

April 14, 2009 Session
Highlights of the Presentation
“Meeting the Fiduciary Standards in Private Board Settings”

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What are the duties of directors who serve on the board of a private, closely held company? That question was the subject of a case study at the April 2009 Boston breakfast meeting of the New England Chapter of the National Association of Corporate Directors (NACD). Using a fictional case study, a panel of experts played the roles of members of the board of directors of a hypothetical company, “Rivets-R-Us.”

In the fictional board meeting, Ed Pendergast played the role of family patriarch and company president Roger Rivet, Jr.; in real life, Pendergast is a corporate financial consultant serving on a number of public, private and nonprofit boards and is a past president of NACD New England. David Dunfee played the role of Roger Rivet III, Rivets-R-Us VP/COO; in real life, Dunfee is vice president and general manager of D.G. O’Brien, a New Hampshire defense contractor that has been acquired by Teledyne. Joshua Davidson, a principal in Phoenix Development LLC, played the role of Willie Worker, a loyal shop foreman who serves on the board. Frank Finlayson, a principal in Entrepreneurial Resources Group LLC, a Boston-based professional services firm, played the role of CPA Clyde Counter, a board member. Paula Cholmondeley played the role of Thomasina “Tess” Trueheart, an NACD member who serves on the board of Rivets-R-Us. In real life, Cholmondeley is a member of NACD who serves as a director and audit committee member for four public companies, as well as chair of three of those audit committees. Stephen Honig, who is a partner in the Boston office of Duane Morris LLP, played the role of outside counsel Mark Mouthpiece.

Here are some of the details from the fictional case study.

FROM THE FICTIONAL CASE STUDY

Roger Rivet, Sr., now deceased, founded Rivets-R-Us (RRU) during the Second World War. Today, RRU manufactures a complete line of rivets and related metallic fasteners.

The Company: A Massachusetts corporation with flat sales of \$100,000,000 per year (99% in the U.S.) and an “unadjusted” pre-tax net of \$6,000,000 per year. President Roger Rivet, Jr. (age 66) earns \$750,000 per year plus variable bonus. His company Mercedes 500 often can be found parked at Eastern Yacht Club, overlooking the company’s 65’ power cruiser.

Vice President/COO Roger Rivet III (MBA 1988) has a salary of \$350,000 per year, fixed annually by the Board. The Aston-Martin in the parking lot is supported to the tune of \$2,000 per month by a company car allowance. RRU's six Sox seats are in the State Street Pavilion.

Equity is owned: 80% by the Rivet Family Trust, a trust controlled by President Roger Jr. as sole trustee during his life; 10% by Mrs. Smith, widow of Roger Sr.'s long-dead junior partner; 5% by Director Willie Worker; 5% by an inactive investor who advanced capital during the 1989-1990 cash crunch.

RRU rents 200,000 square feet of space in Lowell from the Roger Realty Trust, owned by Roger III and his sister Regina, at an annual triple net rent of \$75 per foot.

The Board and Management: The Board of five includes Roger Jr., Roger III, retired company CPA Clyde Counter, Willie Worker (shop foreman since 1970) and Thomasina "Tess" Trueheart. Trueheart, who joined the Board two years ago at the suggestion of the auditors, is an NACD member. Each director is paid \$5,000 per meeting attended.

The Problems: Sales are flat. The RRU Advisory Board, two scientists and one retired businessman, established at Trueheart's urging to "bring new ideas to our board," reports that new technologies threaten riveting as a fabrication method. Roger III wants to run the show but not offend his father, whom he respects in proportion to dad's control of the Family Trust. Omnivore Rivets Co. has approached Roger Jr. with a roll-up proposal - acquiring RRU, guaranteeing Roger III a job, and paying \$60,000,000 cash for the RRU stock. Roger Jr. is not attracted unless he himself (and his wife if she survives him) also gets a lifetime employment agreement at present salary and perks. Production line employees have told Worker that nearby employers are offering restricted stock to employees. Trueheart has suggested various equity compensation programs, or an ESOP buyout of some Trust stock, but none of the Rivet family is paying attention. The Board has no committees and is elected annually by the shareholders.

