Board Organization

State laws, as noted in Chapter 2, prescribe the duties of directors in representing the interests of shareholders. State laws also allow for the chartering and incorporation of the vast majority of businesses in the United States. This chapter describes the process by which a corporation is formed under the provisions and statutes of a given state and how a board of directors is generally organized to oversee the management of the corporation.

The state of incorporation selected by a corporation is critically important because most legal actions related to the activities of the corporation will be conducted under the laws of that state. Normally, the state corporation commission or the office of the secretary of state authorizes the use of the name of the corporation and issues the charter for the formation of the corporation. The articles of incorporation and the bylaws of the corporation become the basic, binding set of rules, procedures, and conditions under which the corporation will be governed. This chapter outlines representative contents of these governing documents as well as their importance to the management of the corporation.

THE STATE OF INCORPORATION

The first governance choice to be made is the selection of the state in which the business is to be incorporated and, consequently, the state law and judicial system under which the firm will operate. Most companies are incorporated in the state in which the business is domiciled. If the corporation is to engage in interstate commerce, it may consider selecting another state that might be seen as more business friendly.

Jay Lorsch, in a review of American corporate boards, provides the following brief history related to corporate location:

> As commerce expanded in the eighteenth and early nineteenth centuries, various states vied to have companies domiciled in their jurisdictions, courting them through the creation of the most liberal laws applying to

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directors. In this context, "liberal" meant that directors would not be held to the same tight standards as trustees, the so-called prudent man rule. Instead, directors were expected to exercise the "duty of loyalty" and the "duty of care," and their conduct was judged according to the "business judgment doctrine." In spite of the evolution of corporate law and legal variations among the states, these principles still remain at the heart of the directors' responsibilities in all jurisdictions.[1]

Delaware has been the most successful of the states in attracting publicly owned corporations and reportedly has incorporated some 50 percent of all such corporations.[2] The State of Virginia adopted what many claim to be a model corporate code in 1985.

THE ARTICLES OF INCORPORATION

Corporations are created by a state charter on the application of one or more individuals acting as the incorporators. Corporations are governed by articles of incorporation, adopted at the time of incorporation, and modified by the acts of the shareholders from time to time. They are filed with the state in which the company is to be incorporated, usually in the secretary of state's office or with a state corporation commission. The articles of incorporation can be thought of as a broad constitution that defines the purpose of the organization and the limits that the shareholders may place on its operations. The articles of incorporation can be changed only with shareholder approval. A number of articles customarily contained in a firm's articles of incorporation are described below.

Article I: Corporate Name

This article merely specifies the name of the corporation. Naming a corporation can be as simple as using the founder's name or the name of the place where the corporation is going to operate, often combined with a descriptor of the nature of the business, for example, Jones Auto Supply or Town Auto Supply. The use of geographic descriptors can be too limiting if the business plans on expanding to other areas, although a number of national chains retain a geographic reference in the firm's name as a description of the regional flair of their products. Naming the corporation also can be a major marketing decision if the name is to be the basis for a brand. When this is the case, the name must be distinctive and work phonetically and graphically. The corporation must clear the proposed name with each state in which it is to be employed to avoid the use of a name that is already taken, as well as to avoid issues of copyright and/or trademark infringement.

Article II: Purpose

A second article of incorporation describes the purpose of the organization. The organizers of the corporation may choose to make the purpose very broad, for example, "To engage in any lawful act or activity for which a corporation may be organized under the laws of the State of [name]." Or the organizers may choose to be very narrow in describing the purpose, restricting the corporation to a specific business or location. Most organizers opt for the broader definition to give the corporation the widest possible latitude in its operations. A more narrow definition is used when the organizers expressly want to restrict the activities of the business to their intentions at the time of incorporation.

Article III: Registered Office or Agent

This article names the address of the corporation's initial registered office in the state of incorporation and the name of the registered agent at that address. The registered agent is the person responsible for filing all required documents and for receiving all legal notices served on the corporation. Usually the registered agent is the organization's lawyer or its corporate secretary. If a corporation fails to maintain a registered agent at the registered office, it will affect the company's ability to do business in the state, cause corporate contracts to become void, and can result in personal penalties or fines for the officers and directors of the corporation.

