



Counsel for
BOARD AND EXECUTIVES

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Acredula is the Latin word for “owl,” connoting wisdom. This newsletter is intended as wise counsel for boards and executives. Acredula is available to clients and friends of the firm. It is not to be construed as legal advice or opinion.

Bad facts often result in bad law, whether made by a court or a legislature. The language of the holding resulting from the bad facts in *Schoon v. Troy Corp.* is bad law. During the director’s term of office, the corporation’s bylaws provided that “the Corporation shall pay the expenses incurred by any present or former director . . . reasonably incurred . . . in defending any threatened or pending Proceeding . . . in advance of the final disposition.” After the director “resigned due to health problems,” the corporation amended its bylaws to “delete former directors from entitlement to advancement.” The spouse of the former director, who had died in the interim, argued that a director’s right to advancement of expenses vests “when he took office” and that the corporation could not subsequently terminate that right without his consent. The court rejected that argument, holding that the right only vests upon “the date of the filing of the pleading against him.”

EDITOR’S NOTE

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The court’s holding ignores a plethora of precedent that nothing should be done that will result in discouraging outside persons, especially those who are independent, from being directors. Oversight by outside persons is not only the best defense against mismanagement and fraud, but also the best offense for good management and

governance. Persons deciding to become or continue as directors should be able to rely upon bylaw provisions in effect at the time of their decision to serve as directors.

Thanks to the holding of the court in *Schoon*, persons deciding to become or continue as directors of a Delaware corporation cannot rely upon any bylaw protection unless it is still in place at the time of a legal action against them.

As discussed in the article by Kevin Kinross, “Do you want protection? – Better get it in writing,” the solution for

directors of the Delaware corporation, and a consideration for directors of any corporation, before accepting or continuing any directorship, is to set forth their rights to indemnification in an indemnification agreement, separate of the bylaws, that is between the corporation and each director.

Although bad facts have apparently resulted in bad law in Delaware, corporations as well as directors should review their organization’s governing documents and consider separate indemnification agreements to ensure the willingness of independent persons to continue as directors.

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The Crunch On Director Responsibility: A storm is brewing

By

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and



By

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A storm is brewing! After 2002, the tides turned on corporate America. The collapse of Enron, then Adelphia, Dynegy, ImClone, Qwest, Tyco, and WorldCom captured the headlines. All of which fueled the distrust of corporate boards and executives and led to Congress, regulators like the SEC, and self-regulating organizations like the NYSE and NASDAQ to increase the responsibility of independent directors for oversight of the integrity of financial statements, the reasonableness of executive compensation, the independence and competence of directors, and the legal and ethical conduct of business.

Fast-forward six years and corporate America again has a target on its back. The credit crisis, which has evolved into a credit crunch, has beaten down financial institutions. And while all of the headlines surrounding the credit crunch, and its impact, are focused on financial institutions, you can anticipate the storm against organizations that have had nothing to do with the credit crunch.

The credit crunch is impacting the cost and availability of credit for all organizations, and increasing expense of operations as well as risk of liability threatening the organization's enterprise. Accordingly, all organizations should review the availability of credit and the increased risks of liability to the enterprise inherent with any debt. Organizations may regret if they fail to quickly and thoroughly make such review. And, who will be the likely targets for such failure? Directors.

Similar to 2002, a safe bet is that directors will be at the forefront of inquisition because they are the gatekeepers of the enterprise risk of any organization. Unfortunately, bad facts involved with a total absence of review directed by directors will likely result in bad laws and precedence on how courts evaluate the decision-making process of directors of all organizations: public, private, for-profit, and non-profit.

Directors are bound by the fiduciary duties of care and loyalty. These duties require directors to act as reasonably prudent persons would act in like or similar situations and to make decisions that are in or not opposed to the best interests of the organization. In recent years, the duty of loyalty has garnered the most attention by commentators, government, and the plaintiff's bar; however, the duty of care will be the focus as attention is turned to enterprise risk-management.

