Private Company Governance Basics: A Director's Guide

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Required reading:

Certificate in Private Company Governance

The Private Directors Association is grateful to

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for their help in producing this guide.

1. **When Do Boards Begin to be Established?**
   U.S. Corporations are required to have boards, although the legal requirements generally do not address the independence or competency of the boards. Boards with independent and competent members can be established at any time. The first model in very early-stage companies, family entities or unincorporated entities (such as Sole Proprietorships and Partnerships) is often what is called an Advisory Board. Advisory Boards are, as their name suggests, purely advisory and possess no legal standing. All *corporations* must have Fiduciary Boards although their design and complexity may vary. Corporations may have both Fiduciary and Advisory Boards. Some directors have preferences for serving on one kind of board or another because the relationships to the owners, legal responsibilities and ramifications of those responsibilities differ in each case. They also typically are compensated differently.

2. **What Are the Types of Directors?**
   Directors are classified as either Executive or Independent. Executive Directors hold employment positions in the company. Independent Directors, or Outside Directors, are members of the board who are not employed by the company or otherwise affiliated with the company other than their board service. They do not get compensated for anything but their board service and do not have relationships with the company that can conflict with their roles as directors.

3. **Why A Private Company Independent Director?**
   Private company independent directors can add great value to a company and accelerate growth and sustainability because of their objectivity. They bring perspective, experience, industry/market or customer knowledge and contacts from outside the company. Importantly, they also protect a company from internal conflicts of interest, executive compensation, better and more objective hires and promotions and financial management and compliance.
4. **What are the Types of Boards?**
   Whether a company has a fiduciary board or an advisory board or both is an issue of practicality, legal responsibility and decision making.
   a. **Fiduciary Boards**
      All corporations, including private corporations, are required by law to have fiduciary boards which are responsible for overseeing and approving all company plans and policies. Many, but certainly not all, corporations are incorporated under Delaware law. Many smaller corporations are incorporated in their own states or Commonwealths. Wherever they are incorporated, they have legal authority to require action by the company and its management. How appropriately the board acts can be legally challenged and carries legal consequences. At their most elemental, fiduciary boards may consist only of the owner(s), family members or senior direct reports who serve all board functions. A sign that a private company is pursuing strong oversight is the inclusion of independent directors in the board. A well-developed fiduciary board will have a majority of independent directors.

b. **Advisory Boards**
Alternately, Advisory Boards do not (and should not) have control over corporate decisions and are not legally responsible for the results of the company. For example, Advisory Boards do not have the power to remove the CEO or hire or fire anyone, other than an external consultant who may be hired by the Advisory Board. These boards are often formed to provide independent perspectives, counsel and assistance to help owners achieve their goals. In early-stage companies, Advisory Boards often help owners with industry or contacts to address specific problems or to raise capital. It is often easier for a Family Business to begin its governance experience with an Advisory Board and serving on an Advisory Board can be a good way for PDA members to gain board contacts and experience.

c. **Higher and Lower Order Fiduciary Boards – Subsidiaries and Enterprise Boards**
When companies grow, their fiduciary boards often evolve into several levels. A board may exist that is responsible solely for a subsidiary. It is often, if not usually, the case where a small number of subsidiary board members hold board seats in the corporation. Likewise, enterprise boards come into being as a corporation grows and diversifies. Enterprise boards are responsible for the entire diversified entity.

5. **What are the Types of Companies and their Implications for Governance?**
A wide variety of ownership structures exist in the private company sector. Many of these at their most essential are tax structures or have tax consequences. These include sole proprietorships, Partnerships, Limited Liability Companies (LLCs), Privately held S Corporations and C Corporations, Private Equity and VC owned, Joint Ventures, ESOPS and Mutual companies. Some of these overlap with each other. Each of these has different challenges, levels of regulation, culture differences and needs from directors as a result of their structures.

<u>Unincorporated Private Entities Not Requiring Fiduciary Boards</u>

a. **A SOLE PROPRIETORSHIP is a type of enterprise owned and run by one person in which there is no legal distinction between the owner and the business entity. They may or may not be incorporated (see below). When they operate under a name other than that of the owner, they often operate under a DBA (Doing Business As…). While the entity is owned by one person, it is possible for the sole proprietor to employ others. If it has some legal corporate structure, the owner of the sole proprietorship most frequently is the board, perhaps with some employees or family members. Owners are personally responsible for the debts and liabilities of the company. Sole proprietorships sometimes have Advisory Boards who help the owner succeed in his/her goals.**
b. **A PARTNERSHIP, at its most elemental, is similar to a sole proprietorship except that it involves 2 or more people or business partners. Partners can include individuals, businesses or organizations like schools or governments who agree to work together to achieve mutual goals. Partnerships may be governed only by a contract or may**

evolve into structures where equity is accounted for and distributed. Like sole proprietorships, "simple" partnerships sometimes have Advisory Boards.

