MANAGEMENT

Board basics

Getting results from directors

By Joseph Sullivan

A good board of directors can be a wonderful benefit to any company with multiple shareholders. A good board brings fresh ideas, sound judgment, perspective, business knowledge, and experience, and sometimes assistance in tackling problems that are outside the usual experience of the company's executives. Directors may help in analyzing opportunities for expansion or growth. They may assist in business or employee negotiations. They have an obligation to help build a balanced, motivated, and accountable executive team. A good board does all this and more. Unfortunately, many boards do far less.

The fact is, there are thousands of boards of directors in the United States, but only a much smaller subset of these have a full complement of well-prepared and active directors serving on them. This is a serious problem for public companies, of course, but it is just as serious for family and closely held businesses. After personally serving on 12 corporate boards and several non profits, and having interacted with many more, I have noticed a few repeating patterns:

- Few directors—and it does not seem to matter how smart or competent they are—have been very well briefed about what it is to be a fiduciary, with the very serious legal responsibility that it puts on them.
- Few fully understand their rights and authority.
- Because of the collective nature of board action, many directors feel uncomfortable taking leadership, especially if they are not the chair.
- Boards tend to become clubs, with great peer pressure to conform.
- Company executives tend to control the information that flows to boards and the topics they consider.

In privately held companies there is also the issue of just where an outside director gets off trying to tell the owner how to run his or her business. That may be the toughest of all. I recommend advisory boards for most such businesses.

Many good people now serving on boards would either resign immediately or become much more engaged if company lawyers would take the time to explain the legal nature of boards. The reality is that a board of directors is completely responsible for the business and holds all authority. Executives—even presidents and CEOs—only have as much authority as is delegated to them by the board. This is true of every kind of corporation, including non profits and charities.

Membership on a board of directors is not an advisory position (and that, of course, is the difference between a board of directors and an advisory board). On the contrary, it is a fiduciary position. It is an honor, but it is by no means honorary. A fiduciary is held to the highest possible standard of care under the law. Fiduciaries are required to exercise at least as much care in their duties as a prudent person would in his or her own personal affairs. Directors are fiduciaries to the corporation and its shareholders.

Rather than going into the details of the law, let's look at the three basic duties of directors.:

1. Obedience: They must act within the powers granted to the corporation by its charter and in adherence to the articles, regulations, and by-laws.

2. Diligence: They must act in good faith, in a manner that a prudent person would act under similar circumstances, and in what they reasonably believe to be the best interests of the corporation.

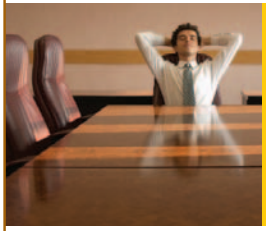
3. Loyalty: There must be no self-dealing, bad faith, or personal advantage at the expense of the corporation.

Numbers one and three are easy to understand (although three is often violated). Number two is a different and slippery kind of fish. That "prudent person" business has been the subject of a whole lot of case law. The gist is that you must take real care to be informed about the company and its business, pay close attention, get reliable expert advice where your own knowledge falls short, and stand your ground if you think something is wrong or unwise. The consequences of not doing these things are unpleasant. A great deal of case law about it exists, because plenty of directors have been sued.

The duty of diligence has been the downfall of many a director. In monstrous blowups like Enron, you often see directors being accused of negligence—that is, of not paying attention, keeping management in line, and having a reasonable basis for their decisions. The same kind of thing can happen in a privately owned electrical distributorship. A director's duties are legally the same, regardless of the size of the company.

Here is an actual case (with details changed for confidentiality). A family-owned company was inherited by two siblings. A third was pointedly left out of the will. The two who got the stock felt bad about the situation and gave a chunk of their personal stock to their relative. Part of the company was sold to an ESOP. A general manager was hired and given full charge. After some time, the business began to lose money. The general manager committed multiyear accounting fraud to hide the losses from the owners and the banks. It all came to a head when the bank got nervous and sent in its own auditors.

At that point, the three members of the board (the original inheritors and one outsider) were in for years of legal expenses, settlement payments, and tremendous mental strain—all because they had not really paid attention to what was going on and had rubber stamped the general manager's resolutions and proposals. They had failed in their duty of diligence, and lots of people wanted blood—ESOP holders, the bank, and especially the other sibling. Pity the poor outside director, who joined the board as a favor and never felt quite right about being assertive in meetings.



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Directors need not suffer that fate. Although no director can be sure he or she will never be sued, there are things he or she can do to make it unlikely. Fortunately, those very things will at the same time make directors much more valuable to their companies.

Here are seven ways a director can be more valuable and at the same time enjoy lower personal risk:

1. Remember that directors have an absolute right to any and all corporate information, so get whatever you need to make up your mind on any issue.

2. Be sure that agendas and report formats are set by the board.

3. Don't be filtered or accept overload by interminable reports or details.

4. Insist on seeing reports and resolutions well in advance.

5. Set goals/standards and hold management accountable.

6. If something does not feel right or if you do not feel adequately informed, be assertive, dig in, withhold your vote, and go on the record with your concerns.

7. Volunteer to serve on board committees—standing ones such as audit or ad hoc committees formed for special things such as acquisition or expansion plans.

To complement our seven "board builders," here are three board killers:

1. Micromanagement by the board is death for the company—either you have confidence in management or you do not, in which case the right action is to replace management.

2. Telephone or video conferencing instead of face-to-face meetings weakens accountability and the bonds of confidence and trust that can only grow through personal contact. Every board should meet face to face for no less than one day four times a year; phone or video meetings in between are fine.

3. Effective boards have vigorous give and take in discussions, but balance must be maintained between courtesy and the expression of strong positions that may be very important to the company. Urgency and intensity may be very much in order, but stridency and abrasiveness never are.

The bottom line is that a director who takes the job seriously, stays well-informed, exercises judgment, and pitches in is a blessing to any company. A director who takes the job as an honorary position or who does not have the time to do it right is not going to contribute much, and will be helplessly exposed to lawsuits if anything ever goes seriously wrong. ■ ■ ■

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