In-House Counsel's Guide on How to Manage Key Issues in Working with Public Company Boards

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- Duty of Care
- Reliance on Committees and Experts
- Board Succession Planning
- Importance of Diversity on Boards

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Business Judgment Rule

The **Business Judgment Rule** is rooted in the fundamental principles of Delaware law that:

- the business and affairs of a corporation are managed by or under the direction of its board of directors; and
- directors have a fiduciary duty to protect the interests of the corporation and to act in the best interests of the shareholders of the corporation.

As applied by courts, the **Business Judgment Rule** "operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation."

Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del.1993) | Cede & Co., 634 A.2d at 360.
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Business Judgment Rule

"The rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose.' To rebut the rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments. If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff."

Cede & Co., 634 A.2d at 360

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Business Judgment Rule

The Business Judgment Rule:

- **is a standard of judicial review** of the conduct of corporate directors, those individuals tasked with managing the business and affairs of a corporation pursuant to Section 141(a) of the Delaware General Corporation Law (the **DGCL**);
- **creates a rebuttable presumption** that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company";
- **places the burden** on the shareholder challenging the decision to establish facts to rebut that presumption by "providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty or due care";
- **requires Delaware courts** to, absent facts proving an abuse of discretion, respect the judgments of directors; and
- **requires Directors**, if the presumption is rebutted, to prove that their decision or an approved transaction is "entirely fair" to the corporation and its stockholders, both in terms of dealing (including timing, initiation, structure, negotiation, disclosure to directors, and how director approvals were obtained) and price (including all economic and financial considerations of the proposed matter or transaction).

Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) | Aronson, 473 A.2d at 812 |Cede & Co., 634 A.2d at 361 | Aronson, 473 A.2d at 812 | Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)

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Duty of Loyalty

As applied by Delaware courts, the **Duty of Loyalty** is defined as follows:

> "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.... A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there be no conflict between duty and self-interest."

Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)

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Duty of Loyalty

- Accordingly, the **Duty of Loyalty** requires directors to avoid conflicts of interest by requiring that "the best interest of the corporation and its shareholders [take] precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally."
- Two examples director self-interest/conflicts of interest that have the potential to run afoul of a director's duty of loyalty are the director appearing on both sides of a transaction or the director receiving a personal benefit from a transaction not received by the shareholders generally.

Cede & Co., 634 A.2d at 361
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Duty of Loyalty

A board's decision will not receive the benefit of presumption under the Business Judgment Rule due to a breach of the **Duty of Loyalty** where self-interested directors:

- constitute a majority of the board;
- control or dominate of the board as a whole; or
- fail to disclose their interest in a transaction to the whole board which a reasonable board member would regard as having a significant effect on the interested directors' evaluation of the transaction.

William M. Lafferty, Lisa A. Schmidt & Donald J. Wolfe Jr., A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law, 116 Dick. L. Rev. 837, 845-846 (2012)

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Duty of Care

- The **Duty of Care** requires directors to "inform themselves, prior to making a business decision, of all material information reasonably available to them."
- In determining whether the decision was, in fact, informed, Delaware courts will consider the "material or advice the board had available to it and whether [the board] had sufficient opportunity to acquire knowledge concerning the problem before acting."
- The **Duty of Care** is not satisfied by a mere passive acceptance of information, but instead requires directors to proceed with a "critical eye" in assessing information in order to protect the interests of the corporation and its stockholders.

Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson, 473 A.2d at 812) | Moran v. Household Int'l, Inc., 490 A.2d 1059, 1075 (Del. Ch. 1985) | Lafferty, et al., supra at 842, citing Van Gorkom, 488 A.2d at 872

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Duty of Care

In determining if directors have complied with their **Duty of Care**, Delaware courts have considered whether the directors in question:

- are supplied in advance with notice of the purpose of the meeting and documentation describing the essentials of the matters to be considered;
- are informed of all developments relevant to the issue under consideration;
- conduct extensive discussions with competent and independent legal and financial advisors;
- review relevant or key documents or summaries thereof;
- make reasonable inquiry and receive a knowledgeable critique of the proposal; and
- take sufficient time under the circumstances and act in a deliberative manner to consider and evaluate the pending decision.

Lafferty, et al., supra at 842-843
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Duty of Care

- Delaware courts apply a "gross negligence" standard in determining whether a board has violated its **Duty of Care**.
- This includes formulations such as "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason."
- The standard applied by Delaware courts, therefore, provides for a higher threshold for liability than the definition of gross negligence under general tort law.

Van Gorkom, 488 A.2d at 873, citing Aronson 473 A.2d at 812 | Lafferty, et al., supra at 842-843, citing Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 192 (Del. Ch. 2005) (quoting Tomczak v. Morton Thiokol, Inc., No. 7861, 1990 WL 42607, at *12 (Del. Ch. Apr. 5, 1990) | Lafferty, et al., supra at 844, citing Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 970 (Del. Ch. 1986)
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Duty of Care

- DGCL 102(b)(7) permits a corporation to include a provision in its certificate of incorporation that eliminates the personal liability of a director for monetary damages for breach of fiduciary duty. However, such exculpatory provision does not eliminate or limit a director's liability for, among other specified exceptions:
  - breach of a director's duty of loyalty to the corporation or its stockholders;
  - acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; or
  - any transaction from which the director or officer derived an improper personal benefit.
- Even if a 102(b)(7) type provision is included in a corporation's certificate of incorporation, directors must nevertheless comply with their **Duty of Care** to enjoy the deference of the **Business Judgment Rule**, and extreme violations of the duty of care may be evidence of bad faith or may amount to a breach of the duty of loyalty to the corporation.