c. **A LIMITED LIABILITY CORPORATION (LLC) is a legal form of a privately held company in the U.S.A. with specific tax, equity and accounting limitations and which provides limited liability to its owners. In the strictest sense, an LLC is not a corporation. In some ways, it is similar to a partnership, although it may be owned by a sole proprietor or have multiple owners. The ownership of LLCs varies depending on the state in which they are formed and the context in which they operate. They may choose to use corporate tax rules instead of being treated as a partnership. Or, they can provide the pass-through taxation of a partnership or sole proprietorship with the limited liability that is accorded to corporations. Legal governance responsibilities are shared by the owners. This model is only available in certain states.**

<u>Private Corporate Entities Requiring Fiduciary Boards</u>

d. **AN 'S' CORPORATION is a private corporation that elects to be taxed under Subchapter S of Chapter 1 of the United States Internal Revenue Code. S Corps do not pay income taxes. Rather, the company's income and losses are divided among the owners (shareholders) who then report the income and losses on their personal income tax returns. Most often, S-Corp fiduciary boards are the owner(s), who enjoy some limited liability due to being incorporated. One often sees S-Corps as the first incorporation step after an unincorporated sole proprietorship or partnership. S-Corps quite frequently have Advisory Boards.**

e. **A "C" CORPORATION, alternately, is any corporation that is taxed separately from its owners and is subject to corporate income taxation. Most major corporations, are treated as C corporations for U.S. federal income tax purposes. C corporations also enjoy limited liability due to their corporate structure. All C Corporations have fiduciary boards and, preferably, include independent directors to help ensure their governance. Our discussion of responsibilities and good governance in Module II primarily will focus on governance of C Corporations.**

    i. **Although FAMILY BUSINESSES can be other corporate structures, we will call Family Businesses special cases of C-Corporations. Family Businesses, especially multi-generation family businesses, are characterized by corporate values that reflect family values, a paternalistic or maternalistic orientation where the culture and practices are family-like, deep rooting in the locale in which the corporation was founded. As the generations increase, these cultural aspects may change due to the changing nature of the values and commitments of shareholders. Decision-making requires more complexity and sensitivity than other kinds of corporations. Decision-making processes tend to be longer and more indirect because the primary goals of survival of the family and survival of the business often compete and must be worked through. Directors must be able to manage these family dynamics and help family members think through these complex issues.**

f. **A JOINT VENTURE (JV) is a business entity created by two or more parties, generally characterized by shared ownership for pursuit of new markets, to maximize access to talent or supplies, or to gain efficiencies and share returns and risks. Although Joint Ventures can exist between individuals, particularly incorporated individuals, most are between corporate entities. They also share their governance structures by forming a a separate JV board that often includes some directors from each of the Venture Partners. To be successful, JV Directors often look quite different from those who would make successful corporate directors. While less legal scrutiny is often afforded Joint Ventures, board service can be more complicated because of potential parent-company conflicts, different partner decision styles and corporate cultures and the lack of ultimate control. They also can be more demanding because a JV Board Director often stands in for management leadership, providing executive oversight of HR, Finance and Operations as well as Strategy and investments made on behalf of the Venture.**

g. **An ESOP (EMPLOYEE STOCK OWNERSHIP PLAN) is a company whose employees own the shares in that company. They typically acquire shares through a share option plan. These plans can be quite selective about who gets to purchase shares--typically only senior executives—but there can also be all-employee plans. An ESOP is wise to include independent directors on its board and the role of the board is to enhance and protect employee retirement funds. An ESOP is held in a Trust that is overseen by a Trustee whose fiduciary responsibilities to the Trust (Shareholders) are greater than those of the Board. The relationship between the Trustee and the Board is somewhat circular. The Trustee is appointed by the Board and does not serve on the board due to conflicts of interest. Rather, the Trustee serves in a consulting and oversite capacity to the board. At the same time, the Board of Directors is elected by the Shareholders (Trustee). This usually does not create complications but could.**

h. **A MUTUAL COMPANY is a private company whose ownership base is made of its clients or policyholders, much like a cooperative. By law, mutual companies in the U.S. must have independent directors. The main feature of a mutual company is that the customers and policyholders who are its owners are entitled to receive profits or income generated by the mutual company. However, rather than focusing on maximizing profits and distributions, Mutual companies focus on maximizing goods and services offered to its shareholder members and to mitigate risks. These organizations range in size from small local companies to large entities. Most operate in specific niches such as healthcare, farming, real estate, insurance or investments. As is true of a corporate board, the board of directors oversees the management and operations of the company and represents the interests of the shareholders where each owner typically has one vote, rather than votes based on shares. Boards of Mutual companies often have very little turnover. The orientation is toward long-term growth, solvency and stability. As such, the pace of change tends to be slower.**

i. **PRIVATE EQUITY (P/E) OWNED AND VENTURE CAPITAL (VC) OWNED COMPANIES are companies that exist within a portfolio of assets owned partially or wholly by funds raised by the P/E or VC firm that are not publicly traded. Both P/E and VC funds are usually Limited Partnerships. Portfolio companies are obligated to maximize**

shareholder value for the shareholders, the investment funds. Serving on a board of a portfolio company necessitates managing relationships between the portfolio company and the investment firm, which can be challenging due to potentially different business cultures and operating styles. P/E and VC investors often prefer the inclusion of professional independent directors on the portfolio companies to ensure strong governance.