To comply with the duty of care, directors must make, and document, an effort to be reasonably informed on all matters that come before the board. This includes having officers or professionals, on whom directors may rely, gather and analyze the data necessary to evaluate the enterprise risk to the organization of its debt as affected by the credit crunch. A court's review of the exercise of the duty of care will focus on a board's decision-making process. And remember, everything looks different in a rear view mirror. Accordingly, for their protection, the directors' focus must be on "process", and they must understand, prioritize, and develop action plans to maximize credit benefits and mitigate credit risks.

First, the exercise of the duty of care requires directors to be informed, prior to making a business decision, of all material information reasonably available to them. However, to rely upon such information, the duty of care requires them to have a reasonable belief in its reliability and competence. The information should be documented in writing and retained, perhaps by the organization's legal counsel, for the directors' protection.

Second, the exercise of care requires directors to do their homework, review critically the information presented, ask questions, request additional information, and follow up on any concerns. Directors need to be particularly alert for red flags or danger signs so that problems can be considered and addressed in a timely manner. The exercise of this diligence should be documented, in summary fashion, in minutes of the directors' proceedings.

In recent years, the duty of loyalty has garnered the most attention by commentators, government, and the plaintiff's bar; however, the duty of care will be the focus as attention is turned to enterprise risk-management.

Third, to enhance their protection, directors should consider obtaining, as necessary, expert advice from inside and outside the organization. Again, any such advice should be in writing and retained, perhaps by the organization's legal counsel, for the directors' protection.

Fourth, given the time and effort such exercise of care may require, boards should consider delegating authority to conduct such review to a committee of directors. In the past, this committee was often the audit committee. But this may be too great of a burden on audit committees in the post-Sarbanes-Oxley environment. A special risk management committee composed of directors familiar with debt and other risks to an organization's enterprise may be more appropriate. The proceedings of any such committee as well as its actions or recommendations should be documented, and such documentation retained, again perhaps by the organization's legal counsel, for the directors' protection.

Fifth, directors will need to broaden their view of risk and not limit discussions or analysis only to specific areas of risk. This will require directors to evaluate the role their board is currently playing in

risk oversight, and make changes where necessary. Directors need to take the position that they are not just looking for fires to put out but should also be proactive to ensure that the fires never start in the first place. The proceedings of this evaluation and the resulting changes should be documented, again perhaps by the organization's legal counsel, for the directors' protection.

Finally, directors must work with management and recognize the challenge that confronts them. Directors in today's world must commit time and effort to understand the issues and activities associated with the risk of the organization's business operations. This challenge has become more difficult as directors may be functioning under a false sense of security. The false sense was created, ironically by the increased focus on creating internal controls to help.

Similar to how all directors today face increased scrutiny and exposure as a result of the actions of those directors of Enron, WorldCom and Tyco. Tomorrow's directors, regardless of the industry in which their organizations operate, might all be seeking cover from the storm unleashed by those who helped usher in the credit crunch.

Do you want Protection? Better get it in writing

It is generally understood that under most state's laws corporate directors enjoy various forms of protection that provide a shield from liability for their actions as a corporate director. Such protections include the business judgment rule, statutory indemnification, D&O insurance policies, and even indemnification agreements, which may include rights beyond those provided by statute and advancement of legal fees.

While these principles are generally understood, it may nevertheless come as a surprise to many that an organization's ability to adjust the provisions may even include the ability to eliminate former directors' advancement rights, at least according to Delaware Chancery Court's recent opinion in *Schoon v. Troy*.

In *Schoon v. Troy*, the court was faced with a claim for indemnification by a former director of Troy Corporation, William Bohnen. Mr. Bohnen resigned in February 2005. Later that year, Troy amended its bylaws to eliminate the right of former directors to advancement of expenses incurred to defend claims. A few months after amending the bylaws, Troy sued Mr. Bohnen and another Troy director for breach of fiduciary duty. Mr. Bohnen asked Troy to advance his defense costs. Troy declined, Mr. Bohnen sued and lost. The corporation's bylaw had originally provided that "the Corporation shall pay the expenses incurred by any present or former director."

