

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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Why the Concern About Governance/Best Practices?

- Legal Responsibilities
- Avoid Liabilities
 - Stockholders Derivative Action
 - Direct Action
 - Statutory Liabilities (Federal and State)
 - Trust fund taxes
 - Securities
 - Environmental
 - Trade Practices
 - Improper Distributions to Stockholders
 - ERISA
- Better Manage the Company
 - Advice
 - Sounding Board/ Mentors
- Create Value
 - IPO
 - Sale



Outline of Discussion

- What are the Responsibilities of a Corporate Director?
 - Duty of Care
 - Duty of Loyalty
 - Business Judgment Rule

- Fulfillment of Duties of Corporate Directors
 - Director Prerogatives
 - Board Composition
 - Independent Directors
 - Committees
 - Application of Sarbanes-Oxley
 - Common Situations In Emerging Growth Companies



Fundamental Duties of a Corporate Director:

A. General Principles

1. Relationship Between Board and Management – The Duty to Manage:

“All corporate powers shall be exercised by or under authority of, and the business affairs of the corporation managed by or under the direction of, its board of directors ... “

2. Two Basic Functions:

- Decision making
 - Formulation of policy and strategic goals
 - Matters requiring board action by law, charter documents or contract

- Oversight

Not management of day-to-day activities



I. Legal Analysis of the Basic Duties of a Director

A. The Duty of Care

1. What is the Duty of Care?
 - Act in good faith, with care of ordinarily prudent person in a like position under similar circumstances
 - In a manner he or she reasonably believes to be in best interests of corporation

2. Aspects of the Duty of Care
 - Regular attendance
 - Agendas
 - Adequate information



I. Legal Analysis of the Basic Duties of a Director

A. Duty of Care (cont.)

- The right to rely on others and the need to keep informed
 - Officers and employees reasonably believed to be reliable and competent
 - Legal counsel, public accountants and others with respect to matters reasonably believed to be within their professional or expert competence
 - Duly authorized Committees of the Board, in absence of knowledge that reliance unwarranted
 - If relying on others, has responsibility to keep informed of efforts of those to whom work delegated

- Direct
 - Become informed, participate and apply business judgment

- Inquire/ask questions



I. Legal Analysis of the Basic Duties of a Director

B. The Duty of Loyalty

1. What is the Duty of Loyalty?
 - Act in interest of corporation
 - Not in own interest or interest of another
 - Not to make personal profit or gain or other personal advantage



I. Legal Analysis of the Basic Duties of a Director

B. The Duty of Loyalty (cont.)

2. Conflicts of Interest

- Arises if a director has financial or personal interest in contract or transaction, or if the director is to enter transaction involving use of corporate assets or competition against corporation:
 - Financial or personal interest in contract or transaction (“self-dealing”)
 - Using corporate assets to own advantage
 - Competing with interests of the corporation
 - Common directorships
 - Representing interests of others, rather than corporation (e.g., venture capital investors)



I. Legal Analysis of the Basic Duties of a Director

B. The Duty of Loyalty (cont.)

- Handling of conflicts:
 - Disclose: provide adequate information
 - Leave meeting when discussed
 - Abstain from voting
 - Seek approval by disinterested directors
 - Appoint committee of disinterested directors when appropriate
 - Shareholder approval/Approval by disinterested shareholders



I. Legal Analysis of the Basic Duties of a Director

B. The Duty of Loyalty (cont.)

3. Corporate Opportunity

- Make available to corporation before pursue for own or another's account
- Make full disclosure
- Seek prior authorization to pursue



I. Legal Analysis of the Basic Duties of a Director

B. The Duty of Loyalty (cont.)

4. Confidentiality

- Treat all information as confidential until there is public disclosure
- Refer outside inquiries to CEO or person designated by corporation
 - Directors not to be spokespersons or respond to inquiries
 - Directors not to pursue corporate objectives with third parties without authorization



I. Legal Analysis of the Basic Duties of a Director

C. The Business Judgment Rule

1. What It Is

- Create a presumption in Director's favor
- Protects disinterested director from personal liability
- Court will not substitute its judgment for that of director, if:
 - Acted in good faith
 - Disinterested
 - Was reasonably informed
 - Evaluated pros and cons
 - Reviewed material
 - Consulted appropriate experts
 - Active discussions
 - Rationally believed action was in best interests of corporation



