

RESPONSIBILITIES OF CORPORATE DIRECTORS AND OFFICERS

Produced by: American Farm Bureau Federation 2008

INTRODUCTION

A corporation is an artificial person or legal entity created under state or federal statute. Corporations are owned by shareholders, or in the case of not-for-profit corporations, by their shareholders or members. Corporate powers are established by articles of incorporation, bylaws, and the statute under which the corporation is organized.

State and county Farm Bureau corporations are generally organized under A State Not-For-Profit Corporation Act. Affiliates usually are organized under the State General Business Corporation Act. As a legal entity someone has to act for the corporation. This is the responsibility of the directors and officers.

Directors and officers of a corporation are generally considered as fiduciaries and must follow certain standards of conduct.

George D. Webster states the following in *The Law of Associations*, prepared for the American Society of Associations Executives;

(1)- Powers and Duties of Directors

An association director-as a corporate director- stands in a position of trust and confidence with respect to the corporation or association which he serves. While he is technically not a trustee, he does have a responsibility of a fiduciary nature.

(a) Directors' Powers are Managerial, Not Legal.

There is one doctrine of prime importance in nonprofit organizations. The basic rule is that the legal entity, rather than the board of directors, is the holder of legal power. The powers of the directors are not inherent in them, but in the organization as such. Underlying most nonprofit statutes, and case law, is the principle that directors or trustees exercise the powers of the organization, but do not own it. For example, the directors and not the members are the proper entity to bring or defend suits in an associations' name. A legal action brought or defended by hundreds of members would, of course, be impractical, but the power to act on behalf of an association does not give to the agents (directors) ownership powers or rights within the organization.

Thus, the board of directors has the power and duty to carry on whatever transactions the corporation or association itself has the power to carry on. The power of

the board of directors is superior in ordinary matters, so long as it is exercised lawfully and in lawful transactions. Nor will the courts interfere unless illegal action, or an action in bad faith, is shown.

In extraordinary matters, the board of directors may not govern, and the will of the general membership must rule. In such matters as a radical change of fundamental policy or purposes, amendment of Articles of Incorporation, dissolution or merger of the corporation, or matters of like importance, the power of decision usually rests with the voting members.

Within the purposes and power of the association, the directors are free to change policies and short-range purposes, but unless the charter or bylaws expressly permit, they may not do acts that amount to changes in the fundamental purposes or operational methods of the association.

In short, the corporate powers of a corporation are vested in the board, except for those powers specifically conferred on the shareholders or members. Powers to dispose of or discontinue the business of a corporation, including merger, consolidation, or dissolution are customarily reserved to the shareholders or members.

STANDARDS OF CONDUCT

Generally, the standards of conduct of corporate directors and officers fall into the following categories:

1. Duty of loyalty and honesty *Good Faith*
2. Duty to care
3. Duty to be attentive
4. Duty to preserve equity

1. Duty of Loyalty and Honesty *Good Faith*

The foremost obligation of the corporate directors and officer is to be unswervingly loyal to the corporation and its stockholders or members. At all times a director must acknowledge the best interests of both and not allow any personal interest to take precedence. In no circumstance shall a director use the position of director for personal gain, or other advantage.

This standard encompasses the legal concepts of: conflict of interest, fairness, purchase and sale for control, declaration of dividends, usurpation of corporate opportunity, and confidentiality.

a. Conflict of Interest

If a director or officer has an actual or potential conflict of interest in a contract or transaction to which the corporation is a party, the existence and the nature of the personal interest must be disclosed to the other directors or officers. A director must refrain from taking part in any action on the matter, should the board choose to proceed in the view of the disclosures thus made.

b. Fairness

When conflicting interest arise, the directors are under a further obligation to ascertain whether the transaction is fair to all concerned. Unfair treatment of minority shareholders must be avoided. The transaction should be less favorable to the corporation than it would be in available from any other disinterested party.

c. Purchase and Sale

A director must refrain from using the position of director to buy or sell the corporation's stock for the purpose of gaining voting control. Gaining control must not be the primary purpose behind the transaction. The test here is intent, regardless of the ultimate effect of the sale or purchase.

d. Declaration of Dividends

The declaration of dividends is discretionary with the board. A conflict may arise if a director's personal interest dictates against a declaration.

e. Corporate Opportunity

While a director is not prohibited from entering into business enterprises similar to that of the corporation the director's fiduciary duty requires a director to forego the personal opportunity presented in deference to the benefit and advantage presented to the corporation. Corporate opportunity is anything related to the corporation's purpose.

f. Confidentiality

Confidentiality, if observed, will protect the corporation from competitive disadvantage. It is of the most importance that the director deals in strict confidence with respect to all corporate matters. This duty is binding until there is public disclosure of the matter.