i. **VENTURE CAPITAL investing is a form of equity investing. Investments are typically made in exchange for an equity stake in early-stage startup companies that are seen as having long term growth potential. The investments are focused on short term rapid growth, rather than long term strategy. Funds, too, are invested for a relatively short time with exits often planned within 5-10 years. Future funding is based on meeting sets of criteria at certain timelines. Boards of venture backed companies are usually quite small and often consist of the company founder(s), 1-2 venture investors who likely have technical expertise and, perhaps, an outside director who often is brought in during later capital raising efforts. Directors are often paid in stock. Although due diligence is done before an investment, these are high risk/high reward efforts. In general, money is made from only 20% of the investments in a fund. To pay off fund investors, investments need a multiple of 30x over 10 years. If one in ten investments succeeds, a 100 multiple in one can cover the investment "failures" in the other nine. Outside directors (they are not truly independent) usually have direct experience running companies in the industry and are known to the VC firm.**

ii. **PRIVATE EQUITY (P/E) typically refers to investment funds, generally organized as limited partnerships, that buy and restructure companies that are not publicly traded. These companies typically are larger, older and more developed than those in which VCs invest. Private equity is, strictly speaking, a type of equity and one of the asset classes consisting of equity securities and debt in operating companies that are not publicly traded on a stock exchange. However, the term has come to be used to describe the business of taking a company into private ownership in order to restructure it before selling it again at a hoped-for profit. Portfolio company growth is often heavily debt-driven. The time between investment and selling the company is longer and PE strategies are more long term than in VC invested companies. The focus, however, is still on achieving the large multiple for the exit. Boards of private equity companies are often quite well developed. In the case where a publicly held company is taken private, major changes in the Board can occur as a result of new ownership, which can cause friction. New board members often are either P/E partners or those who are friendly to the P/E firm.**

6. **Corporate Stages of Life, Company Size and Governance Implications**
   All companies pass through several predictable stages that are connected by inflection points. These stages include StartUp, Growth, Maturity, and Decline or Renewal. However, it is the

inflection points where businesses are the most vulnerable and that determine their futures. Independent directors can be of particular value in bringing companies through the inflection points because they can be objective observers of the organization. The length of time each company spends in a stage or inflection point varies and, depending on the size of the organization, several stages can be operating concurrently. Each stage if associated with demands for change made on the organization and its leadership. These stages require different kinds of leader styles and are associated with different rates of change. In addition, the stages are iterative in the sense that, when a company renews itself, it begins to act much like large start up with a focus on greater focus innovation while maintaining profitable legacy products and services. These stages are associated with size and degree of bureaucracy. While bureaucracy often has a bad name, the bureaucracy/size/organization performance relationship is a positive one wherein rate of change decreases as the company grows and increases in bureaucracy. Appendix A4 contains an article on how and when Family Business Boards evolve.

7. **Corporate Industry and Governance Implications**
   When one is looking at potential board positions, one should also consider the industry in which the position resides. One of the reasons is because different industries tend to differ in their business models embracing risk over stability, novelty over tradition, predictability and accuracy over approximation. The more highly regulated an industry is, the more likely it will embrace tradition, stability and accuracy. Better fits for these kinds of positions will also be those who are drawn to those attributes whereas those who are drawn toward change, novelty, risk are more likely to be better fits in less regulated industries.

8. **Time Commitment for Independent Directors**
   Becoming an independent director is a separate career decision and career path from serving in an executive role. Among other things, it requires a significant time commitment. Directors must come well prepared for board meetings and have thorough understanding and familiarity with the board book and must actively participate in committee meetings or board calls in between board meetings. These meetings and calls can increase dramatically during a crisis, a sale or acquisition. Independent directors are often expected to serve on one or more committees. If the director is also chair or chair of a committee, it can require double or triple the time commitment. Well established boards have attendance requirements for directors in order that directors maintain their roles. The frequency of regular board meetings is specified in the bylaws.

9. **What are the Personal Qualities of a Good Private Company Director?**
   Many of the attributes that enable an individual's rise to the higher levels of an organization are also attributes of good board members. Because high performing boards are high performing teams, fit with the culture of the board and culture of the organization is often as important as content knowledge and expertise. And, yet, there are some basic characteristics and skills that will help to lead to credibility with shareholders, the financial community, Board colleagues and company employees and that will contribute to being a productive member of the Board. Specifically, private company Board Members should possess the

following individual characteristics and skills:

