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Method in the Madness: A Practical Checklist for Corporate Directors

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The variety, complexity and urgency of issues presented to directors for action or assessment can sometimes threaten to overwhelm the fundamentals of sound board practice.

By what means can corporate directors have confidence that they are discharging their core obligations of stewardship and oversight effectively, amid the onslaught of information and advice now visited upon them, and how can management and corporate counsel best facilitate that process?

Directors are called upon to review or make decisions regarding dozens of issues every quarter over a broad range of topics, which can include strategic alternatives, operations, finance, accounting, R&D, executive compensation, and so forth.

These issues, moreover, can range from pivotal corporate events to matters that, in days gone by, would have been considered routine. In the former category, one can readily identify a sale of the company, discontinuing a major line of business, a recapitalization or a bankruptcy filing as a fundamental matter to which conscientious directors will naturally direct their attention. In addition, the corporation's outside advisors will be armed to the teeth with PowerPoint presentations and memoranda to confront such extraordinary situations.

Thus, directors can readily prepare and be prepared to deal with the known and the extraordinary; it is the overlooked and the seemingly unexceptional that most often bedevil them. Indeed, one of the ironies of many corporate upheavals over the past two decades is that they did *not* arise from momentous events or high-profile schemes, but from an accumulation of smaller errors or transgressions that the conscientious director could not detect from a summary presentation of sales or operational results, or a review of standard financial statements: "side letters" issued to individual customers and "bill and hold" arrangements that preclude revenue recognition; overcharging Medicare or Medicaid by pennies per product; capitalizing run-of-the-mill business expenses; "fudged" results at the individual store, facility or business-unit level; misdated or backdated individual option grants; and so on. How are directors to have comfort that some such issue – as yet unknown, or at least not identified as such – is not lurking somewhere beneath the surface? Codes of conduct, compliance programs and audits are the tools frequently deployed to sniff out issues of this kind, but how are the directors to know that *these* tools are working?

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Another irony – further compounding the directors' challenge – is that when they meet, it is not as if the directors have only a bare-bones agenda before them and otherwise lack information. To the contrary, the mass of compliance legislation and rule-making that followed the last recession has resulted in directors routinely receiving mountains of data, qualitative information, and expert advice of all stripes – some not previously recognized as such, for which many consultants are deeply grateful – all in an effort to "amp up" the thoroughness, comprehensiveness and depth of the directors' oversight. But is it the right information? Is it useful, or even digestible? One fears that the human mind has not evolved to process this onslaught in real time, except with primordial "fight or flight" instincts. The result? The important bits are at risk of being diluted, if not washed away, in the deluge of stuff.

Our basic model of corporate governance, in contrast, does not require or even *seek* to have individual directors, or the board as a whole, possess expertise in all possible subjects of board action. Nor does the model require or seek to have directors undertake day-to-day management duties, or to veto all corporate risk-taking. In fact, the model is *opposed* to all such concepts as being inefficient, counter-productive, and potentially inimical to oversight in its most fundamental sense: the application of detached practical judgment and the exercise of disinterested common sense.

These cross-currents may be difficult to harmonize conceptually, and they are certainly difficult to live with on a practical level. Some commentators – influenced by the meltdown in the real estate, credit, and financial markets – will suggest that the basic corporate governance model is itself outmoded and in need of an overhaul. Further, some will argue that the entire apparatus of federal securities regulation and enforcement is broken, while still others will point more narrowly to specific failures in financial-industry regulation. Whatever specific view or views may ultimately prevail, it is apparent that the present drift of public opinion and governmental reaction is for more, not less, scrutiny of corporate officers and directors, more regulation, more enforcement, and more lawsuits. It will be a veritable festival of hindsight.

All of which is perfectly understandable, given the economic meltdown we are experiencing. It is not, however, of any help to directors as they seek to guide their companies forward from where they are *right now*. In particular, the state of overload in which many corporate directors now find themselves is not going away any time soon: an expanding board agenda, in which no item, it seems, is entirely "routine" or free of risk, accompanied by an explosion in the amount of information, data and advice that directors are expected to process in making decisions.

In this environment, it is critical that the *nature* of the director's task – and the corresponding measure of personal liability – be clearly understood. The director's task is not to "take charge" of management itself, but to oversee and guide, as a steward. That does not require having expertise on all *possible* subjects, or knowledge of all *possible* details. Rather, it fundamentally involves asking questions of those persons *charged with* that knowledge and expertise, evaluating their input and advice thoughtfully, and reaching objective, reasoned decisions. There is nothing more a director can or should do.

