

Setting the Table: The Board of Directors, Authority and Obligations

April 4, 2014

State Compensation Insurance Fund

Presented by Randall W. Keen

Overview of Topics

State Fund's unique, quasi-private status

Board's appointments

The Board's authority, duties and obligations

State Fund's Quasi-Private Status

- State Fund is a unique – almost uniquely unique – entity, unlike any other in California government
- Often called “quasi-private” or “quasi-public”
- State Constitution was amended over 100 years ago to give the Legislature the authority to create a complete system of workers’ compensation, including the power to create a state compensation insurance fund
- Legislature created State Fund with the Boynton Act in 1913
- Legislature has amended the statutes governing State Fund and the Board several times over the last 100 years

Board's Appointments – not Pleasure Appointments

The Legislature authorizes the establishment of other state agencies – what is different about State Fund?

First, the Board's appointments are unique, and provide State Fund some independence

- Board positions are required to reflect a broad diversity of interests
- Board positions are for 5-year terms
- These are not pleasure appointments, meaning, Board members cannot be removed at the appointing authority's pleasure, except:
 - The appointing authority may remove a Board member if the member misses three consecutive board meetings
- When pleasure appointments are used, the Governor (or other appointing authority) has the ability to heavily influence Board members, and immediately replace a Board member if unhappy
- When term appointments are used, there is less susceptibility to political influence
 - Political pressures are still there, but far less than those on other state Boards and commissions

State Fund is also exempt from most provisions of the Government Code

- For example, State Fund is not subject to the Tort Claims Act
- Cuts both ways - State Fund is also not “subject to” the state’s exemption from punitive damages

Additional indicia of the Board’s independence and quasi-private status:

- The Board hires and sets the compensation for the top executives
- The Board has the authority to establish a performance awards program

While term appointments and Government Code exemptions provide the Board with independence, this is not enough to make State Fund quasi-private. Instead, State Fund’s quasi-private status flows from the Board’s statutory authority.

The Board has “**full power, authority and jurisdiction**” over State Fund

- Ins. Code § 11781

Full power and authority

- Meaning, the Board is empowered to make all decisions about how to run State Fund (except, of course, where legislation is adopted that limits that power)
- Legislature has backstopped this full power with several provisions that seem intended to remind the outside world that State Fund is quite independent from the State:
 - The State is not liable for State Fund's obligations
 - Advertising must state “not a branch of the State of California”
 - All business and affairs must be conducted in State Fund's name

In addition, the Board has the authority to “perform **all acts** necessary or convenient in the exercise of any power, authority or jurisdiction over the fund, . . . **as fully and completely as the governing body of a private insurance carrier.**”

- In other words, the Board must act like the Board of a private carrier.
- When there are questions about the Board’s role or the Board’s obligations, we look first to the Insurance Code and to the small handful of Government Code provisions that apply to the Board.
- If the Legislature has not specifically applied a law to the Board, then the default is to act in the same way that the Board of a private carrier acts

- The Board's broad authority has been recognized by the courts and others
 - *Courtesy Ambulance v Superior Court*, 8 Cal.App.4th (1992) – State Fund has “greater freedom in conducting its affairs than that enjoyed by more heavily regulated state agencies, with the aim that it compete on more even terms with private insurers. A corollary to this is the recognition that [State Fund] partakes of many of the characteristics of a private company, rather than a governmental organization.”
 - *CASE v. Brown*, 195 Cal. App. 4th 119, 124 (2011) - the authority of the Board over the administration of State Fund is comparable to that of the governing body of a private insurance carrier.
 - *Gilmore v. State Comp. Ins. Fund*, 23 Cal. App. 2d 325, 328 (1937) - “A discretion is conferred on the commission with respect to the proportion of premiums which shall be allowed and distributed in cash dividends to employers who are insured therein.”
 - *Weber Opinion*, Legislative Counsel # 1214213 (Oct. 16, 2013) – Board's authority to implement performance awards program is “consistent with the statutory scheme granting [State Fund] greater freedom to operate”

- Because the Board must act like the Board of a private carrier, the Board should function much like the Board of a private carrier
 - Delegation of duties to committees and President/CEO
 - Strategic rather than operational, as will be discussed more by NACD
 - Decisionmaking should always be focused on what is best for the organization

QUESTIONS?