a. **Intelligence:**
    i. **Outlook: Contemporary viewpoints regarding public/private company governance & relevant business operations; up-to-date; international scope and perspective. Stays current with ESG (Environment, Social and Governance) best practices.**
    ii. **Analytic skills: Realistically and objectively dissects seemingly complex problems, possibilities & dynamics into clear critical elements that can be evaluated, prioritized & addressed**
    iii. **Incisive: Sees both the big picture and the heart of the matter; able to separate the relevant from the irrelevant; recognizes and focuses on true priorities**
b. **Character:**
    i. **Confidence: Willing to exercise judgment; assumes accountability for decisions & actions**
    ii. **Courage: Willingness to face the facts and deal with them; in other words – runs to problems, not away from them**
    iii. **Conscience: Be guided by a good moral compass. Just because something is legal and, in the short run, may be profitable; that doesn't necessarily make it the right thing to do. Ethics impacts employees, customers, suppliers, shareholders, and communities**
    iv. **Commitment:**
        1. **to the company and its owners: Motivated by, and works toward, predictable profitable long-term growth of the business**
        2. **Has the time and energy to be a productive, contributing, value-adding member of the Board**
    v. **Even-tempered: Deals with matters calmly & dispassionately**
c. **Social Style:**
    i. **Collegial: Identifies with the Board member group; works well with his or her colleagues, responsible and reliable in meeting Board commitments and expectations**
    ii. **Candor: Demonstrates strong interpersonal skills to have honest conversations with people, especially when under adverse conditions Viewed by others as capable, honest and open**
    iii. **Influential and Persuasive: Poised, comfortable and appropriately confident dealing with Board colleagues and constituents; diplomatic and tactful**
    iv. **Courteous: Courteously respects the diverse views of others and has the ability to disagree without being disagreeable**
    v. **Communication Skills: Clear, articulate and direct in statements; initiates and responds as appropriate to the circumstance; good at give and take dialogue; adept using current communication/information technology.**

1. **What is the purpose of a Private Company Board of Directors?**
    a.) **The purpose of a Board of Directors in a private company is to maximize the Company's long-term value, or shareholder return. The purpose of the Board also is to serve as trustees for owners or shareholders in determining and demanding appropriate organizational performance. The Board is responsible for policymaking and oversight of the execution and implementation of those policies.**
    b.) **The purpose of the Board IS NOT to run the company; that is management's job. The purpose of the Board is oversight, or "NIFO" – Noses in, fingers out. In other words, directors ensure that good management is happening, but they don't provide it themselves.**
2. **How does the Board fulfill that purpose?**
    a.) **By focusing on substantive issues, especially:**
        i. **Planning for, recruiting, selecting and evaluating the performance of the CEO, Board Officers and the Board of Directors. Nominating Directors and Committee members and overseeing the composition, structure, practices and evaluation of the Board and its committees and taking action on problematic behaviors.**
        ii. **Annually reviewing a management succession and overseeing executive promotion plans that have been developed by the CEO, including being familiar with the leadership talent pool. The CEO plans to be approved by the Board include (a) Emergency Chairman/CEO succession; (b) Chairman/CEO succession in the ordinary course of business; and, (c) Succession plans for the other members of senior management.**
        iii. **Designing CEO/Chair and top management compensation to achieve the desired results consistent with the Board's evaluation of the CEO/Chair as well as providing Counsel and oversight on the selection, evaluation, development and compensation of senior management.**
        iv. **Designing, reviewing and providing oversight of Director Compensation and D&O Insurance.**
        v. **Strategic Planning and Board Policy Development: Reviewing and approving management's strategic and business plans and policies and creating Board policies. This includes scenario and risk planning and monitoring corporate performance;**
        vi. **Monitoring the enterprise's health, performance, and risk by:**
            1. **Overseeing, understanding and monitoring the Company's annual operating plans and budgets prepared by management;**
            2. **Reviewing and assessing the processes and policies in place for maintaining the integrity of the Company, including the integrity of its financial statements, the integrity of Board communications, the integrity of its compliance with law, ethics and the Company's own statement of values, and the integrity of its relationships with employees, customers and suppliers;**
            3. **Reviewing and assessing management's processes and policies to identify the major risks facing the Company, and periodically,**

reviewing management's assessment of these major risks and the options and plans for their mitigation

4. Evaluating and approving all material Company transaction not arising in the ordinary course of business, consistent with the Company's policies. Acquisitions of businesses, dividend policy and long-term financing are the types of transactions included.

vii. Staying up-to-date on the external environment that impacts the organization and its governance

b.) By acting when action is necessary!

c.) By cultivating healthy and effective group dynamics – the interactions within the Board, and between the Board and management – so that the Board can act quickly and decisively when necessary.

3. What are the Board's most basic, fundamental legal requirements?

a.) The Duty of Loyalty: Concerns loyalty to the interests of the shareholders and, more recently, the broad array of stakeholders rather than yourself, management or anyone else. Stakeholders include but are not limited to employees, the community, customers and suppliers. *Don't be sleazy or sloppy.*

i. The Duty of Loyalty mandates placing the organization's interests above one's own or to make a personal profit or gain from their positions or for other personal advantage

ii. It requires minimal conflicts of interest

iii. It requires confidentiality with respect to the Board's deliberations and the information revealed to the Board.

b.) The Duty of Care: Concerns acting with the diligence and competence of a reasonably prudent person in a similar position under like circumstances. *Show up, speak up and keep up.*

i. Requires staying informed and up to date

ii. Requires acting on an informed basis in the best interest of the organization and its shareholders

iii. Requires demonstrating independence and acting in good faith

iv. Requires adhering to good Board process and record keeping.

v. The Duty of Care cannot be delegated to others.

c.) The Duty of Good Faith: concerns making sure that an effective compliance system is in place, is followed, and is working so that the Board evaluates a variety of options and makes decisions that best serve the interests of the shareholders.