Lafferty, et al., supra at 844
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Board Succession Planning

- Planning for Board Succession
- Tools to Help Board Refreshment Process
- Applicable Regulatory Requirements

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Board Succession Planning: Planning for Board Succession

- Key factors for determining the success of a board are:
  - the quality of the directors; and
  - their ability to work together.
- The focus of succession planning begins with an analysis of the qualities sought in a candidate.
- A best practice is to conduct an **assessment of the current board's skills and experience** and consider **the company's ideal mix of skills and experiences**, taking into account the company's business and future direction.

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Board Succession Planning:
Tools to Help Succession Planning Process

Director Skills and Demographic Matrix

	Levinson	Cook	Bell	Gore	Gorsky	Jung	Lozano	Sugar	Wagner
Core									
Leadership	●	●	●	●	●	●	●	●	●
Corporate Governance	●	●	●	●	●	●	●	●	●
Risk Management	●	●	●	●	●	●	●	●	●
Financial	●	●	●	●	●	●	●	●	●
Strategic									
Global Business and Operations	●	●	●		●	●		●	●
Brand and Marketing	●	●			●	●	●		●
People and Culture	●	●	●		●	●	●	●	●
Innovation and Technology	●	●		●	●		●	●	●
Environment and Climate				●		●			
Public Policy and Government			●	●			●		
Privacy and Security		●	●	●				●	
Identity									
Gender Expression	Male	Male	Male	Male	Male	Female	Female	Male	Female
LGBTQ+	No	Yes	No	No	No	No	No	No	No
Race/Ethnicity	White	White	Black	White	White	Asian	Latino Multiracial	White	White

- A skills matrix analyzes the board's composition against previously established criteria.
- A skills matrix can serve as a visually straightforward way of understanding the strengths of the board and can assist in identifying any areas in which it may need improvement.

- **Example from 2023 Proxy Statement, Apple Inc.**

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Board Succession Planning: Applicable Regulatory Requirements

- **SEC Required Disclosure:**
  - Any specific **minimum qualifications** that must be met by a nominee and **any specific qualities or skills** that the committee believes are **necessary** for one or more of the company's directors to possess. (Item 407(c)(2)(v) of Reg. S-K).
  - The **specific expertise and qualifications, attributes or skills** of each director or nominee in light of the company's business and structure. (Item 401(e)(1) of Reg. S-K).

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Board Succession Planning: Applicable Regulatory Requirements

- **Exchange Requirements – Director Independence**:
  - Subject to limited exceptions, both the NYSE and Nasdaq require boards to consist of a **majority of independent directors** and to have adopted specific rules on who can qualify as an independent director. NYSE Listed Co. Manual 303A.01; Nasdaq Listing Rule 5605(b).
    - Board must make an affirmative determination that each director designated as independent has **no material relationship** with the company that would impair independence.
  - Generally, both markets require **independent directors** on the audit and compensation committees. The NYSE requires listed companies to have an independent nominating and governance committee, and Nasdaq requires that director nominees be selected by an independent nominations committee or a majority of independent directors. NYSE Listed Co. Manual 303A.04 - .07; Nasdaq Listing Rules 5605(c)(2)(a); (d)(2)(a) and (e).
  - Proxy advisory firms have adopted definitions of director independence that are different from NYSE and Nasdaq's definitions.

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Board Succession Planning: Applicable Regulatory Requirements

- **Exchange Requirements:**
  - NYSE listed companies are required to specify in their corporate governance guidelines **director qualification standards** that at a minimum must reflect the NYSE's independence requirements. NYSE Listed Co. Manual 303A.09.
  - Both NYSE and Nasdaq require audit committee members to be **financially literate,** and one member of the committee must qualify as the committee's **financial expert.** NYSE Listed Co. Manual 303A.07; Nasdaq Listing Rule 5605(c)(2).
    - If adopted, the SEC's proposed climate disclosure rules would require disclosure about any directors with expertise in climate-related risk.

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Board Succession Planning: Applicable Regulatory Requirements

- **Diversity Requirements:**
- **Exchanges:**
  - The Nasdaq rules require most listed companies' boards to transition to two diverse directors. Nasdaq Listing Rule 5605(f).
  - The NYSE has no current diversity requirements.
- **Investors:** Some influential institutional investors have included board diversity in their voting guidelines. (For example, BlackRock and State Street Global Advisors).
- **State Requirements:** California has adopted law mandating quotas for women directors for public companies incorporated in California. A California state court has subsequently held that the law is unconstitutional under the California state constitution.

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Board Succession Planning: Applicable Regulatory Requirements

- **Proxy Advisory Firm – Diversity Requirements:**
  - ISS will generally recommend **withhold** or **against** the chair of the nominating committees of:
    - **all** companies where there are no women directors; or
    - **companies in the Russell 3000 or S&P 1500 indices** where the board has **no** apparent racially or ethnically diverse members. ISS, 2023 U.S. Proxy Voting Guidelines p. 12.
  - Glass Lewis will generally recommend **against** the chair of the nominating committees of companies:
    - that are on the Russell 3000 index that have fewer than 30 percent gender-diverse directors. For companies outside of the Russell 3000 index, it will require one gender diverse director. Glass Lewis, 2023 Policy Guidelines p. 41.
    - that are on the Russell 1000 index that have fewer than one director from an underrepresented community. Glass Lewis, 2023 Policy Guidelines p.41.

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QUESTIONS

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