I. Legal Analysis of the Basic Duties of a Director

C. The Business Judgment Rule (cont.)

2. The Importance of Process – The leading Delaware case, Smith v. VanGorkom:

- Directors held liable for sale at substantial premium
- No independent financial evaluation or consideration of obtaining additional offers
- No basis for concluding that this transaction was in best interests of stockholders



I. Legal Analysis of the Basic Duties of a Director

C. The Business Judgment Rule (cont.)

3. Duty of Care in Sale of Control Context

- Post “Revlon”
 - Object of directors – generate maximum shareholder value
 - Duty of oversight is heightened
 - “Intense Scrutiny” to process
- Additional issue in a “change of control”



I. Legal Analysis of the Basic Duties of a Director

C. The Business Judgment Rule (cont.)

4. Summary

- Prior to any decisions involving a major event, the board of directors should inform itself as fully as possible
- Applies to non-action as well as action
- Liberal use of independent experts
- Carefully document deliberation on the rationale for the conclusion, free from conflicts of interest



I. Legal Analysis of the Basic Duties of a Director

D. Breach of Duty of Care or Duty of Loyalty

May Result In:

- The board action being held void or voidable; and
- The directors' being held personally liable to the company and its stockholders



II. Fulfillment of Duties of a Corporate Director

A. General Principles

1. What is Oversight:

- Selection of Competent Senior Management
- Establishment of Institutional Norms and Procedures
- Consideration, Analysis and Input into Strategy
 - Formulate by Management/Foundation
 - Strategic, Financial and Organizational
 - Regular review against Plan
- Monitoring of Performance of Management and the Business
- Evaluate Effectiveness of the Board



II. Fulfillment of Duties of a Corporate Director

B. Oversight Responsibilities

2. Responsibility to Oversee Management of Corporation

- Approve and monitor fundamental plans, strategies and objectives
- Evaluate performance of corporation and senior management and take appropriate action
- Select, evaluate and fix compensation of senior executives
- Approve and implement senior management succession



II. Fulfillment of Duties of a Corporate Director

B. Oversight Responsibilities (cont.)

2. Responsibility to Oversee Management of Corporation (cont.)

- Adopt policies of corporate conduct
 - Compliance with laws and regulations
 - Maintenance of controls
- Review process of providing appropriate information to Board
 - Management presentations at board meetings, plant tours, etc.

3. Evaluate effectiveness of Board



II. Fulfillment of Duties of a Corporate Director

B. Oversight Responsibilities (cont.)

4. Promote Best Interests of Corporation and its Shareholders

- Long-term economic objectives primary
- Also consider public expectations
 - Ethics
 - Employees
 - Public/community
 - Creditors
 - Customers
 - Environment

GENERAL RULE – Law only holds board responsible to shareholders; other constituencies are factors that may be taken into account/but should be rational relationship to shareholder value



II. Fulfillment of Duties of a Corporate Director

B. Oversight Responsibilities (cont.)

5. Special Constituencies

- required to exercise independent judgment for benefit of corporation and its stockholders
 - Not to any special constituency
 - Not for any constituency that appointed it
 - Controlling stockholder
 - Strategic partner
 - VC with contractual rights
 - “Zone of Insolvency” – for benefit of creditors
 - Distinguish between capacities – “what hat is being worn?”



II. Fulfillment of Duties of a Corporate Director

B. Oversight Responsibilities (cont.)

- Leading Delaware case of Equity-Linked Investors, LP v. Adams, involving a distressed biotechnology company (Genta Corporation):
 - Board continued Genta's operations by doing massively dilutive financing, instead of liquidating and making distribution desired by preferred stockholders
 - The special protections associated with preferred stock (e.g. liquidation preferences) are contractual in nature and generally the duty of the board is to prefer the rights of the common stock to the preferences and other special rights of preferred stock
 - There was no contractual obligation to make a distribution to preferred stockholders; board's obligation is to do what is right for the company
- Distinguish fiduciary duties to preferred, as a holder of equity



II. Fulfillment of Duties of a Corporate Director

B. Oversight Responsibilities (cont.)

6. Become familiar with Business

- Principal operational financial objectives, strategies and plans
- Results of overall operations and financial conditions
- Relative success of business units



