H.S. Grace & Company, Inc.

What is Corporate Governance?

By H. Stephen Grace, Jr., Ph.D.

The increased attention of board members, senior executives, lawyers, institutions, judges, juries and others to the subject of corporate governance has raised the basic question of "What is Corporate Governance?"

That question is addressed here in two steps. First, a layman's summary of Recognized Duties is set out. Second, there is a discussion of Customary and Normal Board and Management Responsibilities. As is set out in the Summary below, effective corporate governance is the effective addressing of responsibilities. And, just as the division of labor is specific to a firm at a point in time, corporate governance structures and processes are specific to a firm at a point in time.

Recognized Duties

The Delaware Courts and others have thoughtfully developed the legal standards regarding the recognized duties and responsibilities of officers and boards of directors. Important among these duties and responsibilities to the corporation are the duty of loyalty (also referred to as the duty of fair dealing) and the duty of care.

The duty of loyalty requires that, upon becoming an officer or director, an individual commits allegiance to the corporation and accepts that the best interests of the corporation and its shareholders must stand ahead of and prevail over his or her own individual interests. In discharging one's duty of loyalty, the officer or director may not use his or her corporate position to make a personal profit or gain other personal advantage. As such, when matters of interest to an officer or director arise which affect the corporation, careful attention must be paid to satisfying that officer's or director's duty of loyalty. The degree of attention to an officer's or director's duty of loyalty may be even further magnified when there is a transfer of control of an entity or certain of its assets in which an officer or director is interested.

The duty of care imposes a duty to act carefully in fulfilling officers' and directors' respective tasks of oversight, directing, and executing the activities of corporate management. The duty of care requires that the officer or director function in good faith, in a manner he or she reasonably believes to be in the best interests of the corporation and with the care which could be reasonably expected of an ordinary prudent officer and/or director. The duty of care includes the obligation to see that appropriate inquiries are made when circumstances arise sufficient to alert a reasonable officer or director of the need to do so.

Breaches of the duty of care include acts of neglect, mismanagement, and intentional decisions to do wrongful acts. There continues to be an interest in whether there is, perhaps, a separate duty of good faith.

Board and Management Responsibilities

Establishing and implementing a firm's corporate governance structures and processes involves the following:

- The identification of the corporate constituencies - the board, senior management, and others such as shareholders, employees and the community;

- The formulation of the roles of the principal participants - in particular, the board of directors and senior management;
- The determination of the manner in which the board and senior management address their responsibilities; and
- The formulation of the relationships between and among the various constituencies.

These four areas are broad and the governance structures and processes put in place are often based on fundamental considerations, examples of which would be the following:

- The board's duty to select the CEO;
- The board's duty to oversee the CEO and management;
- The board's duty to monitor the efficiency, and effectiveness of the firm's operations, including the firm's adherence to agreed-on ethical guidelines; and
- The board's duty to establish the board committees necessary for effective governance – nominating/governance, compensation, audit, and others – and to ensure the proper functioning of these committees.

Governance processes build on these fundamental considerations. Examples are the board's involvement in the firm's planning processes including enterprise risk management, and regulatory compliance; the board's oversight and control system; the board's monitoring of management's control systems; the board's involvement in employee matters including the hiring, the promotion, and the termination of senior executives, and responding to employee allegations of wrongdoing; and the board's interaction with the shareholders, the independent accountants, the internal audit function and others. Processes arising from the roles and responsibilities of the independent directors are an important subset of these.

The development and maintenance of governance structures and processes in a corporation is evolutionary and dynamic. There must be continual consideration of the need for temporary or permanent modifications in these structures and processes.

Summary

Corporate Governance is that area of Business Conduct which addresses the roles and responsibilities of boards and senior management, the interactions between them, and their interactions with others. Just as the division of labor is specific to a firm at a point in time, corporate governance structures and processes are specific to a firm at a point in time. Effective corporate governance is the effective addressing of responsibilities.

Houston: 4615 Southwest Freeway, Suite 625, Houston, TX 77027
(713) 572-6800 • FAX (713) 572-6806

New York: 300 E. 57th Street, #18A, New York, NY 10022
(212) 644-8620 • FAX (212) 813-1779

Email: hsgraceco@hsgraceco.com
Visit us at: http://www.hsgraceco.com