



ILLINOIS VENTURE CAPITAL ASSOCIATION

BEST PRACTICES FOR BOARDS OF DIRECTORS

NOVEMBER 18, 2008

by: Brian M. Schafer
Partner, Winston & Strawn LLP

I. OVERVIEW - Topics

1. Provide overview of basic duties of directors and identify potential areas of exposure for directors
2. Discuss benefits of a well-functioning Board
 - Value creation
 - Liability protection
3. Highlight potential best practices for Boards of Directors
4. Provide sample “best practices” utilized by Boards
5. Tim Golumb of Nasdaq to provide additional perspective on Board best practices
6. Open discussion of other best practices / what works and what doesn't

I. OVERVIEW - Current Environment; Private Company Boards

1. Challenging economic conditions likely will result in increased lawsuits against private equity portfolio companies and their directors
 - Litigation brought by investors / limited partners has been rare in the private equity context
 - Some increase in activism / litigation from pension funds and other private equity investors
 - As portfolio returns of investors decrease, there will be increased scrutiny by limited partners / co-investors of their investments
 - With increased visibility of private equity and the increase in deal size, there has been greater scrutiny of private equity among regulators, bankruptcy trustees and public pension funds

I. OVERVIEW - Current Environment; Private Company Boards (cont'd)

2. Types of litigation private equity firms and their directors may face:
 - Transaction litigation - broken deals
 - Capital raising – dilutive or below-market terms
 - existing investors may be the only realistic alternative for debt or equity financing
 - Investor suit for poor performance / outside the mandate of the fund
 - Bankruptcy litigation – claims include breach of fiduciary duty, fraudulent conveyance and unlawful dividends
 - directors of an insolvent company may be sued by the company’s creditors or bankruptcy trustee
 - fraudulent conveyance – claim the company was left with unreasonably small capital

I. OVERVIEW - Current Environment; Private Company Boards (cont'd)

- Antitrust investigations / litigation – consortium or club deals
 - Federal securities litigation – following a primary or secondary stock offering
 - Usurping a corporate opportunity
 - Employee lawsuit related to a reduction in workforce
 - Customer or vendor lawsuit related to a material contract
3. With more limited ability of private equity firms to use financial strategies to increase value, there will be a greater emphasis on the ability to create value through strategic and management oversight

II. DUTIES OF A BOARD - To whom does the Board owe duties?

1. Shareholders

- Duties owed to all shareholders, not just those electing a director
- Directors on Boards with diverse shareholder base and potentially differing objectives need to be mindful of duties owed to various shareholder groups
- Increased potential for disputes / litigation with larger and more diverse investor group

2. The “Company” – includes shareholders and other constituencies – employees, customers, suppliers, other creditors, community groups

3. Creditors – when a company moves into the “zone of insolvency”, duties become more focused on creditors

II. DUTIES OF A BOARD - What are the basic duties of the Board?

1. Duty of care

- Directors are required to act in an informed and considered manner and take the care that a prudent business person would when considering a business decision
- Before acting, directors must inform themselves of all material information reasonably available to them
- Courts do not require perfection, but will focus on Board's decision making process to evaluate whether the Board acted in a deliberate and knowledgeable way
- Process is key

2. Duty of loyalty — Requires that a director make decisions based on the best interests of the Company and not any personal interest

II. DUTIES OF A BOARD - What are the basic duties of the Board? (cont'd)

- Questions regarding duty of loyalty arise in many contexts, including
 - sales to or purchases by the Company from directors or related entities
 - financing of an undercapitalized entity by directors or related entities
 - usurpation of corporate opportunities
 - Disclosure of conflicts helps mitigate this risk
3. Duty of Good Faith. Duty to act in a manner that you reasonably believe to be in the best interests of the Company and its shareholders
 4. Duty of full and fair disclosure — Requires Board to disclose fully and fairly all material information within the Board's control when it seeks shareholder action

II. DUTIES OF A BOARD - What standards do courts apply in reviewing Board actions?

1. Business judgment rule — provides a presumption that in making a decision, a Board acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the Company
 - Basic requirements for receiving protection under the business judgment rule are that directors have no self-interest in the transaction, give due consideration of relevant matters and determine action is in best interests of the Company and its shareholders
 - If directors satisfy the requirements, courts will not second guess directors' decisions if they can be attributed to any rational business purpose
2. Heightened scrutiny – for interested transactions, may have to demonstrate the transaction was “fair” to shareholders

