

WIGGIN **AND** DANA

*Counsellors at Law*

**Connecticut Innovations  
Executive Forum**

**Composition of the Board of Directors and Director Orientation  
The Basic Duties and Responsibilities of a Corporate Director**

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**Life Cycle Scenario**

**Frank J. Marco**

*and*

**Paul A. Hughes**

**October 3, 2007**



**The Company** ..... Bleeding Edge, Inc.

**Founders and Directors** ..... Frank and Paul

**Third Director** ..... Pauline

**VC Representative to Board** ..... Peter

**Stockholders (“Friends of Paul”)**..... Audience



## The Founding:

### *Activity*

- Frank and Paul, who is full-time CEO
- Novel Software
- No Patents / No Assignments
- And other “angles” invest, and Pauline

### *Issues*

- Duty of care – Protection of corporate assets
- Addition of board member representing individual investors

### *Suggestions*

- Board review of company’s IP position, including:
  - Assignment of inventions to company
  - Explore available IP protection



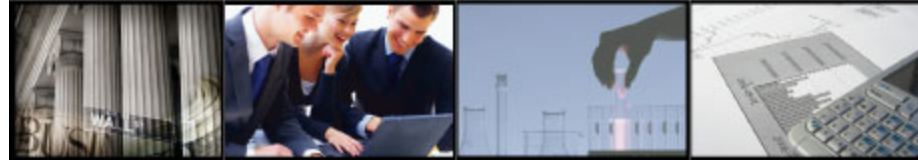
## Month 3:

<i>Activity</i>	<i>Issues</i>	<i>Suggestions</i>
<ul style="list-style-type: none"> <li>• Sell Stock to "Friends of Paul"</li> </ul>	<ul style="list-style-type: none"> <li>• Duty of Care – Monitor compliance with laws               <ul style="list-style-type: none"> <li>– Securities laws and regulations</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Board review of corporate procedures to see that management is complying with law; in particular:               <ul style="list-style-type: none"> <li>– Consider whether company has appropriate counsel</li> <li>– Does each investor meet suitability standards</li> </ul> </li> </ul>
<ul style="list-style-type: none"> <li>• Promise stock to key employees</li> <li>• Projections of value</li> </ul>	<ul style="list-style-type: none"> <li>• Duty of Care – Approval of corporate actions</li> <li>• Duty of Care – Methodology for incenting employees</li> </ul>	<ul style="list-style-type: none"> <li>• Board should approve all sales of stock, reviewing management proposals, overall framework, pricing</li> <li>• Consider structure for selling stock to employees – compensation review, standards, consideration of option plan, vesting terms, etc.</li> </ul>



## Month 4:

<i>Activity</i>	<i>Issues</i>	<i>Suggestions</i>
<ul style="list-style-type: none"> <li>• Building lease from Frank's father; License of software to Paul's Other Company</li> </ul>	<ul style="list-style-type: none"> <li>• Duty of loyalty – Director conflicts of interest</li> </ul>	<ul style="list-style-type: none"> <li>• Use of proper procedures for handling conflicts, including review by board after disclosure, proper approval</li> </ul>
<ul style="list-style-type: none"> <li>• Introduction to Paul's Other Company of vendor useful to the company</li> </ul>	<ul style="list-style-type: none"> <li>• Duty of loyalty – to refer leads to the Company</li> </ul>	<ul style="list-style-type: none"> <li>• Difficulty in preferring one company over another; understand capacity in which lead came to Paul</li> </ul>
<ul style="list-style-type: none"> <li>• Compensation for manager and board (cash and option)</li> </ul>	<ul style="list-style-type: none"> <li>• Duty of Loyalty – Conflict of interest; excessive director compensation</li> </ul>	<ul style="list-style-type: none"> <li>• Delaware law permits directors to set reasonable compensation; differentiate between management directors and outside director</li> </ul>



## End of Year 1:

### *Activity*

- VC Partners Investment
  - 1,000,000 shares of A Preferred for \$5,000,000
  - \$12,500,000 post money value (\$5,000,000 ÷ 40)
  - Peter to be VC board designee
  - 5 person board
    - >Management – Frank, Paul
    - >Investors – Pauline and Peter (as designee of VC)
    - >Mutual Designee - Owen