II. Fulfillment of Duties of a Corporate Director

B. Oversight Responsibilities (cont.)

7. Assure Effective and Timely Reporting to Board on:

- Current performance
- Performance compared to objectives
- Planning issues
- Financial statements
- Compliance
- Litigation and regulatory matters

8. Be Prepared and Work

- Should not be passive
- Attend and actively participate in meetings
- Review materials provided in advance of meetings
- Review reports of all meetings



II. Fulfillment of Duties of a Corporate Director

B. Oversight Responsibilities (cont.)

9. Take Your Time

10. Ask Questions – Probe and Test

11. Reliance on Experts

- Chosen with reasonable care
- Is report sensible, result logical, assumptions realistic



II. Fulfillment of Duties of a Corporate Director

C. *A Directors' Prerogatives - Rights to Access Information and Resources Necessary to Perform Responsibilities*

- To Communicate within Reason with Key Executives and other Employees
- To Inspect Books and Records and Receive Other Data Requested
- To Inspect Plants and Facilities
- To Receive Adequate Notice of Meetings
- To Receive Reports of all Board and Committee Meetings
- To Communicate Directly with External Advisors and, When Appropriate, Retain Outside Advice at Corporation's Expense

Can be exercised consistently with the director's duty to oversee the management of the business and affairs of a company (not to manage the business)



II. Fulfillment of Duties of a Corporate Director

D. Suggested Standard Operating Procedures

1. Circulate one week prior to board meeting
 - Agenda
 - Minutes of prior meeting (to be approved at meeting/review for correctness)
 - Background information for meeting

2. Discussions with management
 - Between board meetings/ongoing
 - Regular communications with CEO
 - Do not shield board from bad news – “No Surprises”

3. Presentations by Management



II. Fulfillment of Duties of a Corporate Director

D. Suggested Standard Operating Procedures (cont.)

4. Who sets the agenda for meetings
5. Keep track of “action” and follow-up items
6. Overall goal of constructive communications and constructive dynamics with management

E. The Corporate Record

1. Minutes
 - Minutes – Style: “less is more”
 - Board “back up” files
2. Note taking by directors during sensitive discussions
3. Executive session of the board/Executive Session without Management Director(s)
4. Set Annual Schedules in Advance



II. Fulfillment of Duties of a Corporate Director

F. Disagreement

1. Consider Implications of Split Board Vote
2. May Ask that Dissent be Recorded in Minutes
 - After thorough discussion
 - Not cause for resignation
3. If Believe Disclosure not Adequate or Corporation not Dealing in Good Faith with Constituencies
 - Have corrective action taken, or
 - Replace management, or
 - Resign



II. Fulfillment of Duties of a Corporate Director

G. Committees of the Board

May Rely on Committee on Which do not Serve if:

- Composition Appropriate to Purpose
- Satisfied that Acting in Appropriate Manner
- Kept Reasonably Informed of Activities Through Reports
- Committee Acts Within Legal Authority
- Duties Properly Established



II. Fulfillment of Duties of a Corporate Director

H. Chairman of the Board

- Who Should It Be

- The Role of Responsibilities of Chairman of the Board of Directors
 - Coordinate/Run Meetings
 - Set Agenda for Future Meetings
 - Review Management
 - Proactive Focus



II. Fulfillment of Duties of a Corporate Director

I. Protective Mechanisms

- Fulfill Duties – Adhere to Best Practices
- Hold Harmless Protection
- Indemnification
 - Certificate of Incorporation
 - Contract
- D&O Insurance

J. Are you “managing” or “being managed?”



III. Application of Sarbanes-Oxley to Private Companies

A. Corporate Governance in the New Age of Scrutiny

WHO IS INVOLVED IN CORPORATE GOVERNANCE CHANGES? ... EVERYONE!

The Securities and Exchange Commission

- Congress and the President
- Nasdaq and the New York Stock Exchange
- Industry Associations and Shareholder Groups (e.g., Institutional Shareholder Services)
- Bar Associations
- State Attorneys General



III. Application of Sarbanes-Oxley to Private

B. Background

- Some provisions of Sarbanes-Oxley Act do apply to all companies, whether public or private
- Venture capitalists, lenders, investors, and insurers expect that even private companies will adopt strong governance practices
- Companies planning public or significant private offering of securities should start compliance efforts now, well in advance of first meetings with underwriters or placement agents
- Good governance practices may ease post-merger integration issues, and thus be beneficial in merger negotiations.