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Director Professionalism®

Presented to State Compensation Insurance Fund

April 3 – 4, 2014

Presented by:

John Hotta, Dennis McCuistion, & Mike Tankersley

Board of Directors Continuing Education – April 3-4, 2014
Agenda Item 3 – Introductions: Setting Expectations





Agenda



- **Introduction/Expectations**
- **Fiduciary Duties of Corporate Boards**
- **The Role of the Board and Management/Board Dynamics**
- **Creating and Sustaining Board Value: Corporate Strategy and Risk Oversight**
- **IT Governance/Cyber Security Oversight**
- **Committee Discussion**
 - The Role of the Governance Committee
 - The Role of the Audit Committee





Introductions: Setting Expectations

Presented by:

John Hotta, Dennis McCuiston, & Mike Tankersley

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Agenda



1. General Principles
2. Duty of Loyalty
3. Duty of Care
4. Business Judgment Rule





Fiduciary Duties of Corporate Boards

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For-Profit v. Governmental – Similarities



Organizational Similarities

- Existence is derived from state law, prescribing requirements for creation, dissolution, limits of existence, governance, operational powers, objectives
- Organizational details not addressed by statute can be addressed by the board
- Operated by officers, other managers, and employees
- Officers and managers are overseen by a board
- Board, officers, employees owe agency duties to organization – loyalty (organization interests before self), reasonable care, candor, confidentiality





For-Profit v. Governmental – Distinctions



Organizational Objectives

- For Profit: Maximize owner value*
 - Within limits of applicable law, social responsibility
 - Value is generally measured in currency, and results in broad commonalities of focus, structure, challenges
- Governmental: Maximize the mission of the organization*
 - Within limits of applicable law, social responsibility
 - The great variety of governmental missions results in a much more varied universe of focus, structure, challenges

*Drucker corollary: Before you start maximizing, make sure the organization will survive.





Fiduciary Duties of Corporate Boards



General Principles

- The business affairs of a corporation are managed *under the direction* of the board of directors
 - Management—not the board—is responsible for managing the company on a day-to-day basis
 - The fundamental role of the board is to oversee management by monitoring performance and compliance with policies and law
- Directors act as a group, not individually
 - They have the authority as a group to delegate broad authority to management or to make very specific directions
 - A director has no authority individually to order management or employees to do anything, except provide information





For-Profit v. Not-for-Profit



Good news (also bad news) for governmental boards

- What it means to “maximize the organization’s mission” has almost no accepted meaning or analytical framework to guide the board and management
- Failure to use the organization’s assets to advance its stated mission can be an actionable breach of duty by the board and management; failing to maximize the mission is not





Ramifications for Board



- Criteria for mission maximization, and limits dictated by prudence,* should be addressed as part of the organization's strategic planning process
- Existence of a large, diverse board with limited prior experience overseeing comparable organizations requires careful analysis, planning
- Requires a commitment to continuous learning – about appropriate board governance responsibilities and techniques, and about the corporation

*And the Drucker corollary to assure long-term survival before focusing on maximizing.





Fiduciary Duties of Corporate Boards



General Principles

- Corporate directors and officers, as agents of the corporation, owe specific “fiduciary” duties to the corporation that have been developed by the courts:
 - *Duty of Loyalty* – Placing the interests of the company first
 - *Duty of Care* – Acting diligently and competently
 - *Duty of Candor* – Communicating honestly and fully with other directors
 - *Duty of Confidentiality* – Protecting boardroom deliberations and company confidential information from disclosure to outsiders while balancing public rights to information, deliberations





