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Corporate Governance Update: So You're Thinking of Joining a Public Company Board

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Candidates for directorships on public company boards have much to consider. Potential exposure to legal liability, public criticism, and reputational harm, a complex tangle of applicable regulations and requirements, and a very significant time commitment are facts of life for public company directors in the modern era. The extent to which individuals can effectively manage the risks of directorship often depends on company-specific factors and can be increased through diligence and thoughtful preparation on the part of the director and the company.

The first year of board membership is critical for newly elected or appointed directors. While the onboarding process varies from company to company, based on our experience, there are several key elements to a successful transition. An effective onboarding process educates the new director with regard to the company's strategy, acquaints him or her with the management team, and integrates the new director into the board. During the first year, the new director is in a position to observe and participate in the board dynamic and determine where he or she can best add value.

Public company directorships are often viewed as risky propositions in the current legal and financial environment. While not all risk can be eliminated, serving as a director on a board that fits well with the individual's expertise and interests can be an extremely rewarding experience. Our system of corporate governance depends on the service of qualified, committed professionals on public company boards, and the future success of corporate America will depend on its ability to attract engaged, experienced individuals who can provide oversight and guidance to management in a challenging environment. While director compensation is not insignificant, individuals generally choose to serve as directors not for the remuneration but for the opportunity to contribute to the success of a public company.

Evaluating the Company

Public company directorships carry prestige, authority, and reasonable compensation. Yet potential candidates—generally sophisticated participants in the business world who are well aware of the legal and reputational risks that come with directorship—are

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justifiably cautious about accepting a nomination to a public company board. The importance of diligence cannot be overemphasized. By asking the right questions, receiving satisfactory responses from the company, and ensuring that important safeguards are in place, potential directors can mitigate many of the risks inherent in a corporate directorship.

The first step in evaluating a potential board membership is due diligence about the company and the current and former members of the board and management team. When first approached about a possible board position, the candidate should review the company's recent public filings, press releases, analyst reports, and news stories. Thereafter, the candidate should meet with the chief executive and separately with some current and former directors, including the current lead director or non-executive chair. Ideally, these conversations will be lengthy, frank, and in person. Telephone conversations, while helpful, are no substitute for personal interaction. Regarding the company, the candidate will want to become familiar with a broad perspective of the firm's competitive position, its long-term strategic goals, its challenges, and any particular concerns or highlights in the financial outlook. The candidate should understand the ramifications of any major potential or ongoing litigation, government investigations, shareholder campaigns, potential takeovers or activist approaches. The candidate should understand the composition of the company's shareholder base and how the company and board interact with investors.

Regarding the members of the board, the candidate should gather a sense of the internal dynamics, the interaction between directors and management, and any areas of conflict or disagreement among the directors or between the board and senior executives. The candidate should be satisfied that directors receive adequate, meaningful information about the company and have access to the right internal people at the company. If any directors are designated by significant investors, the candidate should understand fully the circumstances of that designation. Similarly, if there are any other significant connections between board members and other directors, executives, or shareholders, prospective board members should feel comfortable that such relationships are positive or neutral factors in board functioning, rather than negative ones. If any director recently has resigned from the board, or from a committee of the board, before the conclusion of the term of service, the candidate should be aware of the circumstances. If possible, it is often useful to talk to former directors who have recently left the board to understand their view of the company and board dynamics as well as the reasons for their departure. The candidate should be alert to any red flags that appear during the due diligence process, such as a history of disgruntled directors or executives, widely varying assessments of board dynamics, excessive or unusually structured executive compensation, and other signs of a dysfunctional board.

The candidate should also examine whether the board is properly constructed and well-organized. For example, does the board have the right number of directors to handle the board responsibilities and committee work, and to have an appropriately diversified composition? Do the current directors commit sufficient time to the board, or are they overcommitted to their other obligations? How much time do the current directors spend on board and committee matters? Does the candidate sense that the board functions in a collegial and professional manner? And does the candidate feel that he or she would be a valued member of the board from the outset? Some of these questions will be difficult to answer but often go to

the heart of whether the candidate believes that he or she will be able to contribute to the board in a meaningful manner over time.

The next step for the candidate is evaluating and addressing the potential risks and liabilities attendant to board service. Directors are required to sign the company's annual reports on Form 10-K and any registration statements for the registration of securities, and they are routinely named in lawsuits stemming from other public filings. The candidate should engage personal legal counsel to review the company's director and officer insurance policies, charter and bylaw indemnification provisions, and any director indemnification agreements to ensure that they are up-to-date and provide for coverage to the full extent of the law. In addition to indemnification provisions, the candidate should ask about advancement of expenses in the context of potential or actual litigation in order to minimize the possibility of paying out of pocket for these expenditures and then seeking reimbursement. Does the company's charter provide for exculpation to the extent permitted by state corporate law?¹ Counsel for the candidate should ensure that the candidate's understanding of the insurance and indemnification coverage coincides with that of the company. Any inconsistencies or deficiencies should be negotiated and resolved before the candidate joins the board.