III. Application of Sarbanes-Oxley to Private Companies

C. What Acquiring Companies are Concerned About

- Public companies must adhere to the director independence criteria and disclosure obligations established by SEC rules and NYSE and NASDAQ listing standards
- Public company CEOs and CFOs must certify that they have complied with the Sarbanes-Oxley Act (SOX)
- § 906 of SOX imposes criminal liability on CEOs and CFOs who knowingly or willfully furnish inaccurate certifications of periodic reports



III. Application of Sarbanes-Oxley to Private

Companies

D. Which Provisions of Sarbanes-Oxley Apply to All Companies?

- Enhanced criminal liability for **document destruction**
 - Create and implement *document retention policy* as a safeguard
- Enhanced penalties for **securities fraud**
- Enhanced liability for **white-collar crime**
 - Mail fraud, wire fraud are examples
- Signatories to corporate **tax** returns
- Liability for retaliation against “**whistle blowers**”
- Notice of employee benefit plan “**blackout periods**”



III. Application of Sarbanes-Oxley to Private

Companies

E. Which Provisions of Sarbanes-Oxley Should be Considered by Private Companies

- Loan to Executive Officers and Directors
 - Pre 7/30/02 loans are “grandfathered”
- Board of Directors Requirements
 - Majority of Independent Directors
- Audit Committee
 - Establishment
 - Independence
- Codes of Conduct and Ethics



III. Application of Sarbanes-Oxley to Private

Companies

E. Which Provisions of Sarbanes-Oxley Should be Considered by Private Companies (cont.)

- Relationship with Auditors
 - Prohibition of certain non-audit services
 - Pre-approval of audit and permitted non-audit services

- Other Board Committees
 - Compensation, Nominating and Governance

- Financial Disclosure

Consider implementing procedures now to streamline preparation of public reports, increase value and ease transition to reporting obligations once public



III. Application of Sarbanes-Oxley to Private Companies

E. Which Provisions of Sarbanes-Oxley Should be Considered by Private Companies (cont.)

- Certification of Financial Disclosures
- Disclosure controls and procedures

Consider implementing procedures now to streamline preparation of public reports and ease transition to reporting obligations once public



IV. Board of Directors Composition

A. Benefits of Best Practices Board Composition by Private Companies

- An independent board can provide insight, experience, and instructive oversight.
- Voluntary compliance may prevent delays during the IPO process.
- May increase acquisition value by facilitating due diligence and reducing compliance risks for the acquiring company.



IV. Board of Directors Composition

B. Steps towards Best Practices

- Independent directors, especially for audit and compensation committees
- At least one “financial expert” director on the audit committee
- Address potential conflicts of interest with company directors



IV. Board of Directors Composition

C. Composition of the Board

- Number
- Broad Spectrum
- Key Constituencies
- Independent Directors



IV. Board of Directors Composition

D. Director Independence Standards for Public Companies

1. Requirements

- Companies listing on the NYSE and NASDAQ must have a **majority** of independent directors. [NYSE Rule 303A.07(b); NASDAQ Rule 4350(d)(2)(A)(i)]
- And, under Exchange Act Rule 10A-3(b), the Securities and Exchange Commission (SEC) requires that the audit, compensation, and nominating committees: (1) include one independent member at the time of listing, (2) have a majority of independent members within ninety days following the initial listing, and (3) achieve full-independence within one year of the listing



IV. Board of Directors Composition

2. What is an Independent Director ?

- New York Stock Exchange (NYSE)
 - “Independent directors” have no material relationship with the listed company
 - The board of each listing company must determine whether its directors satisfy this definition, and explain its conclusions if a director has a relationship with the company, but the board deemed it immaterial
- National Association of Securities Dealers Automatic Quotations (Nasdaq)
 - “Independent directors” cannot work for the listing company as officers or employees
- The company’s board must determine that the director does not have any relationship that interferes with the exercise of independent judgment in carrying out her duties



