

# Bare Bones Board Basics - for the Private Company

## Episode #2 - Public v. Private & Fiduciary v. Advisory: Different Boards for Different Situations

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### Panelists

Jonathan Friedland • Will Clarke  
Bob Lerner • Kathleen Murray



# Public v. Private & Fiduciary v. Advisory: Different Boards for Different Situations

- This 2<sup>nd</sup> episode of the series compares and contrasts:
  - a) Advisory boards.
  - b) Fiduciary boards of private corporations.
  - c) Fiduciary boards of public corporations.
  - d) Managing members of limited liability companies.
  
- This is the second in a series of webinars produced by certain chapters of the [Private Directors Association](#) in association with [Financial Poise™](#), [Executive Forum™](#), [Vistage®](#), [Private Director Symposium™](#) & [ChamberWise™](#) to make you a more effective board member.

# Bare Bones Board Basics- for the Private Company

- #1 Series Overview / Preview- Aired *November 11<sup>th</sup>*
- #2 Public v. Private & Fiduciary v. Advisory: Different Boards for Different Situations- *January 26<sup>th</sup>*
- #3 Where the Board's Duties Stop & the C-Suite's Duties Begin: An Overview of a Board's Functions & Fiduciary Duties- *February 23<sup>rd</sup>*
- #4 How to Conduct a Board Meeting- *March 30<sup>th</sup>*
- #5 Committees of a Board & Work Between Board Meetings- *April 27<sup>th</sup>*
- #6 Recruiting & Renummerating Directors & What Directors Should Do Before Saying Yes – *June 8<sup>th</sup>*

# Bare Bones Board Basics- for the Private Company (cont'd)

- #7 Special Issues Require Special Attention: Retaining Experts & Conducting Investigations- *July 13<sup>th</sup>*
- #8 Soft Skills Workshop: Leadership, Communication & Trust- *TBD*
- #9 Enterprise Risk Management- *TBD*
- #10 Going into Executive Session- *TBD*
- #11 The Workings of the Audit Committee- *TBD*
- #12 The Workings of the Compensation Committee- *TBD*

# Session #2 Panel

1. Will Clarke - Clarke Growth and Sustainment Strategies
2. Jonathan Friedland - Sugar Felsenthal Grais & Helsinger LLP
3. Bob Lerner - Monimus Capital Management, LP
4. Kathleen Murray - Board Member, Angel Investor and Advisor

# Types of Boards

- a. Advisory v. Fiduciary (a/k/a/ Statutory)
- b. Private v. Public
- c. Profit v. Nonprofit

# Requirements for *any* Effective Board

- a. Strong leadership
- b. Clear delineation of responsibilities & expectations
- c. Qualified committee members with diversity - of experience, thought, abilities
- d. Collaborative spirit

# Fiduciary Boards

- a. Governance board formed to represent shareholders of a company
- b. Technically required for all corporations
- c. In practice, vast majority of boards of for-profit companies are paper boards
- d. Legal responsibilities - “Nose in - fingers out”
  - i. Overseeing managerial activity (monitoring)
  - ii. Offering expertise, knowledge and support to the management (resource)
- e. Owes ***fiduciary duties*** to all stakeholders and company

# Fiduciary Duties & the BJR

- a. Duty of loyalty - obligation to make decisions in the best interest of company, not personal interest
- b. Duty of care - obligation to be informed and follow the process
- c. Business Judgment Rule - presumption that in making a business decision the directors acted on an informed basis, in good faith and with the honest belief that the action taken was in the best interests of the company and its shareholders
- d. Each board member is considered *individually*

# Special Considerations During Insolvency

- a. Solvent corporation - fiduciary duties owed to company and its stockholders only (no duty owed to creditors)
- b. “Hopelessly” insolvent company - fiduciary duties owed to creditors only (but usually expressed as the “enterprise” or “residual owners”
  - i. *Some exceptions.* For example, nonprofits in NY - Unlike for-profit corporations, even when insolvent, board must balance interests of creditors against interest of preserving & observing organization’s charitable purpose. See *In re HHH Choices Health Plan, LLC*, 554 B.R. 697, 704 (Bankr. S.D.N.Y. 2016)

# Special Considerations During Insolvency (cont'd)

a. Zone of insolvency (Old Rule) - fiduciary duties owed to both shareholders and creditors

i. **But wait...** *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 2007 Del. LEXIS 277 (Del. Supr. May 18, 2007)(holding directors of a solvent company in Zone do **not** owe fiduciary duties to creditors; their “focus ... does not change” and they continue only to owe fiduciary duties to stockholders)

b. Don't abandon ship!

i. *Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings, Inc.)*, 2008 WL 2235330 (Bankr. D. Del. May 30, 2008) (holding D&Os of distressed companies should not abdicate duties and if directors fail to inform themselves fully and in a deliberate manner, they lose the protection of BJR)

# Conversational Lawyer-Speak for the Non-Lawyer

- a. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)- holding board of directors breached duty of care owed to corporation's shareholders when board quickly approved merger without substantial inquiry or any expert advice.
  