i. Similar to the Duty of Good Faith, the Duty of Obedience requires board members to ensure that the Organization's decisions and activities adhere to its fundamental corporate purpose and mission as stated in its articles of incorporation and its bylaws. This means that funds, people, equipment, buildings must be used only for the purposes of the Organization.

d.) The Business Judgment Rule, which mitigates the Duty of Care in that it protects disinterested parties from personal liability. It concerns how directors' decisions and actions are judged legally and states that a court generally won't override a director's judgment if the director:

i. **Acts in good faith**
ii. **Is reasonably well informed**
iii. **Rationally believes action has been taken in the best interests of the organization (prudent person)**

4. **The Primary Documents for a Board of Directors**
Two sets of primary documents exist for well governed private company boards: a Board Policy Handbook and The Board Book, which is published and distributed prior to each board meeting.

a.) **The Board Policy Handbook**
One of the most important tools and an invaluable living resource for a well-functioning board of directors and for prospective board members alike is a well-developed Board Policy Handbook (or Board Handbook). A Board Handbook contains relevant corporate and board policy documents and is developed, maintained and published by the Governance and Nominating Committee in a Fiduciary Board. It may be developed and maintained by either executive members or advisory members in an Advisory Board. While the contents of a Board Handbook may vary depending on the ownership structure of a company, a well-developed Board Handbook is thorough, transparent, and easily understood and applied in the context in which it lives. It establishes a common set of criteria and language that enables a board to function smoothly and for director onboarding. Examples of important relevant documents include the Articles of Incorporation, By-Laws, Committee Charters, Strategic Documents, Organization Charts, Financial Statements, A Board Calendar, Board Policies, D&O Insurance policy, Board and Executive Contact information and bios, articles of interest related to best practice governance, etc

b.) **Board Policies**
Board policies exist as a foundation for board functioning. Typical board policies include, but are not limited to, the following: Board Guiding Principles, Individual Director's Roles and Responsibilities (including compensation, desirable competencies and qualifications, legal responsibilities [see above], attendance and involvement commitments), Consent Agenda Voting, Executive Sessions of the Board, Board Chair (or Lead Director) Job Descriptions, Board Assessment, Individual Director Performance Evaluations, Policy and Procedures for Developing Board Policies, Management Director Elections, Definition of Independent Director, Independent Director Recruitment and Elections, CEO Succession Planning, Conflict of Interest, and Confidentiality.

c.) **Board Committee Charters**
Similarly, Board Committee Charters provide the stated mandates and boundaries for each standing committee of the Board. Topics in each committee charter include such parameters as (a) The Purpose and Scope of the Committee, (b) Committee Philosophy, if applicable (c) Committee Composition, (d) Appointment and Removal from the Committee, (e) Use [and payment] for Independent Advice, (f) Meeting Frequency, (g) Detailed Responsibilities and Duties or Standing Agenda Items, (h)

Reporting, (i) Conflicts of Interest, (j) Other topics not covered, and (k) Approved resources, if applicable.

d.) The Board Meeting Book

The Board Meeting Book is published prior to each board meeting in enough time for directors to study and digest the agenda and relevant materials before the upcoming meeting.

5. Board Composition

a.) Numbers of Directors

Section 149 of the Companies Act states that private companies must have a minimum of 2 directors and companies owned by one individual must have a minimum of 1 director. Other than that, the number of directors can vary quite significantly. There must be at least enough persons on a board who can meet the responsibilities of the board and who can serve on standing committees and board officers. In general, small companies such as VC startups begin with 3-4 directors that include Management and VC investors. Larger private companies can easily run 8-12 directors. The ideal size of a corporate board varies based on the needs of the business but, in general, larger boards are less effective as fiduciary boards than smaller boards because decision making becomes more cumbersome and responsibility more diffuse. The Board should periodically review its own size and determine the size most appropriate for the governance of the business.

b.) Types of Directors

Board members are of two types: Members of Management and Independent Directors, also known as outside directors or non-executive directors. Members of Management typically include the CEO and/or President and, possibly, one or two others – usually the CFO, COO and Corporate Secretary. Family businesses, especially multi-generation family businesses, also often hold a seat for an experienced member of the family. Independent Directors include those persons sitting on the board who do not have a material relationship with the organization or any of its major members other than sitting fees. All independent directors must have the ability to fulfill their duties and act unfettered by extraneous influences or considerations, such as personal financial or other gain through their affiliation with the Board and the Company. In the United States, over 65% of board seats are held by independent directors.

c.) Board Officers

The leader of the Board is called the Board Chair whereas the leader of the Company is the CEO, who also represents the Company to the public. The Board Chair may be an Independent Chair, a Chair who is also the CEO or an Executive Chair (a former CEO of the Company). Many major publicly held companies combine the role of CEO and Chair, although a possible drawback to this model is CEO domination of the board. There is a recent trend to separate these positions due to greater emphasis on board member independence and board efficiency. An Executive Chair is often designated during a transition but is not generally recommended for a long term position. There also is an increasing trend towards the use of a Lead Director, a Director elected by the Independent Directors, to act as an intermediary between the independent directors and the rest of the Board. The Lead Director has the authority to call meetings of the

independent directors, sets the agenda for and leads executive sessions of the Board, collaborates with the Chair and CEO on agenda items and discussions but does not represent the Company to the public unless specifically called upon by the CEO or Chair and can help to mitigate the negative effects of CEO dominance of the board. All board officers are nominated by the Governance and Nominating Committee and elected by the Board.