The Setting: The semi-annual board meeting, attended by the Board and company counsel Mark Mouthpiece. The agenda circulated by the President:

1. *Financial Report – 5 minutes*
2. *COLA salary adjustment for Senior Management – 10 minutes*

The fictional board meeting:

The board briefly discussed the agenda items. Trueheart suggested that Rivet Jr. drop the idea of a COLA adjustment for senior management, since, she noted, the board has no established process for evaluating senior management. Rivet III then brought up the possibility of setting up an incentive-based compensation structure. Rivet Jr., the CEO, then suggested tabling the COLA adjustment for now and setting up an ad hoc committee to look into the topic. Counter and Trueheart offered to research the issue.

Rivet Jr. described the offer he has received for the company. Trueheart asked if the offer was in writing, and Rivet Jr. said it was. Mouthpiece then raised the issue of the company's other shareholders. Trueheart wanted to know what obligations Rivet Jr. has in this state to minority shareholders. Mouthpiece replied that it's always difficult when a Massachusetts corporation has a dominant shareholder; he'd counsel that the company should arrive at an approach to the acquisition process that is fair and evenhanded. In Delaware corporations, he noted, an interested board [such as this one] is held to a heightened standard, but it's not clear that totally applies to a Massachusetts corporation.

Rivet Jr. asked if having a vote of the shareholders would help, and Mouthpiece said it would if there is full disclosure. Trueheart asked if Rivet Jr. could talk to an outside investment banker about the value of the company or get the board some information. Rivet III, on the other hand, thought the deal as negotiated sounded pretty good, and he said the company could spend a ton of money on investment bankers.

Trueheart asked if the only constituent this board is supposed to represent is the family, and Mouthpiece said that's not crystal clear in a Massachusetts corporation. Mouthpiece asked the board if the company is for sale in a formal sense. Trueheart asked if the board could demonstrate to the minority shareholders that it has protected their interests. Rivet Jr. asked if the board could gin up the minutes, so it looks like the board did this in a thoughtful way – and Trueheart replied that, under good governance process, the board doesn't gin up the minutes.

Mouthpiece noted that the minority shareholders could hire someone to look at this – and raised the question of whether there was any discussion of mark-to-market accounting of the lease held by family members. Worker said he felt the board should have a little bit of process here. He said that “when Omnivore comes in, the business is gone. It's going overseas.” Rivet III observed that “People aren't buying rivets anymore,” and “we don't have anything, unfortunately, to replace rivets.” He also raised the possibility that maybe the workers could be given something of the proceeds of the sale. Worker wondered if we can put something in writing and said he would certainly move that the board have some more formal process for evaluating the offer.

Trueheart asked Mouthpiece what process the board needed to follow. Mouthpiece replied that there is no set process that gets you home free -- as long as there's a reasonable process and the board evaluates its options. One option, he said, is to set up a committee of the board to evaluate the offer. Mouthpiece advised that the board really should try to shop the company. You may find you'll get more, he explained. And, if you don't, you'll have satisfied your fiduciary duty.

Trueheart suggested that the board form an independent committee. Rivet Jr. considered tabling the idea until next Thursday – when Trueheart would be traveling. Trueheart indicated that, unless she is on her deathbed, she'll take part in the meeting, by phone. Rivet III said he thought the board should strike while the iron is hot and needed to move forward on the deal. Trueheart then proposed that the board form a committee consisting of her, Rivet III, Counter and Mouthpiece and charge the committee with getting the best deal

possible – while meeting the board’s fiduciary and legal duties. Mouthpiece said that the board should appoint a committee with the authority to hire an investment banker; that would protect both the board and Rivet Jr.

Rivet Jr. adjourned the meeting until next Thursday.

From the Question and Answer Session

Q. How might this case study have looked if the jurisdiction in which it took place was elsewhere, such as New York?

A. Fiduciary duty for an interested board is reasonably the same in jurisdictions I’m familiar with, including New York, Honig said.

Q. When a commanding offer is made with a tight timeline, what’s the quickest way to get through it?

A. Get an investment banker, Honig said, and tell the banker to give you the best process in the time you have. Investment bankers can move fast if they have to.

Q. Do you see any utility in the use of advisory boards for private companies – as opposed to boards with fiduciary duties?

A. Pendergast said he’s a terrific advocate of advisory boards; they’re a terrific source of inexpensive advice. The problem, he said, is one of expectations; the company owner typically expects to get good advice right away, but Pendergast indicated that it usually takes time for that to happen. He added that he thinks that any company of any size that doesn’t have an advisory board is missing an opportunity.

For more information about the New England Chapter of NACD, please contact info@nacdne.org.

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