CORPORATE GOVERNANCE: BUILDING AN IPO AND MERGER DUE DILIGENCE DEFENSE THROUGH BOARD MINUTES

By
Marc Morgenstern

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INTRODUCTION

In the record-breaking 2007 year of transactions, extensive attention was devoted to the importance (and process) of due diligence for liquidity events, i.e., mergers and acquisitions ("M&A")[1], as well as initial public offerings ("IPO's").[2] Due diligence has become increasingly formalized. Buyers, underwriters, and their respective accountants and legal counsel each have their own guidelines, checklists, and procedures to be followed and satisfied. The universal belief is that due diligence commences when a specific deal starts or is contemplated, and the only questions are the extent and historical timeframes for which diligence is required, i.e., due diligence is a backward-looking process. All would agree that due diligence (at some level) doesn't end until the deal has sold and closed.[3]

My perspective is somewhat different and hopefully controversial. Smart businesses exhibit foresight and start building their due diligence defense in preparation for a liquidity event beginning with the <u>first</u> board meeting the Company ever has, i.e., due diligence is at least as much a <u>forward</u>-looking process from the Registrant or seller's perspective. Accordingly, I have also reversed my traditional approach (shared by many) that Board minutes should be short and almost skeletal, limited to identifying the topics discussed, but having lengthy, highly protective, formal resolutions when Board approval or ratification was necessary.

In my case (and many others), the approach reflected a reasoned philosophy, but for some, skimpy minutes simply indicated a lack of concern (or a misunderstanding) about the consequences of the minutes or a desire by the Company to limit costs. Increasingly, however, my belief is that Board minutes should be prepared as if they were: (1) Exhibit "A" of the underwriter's or issuer's Motion for Summary Judgment in the inevitable shareholder litigation, (2) a key document in many regulatory arenas, and (3) the outline of the Seller's private placement memorandum.

The Sarbanes-Oxley Act of 2002[4] ("Sarbanes-Oxley" or "SOX") and recent case law developments have significantly expanded the responsibilities and potential liability of corporate directors in areas such as director independence determinations, the requirement to hold executive sessions, assessments of the financial acumen of the audit committee members, general oversight of internal and disclosure control development, auditor oversight, and whistleblower investigations. Independent compensation committees must now approve all executive compensation, and the "Compensation Discussion and Analysis" in the proxy statement, an obligation created by the Compensation

Rules that became effective for the 2007 proxy season (all of these newer oversight functions of Directors being collectively referred to as the "SOX Oversight Obligations").

Board minutes, information packets, and other materials (collectively, the "Board Package") created for Board meetings (including minutes) have significant Securities and Exchange Commission ("SEC") disclosure ramifications[5] and create risks under both federal securities and state corporate law for corporate Boards (and Directors individually) if inadequately prepared. Among other issues, these documents may establish the degree of corporate awareness concerning business developments which can be used in enforcement proceedings and private class action lawsuits to allege a failure to disclose known material trends or other information.

As a result, this is a critical time for lawyers to re-evaluate their own practices with respect to record-keeping associated with Board of Director and Committee meetings, particularly from the perspective of building a due diligence defense for current securities law compliance, future offerings, and/or a sale of the Company. Other lawyers may disagree with my personal transition to substantially more fulsome minutes and emphasis on Plain English; but I would urge them to do so only after re-examining the basis of their personal philosophy of the role minutes play in the aggregate context of a public company in today's environment. Strong consideration, and considerable corporate introspection, should be given to creating a different and more thorough approach to Board processes, deliberations, and documentation.

In addition to the foregoing, the premise that traditional, minimalist style of minute-taking may no longer serve Directors well reflects conclusions drawn from some observations expressed below, and leads to the proposals for good minute taking substance and style found in Sections IV, V, and VI, *infra*.