2. Duty of Care

The duty of care applicable to directors varies from state to state. The Revised Model Business Corporation Act, which has been adopted by several states, provides:

Members of the board... when becoming informed in connection with their decision-making function or devoting attention to their oversight function, shall discharge their duties with the care that a person in like position would reasonably believe appropriate under similar circumstances. (MBCA, Sec. 8.30, 3d ed. 1998-89 Supp.)

The above MBCA standard of care may be generally interpreted to mean that a director must exercise care greater than the care imposed by an "ordinary negligence standard" on directors.

A director is not expected or required to attend to every business matter or dealing of the corporation or to interfere individually with management. However, the duty of care requires directors to adequately inform themselves prior to taking actions and to exercise proper oversight of corporate affairs. In this regard, a director is allowed to rely on the opinions, information, or reports of others.

3. Duty of Attention

A director must attend board meetings and meetings of committees, on which the director serves, stay adequately informed, maintain communications with other directors and with the corporation's officers and top management, review corporate documents and financial statements, oversee corporate activities, and perform other acts which the director reasonably believes are in the best interest of the corporation and its stockholders.

4. Duty to Preserve Equity

Corporate directors must adhere to a standard of conduct requiring them to preserve the equity of the corporation. The board has a duty to protect and control the corporate assets and to maintain the solvency of the corporation through the adoption of sound fiscal policies.

The board cannot avoid this responsibility through delegation the primary responsibility for this duty is obviously with the financial officer and personnel. However, the board must require progress and financial reports from those to whom responsibilities have been delegated to ascertain whether policies are being carried out and the desired results are being achieved.

VIOLATION OF STANDARDS

Officers and directors may be monetarily liable for acts which violate the standard of conduct. They are also liable for fraudulent breaches of trust, bad faith or willful or intentional violations of their duty, and unlawful acts. A director or officer usually is not liable for the wrongful acts of other directors or officers when a director does not participate in these acts. An exception to this rule is failure to exercise reasonable supervision of corporate affairs, the selections or retention in office of known incompetents or dishonest people, or the failure to prevent a wrongful act of which the director or officer had knowledge. A director can be liable for wrongful act of the board when the director voted for the act. A director may also be liable for an act of the board when the director was present and failed to oppose such act. To help protect against liability for wrongful action of other directors, a director should not hesitate to express an opinion at a board meeting concerning any course of action.

OTHER STATUTORY REQUIREMENTS

In addition to the general standards of conduct for officers and directors, state and federal statutes provide obligations and penalties applicable to officers and directors relative to equal employment, wrongful termination of employment, occupational safety and health, environmental regulation, taxation, antitrust, employee fringe benefits, corporate securities, and other areas.

A board of directors should provide oversight to require management to develop compliance programs to avoid violations of state and federal laws by the corporation and its officers and directors.

Sarbanes-Oxley Act of 2002

In June of 2002, Congress enacted the Sarbanes-Oxley Act. The Act is considered by many as a revolution in corporate governance. Although the Act is only applicable to corporations which are publicly traded under federal securities law, many experts predict that the Act will ultimately change corporate culture and director and officer responsibilities and liabilities of all corporations-including non-publicly traded corporations and non-profit corporations.

Some of the major impacts of the Act (for publicly traded companies) include:

- *That a corporation board may need to include outside, independent directors to ensure objective oversight of fiscal and reporting policies.
- *The creation of the Public Company Accounting Oversight Board.
- * New rules regarding the composition and function of audit committees.
- *Accounting document retention rules.
- *More stringent reporting and disclosure requirements.
- *New rules regarding loans to corporate executives.
- *Prohibition of most loans to corporate “insiders”.
- *Executive officer certification requirements regarding company financial statements.
- *Statutory incentives for corporate adoption of corporate codes of conduct
- *New criminal and civil penalties for security law violations-including executive forfeiture of incentive-based compensation.
- *Prohibition of corporate retaliation against “whistleblowers” who report securities or other statutory violations.

ESSENTIAL INFORMATION FOR BOARD MEMBERS

A director must become familiar with the corporation's basic documents; Articles of Incorporation, By-laws, corporate disclosure statements, conflict of interest disclosure statements, annual stockholders reports, board structure charts, personnel policies, and management long-range objectives and operating procedures. Directors have an absolute and unqualified right to inspect corporate books, records, and documents.