Article IV: Authorized Capital Stock

This article deals with the classes of stocks and the number of shares to be authorized, along with the par value of each share. Every corporation will have at least one class of common stock, which represents the ownership of the corporation. Common stockholders take all the risk, maintain all the control, and receive all the income in proportion to the shares owned, unless they create other classes of stocks or debt that shifts some portion of risk, control, or income to the other stock classes or creditors. Other classes of stock may have preferred positions on income and/or liquidation with less risk; or they may receive preferred distributions of earnings. Other classes of stock also can be created to provide for voting rights disproportionate to the capital contributed, often characterized as class A or class B common stock.

It is important to note that it is shares owned, not capital contributed, that determines how income, risk, and control are allocated. At the time of incorporation, most shareholders will pay the same price per share, although a discount to the price or an outright grant of shares may

be provided to key managers. Over time, as new shares are issued, they will reflect the value at the time of the stock offering.

Article V: Bylaws

This article states that the provision for the regulation of the internal affairs of the corporation will be set forth in the bylaws. Any limitations on the bylaws would be articulated in this article.

Article VI: Duration

Corporations generally have a perpetual duration, and this is stated in this article unless some termination date or event is selected. An example of a corporation with a termination date would be a joint venture between a mining company and the owners of a property. Since a mining site has a definite lifespan, it would make sense to tie the life of the corporation to the depletion of the site's natural resources.

Article VII: Board of Directors

The number of initial directors is specified in this article. Generally, the number of directors is also identified in the bylaws and can be altered by changing the bylaws. Usually, the state requires the names and addresses of the members of the initial board of directors.

THE BYLAWS

The bylaws stipulate how frequently the board must meet and how the agenda will be prepared and by whom. Any special arrangements with regard to directors' voting will be detailed in the bylaws. The bylaws also specify the rules by which individuals standing for election will be ratified by the shareholders. Commonly, such elections occur after the names of nominees for election (or reelection) to the board are forwarded from the nominating committee. The bylaws also indicate the procedures for selecting board and corporate officers and may spell out the terms under which the services of board members may be terminated. These might include term limits, a mandatory retirement age, or the conditions under which a director could be removed "for cause." In one company with which we are familiar, directors who missed two consecutive board meetings were considered to have resigned. Other examples of causes for which a director could be removed might include a change in the director's status (for example, when a chief executive officer of another company resigns that post) or the commission of some reprehensible or illegal act that would bring discredit on the corporation.

The bylaws may specify the level of compensation for directors for their services, including, for instance, annual retainer fees, fees for attending board and committee meetings, restricted stock and stock-option awards, insurance, and perhaps transportation expenses for travel on behalf of the company.

The bylaws may cover additional structural and operational details, such as

- The number of directors who will sit on the board
- The number of "insiders" and "outsiders"
- The length of terms of directors
- The various board committees and their charges
- Details about the annual meeting of shareholders
- The conditions under which proxy statements will be issued to the shareholders
- How directors will vote and how the votes will be counted
- The election and duties of corporate and board officers

The ideal number of directors who should be elected to represent the shareholders is the subject of debate. Some boards function effectively with as few as 7 or 8 directors, whereas others have more than 20 directors. There is a semblance of a consensus that some number between 12 and 15 is most effective for many organizations. Many people feel that fewer than 12 directors can allow a small group to control the board, whereas more than 15 directors renders the board unwieldy. This is one of the many judgments that those setting up a new corporation have to make.

The bylaws normally can be changed by a majority vote of the board of directors, except in cases that are subject to shareholder vote, as required by a specific state statute. The incorporators should give careful consideration to the bylaws. In addition to setting up orderly governance processes, the bylaws can come into play when conflicts of governance arise.