I. <u>Historical Preparation of Board and Committee Minutes</u>

Traditionally, Board minutes were prepared by corporate secretaries and/or lawyers who were often trained in the "less is better" style of minute-taking. This approach was partially justified based on the protection of confidential corporate information. The minimalist style of record-keeping was also favored by some on the theory that with less detail provided, litigation adversaries would have a smaller target to shoot at, and less ammunition with which to second-guess or attack Board conduct and processes, and decisions. This bias resulted in Board minutes that were not only brief, but also frequently intentionally not descriptive of the substance of the discussions held, or the quality of the information provided to, or considered by, the Directors. Committee minutes were even less informative and more informal and frequently heavily employed industry jargon that only someone in the industry could read and understand. They were often prepared by the Chair of the Committee and not even reviewed by the Company's lawyers, virtually guaranteeing a lack of internal consistency in the corporate records between language and approaches used in Committee minutes and the Board minutes reflecting the deliberations and reports of those Committees.

Not surprisingly, in today's more highly regulated environment, in which committees have expanded specific responsibilities, such as justifying and explaining executive compensation decisions, lawyers increasingly attend and codify Committee meetings with minutes reflecting a more formal style consistent with the Company's approach to Board Minutes. This inherently assumes that the Company, not just the individual drafter of a specific set of minutes, <u>has</u> an approach that management and the Board have articulated and agreed to. If they don't, they should. Minutes are a key part of a Company's compliance program and liability minimization efforts. Each set of minutes exists not by itself but within the context of prior and future minutes, and prior and future SEC disclosure. Consistency can only occur if it reflects a philosophical and conceptual viewpoint adopted by the specific Board. Dangerous circumstances are created if one set of minutes are minimal while another are fulsome. In this context, consistency is a virtue.

A notable exception to the minimalist style of minute-taking has been the recording of Board deliberations concerning M&A activity, particularly on the sell side of a transaction. Most lawyers extensively reflect in Board minutes a thorough record of the directors' review and deliberation. Good lawyers want these minutes to be self-explanatory, validate the Company's selling process, and reflect a sound basis for the Board's decision. Were the right alternatives and sales strategy considered and third party valuations sought? Was the proposed sale to the right party, at the right time, and at the right price to maximize shareholder value?

Why the historical difference between the Board minutes for M&A activity compared to other corporate issues? The answer can probably be traced to the famous 1980's Delaware case of *Smith v. Van Gorkom*,[6] where the TransUnion directors were found to be personally liable due to a palpably insufficient and defective process in approving the sale of the company. This flawed process had the impact of vitiating the otherwise potent Business Judgment Rule defense that protects directors from personal liability; even for decisions that turn out to be wrong. In essence, the Business Judgment Rule simply says that if Directors, in good faith, reach a reasonable conclusion based on a process that satisfies both the duty of care, as well as the duty of loyalty, then they are protected from individual liability.[7]

Directors are not intended to be guarantors against failure. Courts rarely question even a demonstrably bad corporate result, provided that the bad result followed a well-conceived and documented process. The *Van Gorkom* case, and the imposition of individual Director liability, shocked the corporate legal community and focused attention on the importance of conducting and memorializing a reasonable process prior to making decisions in the M&A arena.

II. EXPANDING LITIGATION AND CHANGING REGULATORY ENVIRONMENT

More recent cases (e.g., *Caremark*, *Abbott Labs* and *Disney*)[8] and enforcement activity have focused greater scrutiny on Board oversight and processes in the context of decision-making outside of the M&A environment, including executive compensation, regulatory developments, Foreign Corrupt Practices Act (primarily the anti-bribery and accounting rules), environmental compliance, intellectual property, and overall legal compliance programs. All this highlights the fact that insufficient Board oversight and review may undercut the Business Judgment Rule defense of Directors in any aspect of the business where shareholder value could be impaired (including the SOX Oversight Obligations), thereby creating corporate and individual Director liability. Board minutes, notes taken by individual Directors, and other records can also play a pivotal role in regulatory enforcement proceedings as exemplified by the often-cited SEC enforcement actions against Sony and Caterpillar[9], as well as in private securities class action litigation. Should legal counsel encourage each director to save or discard their individual meeting notes after the official corporate minutes for the meeting are approved? There are fair arguments to be made either way – but the advantages and disadvantages of each approach should be considered with each client and not presumed by the lawyer.[10]

A. Transaction Speed

The speed at which transactions occur continues to accelerate, making it harder to "catch-up" for sloppy documentation. A different way of looking at it is simply that with minimalist minutes, more time must be spent, and documentation produced, in the condensed time available for due diligence in fast-moving transactions. There's more to be explained because the minutes aren't self-contained and explanatory.

