

INSIGHTS + NEWS

Corporate Insights: Solving the Puzzle to Improve Corporate Governance

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An often overlooked and critical function of operating a successful business is sound corporate governance. But what is corporate governance? Generally stated, corporate governance encompasses the rules, mechanisms and processes by which business entities are controlled and operated.

When business owners and management are focused on operating the business and seeking to maximize profitability, oftentimes important governance matters take a back seat, are ignored altogether, or are applied incorrectly or not at all.

There are ways to avoid these pitfalls without having to take too much time away from everyday business. Reviewing some key principles outlined below is a great start. Even better, initiate one or more short, interactive training sessions with your corporate counsel to help Board members and other key stakeholders better understand the benefits of good corporate hygiene.

KNOW THE SOURCE: ENTITY FORM AND APPLICABLE LAW

Boards and company management often overlook the most fundamental sources that dictate governance, including:

- What type of entity form is involved (i.e., corporation or LLC), and
- The state and laws under which the entity was formed.

A basic understanding of entity form and applicable law helps define the governing structure and rules. For example, if your business is formed as a corporation, it must have a Board of Directors (unless a shareholder agreement states otherwise) with at least one Board member. The corporation must also have a set of written by-laws, which contain the basic rules for the conduct of the corporation's business and affairs and cannot be inconsistent with applicable statutory law or the corporation's Articles of Incorporation.

For an LLC, the same structure should exist. The LLC's written rules will be set forth in an Operating Agreement or LLC Agreement. While an LLC will typically have a Manager or a Board of Managers who carry out the same duties as a corporation's Board of Directors, the LLC can also be governed by its owners, the Members. The Operating Agreement or the LLC Agreement must set out whether the LLC is Member managed or Manager managed. Most importantly, every state has a different set of statutory laws that apply to corporations and LLCs, and it is prudent that the owners and your Board and management team understand which set of laws apply to your business.

REMEMBER THE RIGHTS OF SHAREHOLDERS/MEMBERS

Keep in mind that a company's Board of Directors or Board of Managers ("Board") usually will not have complete authority and autonomy in carrying out the governance functions of a business. For example, under applicable state law and/or your incorporation documents, the right to elect members of the Board, sell the company, amend the Articles or by-laws, or dissolve the company, may be rights held by the shareholders. Furthermore, owners of the company have rights to obtain or inspect certain corporate records, including a list of owners, financial records, meeting minutes or other business records requested in good faith. It is fine if your Board or management group cannot recite these rules of governance, but spotting the issues and knowing the sources for these rules will improve efficiency and reduce the chance of mistakes.

KNOW YOUR ROLE

Given that a business faces many different operational, administrative and governance issues on a daily basis, it is essential that Board members and officers have a clear understanding of their role. For example, the responsibility of the Board is to establish and adhere to the mission of the business and set high-level organizational goals. The focus of the Board should be on major decisions, corporate policies, and risk management. Conversely, company officers or other management-level personnel are entrenched in day-to-day operations of the business and ideally are responsible for everyday decision-making surrounding operations and management.

UNDERSTANDING YOUR OBLIGATIONS AS A BOARD MEMBER OR CORPORATE OFFICER

Serving as a Board member of a private company carries with it certain legal duties and obligations. It is vital for Board members to have a basic understanding of these legal duties and obligations to avoid liability exposure to the company and/or to the individual Board member. While the legal standards underlying the fiduciary duties (described below) may vary slightly from state to state, statutory and common law in most states share common legal principles.

- **Duty of Care:** The duty of care describes the level of competence and business judgment expected of a Board member and requires each Board member to act in good faith, with the care that a person in a like position would reasonably believe appropriate under the circumstances and in the best interests of the company.
- **Duty of Loyalty:** The duty of loyalty requires Board members to act in the interests of the company first, and most certainly ahead of any personal interest. The duty of loyalty, while seemingly straightforward, might typically arise in a conflict-of-interest scenario that is not always easy to navigate.

These fiduciary obligations become more difficult given the reality that Boards are facing new and complicated initiatives and real-world issues such as AI, cybersecurity and other non-financial performance indicators such as environmental, social and governance (ESG) policies.

BEST PRACTICES FOR BOARD LEVEL GOVERNANCE

Finally, there are some best practices tips that will greatly improve governance and corporate hygiene without taking too much time and focus away from operations and maximizing profit. We recommend that company management, Boards and Board members keep in mind the following:

1. Be active and diligent; listen and speak up; be respectful of other Board members
2. Focus on the Board's oversight function – govern and set policy instead of running operations
3. Diverse Board composition (competencies and perspectives) is typically good
4. Cultivate a healthy and accountable relationship with your CEO
5. A "workable" Board size; use Committees to carry out, focus and improve the Board's work

6. Meetings that have a written agenda, are informative, interactive and action-based; actions and decisions are recorded by meeting minutes
7. Think and act in the best interest of the company, the mission at hand, and stakeholders, NOT on personal, economic or self-interest factors
8. Train and orient new Board members
9. Conduct annual Board performance evaluations
10. When in doubt, consult your corporate counsel!

Bowditch's Business and Finance Practice Group regularly provides advice and in-person training to management and Boards of privately held companies. If we can be of assistance, please reach out to the authors or your personal contact at the Firm.