The annual shareholders' meeting is a major event for public corporations. These meetings are scheduled routinely at a convenient time after the close of business at the end of the corporation's fiscal year and following the availability of audited financial statements. The chairman of the board presents the results of the year's operations and takes questions from the shareholders and others in attendance. The degree of harmony or discord at these meetings invariably reflects the perception by the

attendees of the soundness and attractiveness of the corporation's operating results.

The board must communicate with the company's shareholders when shareholder approval is required for certain actions of the board and management. These communications are achieved through the mailing of proxy statements to each shareholder. The proxy statements (often referred to as *proxies*) advise the shareholders of the board's position on one or more issues for which the shareholders' opinions must be gathered in the form of votes. Thus the proxy statement outlines such issues as a slate of candidates for election as directors, approval for a sale of major assets, or a merger or sale of the company. The board is also required to provide certain details in the proxy statement about executive compensation, including salaries, bonuses, and stock options or restricted stock awards. The proxy statement normally includes a ballot in the form of a card or letter on which the shareholder can indicate his or her approval or disapproval of management's proposals. These proxies are returned to the company, often to the company secretary, allowing management or the board to vote for a shareholder's preferences in the event that the shareholder cannot attend the annual meeting of shareholders in person. Occasionally, proxies are tallied by independent organizations hired solely for this purpose. Hence the term *giving someone a person's proxy* refers to the act of entitling the holder of the proxy to vote instead of the absentee.

Major Considerations Relative to the Bylaws

A major question for the incorporators drafting the bylaws of a firm is how much flexibility should be given to the shareholders to call special shareholder meetings and to present proposals for voting. For example, the bylaws would stipulate how much advance notice would be required to call such a meeting. On the one hand, the shareholders own the business and should be given ample opportunity to express their views and to vote on the issues they think are important. On the other hand, corporations frequently must deal with vocal minorities who push agendas that may not be shared by the majority of shareholders. Such proposals often reflect a political or social agenda, or they may come from individuals attempting to gain control of the majority of the shares of the corporation at a low value in order to pursue their own interests. In many cases, these rogue proposals are not considered to be in the best interests of most shareholders.

It is important, however, not to generalize about the motives or competence of either the board of directors or of the dissident shareholders. History provides us many examples of irresponsible or illegal behavior in each camp. What is important is that there be an orderly set of rules to ensure that the interests of all shareholders are protected while the dissenting voices can be heard. Vignette 3-1 provides an interesting example of the use of the bylaws to maintain control of a company.

VIGNETTE 3-1

BYLAWS MATTER

THE ISSUE

Bylaws are the rules that govern the operation of a board. In routine times, they are followed as a matter of practice and have little impact on decisions. In fact, there may be very little awareness of them. However, when there is conflict, bylaws can play a major role in which party prevails.

THE SITUATION

In one company there was a bitter disagreement over whether the chairman and chief executive officer (CEO) should continue in his role. There were 12 members on the board, and they were evenly split on the issue. As they were negotiating a resolution to the dispute, one of the members opposed to the chairman had a debilitating stroke and was no longer able to function. This created a potential six-to-five vote in favor of the chairman.

The bylaws stated that the chairman could call an official meeting without stating the subject to be discussed as long as a quorum, defined as a majority of the directors or in this case seven, were present. This meant that the six directors favoring reelection of the chairman would need at least one director opposing his reelection to be present to take a vote.

BOARD ACTION: THE MEETING

The chairman chose to call the meeting, and prior to its occurrence, the chairman's supporters requested that a relative of the ill director use his power of attorney to submit the director's resignation from the board, creating an opening. The opposing side did not know of

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Concluded

this proposed action until the meeting began, at which time the resignation was submitted and accepted.

The chairman's supporters then immediately elected a replacement director who was friendly to the chairman on a vote of six to five. The individual who was elected then joined the meeting, creating a seven-to-five majority. The opposing side could have disrupted this process by walking out and destroying the quorum; however, because they were caught by surprise, they did not think to do this at the time.