In a world of business consolidation, every company (public or private) is for sale every day; whether it knows it or not. The only question is price. Frequently the only barrier is due diligence or lack of clarity of corporate liabilities (including securities compliance). Some recalcitrant sellers may perversely view inadequate minutes as a mild defensive measure because it's harder for a buyer to perform due diligence. It is at least as likely that director liability exists if a good transaction is lost because the buyer is dismayed by the lack of corporate formalities and inability to confirm or deny corporate and securities compliance, and therefore stops a favorable purchase process; all to the detriment of the shareholders.

Also, because a sale or public offering can occur more quickly than ever before, a company's corporate governance and due diligence "preparedness" needs to be both well-designed and rigorously maintained. If a desirable buyer or underwriter wanted the due diligence process to begin tomorrow, and the first request would be to read all of the Board and Committee minutes, then the seller or issuer should be comfortable that it is always in the position of complying immediately. Price and terms should be what the Board is focused on; not the status of its corporate minutes.

B. GLOBALIZATION

In a world of virtually seamless capital markets, the issuer can no longer assume that its initial public offering will be on a domestic stock exchange. "Real" companies going public used to have two acceptable choices: New York Stock Exchange or NASDAQ. Now they can list on the London Stock Exchange, Euronext, AIM, and the Deutsche Börse, among literally dozens of well-regulated and relatively liquid marketplaces.

Unsurprisingly, many American-based companies are starting to choose the exchange with the lowest initial and ongoing operating costs and the least governmental regulation, i.e., <u>not</u> the U.S. exchanges and being subject to the regulatory burdens, financial and operational, imposed by Sarbanes-Oxley. While the numbers of U.S. companies choosing to list abroad appears to have been small so far, the question of <u>where</u> to list has become part of every Board's IPO discussion, and should be so noted in the minutes. As a consequence, their counsel need to know, at some level, differences among registration and listing requirements of foreign exchanges. Fortunately, in general, a company that would survive the due diligence of domestic requirements will exceed those of the alternative marketplaces.

With respect to M&A activity, a trend seems to be emerging that instead of an IPO, many venture-backed emerging growth companies achieve liquidity through a sale, whether to a foreign or domestic buyer. From the buyer's perspective, particularly in cross-border transactions, due diligence is imperative to determine whether an acquisition should be made of a foreign company, particularly if the seller's foreign sales are dependant on practices that violate the Foreign Corrupt Practices Act. If an SEC registrant learns of such practices, it is compelled to stop such violations on a go-forward basis, as well as assessing their risk as a buyer based on the historical exposure created by the seller.

C. DUE DILIGENCE LIABILITY DEFENSE UNDER THE 1933 ACT

In an IPO context, there has been a long-standing debate among lawyers as to the best preparation for affirmative defenses for management and Directors against liability under Sections 11 and 12(2) of the Securities Act of 1933 available to various participants in the IPO process against liability. The statute is silent on the role of due diligence as a defense and, in fact, does not use the term. The two sections do not cover the same potential defendants.

The term “due diligence” defense in an offering context, however, based on significant litigation history, generally refers to either: (1) the ability of a non-expert to rely on a non-expertised portion of a registration statement if a reasonable investigation (with reasonable grounds) were conducted by the non-expert, and (2) any person who has the statutory right to rely on “reasonable care” or “reasonable investigation” as the basis for a due diligence defense.

