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Director liability: corporate minutes as Trojan horse

By Stephen M. Honig

What should director minutes say and how detailed should they be? It likely depends on the maturity of the company, the personality of its management and the input of its lawyers.

But lawyers often have disagreed on what minutes should look like. So, what are the best practices?

Last month, the National Association of Corporate Directors took a stab at identifying ground rules in its “Directors’ Guide” to corporate board and committee minutes. The guide is, well, just that — a guide. There are no bright-line answers, but many “it depends.”

Background

In small or emerging entities, minutes tend to be drafted by management, or sometimes even by a trusted office employee.

The minute book may not even reflect legally required annual meetings, and rather may consist solely of those things mandated by external relationships: a vote authorizing a lease or a bank account, or an application for some governmental permit.

Such enterprises seldom get involved in court battles involving director duties divorced from shareholder abuse. Not even counsel pays much attention to how minutes might appear to a jury when shareholders sue directors for mismanagement. Lawsuits for those companies generally involve gross misuse of power by dominant shareholder interests, and the fight seldom turns on the contents of the minute book.

Minutes of smaller companies, even when carefully prepared, may approach the appearance of an abbreviated transcript, reflecting in detail certain operational issues that were discussed, often with several members of management in attendance. The parties may be trying to figure out a production or sales problem, and they want to remember the discussion and the resolution.

There is not much danger in recording such detail, except in certain circumstances; for example, when the company is being acquired and the larger acquirer does diligence in the minute book and discovers all sorts of rough edges and problems in the company (and thus creates a basis for revising a proposed acquisition valuation downward).

Another risk is the unfortunate recording of some improper act, such as a president proudly reporting to his board that at the annual trade convention he was successful in agreeing with his competitors on a joint pricing strategy for the coming year so that everyone would have a fair shot at getting business.

When companies are more mature, and have public shareholders or outside private capital, the ground rules change. Equity stakeholders often look to the directors when a business fails or just fails to perform, and in that setting, the contents of the director minutes become vital as evidence.

Such companies also tend to have more complex exposure to regulatory review from all government agencies, notably from the Securities and Exchange Commission, Department of Justice or Department of Labor, and poorly kept minutes can exacerbate the problem.

With more mature companies, the lawyers tend to get deeply involved. The NACD Guide is directly applicable to those companies.

Legal touchstones

In mature or public companies, what is the role of corporate minutes beyond authorizing major transactions and electing officers and satisfying lenders?

The minutes should place the directors squarely within the protection of the business judgment rule, which in virtually all states, protects directors from liability for directorial decisions that do not work out, provided directors without a personal economic interest have utilized their best judgment after considering carefully the decisions to be reached.

One aspect of understanding the business judgment rule is an appreciation of the duty to supervise the company to make sure that management is doing the right thing. That is not a duty to spy, but rather a duty of reasonable inquiry to ensure that management is maintaining proper supervision of all material aspects of the business.

Commentators have questioned whether Delaware court opinions in this area really create a distinct supervisory duty, given the propensity of the courts to determine that boards did in fact meet the standard, but well-advised directors should devote some attention to that issue.

Someday, some bad luck befalling a company will come back to haunt directors who will be determined to have breached the duty of care by not inquiring if management was itself inquiring about the relevant risk.

Sometimes identified by reference to Delaware corporate law cases as the Caremark duty or the Van Gorkom rule, this body of directorial obligations thus requires directors to make some effort at assuring themselves that management is monitoring operations so as to avoid obvious dangers.

Ground rules for minutes

With this background, it becomes clear that minutes of mature companies should demonstrate that time, care and attention were paid to all matters, and more paid on the most important matters.

That involves documenting process. Proper process, involving due consideration of a matter, will protect directors under the business judgment rule and, incidentally, lead to better directorship as well.

Here is how the NACD Guide suggests that minutes be drafted:

- Tell the story. What is the story? It reflects the issue addressed, the robustness of the discussion and the substance of the conclusion. It does not involve a recitation of the contents of the debate. It involves reference to who reported facts, to what documents were provided before and during the meeting, to board engagement in discussion, and to management answering questions and responding to comments posed by the directors. The content of those discussions and answers should not be set forth, as that content may just create cannon fodder for lawyers who later claim that the directors did not fully address concerns in reaching a decision that turned out badly.

- Demonstrate debate. You can recite in minutes that you debated a long time, but that is not enough. And be careful about being hoist by your own petard. A meeting that begins at 10 a.m. and ends at 11 a.m. and recites that four crucial decisions were “debated at length” reeks of fabrication. Lay out the factors that were considered and discussed; identify the factors, not the substance of that discussion.

- Don’t use names. The point is that the board as a whole discussed and debated. If you document that a particular director expounded in favor of a failed policy, you may set that director up for scrutiny and possible liability. Name directors only if they are rendering reports, or when they insist on being recorded as opposed or abstaining (or if they have a personal interest and should be recorded as not participating in the vote). The guide suggests all negative voters be named, with which I disagree. I prefer to record that a vote was passed simply by saying, “seven in favor and one against with one abstention.”

- Demonstrate certain considerations. One suggestion in the guide, often not followed but very valuable, involves stating that certain specific aspects were discussed: risks recognized, alternative approaches and strategy if the adopted approach is tried and fails. The guide also suggests that each major decision be recorded as being in the best interests of the company. I have always been embarrassed by such a self-serving platitude. An affirmative vote after due discussion implicitly contains the conclusion that a given decision is of corporate benefit. I suggest that language asserting corporate benefit should be included only as required by statute or where issues of ultra vires may be involved (for example, with a vote authorizing a guarantee of the debt of another company).

- Read and correct minutes. Directors need training here. They tend to read generally and pounce on any error, without considering the above principles. Further, the practice of sending minutes with the board book for the next quarter’s meeting is in error as too much time elapses. In my view, draft minutes should go out within two weeks of the conclusion of any board meeting.

Concluding thoughts

The guide does not discuss the practice, followed by some boards, of collecting and destroying all board books, meeting notes and agendas after each meeting. Some boards that keep extremely sparse minutes do not want to leave other evidences of any discussion that may be subject to discovery in the event of litigation.

What good, such boards ask, are minutes that are carefully crafted to omit details, and which are designed to reflect

proper process, if those details are documented elsewhere?

But that practice is fraught with problems. Many directors want to keep papers to both document what they decided, and to aid them in the performance of their duties. Retaining robust materials sent to directors in board books supports the argument that due care was applied.

Also, it is almost impossible to eliminate all traces of something in this day and age. Computer records, ancillary communications by email, and secure websites utilized by directors to communicate between meetings create a substantive record anyway.

Directors should remember that they are protected if they utilize robust process in the board room and are well-served if they just document that process. Directing while always in fear of some putative ill-guided cross-examination is no way to discharge one's fiduciary duty.

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