In addition, a director:

1. Should freely scrutinize the information reporting system from management to the board in critical areas such as finance, compliance reporting, business developments, forward planning, and policy development.
2. May develop informational sources from the board's use from sources outside the corporation, e.g. business publications, trade associations' reports, etc.
3. Should expect to receive (and may insist on) adequate notice of meetings and advance meeting schedules.
4. Should be furnished with an adequate agenda (even if tentative) and supporting materials in advance of board meetings.
5. Should be provided with adequate minutes of all board and committee meetings since the minutes will constitute as evidence of actions taken by the board.
6. Should be attentive to authority granted to top management and executives to obligate the corporation in substantial transactions.
7. Should be attentive to the corporation's asset protection program, including adequate employee bonding, liability insurance coverage, and arrangements to assure employee loyalty through conflict-of-interest questionnaires.

A director also has certain rights to information including:

1. Reasonable access to management.
2. Reasonable access to the corporation's books and records.
3. Adequate notice of meetings.
4. Copies of minutes of all board meetings and committee meetings (even if not a committee member).
5. Reasonable access to the corporation's principle advisors when there is a need for outside advice.

EXERCISE OF POWERS

Generally, board powers include:

- ❖ Established basic corporate objectives
- ❖ Select competent senior executives
- ❖ Monitor management's policies and procedures
- ❖ Monitor the performance of company managers
- ❖ Adopt or amend bylaws
- ❖ Approve amendments to Articles of Incorporation (subject to stockholders or members approval)
- ❖ Appoint or change registered agent
- ❖ Designate registered office
- ❖ Approve any plan of merger, consolidation or dissolution
- ❖ Elect corporate officers
- ❖ Call special shareholder or member meetings
- ❖ Declare dividends
- ❖ Assure that diligent attention is given to changes in assets of the corporation, e.g. capital investment, acquisitions, dispositions, new business, etc.
- ❖ Assure that the corporations' disclosure documents are complete and accurate
- ❖ Appointment of audit and executive committees

The directors of the corporation function as a board, not as individuals. Members of the board, acting as individuals outside a meeting, cannot bind the corporation, even though a majority on the entire board may agree with the determination. They must meet and act as a duly constituted meeting.

Differences of opinion among members of the board on corporate business matters should be thoroughly discussed at board meetings. Members of the board have an obligation to support the majority position of the board after a decision is made, even though they opposed the action during the meetings.

Directors should not become involved in the operations of the company unless they have been delegated executive responsibilities by the board. Otherwise there will be confusion and disruption of the executive authority.

INDEMNIFICATION

Most state statutes provide that directors and officers must be indemnified by the corporation for their costs when found not liable for a court of law or administrative agency for claims made against them while acting as directors and officers of the corporation.

Some state statutes limit the liability of officers and directors under certain circumstances.

The Revised Model Business Corporation Act and many state corporation laws provide that a corporation has discretionary power to indemnify directors against expenses, judgments, fines, or settlement payments (except in derivative actions). Generally, to be indemnified, the director being sued must have acted in good faith, and in a manner reasonably believed to be in, or not opposed to, the best interest of the corporation. If the proceeding is for alleged criminal action, the director must have had no reasonable cause to believe the conduct was unlawful.

In addition to indemnification, a corporation and its directors and officers may be further protected through the purchase of insurance.

Exclusions under directors and officers insurance usually will include libel or slander, personal profit, excess remuneration, and dishonesty. Libel and slander are usually covered under comprehensive liability coverage. With regard to personal profit taking, it is the director's responsibility to return to the corporation any personal gains the director has wrongfully obtained.

CONCLUSION

The responsibilities and standards of conduct of directors and officers are essentially loyalty, honesty, due care, exercise of sound business judgment, attentiveness to corporate affairs, and adherence to state and federal laws. Principles of liability have been discussed only in general sense in the article. In the final analysis, directors and officers should remain aware that responsibilities and liabilities in any situation depend upon totality of the circumstances and upon the law involved. Counsel experienced in corporate practice should be consulted whenever questions relating to conduct, specific corporate transactions, or liabilities arise.

Corporate indemnification of directors and officers, statutory limitation of liability and the procurement of insurance are significant measures to encourage the service of officers and directors and to assist a corporation in attracting and retaining competent individuals in these positions.