While the relationship is not 100% analogous due to the different context of the transactions, the approach to correct documentation establishing due diligence defenses in both the offering and the M&A context frequently reflects a similar approach to whether protection is best obtained by more documentation or less. In the context of public offerings, one group of lawyers argues that only by <u>saving</u> every draft of the prospectus can the issuer demonstrate the thoroughness with which the facts were reviewed and the narrative revised, to reflect increased understanding and more precise disclosure; thus increasing the likelihood of preserving a due diligence defense. The other group equally fervently says that the underwriting team should <u>discard</u> every written draft and let the final version speak for itself. Proponents of the latter think it's much safer to only have the final version survive.[11] Otherwise, everyone present at the drafting session may need to explain why use of the term "substantial" in Draft One, was altered to "significant" in Draft Two, but ended up being characterized as "material" in Draft Three. Did each person agree with the change, and if so, why (or why not)?

Lawyers' opinions on "save" or "discard" generate very strong views, and frequently are not uniform within a law firm. The approach, however, should probably be agreed to, or at least discussed, by the entire IPO offering team. If some discard while others save, the "save the draft" proponents view will obviously be won by them by default. Anecdotally, the practices appear to be split almost evenly.

To disclose my own bias, I have always been strongly in the "get rid of every draft" camp for offering statements. We're all the products of our own experience. As a young lawyer I spent months preparing for, and participating in, securities litigation depositions stemming from a failed offering. I had the privilege of watching some truly gifted litigators tear apart every word in an investment banker's multiple drafts of the prospectus, focusing particularly on one investment banker's <u>hand-written</u> marginal comments. It left a searing impression on me of the danger of having to explain subtle distinctions in language choice many years after the prospectus was written. My approach of discarding all but the final version of offerings remains unchanged after 30 years of practice.

III. POST SARBANES-OXLEY APPROACH TO BOARD MINUTES

By contrast, my view of Board minutes generally, how they're written, what philosophy they express, and the role they play in an ever more integrated securities disclosure system and due diligence process have changed sharply.

I used to believe that "less" was "more" was also the right approach for board minutes, and was the logical, philosophical corollary of discarding all the drafts of offering documents. Limit the minutes to reflect that the financial statements were discussed, or that a dialogue about a possible M&A deal occurred, and nothing more. Make it clear that the references represented only the most minimal summary of the discussions. This minimalization left the Board free to demonstrate compliance with the Business Judgment Rule with great freedom, at a later date, unhampered by too much contemporary narrative explanation.

I now believe that the role of lawyers and the role of Board meetings, preparation, and procedures has sharply changed from: (1) an ongoing due diligence perspective (2) good SEC compliance (or liability avoidance), as well as (3) how to best protect Directors under the Business Judgment Rule.

A. CHANGING THE BOARD MEETING PROCESS TO RESPOND TO SARBANES-OXLEY

Elsewhere[12] I have suggested that as corporate pressures have been exacerbated, and time-frames for SEC "real-time" disclosure reduced, companies and Boards have had to significantly modify their preparation for, and conduct and memorialization of, board meetings, in order to meet the increased responsibilities and oversight demanded in today's capital markets. A reasoned response to the changed environment is to improve the quality of the preparation period[13] for board meetings, perform more extensive analyses, involve a broader range of the company's professional advisors in the planning and board process (the "Disclosure Team")[14], and document the resulting analyses and actions.

These suggestions posit that companies and Directors have not historically regarded board meetings as being the source for certain kinds of precipitating events or links within the current SEC disclosure chain, nor necessarily part of an ongoing due diligence process. The intuitive legal view of board meetings and process is that the lawyer's job is to focus on corporate and director liability under substantive corporate law (i.e., the Business Judgment Rule) rather than viewing this process as a key component immediately and dramatically impacting an issuer's SEC public disclosure obligations. The better analysis is that both the meetings and the minutes must be viewed to satisfy all of these objectives – corporate and securities.

About a week prior to the Board meeting, the Board Package, containing corporate-specific information, including internal and third party documents, are compiled and distributed to Directors to permit them to properly prepare for the board meeting. They generally contain draft minutes of the immediately preceding meetings of the Board and Committees that have not yet been approved by the

Board, and that are still subject to revision and modification. Board Packages also contain operational data about the Company and other third-party information often compiled from multiple sources and prepared with varying degrees of formality, conservatism, knowledge of the legal environment, and standard disclaimers or use of generalities rather than absolutes, that would significantly reduce time and effort involved in the due diligence process. These tend to be prepared by operating personnel and financial officers primarily from an operational perspective rather than from an SEC disclosure perspective, and typically without prior legal review and input from counsel. This information, collectively, however, can have significant disclosure ramifications.