The candidate should have a full discussion with his or her personal counsel about the fiduciary duties of directorship as well as a similar discussion with the company's general counsel. This is particularly important if the candidate has not previously served on a public company board, but even if the candidate is experienced, personal and company counsel should update the candidate on recent developments in Delaware and applicable state law. Diligent and responsible fulfillment of fiduciary duties is the best protection a director can have against potential legal liability. The candidate should also receive a thorough briefing from counsel, whether personal or the company's, regarding directors' obligations under the securities laws and restrictions on trading in the company's securities (as well as in the securities of the company's competitors, suppliers or customers, as appropriate). If the company has a trading plan for director transactions in company securities and/or stock ownership guidelines, counsel should review it with the candidate.

Company counsel should take some time to review with the candidate the confidentiality obligations of the directors, both under state fiduciary law as well as the company's own policies. As we have noted previously, "confidential board information is unique in the corporate context. It includes material, non-public information, the disclosure of which is regulated by federal securities laws and by company-wide policies and procedures, but it also includes sensitive boardroom discussions that have both personal and business elements

¹ Section 102(b)(7) of the Delaware General Corporation Law permits a corporation to include a provision in its certificate of incorporation that protects directors from liability for monetary damages in a lawsuit for a breach of the duty of care. There is no limitation on personal liability under this section for breaches of the duty of loyalty, behavior that is not in good faith, intentional misconduct, or knowing violations of law. Many other states have similar provisions in their corporate statutes.

and implications.”² In addition to fiduciary confidentiality requirements, the contours of these confidentiality obligations may vary depending on the industry in which the company operates, as well as on any contractual confidentiality agreements that the company may require of its employees, executives, and directors. Confidentiality is essential for business purposes, for a strong, trust-based relationship among board members and management, and for purposes of compliance with securities regulations such as Regulation FD.

The candidate should become familiar and comfortable with the company’s compliance and oversight practices. Legal requirements exist at every level, including stock exchange regulations, state and federal laws, securities regulations, and foreign laws and rules affecting global businesses. While it is not incumbent upon a director to have a detailed understanding of every rule or law applicable to the business, a candidate should join a board only if he or she feels confident that compliance is a priority for the company. For example, the candidate should be aware of any significant issues between the company and its outside auditor, including whether (and if so, why) the auditor has been replaced in recent years. If the company is in a regulated industry, the candidate should understand the broad ramifications of such regulation on the company as well as on the board. If the company conducts business outside the United States, the candidate should be confident that the company’s compliance with the Foreign Corrupt Practices Act, as well as other countries’ similar laws, is well managed. Most important, the candidate should have a positive sense that the company’s top management maintains a culture that prioritizes the ethical conduct of business and compliance with law that is broadly supported by the board. Tone at the top is very important in this area.

If the candidate will be an independent director on the board, the candidate should review all relevant biographical information with company counsel to ensure that independence criteria and any other requirements are met. Under NYSE rules, a board is required to make an affirmative determination of independence in order for a director to be deemed independent.³ In addition to the required elements of independence, the candidate and the board should consider any aspects of the candidate’s professional or personal associations that, though they may not actually compromise independence, may give the appearance of doing so.⁴ The appearance of close ties can, in some instances, result in negative publicity that could be embarrassing or even detrimental to a director’s effectiveness as a board member.⁵ While the possible perception of a conflict should not disqualify an otherwise qualified independent director, boards and candidates

² David A. Katz & Laura A. McIntosh, “Boardroom Confidentiality Under Focus,” N.Y.L.J., Jan. 23, 2014, available at <http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.23058.14.pdf>.

³ New York Stock Exchange Listed Company Manual §303A.02, available at nysemanual.nyse.com.

⁴ See, e.g., G. William Domhoff, “Interlocking Directorates in the Corporate Community,” Who Rules America? (first posted Aug. 2005; most recently updated Oct. 2013), available at http://www2.ucsc.edu/whorulesamerica/power/corporate_community.html.