d.) Committee Membership

Membership on the three typical key standing committees (Audit, Governance and Nominating and Compensation) should be limited to Independent Directors, unless there is real reason to include members of management or family/owners. Each Independent Director should be assigned to at least one standing Committee and is a voting member on that committee's matters. A particular senior officer of the Company is often designated by the Chairman or Lead Director to serve as the (non-voting) corporate liaison to each Committee. Each of the Committees should be composed of no fewer than three members. A director may, and usually does, serve on more than one Committee.

Many Boards, particularly in larger companies, expect to accomplish a substantial amount of its work through the Committees. Each Committee reports regularly to the Board summarizing the Committee's actions.

The Governance and Nominating Committee is responsible for identifying Board members qualified to fill vacancies on any Committee and recommending that the Board appoint the identified member or members to the applicable Committee.

6. Board Recruitment and Selection

a.) Matrix Planning and Board Balance

As a group, the Board should be sufficiently diverse in perspective, age, geography of business, background and experience to provide credible and effective oversight of all aspects of the work of the enterprise. Because a Board is limited in size, Boards tend to comprise people who have generalized experience augmented by some in-depth experience in a critical industry or issue to the success of the board (e.g., brand marketing, industry, technology, government, regulatory, HR/compensation). Nevertheless, collectively, the Board should have the following minimum combination of skills and should be constructed to best account for interests of the Company and the shareholders as a whole:

i. Experienced in running a business or being a senior operating leader of a busines
ii. Experienced in strategic planning
iii. Experienced in business development and/or mergers and acquisitions
iv. Experienced in international business
v. Independence (in the case of Independent Directors)
vi. Financial Literacy or, in the case of an Audit Committee member) Expertise (e.g., CFO type)

Matrix planning allows the Company to identify the critical skillsets for the Board and evaluate all directors against those skills along with other important information related to their terms. Often, a Board identifies several

sets of criteria in order to separate needed board experience from needed committee experience.

b.) Board Selection

A Governance and Nominating Committee manages the Board selection process. The Committee nominates potential Board members to the board for its consideration. The Board then selects the slate of Board members who will be on the shareholders' ballot at the next annual meeting. The Committee also nominates potential Board members to the Board to fill any vacancies that may arise. The Board then elects new Board members to fill such vacancies. The Committee may use outside consultants to assist in identifying candidates.

c.) The Board Selection Process

It is typical and highly recommended that a board recruitment and selection process for both Executive members of the board and for Independent Directors be specified in the Board Policy Manual. Absent that, a board minimally should also lay out and publish a recruitment and selection process to be used and updated as needed. The responsibility for the recruitment and selection process usually lies with the Governance and Nominating Committee or a sub-committee (a selection committee) under G&N's aegis. The recruitment and selection process should specify the steps the board needs to take, the description of the role and responsibilities and how decisions are made.

d.) Term and Age Limits and Board Refreshment

Some boards have term and age limits outlined in the Board Policy handbook. Terms can be staggered (i.e., a certain number of directors face election/re-election every year) or annually reconfirmed. In the past, board positions often were seen as "appointed for life." The trend today for both public and private boards is to ensure a strategic approach to continuous board improvement where a healthy turnover of board seats is systemized. Using the company's current and future needs as a starting point, the board makes planned changes in order to stay competitive and to create new ideas in a time of increased turbulence and competition while retaining important institutional knowledge and continuity. In addition, when a board is balanced between new and/or younger directors, middle aged and/or medium tenured (5-10 year) directors, and older or more highly tenured (greater than 10 years) directors, board diversity is enhanced and directors can retain the kind of independence and objectivity that typically benefits the company best.

e.) Avoiding Problematic Behaviors

Boards at their best are the best of teams. Decision-makers need to balance or avoid renewal of directors who are partisan, too highly tenured to be objective, come unprepared for meetings, are financially illiterate, exhibit poor attendance, are either too "nice" or too "bullish" are lawyer-reliant, or have a celebrity or "star" mentality. (NACD Directorship, July/Aug 2018). These behaviors and attributes can be collapsed into 4 general categories:

i. <u>Inattention to Detail</u>

Often those directors who are very strategic or conceptual get the big picture, grasp issues quickly, figure out broad strokes and immediately cut through

complexity have little tolerance for nuance and dislike or ignore detail. Deep data dives hold no interest for them and their meeting preparation often is lacking, particularly in the areas of finance, risk management and resource allocation. They often are quick decision makers and impatient with discussion or process. One can often see these characteristics in entrepreneurs, which make them good at what they do.

ii. Narrow Field of Focus

These directors have their own agendas. They often are specialists whose world view is narrow. Like those whose solutions to problems are always the same nail, these directors always know that there is one best way – their way. When a topic is decided on, they often revert to the same discussion. This can frequently occur in family businesses where topics are revisited multiple times, even when the board has seemingly moved on.