To negate the possibility of quorum issues at future meetings, the majority also proposed to immediately amend the bylaws to add 2 additional directors. This would bring the total number of directors to 14 and the quorum requirement to 8. On passing the amendment, the majority immediately elected the 2 additional directors and attained a working majority of 9 who favored the chairman versus the 5 who did not.

THE POINT

One side of the described dispute understood the bylaws and used them to design a process that settled the dispute. The other side did not think to use the bylaws strategically to their own advantage, and their lack of understanding played out in their defeat.

Defensive Measures

During the 1980s, there was a period during which hostile takeovers occurred frequently. Buyers, often referred to as *raiders*, were characteristically either strategic buyers, usually meaning a competitor, or financial buyers, meaning individuals or groups looking for a bargain. The target companies were as a rule perceived to be underperforming, demonstrating attractively low market valuations, often having substantial liquid assets, and sometimes having business units that could be sold off. The raiders would use a variety of financial instruments, including high-yield "junk" bonds and/or a company's own assets to finance a hostile takeover offer. The practice of hostile takeovers was justified as a way of removing entrenched management and unlocking the value of the business for the shareholders, and in some instances, this was the case. In many cases, however, the raiders were attempting to gain control of the company at a substantial discount. Often raiders did not want to purchase the whole company but instead only enough shares to gain control. If the raiders were successful in gaining control of a firm, the remaining minority shareholders were left in the unenviable position of having little or no voice in the ongoing governance of the firm.

Defensive measures were developed in response to the practice of hostile takeovers, and critics remain divided on their utility. Some claim that defensive measures serve to protect entrenched management and boards of nonperforming companies at the expense of shareholders. Those with an alternate view contend that the measures are not designed to protect management, but instead the shareholders, by allowing the board to maintain control of any transaction process. This situation, the supporters of defensive measures believe, ensures that shareholders would get the best possible price if the company were to be sold.

Both arguments have merit. Certainly there are entrenched, underperforming managers and boards, and the threat of a hostile takeover could make them more responsive to shareholder interests. Alternatively, the raiders are not always "good guys" looking out for the shareholders' interests. A determination of which side actually represents the best interests of the shareholders can only be made on a case-by-case basis and often only after the fact.

Defensive measures commonly used by corporations when under hostile attack include

- Limitations on special meetings
- Staggered terms
- "Poison pills"

We describe each of these briefly below.

Limitations on Special Meetings

The bylaws typically state the types of decisions that require shareholder approval, and universally, one of these decisions is the consideration of a tender offer or offers. The ability to call special meetings and set agenda topics is a powerful tool that can be used when a firm is a takeover target. The board of directors empowered to call special meetings and/or set their agendas could keep a takeover attempt at bay by delaying shareholder meetings or by controlling the agenda so that raiders could not present their proposals to the other shareholders.

Staggered Terms

Before the times of prevalent hostile bids, boards historically had been elected at the annual stockholders meeting for a yearly term or until their successors were elected. This last phrase is a technical term often included

in bylaws to ensure that the board would not be reduced to an unworkable extent by the failure to elect new candidates. Under this election protocol, raiders found that they could get an entirely new board elected with a simple majority vote, and as a result, they could control a corporation with just 51 percent of the outstanding shares.

In order to make it more difficult for anyone or any group to gain control of the board, many public corporations now employ staggered terms for directors. The members are split into a number of classes, usually three or four, much like graduation classes. The classes for a given board contain approximately the same number of directors, and they are elected to 3- or 4-year terms. If 3-year terms were employed, it would take 2 years for a takeover group to gain control of the board and 3 or perhaps 4 years for it to install a total slate of board members. The process of extending the time interval required and making the battle more difficult gives the shareholders a better handle on the issues at stake and the motives of the dissident groups.