⁵ See, e.g., Theo Francis & Joann S. Lublin, “Boards Get More Independent, but Ties Endure,” Wall St. J., Jan. 19, 2016 (describing the many personal and professional connections that link board members at some companies), available at <http://www.wsj.com/articles/boards-get-more-independent-but-ties-endure-1453234607>.

should discuss the issue ahead of the candidate's election. If the candidate is to be an audit committee member, additional NYSE (or NASDAQ) and SEC requirements for independence and qualification also apply.⁶

Before accepting the nomination or appointment, the candidate should make sure that he or she understands the company's director compensation structure and perquisites (if any). All directors should be compensated in the same manner, with appropriate additional compensation for committee chairs and membership on certain committees with larger workloads or more meetings. There may be meeting fees for board or committee meetings, or additional compensation for days spent on board or company business. Director compensation may include company securities, in which case company policy may include mandatory holding periods for such securities.⁷ Directors should avoid consulting agreements, which may compromise independence, or the appearance thereof. Excessive or unusually structured director compensation will be viewed critically by institutional investors and may draw scrutiny by regulators or potential shareholder plaintiffs. If a candidate finds that director compensation is at or above the high end of the range for comparable companies, the candidate and his or her counsel should undertake further review to determine if there is an acceptable rationale for the divergence.

Evaluating Oneself

At the end of the diligence process, the candidate should ask whether the board is a good fit for him or her. From a professional standpoint, the candidate should consider whether he or she has the necessary expertise and skills to contribute meaningfully in some way to the work of the board and the future of the company. The candidate also should consider whether he or she has the interest, and the available time, to put in the work required for robust board participation. The candidate should evaluate the sense of the company and board that he or she has gathered from due diligence meetings to decide if there is a culture of ethics and collegiality that will produce a positive and productive director experience. Further, the candidate should ensure that he or she has obtained all needed (or advisable) approvals from his or her primary place of business, other boards, or organizations to which he or she devotes significant time. It can be difficult and embarrassing to leave a board prematurely, so candidates should be very confident in their decision to be appointed or elected.

The candidate should also consider the loss of privacy that goes with a public company directorship. Detailed biographical information must be provided in a company's

⁶ See NYSE Listed Company Manual §303A.07; NASD Corporate Governance Requirements §5605(c); SEC Rel. Nos. 33-8220; 34-47654.

⁷ Some companies do not permit directors to sell company securities until they have retired from the board. This is a wise policy from the standpoint of preventing the appearance of insider trading or inadvertently indicating pessimism about the company's prospects. However, the policy can create a perverse incentive for directors who have helped to make the company profitable, and who wish to sell their securities for financial planning purposes, yet must leave the board to do so or create some type of corporate event that would permit the sale.

public filings, such as the director's age, recent work experience, other board memberships, stock ownership, and compensation. Many companies go further and disclose directors' educational background as well as experience and skills that qualify the director for board membership. Many public companies run extensive background checks on board candidates, including scrutinizing their financial position as well as confirming their educational credentials and business experience.

Candidates should be aware that if the board is targeted by an activist investor in a withhold vote or other public campaign or proxy contest, it is likely that the activists will publicize additional information about directors' backgrounds. Personal information about the director may be widely reported and scrutinized.⁸ Biographical details, including the director's gender or racial and ethnic heritage, may become subjects of controversy. Any close ties that may give the appearance of impairing a director's independence are certain to be focused upon by activists in a campaign.

The First Year

Once elected, a new director will attend an orientation or "onboarding" program that typically will take place over one or more days. The director likely will hear presentations from key members of senior management, such as the chief executive officer, the heads of important divisions or businesses of the company, the corporate secretary, the general counsel, and the chief financial officer, the internal and external auditors, and the heads of communications, investor relations and human resources. Senior management typically will review the elements of the company's short-and long-term strategic plans, along with risk management and oversight issues. The director will also participate in orientation sessions for his or her board committees, generally led by committee chairs with relevant members of senior management. While there is no one-size-fits-all orientation or onboarding process, it is essential that new directors meet key members of management and gain a deeper understanding of the company's business and financial outlook so that they can hit the ground running. Completing the orientation program prior to the first board meeting tends to better ground a new director in the company and make that new director a more effective board member.

In the first year, the director should spend time building strong working relationships with the chief executive officer, senior management, and other directors. The director should consider how he or she can best contribute to the board. Likely this will have been discussed at some length with other board members and the chief executive officer before the director was nominated and elected. Once the director is on the board, he or she will develop a better sense for how specifically to maximize his or her contribution in the context of a fuller understanding of the issues facing the company. An important part of this context is the company's relationships with its shareholders, in which, depending on the circumstances, the

⁸ Directors may find themselves the subject of public commentary even in the absence of activist campaigns. In the current environment, with the impact of the 2008 financial crisis still a recent memory, it is not uncommon to read news stories targeting directors—whether fairly or unfairly—for real or perceived excesses, abuses, or conflicts.