B. CONSISTENT, THOROUGH BOARD PACKAGES WILL FACILITATE SEC DISCLOSURE COMPLIANCE

As an example, to avoid creating bad facts and securities liability similar to *Caterpillar*[15], the Board Package has to provide Directors sufficient information to understand what <u>has</u> previously been disclosed, and more subtly, what <u>has</u> <u>not</u> yet been disclosed. Trends occur only within a context. Information is frequently not publicly disclosed because at the time of original analysis, the information was not material or disclosure was not otherwise mandated. At an earlier time, the probability of a potentially disclosable event occurring may have been too remote to warrant disclosure.

1. <u>PUBLIC DISCLOSURE</u>

For example, at some point, early indications of softness in the sales channels may turn into a material downward revision in the revenue forecast. As the quarter progresses, highly prejudicial facts about the Company's outlook are revealed, and what appeared to be a manageable problem unexpectedly seems serious. In short, evolving facts and circumstances continuously require disclosure analysis. Prior analysis cannot remain static because new information can change previously correct decisions and disclosures.

Information provided to the Board has to be prepared in a manner calculated not to overstate (or understate) risks. Care needs to be taken to distinguish between forecasts (what management believes will occur) from hypothetical calculations of future financial results based on alternative management assumptions (what may occur), i.e., projections. There's an enormous difference in the level of certainty of events and financial results raised by forecasts rather than projections. If information discussed is hypothetical and represents an alternative or approach, then it should be clearly identified as such directly on the document. You can't easily rely in a later litigation on cover letter disclaimers indicating that everything in the Board Package is a draft or a preliminary projection. If it's either, then label it as such contemporaneously. Let the document speak fully for itself without the need of later proving that this was a specific document encompassed within an overall disclaimer.

To accomplish this, the Board Package should be prepared or reviewed by individuals who understand both a public company's disclosure obligations, as well as the pre-litigation nature of the documents and information presented.

The advantage gained in better preparation, however, may be lost unless the minutes clearly reflect whether that what was distributed and discussed as future financial results was a <u>forecast</u> or a <u>projection</u>. When the minutes characterize information presented to the Board as "absolute", without qualifiers, modifiers, or footnotes, information may appear to require immediate disclosure while a fuller explanation (clearly indicating that disclosure was either premature or the information was merely one of several possible scenarios) creates a very different record – one that can create liability and concerns needlessly. So the care and attention given to "adjectives" in the minutes, of using consistent narrative descriptions so that a three hour discussion doesn't look like it was accomplished in 120 seconds, have strong, long-lasting impact – on both current disclosure issues and analysis, as well as the appearance the minutes create later in the relevant due diligence process.[16]

Individuals who are given responsibility for preparing or reviewing SEC reports, press releases, and other public disclosures must have access to, and take into account, what is contained in Board Packages. This is particularly important for the Management Discussion and Analysis section of periodic reports. Board members must be proactive in requiring the Company's Disclosure Team to confirm that risks and developments identified in Board materials either have been, or will be, properly disclosed, or do not require disclosure. Significant inconsistencies between internal and external disclosures of risks, trends, and developments should immediately raise questions for the Company's lawyers and financial officers concerning the Company's disclosure obligations. At the conclusion of a Board meeting, Directors should be advised by counsel (or other members of the Disclosure Team present) whether any issues discussed, facts learned, or conclusions reached, have altered the adequacy of the Company's prior disclosure or created new disclosure obligations. How best to reflect the foregoing in minutes (i.e., evidencing careful discussion and reliance on legal advice) without inadvertently mischaracterizing information and analysis, thereby creating liability, is regrettably, "art" and not "science." No general guidelines will ever replace reasoned, knowledgeable, analysis.