The "Poison Pill"

The "poison pill" is a very complicated way of dealing with potential hostile takeovers. The pill is so effective that one has never been triggered. Further, it has been litigated successfully in a number of court challenges. The poison pill is a plan whereby the board issues existing shareholders the "right" to purchase additional shares at a very low price, say, 1 cent per share. These rights would be triggered if a hostile purchaser were to accumulate more than a predetermined percentage of the outstanding shares, usually in the range of 10 to 20 percent of the outstanding shares. The new shares issued to preexisting shareholders would dilute the shares of the hostile pursuer dramatically.

The intent of putting the poison pill in readiness is not to prevent a transaction from taking place but rather to ensure that the board is in control of the process. Several studies indicate that companies with poison pill provisions get a higher price for a sales transaction (in the event of a sale of the company) than those without one, the obvious reason being the mere existence of the poison pill threat.

PROCEDURE GUIDELINES

In addition to the bylaws, many corporations have formal board procedure guidelines that expound on how the board is to function. For example, the procedure guidelines used by one major industrial corporation provide the basis for the discussion of guideline elements below.

Corporate Officers

State statutes generally require that a corporation have a president and a secretary, with other officers optional.

The Chairman of the Board and the CEO

The major governance issue with regard to officers is whether to have a CEO who is also the chairman of the board or to separate the two positions. Clearly, there are two jobs: one manages the affairs of the business, and the other supervises the work of the board in overseeing the affairs of the business. The majority of public corporations over the last several decades have combined the two jobs, primarily on the theory that the organization needs a strong leader. This move has been motivated by a fear that a strong chairman would become a rival to the CEO and undercut his or her stature. Many interested observers, however, feel strongly that these jobs constitute a distinct conflict of interest for anyone holding both positions. Given that the board (and especially the chairman) must evaluate the performance of the CEO, a person holding both positions is necessarily called on to evaluate himself or herself. Consequently, there has been a slowly emerging trend to use a nonemployee chairman of the board who works closely with the CEO in managing the board's work. A very good alternative is to have a lead director, who often serves as chairman of a committee of outside directors, one of whose primary tasks is the evaluation of the CEO's performance.

A related issue is whether to have executive officers, in addition to the CEO, on the board as inside directors. When there are insiders on the board, the outside directors come to know management better and get a broader exposure to the inner workings of the company. One danger related to this arrangement, however, is that the managers who are subordinate to the CEO will have great difficulty disagreeing with their boss. If this is not the case, the alternative danger is that the inside directors could undercut the leadership of the CEO, particularly if they differ with him or her on some important issues. In any case, it is critically important that there be more outside directors than inside directors in order to have a board that is independent of management when judgments about management performance are made. If there are inside directors, an effective and active committee of outside directors facilitates the performance of functions requiring independence.

The committee of outside directors is somewhat similar to the European two-tiered model of governance, in which there is a supervisory board and an executive board. The supervisory board is usually composed of outsiders who represent the employees and shareholders. It

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appoints and oversees the activities of the executive board and is broadly responsible for what the law terms "the well-being of the company." The executive board, on the other hand, is composed of senior managers, the insiders, and is responsible for running the company.

Board Committees

A board of directors normally conducts its business through a well-organized committee structure that partitions the work of the board and allows directors to make maximum use of their expertise. Many issues are too complicated to be dealt with by the entire board. It is a matter of time and efficiency as well as expertise. The board can delegate certain policy or issue decisions to the relevant committee or can ask the committee to complete a detailed study of the issues and come back to the entire board with recommendations. Each committee should have a clear charge, or set of duties, and their reports become part of the board's minutes as they report at appropriate board meetings.

Most boards have the following standing committees in some form:

- Committee of outside directors
- Executive committee
- Compensation committee
- Audit committee
- Nominating and governance committee

Boards also may have other committees that reflect their specific industry or circumstances. Each of the listed committees is described briefly below.

The Committee of Outside Directors

This committee was described previously. The chairperson of this committee is elected by the other directors and commonly serves as the lead director. The office of the CEO ideally provides staff support for this committee, and the company's general counsel often advises this committee, particularly when there are issues that have legal implications.