What follows, then, is a set of ten practical guidelines that together constitute a basic methodology for directors to discharge their duties as corporate stewards. These same guidelines provide a basis for management and corporate counsel to support the directors in this effort, and for the two camps to have a productive dialogue about process improvements over time.

Step 1 – Define the Task

Notoriously overlooked, but extremely useful, is the simple step of defining at the outset exactly *what* the directors are being asked to do with respect to each item on the board agenda. Consistently applied, this simple step is a powerful tool for the selection and preparation of appropriate meeting materials, effective meeting preparation, and productive conduct of the meeting itself.

Clarity on this point assists all involved in identifying and focusing on *what* information is pertinent to the task at hand, and *how much* of it is needed – be it a particular type of raw data or data analysis, qualitative information, professional advice, or identification of the practical implications for the business.

As important, the nature of the directors' action can have a significant impact on the degree of deference courts will accord that action in the event of a subsequent legal challenge, and the relative likelihood and scope of regulatory intervention. In practical terms, clarity at the outset on *what* the directors are being asked to do translates into more timely and effective risk management – for the corporation itself and for its individual directors.

To illustrate, is the full board (a) receiving a routine status report, with no major surprises or developments; or (b) receiving notice of a significant operational, regulatory or other development; or (c) providing input or guidance with respect to an ongoing process that is being spearheaded, under appropriate authority, by management or a board committee, or (d) is the board itself making a definitive decision on a significant matter? As one moves through the progression of increasing board involvement and decision-making, the raw amount of information the directors require, and its granularity, necessarily increases until, at the outer limit, the directors are expected to review individual contract terms before they approve a sale of the company. The information that is produced for and provided to the board with respect to each agenda item should be calibrated accordingly.

Similarly, is the full board relying upon information or reports that have been provided by management or by a board committee, as part of the board's decision-making process? If so, the directors may rely in good faith on the information that is presented to them from these sources, absent any "red flags" to the contrary. Directors are not expected to reproduce the efforts of, or independently test information and reports provided by, other corporate fiduciaries who have been charged with such tasks, unless there is some reason – such as a palpable conflict of interest – that such reliance would be misplaced. Indeed, doing so would defeat the purpose of delegation. In such circumstances, it is not the proceedings of the *board* that provide the granular "record" of the basis for this input, but the corporate records from which management drew its information, or the proceedings of the relevant board committee. What the board needs in such circumstances is a report that is sufficient for the board to understand the methodology and conclusions of the reporting fiduciaries; it does not need a complete reproduction of their working files.

Step 2 – Meeting Preparation

It goes without saying that directors should prepare for meetings and devote adequate time to that task, and likewise that materials should be distributed to directors sufficiently in advance of a meeting to afford a reasonable amount of time for review, unless circumstances truly do not permit. Because these are truisms, this segment focuses on *enabling* that process and, in particular, on encouraging the dialogue with management and corporate counsel that will support and improve the process over time.

Thus, flowing directly from the prior segment, directors should be provided with information that is sufficient to enable them to execute on each agenda item *in light of* the particular action they are being asked to take. Here, the touchstones are the scale and accessibility of the information provided, relative to the task at hand. *How* information is presented is important, and this is the step that is all too easily overlooked. In particular, it is all too easy for outside advisors and management personnel to present information in a fashion that is familiar *to them* and their respective disciplines. But is it useful in that form *to the board?*

If, for example, the directors are well aware of the metrics by which operational performance is judged from quarter to quarter, a seemingly telegraphic presentation may be adequate, assuming the business is behaving well. In contrast, if some aspect of the business is behaving badly, or some other material development (positive or negative) has arisen, it may be necessary to step back and consider *how* the directors are best informed. Importantly, this is not a time for management to "go underground;" the task is one of truly educating the directors, presenting potential responses and their implications, and soliciting the directors' input.

In addition, consideration should be given to such mundane issues as effective delivery of meeting materials to the directors. Are all of the directors comfortable with e-mails, PDF files and external portals, or do they need (or prefer) that hard copies be delivered to them? To what address? Does it depend on the season, and where individual directors are then located? By the same token, will some directors rarely receive, still less carry with them in their travels, voluminous hard copies of documents? Rather than operating on assumptions, inquire as to the needs of the individual directors and design delivery systems to meet their needs. There is perhaps nothing more discouraging than discovering in the midst of a meeting that half of those in attendance have never seen the material that is to be discussed. In sum, step back and structure a process that will work.