- b. *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996)- holding to satisfy its duty to stay informed and oversee company's exposure to risk, board must make good faith efforts to implement information and reporting system).

# Conversational Lawyer-Speak for the Non-Lawyer (cont'd)

- c. *In re Walt Disney Co. Derivative Litigation*, 2005 WL 1875804 (Del. Ch. 2005)- often cited regarding application of the business judgment rule and requisite standard for proving directors breached fiduciary duties by failing to inform themselves of all material information reasonably available before making a business decision.
  
- d. *In re Emerging Communications, Inc. Shareholder Litigation*, 2004 WL 1305745 (Del. Ch. 2004)- holding court must evaluate directors' duty of care obligations individually; and individual directors with special expertise or experience may be held to higher standard.

# Board-Managed LLC/ Managing Members of LLC

- a. Under most state laws, LLCs may provide for the use of boards of directors, which are usually designated as boards of managers. When in place, these boards are often operated in the same manner as privately held corporation boards, with some differences under state laws
- b. An LLC's operating agreement may allow a variety of structures and management schemes
  - i. Members of LLC can create a board and delegate to it particular authority, at least on an *inter se* basis, the board is exercising authority collectively delegated by the members and may be viewed, collectively, as their agent
  - ii. Ask: whether the board is then acting as an agent of the members collectively, or whether the board is the controller of the LLC that acts as to third parties as the principal

# Fiduciary Duties - Board-Managed LLC/ Managing Members of LLC

- a. An LLC manager generally owes traditional fiduciary duties under common law, including duty of loyalty and duty of care
  
- b. *However***, under certain state laws, fiduciary duties traditionally imposed upon those in control of an LLC can be expanded, eliminated or restricted in the operating agreement

# Fiduciary Duties - Board-Managed LLC/ Managing Members of LLC (cont'd)

- i. BUT... See In re Caira Group Holdings, LLC Litigation, 2021 WL 2912479 (Del. Ch. July 12, 2021)(holding that an agreement that purports to replace traditional fiduciary duties with duties not to engage in bad faith, willful misconduct, or gross negligence (contractual duties) as instead having imposed the traditional fiduciary duties of loyalty and care); see also Largo Legacy Group, LLC v. Evens Charles, C.A. No. 2020-0105-MTZ (Del. Ch. June 30, 2021)*
  
- ii. See MedCision LLC v. Ehrhardt et al., case number 3:19-ap-03059, in the U.S. Bankruptcy Court for the Northern District of California (holding LLC agreements are creatures of contract - while the duty of good faith and fair dealing can never be eliminated, the other duties can be modified by the LLC's operating agreement)*

# Advisory Boards

- a. No legal authority / no fiduciary duties under corporate law
- b. A/k/a “councils”
- c. ‘Lighter touch’ in terms of process
- d. Purposes: advice, access & influence
- e. **Not** a substitute for a statutory board

# Nonprofit Fiduciary Boards

- a. Nonprofit boards fulfill their duties to the corporation with consideration of its purpose - the qualifying purpose for its tax-exempt status a/k/a its mission
- b. In addition to duties of care and loyalty, directors of nonprofits are also required to exercise *duty of obedience* - requires board to be faithful to the organization's mission
- c. Board members not paid; they usually *pay*

# Who Polices a Nonprofit Board?

- a. State charity regulators (i.e. Attorney general)
- b. IRS
- c. Private watchdog groups

# What's a Better Steppingstone - an Advisory or Nonprofit Board?

a. This is the wrong question- ask instead:

i. What am I passionate about?

ii. Who needs me and why?

iii. What purpose will I serve?