iii. Entitlement Mindset

These directors are easily identifiable by their disruptive and controlling behaviors. Their sense of entitlement is an attitude. Board membership is about position, authority and power. They often exhibit more passive disruptive behaviors, like arriving late, poor attendance, last minute cancellations, special requests, meeting interruptions (phone calls) and the like. They can come on too strong and often stay too long. They are accustomed to leading and being above the fray.

iv. General Inadequacy

Some directors are simply incompetent to serve as a fiduciary. They may lack understanding of current corporate issues, lack cooperation, intellectual insufficiency, lack intellectual curiosity, financial or legal literacy, or integrity. It is often the case that they may be stubborn and get stuck in their positions and usually overrate their confidence as a mask for their inadequacies. Because even private company boards are experiencing greater regulation, some may not have the tolerance for or interest in greater scrutiny. Fatigue can set in. In a way, these directors can be the greatest risk to the board because the legal system judges the integrity of the board processes and behavior, including taking action when necessary and adhering to fiduciary responsibilities.

f.) Board Interviews

The purpose of board interviews is to identify potential board talent that fits with the culture, needs of the company and board and to cull out any potential red flags as well as to ensure that the candidate can contribute as well as be challenged and grow. Board selection is a joint decision between the candidate and the board so that both parties have sufficient time to ask questions, obtain answers and discuss issues in the open.

It is important for the board to understand first, whether a candidate's experience complements that of other board members. Beyond that, when done well, behavioral interviews (i.e., asking open-ended, targeted questions that ask the candidate to provide real and detailed examples from the past) have been shown to be valid

predictors of behavior and style and to be less easily fabricated.
In preparing for interviews, governance and selection committee members need to homework in addition to culling through writing position descriptions and culling through board resumes. They need to make sure they ask questions of the candidate in the first interview that will get at information that is important to them. They need also to be ready to answer viable candidates' often tough questions. They should have a clear and honest evaluation of and be able to articulate how the board itself functions as a group, makes decisions, how information flows to and from the board, how conflict is settled, the relationship and stability between management and the board or the family and the board, the company's financial position, the orientation and expectations toward continuing education, the most significant risks, and the company's approach to compliance as well as indemnification and D&O insurance details, etc.

7. **Onboarding of New Directors**
   Onboarding of directors supports the speedy integration and performance of new directors. New directors function best if they understand the operating environment and culture of the company, board practices and dynamics, and have well-articulated roles and responsibilities. A copy of a well-developed and current Board Policy Handbook is a valuable foundational resource for communicating important information. While onboarding efforts are led by and under the aegis of the Nominating and Governance Committee, involvement of all board members ensures a new director's speedy integration. Activities that a board should consider in its onboarding process include (a) regular meetings with the lead director or non-executive chair; (b) partnering an existing director with a new director as a "mentor" to help the new director understand acceptable and "taboo" behaviors for early in one's tenure, (c) introductions and meetings with key management as well as mid-level employees, (d) visitations to sites, (e) attending director education programs with the primary contact, and (f) attending at least one of each committee meeting during the first year.
8. **CEO, Board and Board Committee Evaluations**
   a.) **CEO Evaluations**
   The Board should annually review the Chairperson and the CEO using the opinions of the Directors and Managers. The results should be discussed privately with the Chairperson and the CEO. This evaluation and reporting activity should be the responsibility of the Compensation Committee and the results should be tied to his or her compensation packages going forward.
   b.) **Why conduct Board Evaluations?**
   One of the most difficult tasks that a board engages in is to regularly evaluate itself – especially when the board begins to conduct self-evaluations. No one particularly likes to be evaluated and, because private companies are not legally held to the same standards as are public companies, it is easy for boards to miss this important self-improvement process. Yet, a high-performance Board must be able to distinguish good contributions from poor and, above all, ensure that all directors act to hold themselves and the Company accountable, to ensure that the company has the right set of directors for now, and to ensure that the board is constantly in a state of incremental improvement. When private company boards begin to evaluate

themselves, they usually start with a full board evaluation with the plan to later include committee and individual evaluations.

c.) Board and Board Committee Evaluation Processes

The Governance and Nominating Committee is responsible for assessing the effectiveness of the Board as a whole. The evaluation process includes requiring each Director to complete, on an annual basis, an evaluation with respect to the performance of the Board of Directors. These evaluations may take the form of confidential interview, multiple choice, Likert-like scales, fill-in-the-blank or open-ended questions – or a combination of these. The Governance and Nominating Committee reviews the evaluations with the Chairperson. The results of the evaluations are summarized and presented to the full Board of Directors. The Chairperson, as appropriate and possibly along with the Lead Director, may review with a Director that individual's peer evaluation findings rather than having the Governance and Nominating Committee provide feedback for individual Directors. In the course of the evaluation process, the Board also considers the appropriate time for retirement if no mandatory retirement age has been established by the Board. Outside advisors who specialize in Board evaluation often are called upon to evaluate the Board, particularly when the evaluations include individual performance information.

d.) Privilege Concerns:

