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Selecting Your Corporate Board

A well-constituted board of directors can make a company more profitable, more valuable, and less vulnerable to risk. Closely-held corporations and limited liability companies can customize their boards in many ways, including standards for board composition and procedures for electing directors. The right blend of directors (and a mechanism for maintain the right blend, despite turnover on the board) can provide strong leadership and good decision making, valuable expertise, broader networks and credibility in the marketplace, and a means for resolving owner discord without adversarial proceedings.

State statutes provide standards and procedures that apply to board composition and election, but these are one-size-fits-all provisions (referred to as "statutory defaults") that are meant to apply only if a company has not adopted its own, customized provisions. In fact, the statutes recognize that many closely-held companies are poorly served by a board of directors that is constituted according to the statutory defaults, and thus the statutes repeatedly invite companies to consider alternative provisions.

This article will discuss some of the alternative provisions that a company may consider for board composition and electing directors that may be more suitable to the company's unique combination of owners, industry, market, size, and stage of lifecycle. (Note that, although the concept of a board of directors originated with corporations, it can also be applied to limited liability companies.)

Board Composition

Under statutory defaults, a board must consist of one or more natural persons. So the only express qualification is that a director must be a human being. (This would be an unreasonably low bar for almost any position in the company, but especially for a seat on the company's governing body.) However, the statutes state that a company's governing documents may impose additional qualifications. Of course, a company should adopt additional qualifications, but those qualifications do not need to be the same for every seat on the board.

For example, some seats can be reserved for owners. Some seats can be designated as "*ex officio"* seats, to be occupied by whoever is serving in a particular capacity, such as the company's CEO or the CEO of the company's parent company. Some seats can be reserved for "outside directors," which are

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individuals who are not owners or employees but who engage in business with the company, such as the company's lawyer or accountant; and some seats can be reserved for "independent directors," which are individuals who are not owners or employees and do not otherwise do business with the company. The company can, and should, impose additional qualifications on independent directors, such as standards for education, experience, expertise, and objectivity.

Election Procedures

Under statutory defaults, each year, at the annual meeting of shareholders, each director is elected or re-elected to a one-year term by plurality vote of the shareholders (i.e., the candidate receiving the most votes, even if not a majority, is elected). This means that each year, all directors may be removed and replaced. It also means that the largest voting block of shares controls can control the election of every director on the board.

It is easy to imagine that these statutory defaults could be disruptive for a closely-held company and that they could give a disproportionate amount of control to the persons who can vote the largest block of shares, possibly leaving other substantial shareholders with no input as to who sits on the board. Fortunately, a company can also change these statutory defaults in the company's governing documents.

For example, a company may provide greater stability on its board by providing for directors to serve terms that are longer than one year, and providing for the terms of various directors to be staggered to terminate in different years (referred to as a “staggered board”).

Further, a company can require greater consensus for electing directors by requiring that directors must receive a majority (not just a plurality) of share votes to be elected. In the alternative, the company may provide greater input to minority shareholders by allowing shareholders to cumulate their votes and cast them all for one director. (For example, if a shareholder has 100 votes per director and there are three open seats, the shareholder could cast all 300 votes to fill just one seat) (referred to as “cumulative voting”).

Another way for a company to protect minority shareholders or other special interests may be to “classify” board seats so that only a certain class of shareholders or only a particular shareholder may be allowed to elect a director to fill that seat (such a director is sometimes referred to as a “representative” or

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"constituency" director). Even debt holders or other stakeholders can be given the right to elect a representative director through a proxy, voting agreement, voting trust, or similar mechanism. In addition, shareholders can execute agreements among themselves as to how they will vote their shares to fill open board seats.

Conclusion

State statutes provide companies with wide latitude to customize the rules that govern composition and election of their governing boards. Most companies should not rely on the statutory defaults but rather should design rules for board composition and election that will best serve the company, considering its business, its ownership, and other unique circumstances. A well-constituted board should be a valuable source of leadership, wisdom, and stability for the company.

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