II. DUTIES OF A BOARD - Limitation on Liability, Indemnification for Directors

1. Sources

- Fund agreement
- Partnership agreement
- Individual indemnification agreement
- State corporation statutes
- Certificate of Incorporation / Bylaws
- D&O insurance policies

2. Limits on Liability

- Indemnification and limitations on liability may not apply to
 - breaches of the duty of loyalty
 - acts not in good faith
 - transactions from which the director derives an improper personal benefit
 - certain unlawful dividend payments and stock repurchases

III. BENEFITS OF A WELL-FUNCTIONING BOARD

Value Creation

1. Enhances effective decision making at the Board level and improves oversight of the management team
 - Demonstrates for management shareholders and other minority shareholders that the Company is being run for the benefit of all shareholders
 - Helps facilitate a smoother sale of the Company or an IPO
 - Sets the tone for the Company – demonstrates for management the level of detail and attention to process that they should incorporate in the Company's day-to-day operations
2. Greater emphasis on ability to add value through strategic and management oversight

Liability Protection

1. Helps ensure directors fulfill their fiduciary duties
2. Helps mitigate the potential for lawsuits and insulate the Company and the Board from potential claims

IV. ROLE OF THE BOARD – Strategic Oversight

1. Board is responsible for overseeing the business and affairs of the Company
2. Strategic oversight includes:
 - Overseeing strategy and risk
 - Establishing institutional norms and procedures
 - Approving material capital expenditures and transactions not in the ordinary course of business
 - Ensuring integrity of financial controls
 - Approving corporate policies
 - Ensuring the Company complies with ethical guidelines and applicable laws

IV. ROLE OF THE BOARD – Management Oversight

1. Select, monitor, evaluate, compensate and potentially replace CEO and management team
2. Review and approve management's strategic and business plans and monitor corporate performance against such plans

V. BEST PRACTICES/KEY PRINCIPLES - Board Governance Structure

1. Board should adopt governance structures and practices that position it to fulfill its duties effectively and efficiently
 - Tailor governance structures to meet needs of the Company
2. No one-size fits all
 - Governance structure depends on circumstances, including:
 - complexity of business operations
 - composition of shareholder base
 - culture of Board
 - stage of development
 - scrutiny from stakeholders (employees, customers, suppliers, communities, regulators)
 - Encourage experimentation; avoid rigidity
 - Board, not the PE firm, responsible for overseeing the Company
 - Structures change over time
 - Review governance structures on an annual basis

V. BEST PRACTICES/KEY PRINCIPLES - Board Governance Structure (cont'd)

3. Board determines:
 - How it should be organized
 - How it should function
 - How to order its priorities
4. Consider establishing a set of Board priorities (and reviewing on an annual basis)
 - See precedent “Matters Reserved for Board” – Excellere Capital Partners precedent
5. Maintain distinction between Board and management - need objective judgment of management performance
 - Consider separation of Chairman and CEO positions

V. BEST PRACTICES/KEY PRINCIPLES - Board Governance Structure (cont'd)

6. Other potential structure issues for Board to decide
 - Use of Board Committees
 - Audit Committee
 - Compensation Committee
 - Independent / Special Committees for certain transactions
 - Oversight of committees
 - committee's composition, including experience and independence from management, should be appropriate for its purposes
 - make efforts to stay aware of activities of the committee
 - duties of committee should be clearly defined and periodically reviewed
 - Executive session of the Board (without management present)
7. Governance structures and practices should be designed to promote an appropriate corporate culture of integrity, ethics and corporate social responsibility
 - Consider adopting a Code of Ethics

V. BEST PRACTICES/KEY PRINCIPLES - Composition and Selection of Board Members

Composition and Selection of Board Members

1. Ideal Board size: No one size fits all
 - Directors should consider the nature, size and complexity of corporation as well as stage of its development
 - Smaller boards tend to be more cohesive and work more effectively than large boards
2. Board composition
 - Directors with relevant business and industry experience provide a useful perspective on significant risks and competitive advantages and an understanding of the challenges facing the business