IV. Board of Directors Composition

3. A Director is not Independent if ...

- ... they worked for the listed company anytime during the past three years
- ... they, or a family member, have been employed as an executive officer of another company where any of the listed company's present executive officers serve or served at the same time on that company's compensation committee.
- ... they, or a family member, received over \$100,000 in direct compensation from the listed company during any 12-month period in the last three years (with exceptions)
- ... they, or a family member, is a general partner in, or executive officer of, any organization to which the company made, or from which the company received, payments for property or services in excess of certain amounts



IV. Board of Directors Composition

4. Audit Committee

- All public companies must have an audit committee.
- Audit committees typically oversee the company's outside auditors, evaluate the overall audit plan, study and review the internal and external audits, and evaluate and discuss internal financial controls
- Issuers must comply with:
 - SOX § 301 and the SEC's Exchange Act Rule 10A-3, which requires that national securities exchanges and associations establish minimum requirements for audit committees in their listing standards
 - SOX § 407, which requires that issuers have at least one financial expert on the audit committee
- Also, all audit committee members must be financially "literate," or "sophisticated," as determined in the business judgment of the listed company's board
- And, if a member serves on the audit committees of more than three public companies, the board must determine that such simultaneous service does not impair the member's service.



IV. Board of Directors Composition

4. Audit Committee (cont.)

- Financial Expert on Audit Committee - SEC Regulation S-K, Item 407(d)(5)
“Audit committee financial expert” is one who:

- understands and can apply generally accepted accounting principles;
- has experience preparing, auditing, analyzing or evaluating financial statements;
- understands internal control over financial reporting; and
- understands audit committee functions;

and has acquired such attributes through

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.



IV. Board of Directors Composition

5. Compensation Committees

- Like the audit committee, the compensation committees for public companies must be composed entirely of independent directors
- Committee members must satisfy the requirements for "non-employee directors" under Exchange Act Rule 16b-3(b)(3) in order for securities transactions (including share based compensation arrangements) between issuers and their officers and directors to be exempt from Section 16(b) of the Exchange Act
- Under Exchange Act Rule 16-3b, a 'non-employee director' is a director who
 - *is not* currently an officer or employee of the issuer
 - *does not* receive compensation in excess of \$100,000
 - *does not* possess an interest in any other related party transaction for which disclosure would be required under Item 404(a) of SEC Regulation S-K; and
 - *is not* engaged in a business relationship for which disclosure would be required
 - Also, committee members must qualify as "outside directors" for purposes of Internal Revenue Code § 162(m) to preserve the deductibility under that section of certain compensation paid to executive officers.



Evolution of Typical Boards of Venture Backed Companies

Development Stage	Typical Total Number of Directors	Typical Mix	Governance Processes to be Considered
Seed / Product / Technology / Service Development	3 – 4	Management 1-2 VC 1-2 Independent 0-1	<ul style="list-style-type: none"> Typically implemented by the board as a whole
Early Commercialization	4 – 5	Management 1-2 VC 2-3 Independent 1-2	<ul style="list-style-type: none"> Either (a) formally designate specific board members with the responsibility to lead Audit and Compensation Committee functions for the entire board or (b) establish formal Audit and Compensation Committees Those directors responsible for (a) or (b) should take responsibility for implementing corporate governance policies
Late Stage Expansion	5 – 7	Management 1-2 VC 2-3 Independent 2-3	<ul style="list-style-type: none"> Establish formal Audit, Compensation Nominating/Governance Committees Consider naming formal board Chairman Consider implementing public company governance practices, as appropriate
Liquidity (IPO or Acquisition)	7+	Management 1-2 VC 2-3 Independent 2-3	<ul style="list-style-type: none"> Name formal board Chairman/ Lead Director (in IPO process)

Source:
The Basic Responsibilities of VC-Backed Company Directors,
 A White Paper Written by the
 Working Group on Director
 Accountability and Board
 Effectiveness, January 2007



IV. Common Situations in Emerging Growth Companies

- Pricing of “Inside” Rounds by VC Directors
- VC director role in approving Draw Down of Tranches
- Director (or affiliate) also on Board of Competitor/Customer
- Backsliding on Process – Approval of Major Corporate Transactions
 - M&A
 - Liquidation to favor Preferred Stockholder
- “Zone of Insolvency”
- Building of Stockholder Value – Long Term v. Short Term
- Non-Alignment Among VC Board/and with Management
- Dilution to Pursue Business Expansion/Acquisition
- Duties owed to Preferred Stockholders – Contract v. Fiduciary