Board evaluations should be as confidential as possible with as few communication trails as possible. Ideally, the best way to protect the organization is to use an unbiased and independent outsider, often a specialist in board evaluations, a corporate psychologist or an attorney (both of whom have privilege). Best practice recommends that board evaluation documents and communications are not handled digitally, that they are destroyed immediately and that only summary results and action steps are recorded and/or minuted. Both digital and hard copies of these evaluations are discoverable.

e.) Post Evaluation Follow-up and Board Development

Goal setting and action steps following a board evaluation ensures that the evaluation process is taken seriously and that the board can actually improve and report progress by measuring the accomplishment of goals. Finally, Board evaluations can be used to help build a high-performance board by using assessment specifically to prepare for recruitment

9. Board and Committee Meetings

a.) Content and Process of Board Meetings

The content of Board meetings should include all key matters brought forth by senior executives and a review of past activities so that management can be held accountable. Because there are many topics for which Board oversight is required, a Board Calendar usually lays out the regular topics to be covered over the course of the year. The Board usually makes decisions by simple majority vote. The process should be spelled out in the Company bylaws. It is important for all directors to stand behind the board's decisions.

The Agenda for each Board Meeting is established by the Chairperson. Any Board

member may suggest inclusion of additional subjects on the agenda. The agenda for each Committee meeting is established by the Committee chairperson in consultation with members of the Committee and, where appropriate, in consultation with the chairs of other committees. Board and Committee members should provide the information needed for the Directors to make informed judgements or engage in informed discussion. Such information should, to the extent practicable, be circulated to Board and Committee members in advance of meetings in the Board Book, which contains all relevant materials for review for the meeting.

The agenda materials and minutes for each Committee meeting is available to all directors and, unless a Committee expressly determines otherwise, all directors are free to attend any Committee meeting. In addition, all directors, whether or not members of the Committee, should be free to make suggestions to a Committee chairperson for additions to the agenda of his or her Committee or to request that an item from a Committee agenda be considered by the Board.

b.) Board Dynamics and Productivity

Good process enables a successful board to hear the voices and opinions in the room, to avoid dominance from one or more members and to stay on task and, at its best, to enjoy and be fulfilled by the work and each other.

Another way to ensure free and open discussion in committee and board meetings is for Independent Directors to meet in Executive Session with no members of management present. When a Lead Director exists, the Lead Director chairs Executive Sessions. Otherwise, executive sessions may be conducted by the Governance and Nominating Committee, usually led by that Committee Chair. Each Independent Director has the authority to call an executive session. The proceedings of these sessions are not included in the regular minutes.

c.) Frequency of Board and Committee Meetings

The Board should meet in regular session at least three times per year, or once a quarter with the Annual Meeting being held in lieu of the fourth meeting. Additional meetings may be held when deemed desirable by the Board or its Chairperson. In high growth companies, in particular, Board meetings are often held monthly or every other month. Directors are expected to attend all activities associated with the Board meeting. It is often the case that formal Committee meetings are held the day before the Board meeting, with a dinner of all Directors and key Executives the evening before the Board meeting. It is not unusual for interim Committee meetings to be held or phone calls among Committee members or chairs be required to conduct business in an orderly fashion.

d.) Attendance at Board and Committee Meetings

Participation in Board meetings is critical to Board effectiveness. Board Members are expected to make every reasonable effort to physically attend all regularly scheduled full Board and regularly scheduled assigned Board Committee meetings and to spend the time needed to discharge their responsibilities as Directors. Directors are also expected to attend the annual meeting of the Company's stockholders.

Most highly functioning Boards have written Board and Committee attendance policies. Board members are expected to attend all meetings and advance notification

of any absence is highly desirable and expected when practicable. Recognizing that Board Members have distance and time constraints, participation by phone, zoom or other communications media is usually acceptable when physical attendance is not practicable. The Governance and Nominating Committee is responsible for evaluating the facts and circumstances of any director's failure to meet the aforesaid attendance expectations as part of its evaluation process. An example of a fairly lenient Board attendance policy states that the Board may remove any Board Member from their assigned Committee for missing three consecutive regularly scheduled Committee meetings or three combined Board/Committee meetings in the same fiscal or calendar year.

10. Personal Liabilities and Risk Management when serving on a Board

Fiduciary Board service brings with it a number of associated financial, reputational, relational and time risks. Although it is estimated that serving on a board can require over 200 hours of time per year, if a company is in distress, is preparing to buy or sell or there is crisis of any form, the time cost can be much greater. Guilt by association during crises and disruptions of business invariably land on the board's lap as the fiduciary. Along with reputational risks associated with rapid fire news dissemination, directors can be subject to law suits – particularly as a result of major decisions. In these days of high conflict and high degree of litigation, one can expect over the course of a board career a high probability of being sued as part of a major corporate event. At the same time, the personal risks associated with board service can be managed or mitigated by attention to some or all of the following:

a.) Serving for the right purpose
b.) Pause before accepting a leadership role
c.) Come to board and committee meetings fully prepared to share questions and perspectives
d.) Vote "yes" only when one is confident that it's the right thing to do
e.) Be courageous
f.) Listen to the small voice telling you to speak up
g.) Make sure that a solid D&O policy exists before signing onto the Board