The Chancery Court held that while a bylaw amendment cannot rescind a vested contract right,

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Mr. Bohnen’s right to advancement was not vested at the time of Troy’s bylaw amendment because no claim had been made against him at that time even though the incident, or the act or omission, giving rise to the claim arose while the right to advancement existed. In doing so, the Court rejected Mr. Bohnen’s argument, holding that the language of the original bylaws did not preserve his right to advancement because his right vested *only* after the amendments took place, at the commencement of litigation.

With *Schoon*, until an actual claim is asserted against a director in a proceeding for which the director would ordinarily be entitled to advancement of legal fees, the director has no vested legal right to advancement, and yes, the director’s rights can be lawfully terminated. Prior to this decision, it was well accepted and understood that the purpose of indemnification and advancement is to encourage board service and assure directors that their expenses relating to their official actions will be repaid – even if litigation arises after they resign from the board. Now this can no longer be accepted as true.

If you are a director reading this article, then yes, shock is the appropriate word to describe what you are feeling. Especially since the purpose of indemnification and advancement is to encourage board service and assure directors that their expenses relating to their official actions will be repaid.

In light of this ruling, the only certain way for directors to avoid Mr. Bohnen’s fate in *Schoon* is to insist that the corporation provide indemnification rights via a separate agreement, which as a formal, written contract cannot be amended without the director’s consent. Corporations may also consider including in their bylaws a provision intended to override the *Schoon* principle—such as a clause to the effect that “any repeal, modification, or amendment to these indemnification or advancement provisions shall not adversely affect any right in respect of acts or omissions of any indemnified person occurring prior to such repeal, modification, or amendment.” There is no apparent downside to such a provision, but there can be no assurance that it cannot be amended away just as in *Schoon*.

At the same time, however, directors must remember that most D&O liability insurance policies include former directors within their definition of insured persons, and that under most circumstances a former director for whom advancement and indemnification has been withheld should still have a right to seek defense expenses and indemnification under such policies. Thus, an organization’s D&O policy should provide adequate protection even for former directors – assuming that the limits available under the policy were not exhausted by other insured persons. Further, former directors who are concerned that they may be exposed with no protection can now also consider a “retired director and officer liability insurance policy.” This kind of coverage, which is popular in England and Australia, which is currently only being offered by a few carriers, are noncancelable and nonrescindable, and provides coverage for up to 6 years after the director resigns, retires or is fired.

The point being, that the director in *Schoon* lost his expected right of advancement after he left the board. Directors concerned about their rights following board service will want to fully consider any available protection.

At a minimum, this holding stresses that for a director to be guaranteed protection, without any personal out-of-pocket expense, the director needs to have his or her own separate indemnification agreement with the organization. Such agreements will reduce the possibility that a later board could eliminate advancement rights after the director has left board service. Without a separate agreement, directors now have no reasonable assurance that after they leave the board their rights to advancement and indemnification will be preserved. If you want to ensure that your rights to advancement and indemnification will be preserved, its simple - ***you better get it in writing.***

If your organization has not reviewed its articles or code of regulations in several years and either or both may be outdated, good corporate governance suggests you contact your corporate attorney to begin a review. In doing so, your organization’s governing documents may be updated to provide the greatest protection to your board.

If you are a director reading this article, then yes, shock is the appropriate word to describe what you are feeling.

Thinking of becoming a director?

Congratulations! You have been asked to serve as a director. Now what? Deciding whether or not to serve as a director for any corporation is a difficult decision that must be considered carefully. Being a director is hard work, and while it can be an extremely rewarding and beneficial experience, one should not agree to serve without learning specific information about the corporation, including whether the corporation is private, public, for profit, or nonprofit.

Below is a checklist to assist anyone considering becoming a director to help facilitate their consideration of whether to accept the role.