# Key Differences Between Private vs. Public Company Fiduciary Boards

## a. Differences:

i. Pathway to membership

ii. Complexity

1. Public company boards have a formal board process with significant time spent satisfying complex regulatory requirements imposed by:

a. State laws

b. Federal laws (i.e. Sarbanes-Oxley, Dodd-Frank Act & SEC rules)

c. NASDAQ and NYSE

# Key Differences Between Private vs. Public Company Fiduciary Boards (cont'd)

2. Exchange and SEC rules require public companies to have an audit committee comprised of **at least three** independent directors who meet the SEC's enhanced independence standards for audit committee members

b. NYSE and NASDAQ listing standards incorporate the SEC's independence requirements, but each has its own **additional requirements**

iii. Board composition - independent audit, nominating, and compensation committee

iv. Time commitment

i. Compensation

# Key Differences Between Private vs. Public Company Fiduciary Boards (cont'd)

**b. However**, whether the board members govern a publicly-owned company, privately-owned company, or nonprofit – they have fiduciary duties and legal duties that are nearly identical to each other

# Private Company Fiduciary Boards

- a. The way a board operates is in large part a function of *who owns the company*
- b. When majority stockholder controls board, minority stockholders' rights are more at risk of being oppressed
  - i. When preferences of controlling and minority shareholders diverge, board more likely to align with controlling shareholders
- c. In companies where ownership is concentrated, separate roles of stockholders, directors and officers mix, distinctions fade, and the special function of the board can be overlooked => high risk of management entrenchment

# Boards of Companies Controlled by an Owner/Operator

- a. Owner, operator, and board are usually the same person
- b. As company grows + gets more complex, owner & operator objectives may no longer align
  - i. Ownership primary goal - earning return by growing *value* of company
  - ii. Operator goal - growing *revenue*, managing expenses, hiring talent, and keeping the operations running smoothly
- c. Potential source of friction between ownership and operations:
  - i. Revenue growth
    - 1. Top-line growth is usually a priority for operator, but in some instances it may marginalize value building in the long run - contrary to ownership interest

# Boards of Companies Owned by a Family

## a. Family first or business first?

- i. Board's time is spent to settle family disputes rather than for its intended purpose of advancing company and shareholder goals
- ii. Combination of family counsel + traditional board can improve communication, transparency, accountability, and family harmony

## b. Succession planning is big issue

# Boards of Companies Controlled by a PE Fund, VC or Family Office

- a. Capital investment terms typically include right to appoint a representative of the fund to the board (or observation rights are negotiated)
- b. Funds with substantial ownership & board ties also face the risk of controlling stockholder status
- c. “Dual-fiduciaries” owe twin fiduciary duties of care and loyalty (like all directors) but they also duties and obligations to their employers
- d. Conflict issues most likely to arise:
  - i. Investment strategy - short-term v. long-term value creation

## Boards of Companies Controlled by a PE Fund, VC or Family Office (cont'd)

- i. Transactions in which the interests of preferred and common holders diverge (i.e. down-round financings and acquisitions resulting in disparate treatment of stockholder)

1. *Frederic Hsu Living Trust. V. ODN Holding Corp* (court refused to grant a motion to dismiss a claim involving a board's decision to sell assets to pay for a mandatory preferred stock redemption at the expense of common stockholders)

# Boards of Companies Controlled by a PE Fund, VC or Family Office (cont'd)

- iii. Financing
- iii. Capital allocation
- iv. Valuation
- v. Executive compensation
- vi. Management fees
- vii. Conflicting interests of two or more portfolio companies of fund

# Boards of Startup Companies

- a. Board composition typically includes CEO (likely its founder) & financial investor (Angel or VC); startup boards tend to evolve over time
- b. Board frequently and intimately involved in strategic decision-making & personnel issues
- c. High level of risk and asymmetric information creates capital structure that can give rise to significant differences between shareholders concerning control, potential deal payouts & post-exit opportunities

# Boards of Startup Companies (cont'd)

1. For example, startups typically issue common stock, stock options to employees and raise money by issuing rounds of convertible preferred stock with possibly varying terms and contractual rights
- d. As additional VC rounds are completed, VC gains additional board seats in new round = VC gains additional control over board
    - i. VC may also exercise contractual control (i.e. veto rights)

# Boards of ESOP-Owned Companies

- a. Just like other retirement plans, ESOPs are required to hold plan assets in trust
- b. Assets of ESOP held in trust are generally managed and controlled in the exclusive authority and discretion of the ESOP trustee, who is an ERISA fiduciary
  - i. Trustee has duty to all shareholders as officer/director, but ERISA fiduciary duty is “solely” to and for participants
- c. ESOP trustee is appointed by the board. Trustee that controls majority of sponsor company stock enjoys significant influence over board
  - i. Trustee also appoints directors to serve on board, most of whom are identified and nominated by the company and the management team for their operating and/or industry experience
- d. Business succession planning is a chief concern