The Executive Committee

The executive committee can be used in three distinct ways:

- It may provide a backup mechanism that acts for the board when time or circumstances make it difficult to bring the entire board together. Members are chosen, among other criteria, on their ability to be available on short notice.
- It may be composed of the chairs of the other standing committees and may be the means for coordinating their activities.
- It may be a senior board to which all issues are presented before going to the whole board. This is usually found when there is a very large or oversized board that does not meet as frequently as the situation requires. In past years, banks that preferred large boards, primarily for marketing benefits, used a senior board. One disadvantage of this arrangement is that it may create an "in group" and an "out group."

The Compensation Committee

The compensation committee deals with the compensation and benefits of executives. The senior human resources officer provides staff support, and frequently the committee employs outside compensation advisers. The committee obviously should be composed of outside directors. In some companies, the management of retirement investments is also a responsibility of this committee. When this situation is not the case, the function of managing retirement benefits is delegated to a separate committee composed of individual directors who have investment expertise.

The Audit Committee

The audit committee is a critical committee and must, by Securities and Exchange Commission (SEC) regulation, be composed of independent directors. Independence means not only that the members should not be in management but also that no one with close family or business ties to management or who has been part of management in the last 5 years should be a member of the audit committee. The chief financial officer (CFO) of the company provides staff assistance for this committee, along with senior accounting managers. This committee works closely with the external auditing firm and generally meets quarterly with its representatives to review the company's 10-Q form, which must be filed quarterly with the SEC. Management is generally absent from these external auditor review sessions.

The audit committee's traditional responsibility has been to know what is in the financial statements and to ensure that they are accurate and reported properly to those outside the firm. Over the years, the audit committee's function has expanded into oversight of financial controls, often using an internal audit staff. More recently, these responsibilities have tended to expand to overseeing processes that monitor compliance with laws, regulations, and the corporate code of conduct and to conducting special investigations.

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A few companies have begun to use the internal audit staff as consultants to review the effectiveness of operations and transfer best practices between or among corporate entities. A growing area of audit committee concern is risk management. Traditionally, this has been interpreted to mean management of the insurance program. It is beginning to extend into an understanding of all the risks the company faces and how they can best be managed, such as the risks inherent in interest-rate swaps and hedges.

Appendix 3-1 summarizes in more detail the functions of and current thinking about the crucial role of audit committees.

The Nominating and Governance Committee

The nominating committee identifies and recruits new members of the board when openings occur, with staff support provided by the CEO. In many companies, this committee has begun to manage the process of evaluation of individual board members, as well as the board as a whole. This has led to its being responsible for much of the governance process. The committee is also usually responsible for the procedure guidelines.

Other Standing Committees

There are a number of other committees that might be appropriate in specific situations. Some companies use a strategy or planning committee. Some will have a finance committee to manage the capital structure and related financial instruments. There also may be a committee on the environment.

Special Committees

From time to time, the board may appoint an ad hoc committee to deal with a specific issue. The special committees are directed to study and report on novel issues facing the corporation or urgent issues not covered by other standing committees. These special committees usually dissolve upon the completion of the assignment.

SUMMARY

This chapter has described and provided examples of the nuts-and-bolts actions and procedures that provide for the governance of public corporations. Many of the same precepts also apply to private companies. Unfortunately, too many managers and even members of boards of directors have less than a requisite understanding of these important governance procedures. The fiduciary responsibility that goes with serving on a board of directors as the custodians of the shareholders' interests, however, requires that the company's structural underpinnings be well understood. Numerous examples throughout the remaining chapters illustrate the pitfalls associated with a failure to understand the rules and conventions of corporate governance.

We now move on in Chapter 4 to the process of selecting directors.

REVIEW QUESTIONS

1. What important facets of a corporation are covered in the articles of incorporation?
2. What important aspects of the board's organization and operation are covered in the bylaws?
3. Why is it essential that every director know the bylaws in detail?
4. What are the advantages and disadvantages of having one person hold the offices of chairman of the board and CEO?
5. How does the board use committees to further its work?

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