- **Company expectations.** Discuss with the chief executive officer and, if different than the CEO, the boards chair the expectations of directors, including the frequency, typical duration and dates of meetings; expected availability of directors between meetings; any continuing education required of each director; any customer or client referrals expected of each director; and any charitable contributions required of each director.
- **Directors' qualifying shares or contributions.** Determine whether directors are required to purchase or otherwise own a minimum number of shares of capital stock and, if so, whether such shares are to be purchased at market or from the company, and, if from the company, at what price. For nonprofit corporations, one must determine if directors are expected to donate a specific financial contribution to the organization on a yearly basis.
- **D&O insurance.** Determine type of policy, policy limits (including deductible or retention), and endorsed coverages (securities law liability, ERISA, employment practice) of the company's directors and officers liability insurance. Have policy reviewed by lawyer or insurance consultant.
- **Directors' indemnification agreement.** Determine whether directors are indemnified by the company against liability and the extent of such indemnification under the company's governing documents. Consider seeking an indemnification agreement from the company and have this agreement reviewed by a lawyer in order to ensure this protection continues after your service has concluded and to ensure that you will receive advancement of fees immediately upon a claim being made.
- **Net worth.** Determine the company's net worth and the extent of its current assets to provide directors' indemnification.
- **Compensation.** Determine compensation of board members, including annual retainer and meeting fees (both board and committee); form of payment (cash or stock); ability to defer receipt; and policy for reimbursing expenses. Typically, compensation is a combination of an annual retainer for time spent in preparing for meetings and meeting fees. The amount of compensation should be commensurate with the work required and risk of liability.
- **Audit committee financial expert.** Determine whether the company's audit committee has someone meeting the Sarbanes-Oxley definition of an audit committee financial expert.
- **Committee assignments.** Determine committee assignments that you are likely to have. Do you believe you have competency in the matters handled by each such committee?
- **Board vacancies.** Determine whether there are any vacancies on the board, and if so, inquire why.
- **Other independent directors.** Determine the number of directors or non-management directors and their identity.
- **Discussions with other independent directors.** Discuss with other independent directors their perceptions of the company's business, the experience and competency of management, and the conduct of board meetings, especially the materials distributed (and whether in advance).
- **Oversight committees.** For those considering a seat on the board of a publicly traded company

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one must determine whether the company has required oversight committees (NYSE and NASDAQ require audit, compensation, and nominating committees) and the extent the composition of these committees consists of non-management directors.

- Discussions with the audit partner. Primarily, for those considering a seat on the board of a for profit corporation, consider discussing with the audit partner the company's cooperation in the audit process; critical accounting policies that the auditor believes the board should know; and the effectiveness of the company's internal accounting controls.
- Discussions with management. Discuss the company's prospects with the chief executive, chief financial, and chief legal officers. Do you feel they are competent and reliable? Is the chemistry between you and them good?

- Annual report. Those considering a seat on the board of a publicly traded company should review the notes to financial statements, as well as the management discussion and analysis of financial information in the company's most recent annual report to shareholders or Form-10-K annual report filed with the SEC. Do the disclosures make sense? Are they written in understandable English? Are there any problems you did not anticipate?
- Director orientation. Inquire whether the company will conduct or sponsor any form of orientation of you as a new director and, if so, by whom and when.

Finally, you should consult with legal counsel with any questions or concerns you have with the information you receive from the company, including review of the D&O policy, directors' indemnification agreement, and the company's annual report (if applicable).

Attributes Of Quality Board Members Asks Simple Penetrating Questions



By
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As the owner of a private company, you have formed and invested in a board of advisors or board of directors to bring value to the company. That value comes in part from the unique attributes that the outside directors bring with them to their board participation. Using and leveraging those unique talents of each of your board members multiplies the return to the company.

Years of participating on the boards of private and public companies have made it clear that certain attributes of outside board members are important to achieving the purpose of a productive and effective board of directors.

This series of articles will consider and describe some of those attributes. As you consider the composition of your board, these articles are meant to provide you with thoughtful insight for enhancing its performance.

This fourth article will discuss the attribute of ASKS SIMPLE PENETRATING QUESTIONS.

As a board member the job of asking the right questions is fundamental to the value and responsibility

of the board. Critical questioning is the road to not only understanding the business but also knowing the management.

Asking questions that get to the heart of the issue or the core of the business not only informs a board member, it also focuses the owner or managers on root causes. Questions that probe the deep and fundamental "why" need not be complicated; in fact, the simpler the question the more likely the answer can uncover real issues and lead to effective solutions.