# About Faculty of Session #2

1. Will Clarke - Clarke Growth and Sustainment Strategies
2. Jonathan Friedland - Sugar Felsenthal Grais & Helsinger LLP
3. Bob Lerner - Monimus Capital Management, LP
4. Kathleen Murray - Board Member, Angel Investor and Advisor

# Will Clarke

Will Clarke is the Founder and President of Clarke Growth and Sustainment Strategies, an advisory firm specializing in guiding early-stage companies' business expansion. He serves as an Independent Director for Ascent Solar Technologies (OTC: ASTI), an Advisor for Glass Inc, and on two nonprofit Boards. Previously, he led the Global Supply Chain business unit for Atlas Airlines (NASDAQ: AAWW) and directed turnaround initiatives for Best Buy (NYSE: BBY). Will served 25 years as a Naval Officer, where he completed 10 deployments on a ship, submarine, and two aircraft carriers in support of war and peacetime operations. Will earned a BSc in Mathematics from U.S. Naval Academy, an MSc in Management from Naval Postgraduate School, and completed the Corporate Governance Program at Columbia University.

[will@cgass.com](mailto:will@cgass.com)

<https://www.linkedin.com/in/willaclarke/>

# Jonathan Friedland

Jonathan Friedland is a partner with Sugar Felsenthal, where he regularly counsels boards of directors and owners of companies in financial distress. His broad experience includes representing companies, buyers, and committees in chapter 11 bankruptcy, out-of-court workouts, and liquidations. He also has substantial experience in running a wide variety of corporate transactions and a wide array of commercial litigation. Peers and legal publications recognize Jonathan as a leading corporate restructuring and insolvency attorney. For example, he has been rated for many years as AV<sup>®</sup> Preeminent<sup>™</sup> by Martindale-Hubbell, 10/10 by AVVO, and 10/10 by Justia). Jonathan is the principal author of two leading legal treatises and more than 100 peer-reviewed articles widely cited by legal scholars. In three years, Jonathan graduated magna cum laude from the State University of New York at Albany University (in three years) and the University of Pennsylvania Law School.

[jfriedland@sfigh.com](mailto:jfriedland@sfigh.com)

<https://www.linkedin.com/in/jonathanfriedland/>

# Bob Lerner

Robert L. Lerner has 35 years experience in the investment management industry. Bob has co-founded and invested in several successful startups and has been a director to private and public companies. He has been a trusted advisor to early-stage hedge funds, investment research firms, and growth equity investment funds. His focus is on business development, product design, strategy, business operations, and compliance. He currently is chairman of InfraSight Software Corporation. Bob is a graduate of Cornell University and Boston University Law School.

[bob@4lerner.com](mailto:bob@4lerner.com)

<https://www.linkedin.com/in/boblerner/>

# Kathleen Murray

Kathy Murray is an approachable and creative business growth executive, board member, angel investor and advisor. Kathy is Co-Founder of Tech Up for Women and Principal of McMorran Strategists. Earlier, Kathy held key C-Suite roles at publicly-traded firms and partnerships - Aetna, PwC and FARO. Currently, she is Fiduciary Board Member & Diversification Committee Chair of Daily Gazette (Winner of 2021 Private Directors Magazine Board Award), Founder of Executive Forum Angels, Board Chair of Harvard Business School Women's Association, Life Trustee for University of Rochester, and Fellow at the Foreign Policy Association, Kathy received a BA in Math/General Science from the University of Rochester and the Advanced Management Program Degree from Harvard Business School.

[mcmorranstrategists@gmail.com](mailto:mcmorranstrategists@gmail.com)

<https://www.linkedin.com/in/kathymcmorranmurray/>

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- Our close to 3,000 members include current and qualified future board members, private company owners, and C-level executives of family-owned businesses, ESOPs, private equity owned, early stage, and start-up organizations.
- The PDA's mission is to:
  - Advocate for and teach board formation and governance
  - Enhance private company value through high-performing boards
  - Advocate for the value of diverse and inclusive boards
  - Create a national alliance of directors, executives, and private company owners interested in board service to learn, network, and identify and attract exceptional board members

# The Co-Producing Chapters

- Bare Bones Board Basics- for the Private Company is a co-production of Financial Poise, Executive Forum, Vistage, Private Director Symposium, ChamberWise, and the following chapters of the Private Directors Association:
  - Alabama
  - Dallas
  - DC Metro
  - Nashville
  - New England
  - New York Metro
  - Tampa Bay
  - Wisconsin
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