Fiduciary Duties of Corporate Boards



General Principles

- A director shall discharge his/her duties:
 - *In good faith* – Act honestly
 - *With the care* – Be diligent and deliberate
 - *An ordinary person in a like position* – Use common sense and practical wisdom
 - *Would exercise under similar circumstances* – Context matters
 - *In a manner s/he reasonably believes* – Analyze rationally
 - *To be in the best interests of the corporation* – Allegiance to the corporation





Fiduciary Duties of Corporate Boards



Duty of Loyalty

- A director must in good faith (honestly) believe that he or she is acting in the best interests of the corporation and be free from conflicting personal interests
- Litigation alleging breach of the duty of loyalty by directors typically asserts that one or more members of a board that approved a disputed transaction were interested or lacked independence





Fiduciary Duties of Corporate Boards



Duty of Loyalty

- A director is “interested” in a challenged transaction if the director will receive a personal benefit or if the director was on both sides of the transaction
- A director lacks “independence” if the director’s decision is based on extraneous considerations or influences, including personal or professional loyalties
 - When one or more directors have an interest in a transaction, the independence of the remaining directors may be questioned/analyzed





Fiduciary Duties of Corporate Boards



Duty of Loyalty

– Legal Standards

- The legal standard of independence focuses on financial relationships between a director (and affiliated entities) and the company, as well as personal, family, and social relationships.
 - The standard for Independence is a subjective, actual person, fact-specific analysis
 - The standard for independence considers allegations that certain directors are not independent because they are “dominated” by the interested director(s)





Fiduciary Duties of Corporate Boards



Duty of Loyalty*

- Includes the board’s obligation to:
 - (i) Ensure that adequate information, reporting systems, and controls that are in place are designed to reasonably inform management and the board about the corporation’s performance and compliance with the law, and;
 - (ii) Monitor the results of those systems and controls and respond to issues that come to their attention, as identified in the *Caremark* decision, sometimes called the “duty of good faith.”
- Director liability requires a “sustained or systematic failure to exercise reasonable oversight” – a difficult standard for a plaintiff to meet

*Confirmed as a duty of loyalty issue in *Stone v. Ritter (AmSouth)*





Fiduciary Duties of Corporate Boards



Duty of Care

- Directors are required to:
 - Act with the diligence and competence of a reasonably prudent person in a similar position under like circumstances
 - Avail themselves of all material information *reasonably* available to them
- Allegations that a director breached the duty of care typically assert a failure to:
 - Obtain adequate information
 - Give thorough consideration to a decision





Fiduciary Duties of Corporate Boards



Duty of Care

- Directors may rely in good faith on information prepared by officers, employees, committees, and experts
 - If there is a reasonable basis for believing information relied upon is within the person's professional or expert competence
 - Directors may not delegate their fiduciary duties to others and may not make binding agreements to exercise their fiduciary judgment in a specific way





Fiduciary Duties of Corporate Boards



Duty of Care

– Gross negligence

- The standard applied for determining whether there is a breach of the duty of care is gross negligence
 - In the *Disney* case, directors were considered negligent, but not *grossly* negligent





Fiduciary Duties of Corporate Boards



The Business Judgment Rule

- When director action is challenged, the courts will apply the business judgment rule
- The business judgment rule is a judicially developed concept:
 - When the board acts in good faith, and on an informed basis, a court will not substitute its judgment for that of the board and will uphold the board's decision as long as it is based on any rational business purpose
 - Affirmative decisions are protected by the business judgment rule; inaction without board deliberation is unprotected





Fiduciary Duties of Corporate Boards



The Business Judgment Rule

- Does not apply to board action taken where conflicts of interest exist unless the board meets the requirements of approval by majority vote of disinterested, independent directors; courts in those cases apply an “entire fairness” to the company test





Summary



A Director:

- Must be free from conflicting personal interests
- Must obtain adequate information and give thorough consideration to a decision
- Is protected by the business judgment rule when they have acted reasonably
- Where conflicts are unavoidable, they should be acknowledged and their influence on specific decisions analyzed