### *Issues*

- None yet – but, be wary of duty of loyalty issues – duty of directors is to all stockholders, regardless of who elects them or their affiliations

### *Suggestions*

- Due care in approving of this transaction
- None yet – involve counsel when appropriate; consider reviewing fiduciary duty issues with board



## *Activity*

- **Second Tranche**
  - \$5,000,000
  - Achieve milestones
    - >acquire Paul's Other Company
  - VC representative (Peter) must approve "call" of funding

## *Issues*

- Duty of loyalty – Paul's potential conflict: he will benefit as stockholder of Paul's Other Company, so may be conflicted in approving any transaction with them, and might vote against acquisitions that interfere with the acquisition
- Duty of loyalty – Peter's potential conflict: to avoid future funding, Peter might vote against acquiring Paul's Other Company so the Company couldn't hit the milestones and call the second tranche; or might refuse to "call" (more obvious conflict)

## *Suggestions*

- Implement conflict management procedures when appropriate (Paul should disclose conflict and recuse self from deliberations and/or approval)
- Take decision making away from board:
  - Provide that special board committee of disinterested directors to determine advisability of acquisition, and/or
  - Provide that VC will have contractual approval right, as a stockholder, not in capacity as a director
- Assume that Peter is well counseled on how to use cover of business judgment rule



## One Year and One Month:

### *Activity*

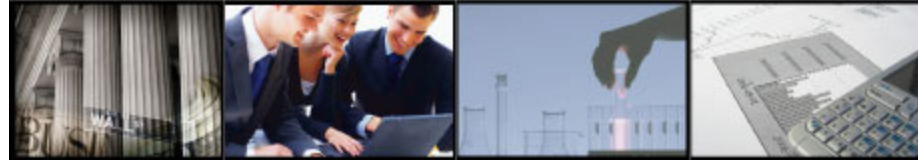
- VP Operations discriminating and harassing; No action taken by Paul

### *Issues*

- Duty of Care – Duty to oversee management / protection of corporation from liability

### *Suggestions*

- Ask questions and review reports from management about operations; Compliance with laws / should be part of board calendar
- Encourage atmosphere of communication, of bad news as well as good, potential liabilities, etc.



## One Year and two Months:

### *Activity*

- To reward Paul, especially in view of his below market salary and value to the Company, the Company makes a \$500,000 loan to assist Paul in relocating and purchasing a new home

### *Issues*

- Should the Company make the loan?
- Conflict of Investor
- The Company is not public so not subject to Sarbanes-Oxley; the loan would not be "grandfathered" once public

### *Suggestions*

- Is the loan in the best interest of the Company / implement conflict handling procedures
- This will come up in connection with an IPO – the board should know that this pre-IPO loan will likely have to be disclosed and will have to be repaid. Consider other compensation alternatives.



## Two Years:

### *Activity*

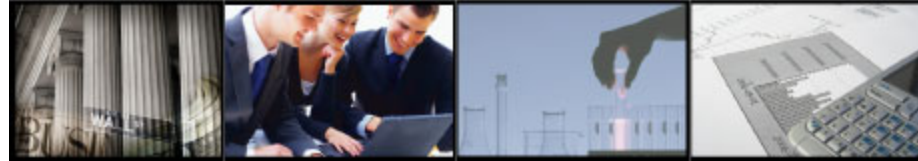
- Company needs more capital: Paul favors "inside" investment at flat value; Valuation believed to be higher; Board approves
- Company out of cash in one month

### *Issues*

- Duty of Loyalty – VC board member's conflict of interest in subsequent rounds
- Duty of care in monitoring financial position

### *Suggestions*

- For conflict:
  - Use independent investor to set value
  - Take inside VC's money on a "bridge" of convertible loan plus warrants to buy stock in next financing
  - Use conflict handling procedures
  - Have "disinterested" stockholders approve and waive conflict
- Monitor cash position and burn rate on ongoing basis and begin planning well in advance



## Two Years and Two Months:

### *Activity*

- The CFO, tired of missing projections, implements some side deals with customers to encourage them to take delivery of products with a promise that they can make returns within six months
- Several friends of Paul complain to the SEC that they were defrauded due to the Company's projections. Under the Company's document retention policy, the projections, emails and other information from two years ago are scheduled to be destroyed.