director may or may not become personally involved. If the director will be involved in shareholder engagement, it is important to begin building relationships with key investors.⁹

One note of caution to potential director candidates: In the current age of activism, many activists are seeking qualified individuals to become independent directors of the companies that they are targeting, either through a negotiated settlement with the company or through a contested election (proxy fight). Activists are choosing individuals with business experience who have no affiliation with the activist, both to make it more likely to achieve a negotiated settlement with the company and to gain support from institutional investors in a proxy contest. Although the stigma of being an activist's candidate in a proxy contest has diminished, candidates who agree to serve in such a capacity may find it more difficult to find directorships on other public company boards. In the event that an activist's suggested candidate is elected or appointed to the board, we strongly recommend that boards seek to integrate rather than isolate these new directors. In our experience, new independent directors who are welcomed onto a board tend to form strong working relationships with their fellow directors and are less likely to blindly follow the activist's approach. By the same token, directors who are isolated can be forced into a role that is detrimental to a cohesive board dynamic.

The Big Picture

The board of directors is charged with oversight. While directors must review detailed information concerning the company, they must at the same time keep their focus on the big picture and not on day-to-day management. As a general matter, boards confront evolving and complex challenges. Directors must grapple with topics such as data security and cyber risk, issues that are in a constant state of flux as technology advances and the legal landscape develops. The recently adopted Cybersecurity Act of 2015, for example, has established new mechanisms for cybersecurity information sharing; further guidelines pursuant to the new law are expected by mid-February.¹⁰ Advance planning for crisis management similarly is an ongoing project, as boards adjust to changes in the business environment.

Along with crisis management planning, the big picture issues include chief executive succession planning, executive compensation, risk management—including, for example, financial, strategic, cybersecurity, and reputational (particularly through social media) risk—accounting and compliance oversight, significant transactions, and shareholder relations. All of these are crucial to the continued success of a company, and all must be addressed and monitored by an active board. For a new director, getting a sense of the corporate culture and

⁹ Directors' and executives' interactions with key investors are extremely important. Shareholder activism continues to be a significant factor in the corporate environment and a top priority for boards and senior management. As one commentator put it, "[A] lot will hinge on [activists'] relationships with CEOs and directors, especially when their ideas are complex." Josh Black, Editors' Foreword, in "Activist Investing 2016," available at http://www.srz.com/The_Activist_Investing_Annual_Review_2016/.

¹⁰ See, e.g., John Evangelakos et al., "The Cybersecurity Act of 2015," The CLS Blue Sky Blog, Jan. 6, 2016, available at clsbluesky.law.columbia.edu/2016/01/06/sullivan-cromwell-discusses-the-cybersecurity-act-of-2015/.

strategic trajectory may take some time, but it is nonetheless one of the most important elements of being a successful board member.

The essential job for a board is to make sure that the company has the “right” chief executive officer and strategy. That said, one of the most important priorities for a board is to help the chief executive in setting the “tone at the top.” If a company cultivates a culture of, and requires an adherence to, “ethical standards, principles of fair dealing, professionalism, integrity, full compliance with legal requirements and ethically sound strategic goals,” it will be well-positioned to handle crises and implement strategies that benefit not only the company itself but society at large.¹¹ A recent article in *The Atlantic* illustrated the extent to which corporate culture influences actions from the top to the bottom of an organizational hierarchy. Good decisions can flow “more or less automatically” from a strong culture of ethical conduct of business, whereas, in an ends-justify-the-means culture, unethical business decisions can come to be seen as practical or necessary.¹² The board and chief executive officer play influential roles in creating a corporate culture in which all employees understand that the company expects and rewards ethical behavior.

The decision to join a board involves a great deal of due diligence and preparation, and a careful evaluation of the risk/reward tradeoffs. There are numerous resources for new directors that provide helpful advice and information about board issues. The National Association of Corporate Directors, the Business Roundtable, and others provide current and useful materials online.¹³ With reasonable investigation, careful consideration, and enthusiasm for the task, director candidates can choose the right opportunities for board membership and are likely to find board service a highly rewarding investment of time and effort.

¹¹ Martin Lipton et al., “Some Thoughts for Boards of Directors in 2016,” WLRK Memorandum, Dec. 9, 2015, available at corpgov.law.harvard.edu/2015/12/09/some-thoughts-for-boards-of-directors-in-2016/.

¹² Jerry Useem, “What Was Volkswagen Thinking?” *The Atlantic*, Jan/Feb 2016, available at <http://www.theatlantic.com/magazine/archive/2016/01/what-was-volkswagen-thinking/419127/>.

¹³ See, e.g., National Association of Corporate Directors, nacdonline.org; The Business Roundtable, businessroundtable.org.