care, loyalty, and obedience that govern their authority, from taking actions that benefit or may be perceived to benefit themselves, members of their immediate family, or their business affiliates.

Generally, when a conflict of interest is identified, the conflicted officer, director, or other person will abstain from participation in any discussion or vote or other action or decision-making concerning the transaction. Whenever a director or officer abstains from participation in a committee or board vote, the abstention should be formally recorded in the minutes.

Properly adopted and administered conflict of interest policies can help to ensure that the nonprofit organization receives fair value for the goods and services it obtains, and that no one affiliated with the organization receives an unfair benefit from the affiliation. Perhaps even more importantly, the adoption and effective implementation of conflict of interest policies and procedures protect the reputation and credibility of the organization with donors, the public, and the other constituencies of the organization.