### *Issues*

- The Company is not public – the CFO hopes the customers will keep the products and if not he will restate the financials
- Is a two-year destruction policy reasonable? Should the Company stop routine destruction of documents even though it's conducted in accordance with its policy?

### *Suggestions*

- All companies should conduct reviews of compliance with law and Company policy, and periodic reviews of adequacy and scope of controls. Consider implementation of "best practices" to position the Company for eventual liquidity event as well as due diligence by lenders, insurers, investment bankers and buyers
- Review composition and role of audit committee
- The document destruction provisions of Sarbanes-Oxley apply to all companies, whether or not public; the policy should have a "stop function" which provides for ceasing document destruction when an investigation is contemplated or commences



## Three Years:

### *Activity*

- Board observer receives confidential information; No confidentiality agreement

### *Issues*

- Duty of loyalty – Duty to maintain confidences by directors
- Observance of proper formalities

### *Suggestions*

- Have observers sign confidentiality agreement
- Consider ability to exclude and protection of privileged communications



## Three Years and One Month:

<i>Activity</i>	<i>Issues</i>	<i>Suggestions</i>
<ul style="list-style-type: none"> <li>Peter impatient with management and prospects; Peter wants to sell – talks to possible strategic buyers</li> </ul>	<ul style="list-style-type: none"> <li>Duty to maintain confidences by directors and to be observant of proper formalities</li> </ul>	<ul style="list-style-type: none"> <li>Get clearance from board before discussing possible sale, after following proper process in deciding about possible sale</li> </ul>
<ul style="list-style-type: none"> <li>Peter talks with VC firm portfolio company / competitors</li> </ul>	<ul style="list-style-type: none"> <li>Duty of loyalty – serving on board of competitor</li> </ul>	<ul style="list-style-type: none"> <li>Conflict clearance procedures, including notice; possible “wall” in VC firm; ensure protection of confidences</li> </ul>



## Three Years and Two Months:

<i>Activity</i>	<i>Issues</i>	<i>Suggestions</i>
<ul style="list-style-type: none"> <li>Peter wants to fire Paul; Paul says "I'm a director" and refuses to leave board meeting</li> </ul>	<ul style="list-style-type: none"> <li>Duty of loyalty – conflicts</li> </ul>	<ul style="list-style-type: none"> <li>Paul should remove self from discussion due to conflict; failing voluntary action, board could vote to exclude him and proceed to vote; better management of the issue pre-board meeting</li> </ul>
<ul style="list-style-type: none"> <li>Peter backs off</li> </ul>	<ul style="list-style-type: none"> <li>Duty of care - meet standards of business judgment rule</li> </ul>	<ul style="list-style-type: none"> <li>Board should not back down from taking proper action – properly deliberate, etc.</li> </ul>



## Four Years:

### *Activity*

- Peter delivers offer to purchase company for \$21 million from a competitor/VC portfolio company
  - \$2 million signing bonuses
  - \$16 million to VC (liquidation preference of \$10 million invested plus \$2 million accrued dividends, and \$4 million “participation”)
  - \$3 million to Common

Instead, Paul wants to take new investor money and continue building value

No experts, no advisors, no process

After two hours, board votes to approve sale of Company

- Paul dissents, Pauline absent

### *Issues*

- Duty of care – Smith v. Van Gorkham
- Duty of loyalty – conflicts of interest
  - Duty owed to equity holders, not Preferred stockholders, despite preferences of Preferred Stock
  - Management Directors
- Implications of dissenting vote by Paul; Where is Pauline?

### *Suggestions*

- Need for more deliberative process of considering first whether sale is appropriate, Company’s business plan, alternative strategies, and whether it would be in best interest of stockholders to sell or continue operations;
- If decide to sell, observe process to maximize value
- Consider handling procedures:
  - Any disinterested directors?
  - Submit to separate vote of disinterested common stockholders
- Record of proceedings, including dissenting vote – roadmap for plaintiff’s lawyer