When considering what questions to look for from your board, remember this guiding principle: Simple and direct questions help the business and the managers analyze, consider, understand and think in new ways. In addition simple, direct questions have the following beneficial attributes:

- They enhance knowledge of the business
- They stimulate the discussion
- They encourage new thinking
- They allow listening and learning

- They demonstrate that both the board and the management have the interest of the business at heart

On the other hand, board members ought to avoid asking questions merely to:

- Demonstrate knowledge of the issue or question
- “Trap” or “trick” the respondent

Experience indicates that board members who ask good questions and managers who provide straight answers build trust as a team, resulting in a strong business model.

New members of the company’s board may ask questions to build a basic understanding of the company. Experienced, long-term board members may ask questions to check the strategic compass of the company. Both new and long-term board members, however, need answers that may seem simple but are actually critical to the health of the company and the value of the board.

Following are some sample questions you might be looking for from your board:

- What is the company’s real or most likely vulnerability?
- Is the business leadership backed up with identified and qualified successors?
- What plans are in place to ensure the company’s growth?

- How does the company stack up against the competition?
- Is the company getting appropriate prices and margins for its products or services?
- How does the management get paid?
- Does bad news travel as quickly and easily as good news?

In recent years the media has reported examples of companies in which the board listened to only good news, failed to ask penetrating questions and/or accepted inadequate answers to probing questions. Enron, WorldCom and Adelphia are good examples of companies that lacked governance by the board. Good governance includes asking simple and appropriate questions that get to the heart of fundamental issues. It’s beneficial to the business when board members get comfortable with the process of asking management what is underlying the results and what is the forecast. Encourage questions from your board that test the fundamental strategy and goals of the company.

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Questions that probe the deep and fundamental “why” need not be complicated; in fact, the simpler the question the more likely the answer can uncover real issues and lead to effective solutions.

The “What” and “Why” of Advisory Boards

Do you sit around during the day or up a night asking the following question:

“My company has grown in revenue each of the last 3 years but now it has plateaued, how do I get it back on track to accomplish future revenue goals?”

If so then it might be time to form an advisory board. But first, it is likely that your company is not “off track” but simply that your management team has taken the organization as far as it can with

the skills present among management. Second, however, if you do discuss this question in management meetings or have thought it yourself then it might be time for an advisory board.

What is an Advisory Board?

An advisory board is a select group of advisors chosen by the company, who lend insight and counsel to the owner, chief executive officer, or management team. Advisory boards provide independent and objective advice and mentorship, and

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An advisory board will only be effective if the company is willing to expose its skeletons and share its ideas.

allow the organization to tap into the knowledge and experience of others that might not be present currently among the company's management.

Most advisory boards consist of 3-5 members, which provide counsel, advice, contacts and complementary competencies that go beyond that of the management team. Advisory boards have no statutory fiduciary duties and serve at the will of the company. It is important to recognize that an advisory board does not replace the company's statutory board. The true benefit of an advisory board is that it helps companies focus on business strategies and the issues that matter most as they grow and prosper.

Why Create an Advisory Board?

Growing companies benefit from advice and counsel of skilled advisors to supplement management's knowledge and experience. Advisory boards lend insight and perspective to business strategies while leaving the implementation to management and employees of the company. Further, an advisory board can:

- Help determine benefits and risks;
- Generate contacts and potential resources;

- Mentor management;
- Provide industry expertise;
- Assist with succession planning; and
- Help hold management accountable to deadlines and tasks.

A good advisory board can be a powerful tool to aid the growth of your company. In order to make the most effective and efficient use of your advisory board you must be willing and able to:

- Confide in others about yourself and your business;
- Present key strategic issues for consideration of others;
- Be able to accept criticism; and
- Take the necessary time to prepare for meetings and communicate.

An advisory board will only be effective if the company is willing to expose its skeletons and share its ideas. While a company's statutory board provides oversight of the company, an advisory board provides discretionary advice for the company as it develops strategies and helps the company reach their future goals and aspirations.

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