Step 3 –Company Information

Whenever an issue arises, it seems that everyone rushes to call the accountants, the lawyers and the consultants. A sound strategy, but never overlook the obvious: directors also need to receive pertinent information that is available directly from *company* sources, undiluted by third-party summarization or interpretation. The range of potential topics is as broad as the business itself, and determined by the issues at hand – operations, sales and marketing, finance/accounting, management performance, industry trends or conditions, and so forth.

The task is to determine *what* is needed and *in what form*, to provide the directors with a handle on the corporate data upon which they are to act, or the outside advisors are to offer input. Generally speaking, undigested computer databases will not be helpful; thought should be given to the preparation of reports and summaries that accurately reflect the underlying data. What lies behind this is the notion of an iterative process, through which puzzles and anomalies – in data, information or outside advice – can be hammered out until the directors feel they have a stable platform for decision-making.

Step 4 –Independent Information and Advice

When the matter at hand implicates a field of specific professional expertise (legal, accounting, investment banking, commercial banking, or otherwise), directors will naturally call upon outside advisors to assist. More interesting are those situations in which the directors need to ensure that they are receiving an *independent, competent* set of eyes – either because regular corporate counsel may be conflicted or lack experience in a particular area, or the directors seek market metrics to assess corporate performance or arrangements (*e.g.,* executive compensation) relative to such metrics.

The critical issue for the directors is to confirm that the outside advice they intend to use is advice upon which they can rely – that such advice is both competent and uncompromised by conflicts. Generally speaking, board committees that are formed to address particular issues – such as internal corporate investigations or the assessment of stockholder demands or derivative claims – require independent counsel, and industry consultants should be independent as to the issues they address (*e.g.,* executive compensation consultants should not be chosen by management).

Step 5 –Potential Conflicts

Does the matter at hand present any actual or potential conflicts of interest, and if so, have appropriate protective measures been taken (*e.g.*, by recusal of interested directors, the formation of a board committee, or other means)? Areas where conflicts may arise include executive compensation, and transactions in which management, a director or a director-affiliated person or entity has a personal financial interest. In assessing these issues, directors should consider that the *appearance* of a conflict may be just as distracting (and costly) as an actual conflict, because the law, in effect, subjects *potential* conflict situations to increased scrutiny – rendering it more difficult to dispose of lawsuits and regulatory inquiries. In this context, an ounce of prevention may be worth substantially more than a pound of cure.

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Step 6 –Technical Compliance

Directors should confirm – by the simple expedient of asking – whether the proposed action before them, and the procedures surrounding it, are in technical compliance with all pertinent laws, regulations, governance requirements, contracts and the like. Is the proposed action consistent with internal corporate requirements, such as the corporate charter and by-laws, stockholder agreements, investor rights agreements, stock option plans, and so forth? Have all pertinent corporate, tax, accounting and other relevant statutes, rules and regulations been considered? Are any third-party consents required? Is further monitoring (*e.g.,* until a proposed transaction closes) necessary, and if so, has the apparatus been put in place to do so?

Step 7 – Adequate Deliberation

It goes without saying that directors should be afforded adequate time to probe the issues, review relevant information and advice, deliberate, and reach a considered decision. What *amount* of time is adequate will, of course, depend upon the nature of the decision being made and the surrounding circumstances, including the process *leading up to* the final decision. To be sure, in a crisis, prompt action may be required, and no one of sound mind will dispute that. The issue is one of structuring reasoned decision-making *in light of* the surrounding circumstances.

Step 8 – Making the Record

A conscientious board should document its efforts. *All* proceedings of the board and its committees should be recorded in contemporaneous minutes or written consents – such a record is the most credible evidence of a fiduciary's care and diligence, and a record created after the fact has far less weight. The minutes should reflect the directors' process of deliberation over time, including the consideration of pertinent data and, where applicable, outside advice. The minutes should also reflect any protective measures taken in light of potential conflicts of interest – the recusal of interested directors, the formation of special committees, and the like. The record should also include appropriate exhibits, including approved documents, non-privileged presentations and reports.

Step 9 –Disclosure

To whom must a particular corporate action be disclosed, when, and in how much detail? Generally, matters that are still in process are not fit subjects of disclosure, and matters that are not material need not be disclosed. But regulatory requirements and credit agreements may require disclosure above and beyond that required by corporate law or the federal securities law. Simply ask – it is a technical legal question – and proceed accordingly.

Step 10 – A Final Gut Check

Everything should now be done. Nonetheless, step back and ask: Is there anything that seems incomplete, puzzling, or somehow "sideways" – about the situation, the process, the information or advice that was received, or the result? If something doesn't sit well, please say so. This piece is intended to help directors confidently take ownership of their actions and decisions. If something seems awry, the time to speak is before the decision is final.

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