V. BEST PRACTICES/KEY PRINCIPLES – Composition and Selection of Board Members (cont'd)

- A diverse collection of backgrounds and experience is key
- Because a Company's needs change over time, the board should monitor the mix of skills and backgrounds that directors bring at each stage in the life of the corporation
- Consider inclusion of representatives of minority shareholders

3. Ideal characteristics include:

- Ability to devote time and careful attention to fulfilling their duties (e.g., reviewing meeting materials, attending meetings, monitoring the performance of the Company's management and other directors)
- Specialized knowledge of the business and the industry
- Objectivity
- Ability to reach consensus
- Staying informed on the business and industry

V. BEST PRACTICES/KEY PRINCIPLES – Composition and Selection of Board Members (cont'd)

4. Precedent (Director Recruitment and Selection Materials – Excellere Capital Partners precedent)
5. Consider establishing guidelines which:
 - Encourage members to limit the number of boards they serve on
 - Communicate expectations re: the time and energy expected of each member
6. Consider including independent directors
 - For a Company considering a potential IPO, consider moving towards compliance with SEC and exchange rules re Board composition and governance

V. BEST PRACTICES/KEY PRINCIPLES – Board Meeting Mechanics

1. Establish regular Board and Committee meeting calendar
2. Information exchange and documentation
 - Board must be actively engaged in determining its own priorities, agenda and information needs
 - Board and Company management should work together to identify the type and quantity of information to be provided on a periodic basis
 - In advance of meetings, distribute Board book with draft agenda, documents for review and proposed resolutions

V. BEST PRACTICES/KEY PRINCIPLES – Board Meeting Mechanics (cont'd)

- Crisp reports distributed in advance of meetings should reduce the need for lengthy management presentations in most meetings so that maximum time is preserved for discussion
- Comply with corporate organizational documents – e.g., advance notice of meetings, quorum requirements, etc.
- Accurately document the process followed and decisions reached by the Board
- Distribute minutes of meeting for review and ratification promptly after each meeting
 - Board record should document the decision making process in a deliberate and methodical manner, but should not become a full transcript of a Board meeting
 - Board meetings and other records will be reviewed by potential acquirers

V. BEST PRACTICES/KEY PRINCIPLES – Board Meeting Mechanics (cont'd)

- If you choose to keep notes of Board meetings or conversations, make sure they are accurate, complete and free from material which someone could misunderstand out of context. The Board minutes are the official record of Board proceedings.
- Have legal counsel review Board books, minutes and resolutions
- Communicate / disclose to shareholders all material items in accordance with governing documents and applicable regulations

V. BEST PRACTICES/KEY PRINCIPLES – Board Meeting Dynamics

Board Meeting Dynamics:

1. Exercise due care in making decisions:
 - Avoid haste and appearance of haste
 - Review carefully all documents before approving them
 - Ask questions and probe and test all information
 - Consider whether advise of outside advisors is appropriate
 - Fairness opinion / solvency opinion
 - Consider advice of corporate officers and employees with relevant information
2. Engage in real discussion of agenda – not just a rubber stamp
3. Give all directors an opportunity to be heard

V. BEST PRACTICES/KEY PRINCIPLES – Board Meeting Dynamics (cont'd)

4. Allow sufficient time for a meeting so that all agenda items can be carefully considered (e.g., avoid hard-stop deadlines whereby remaining agenda items may not receive sufficient attention)
5. Disclose to the Board all existing material relationships (financial or otherwise) in order to identify and help avoid any potential conflicts of interest
 - Consider establishing a process and/or ethical guidelines whereby a Board member is recused from consideration of, or approval of, certain self-interested transactions
6. Substance of Board deliberations should be kept confidential

V. BEST PRACTICES/KEY PRINCIPLES – Other Best Practices

1. Review and analyze D&O insurance on an annual basis
2. Provide financial incentives (e.g., stock ownership, option awards, etc.) to focus Board on optimizing long-term value for shareholders
 - Hire consultant to advise on Board compensation issues
 - PE directors typically do not receive fees
3. Have legal counsel review with new Board duties of the directors and Board mechanics
4. Perform meaningful Board evaluation (including self-assessments) on a continual basis for each member, the full Board and each committee