2. PUBLIC DISCLOSURE AND CORPORATE OVERSIGHT

Board Packages, Director notes, and other contemporaneous records may play a pivotal role in verifying that appropriate disclosure was timely made. This will also be crucial in regulatory enforcement proceedings (as exemplified by the SEC enforcement actions against Sony and Caterpillar), as well as in private securities class action litigation. Directors have statutory obligations to provide oversight to these management functions and avoid personal liability – and good minutes should specifically note that important matters have been raised – and that the discharge by Directors of their SOX Oversight Obligations are confirmed in the minutes.

Specific tasks and responsibilities of Boards resulting from governance reform legislation and rule-making (particularly for committees) should be considered in preparing Board agenda and resolutions approving matters related to periodic reports and proxy statement filings.[17] Compliance with, and documenting compliance with, these obligations, involves advance planning by management, the Board, and counsel to ensure that the right issues are addressed in a timely fashion, and that Directors have sufficient facts and information to meet their statutory obligations.

3. Documentation of 8-K Events

The broadened list of 8-K disclosure events, and the reduced time period in which to make such filings (from five or fifteen business days, depending on the item, to four business days for most items) further exacerbates the need for coordination among the Disclosure Team and the Board. Documentation for the meeting, particularly the official minutes, must be consistent with previous disclosure, and appropriately support disclosure conclusions reached during the meeting. It's not always easy in a lengthy Board meeting to precisely determine either the magnitude of an event that is mentioned, or the probability that a possibility discussed will occur, and, in either case, whether the information alters the company's disclosure mix. The degree of difficulty of the task, however, is significantly compounded if appropriate planning doesn't occur for the meeting. There is considerable nuance involved in positioning the likelihood and magnitude of an event (i.e., the basis for materiality) in the Board Package and captured in the minutes.

IV. <u>Interplay of Timing and Disclosure Processes</u>

A. Approach to Preparing Minutes

In short, the logical extension of the thought that if Board meetings should be prepared for differently, processes started sooner, and a larger Disclosure Team involved, then the minutes should reflect the same approach. The Company's ongoing process for due diligence will have so increased, that the company's minutes can, and should reflect, the Board's review of the numerous statutorily enumerated Board oversight role.

The Board Package includes internal and third-party documents, including draft minutes of committees and boards. These minutes have not yet been approved by the board or the relevant committee. While they are very rarely "wrong," nuance is frequently missing and incompletely expressed thoughts may well create the reality or illusion of liability when in fact the actual event has simply been poorly described, or words used colloquially rather than in a precise, formal legal manner. Recognizing that in the context of a transaction these minutes can, and frequently are, the basis for either raising or allaying concerns by buyers or underwriters, the documents should be viewed from a longer, more inclusive timeline, always contemplating a future liquidity event – and that each set of minutes is a part of a future due diligence.

Minutes are frequently written solely to the current "corporate family" rather than being intended to be read under the scrutiny and rigor of outsiders lacking knowledge of preceding meetings or subsequent conversations. Consider the "audiences" which read minutes besides the current board: buyers, underwriters, lenders, SEC, IRS, numerous regulatory agencies, adverse parties in litigation, and the trier of fact (judge, jury, or administrator) involved. None of these readers are "friendly"; each is looking to find an exploitable fact or failed process or problem memorialized in what is <u>in</u>, or what is <u>not</u> in, the minutes.

Prepared with foresight and care, the information contained in minutes can <u>minimize</u> liability, while conversely, inadequately prepared minutes can <u>create</u> liability. Minutes and the Board Package in its entirety reflect the degree of corporate awareness (or lack thereof) concerning developments in the issuer's business. If minutes from one meeting reflect concerns raised by directors, and subsequent meetings and minutes never reference that management satisfactorily addressed such concerns, then the entire process has failed. Each set of minutes is part of a continuous disclosure chain and a continuous corporate history. Omissions in the chain, frequently inadvertent, may raise significant questions – where no question ever should have arisen – had the minutes been prepared from a different perspective.

From one disclosure standpoint, the documents reflect the degree of corporate awareness concerning developments in the issuer's business. Knowledge by the board of material facts and developments can, in turn, be used in subsequent regulatory enforcement proceedings by the SEC and state attorneys general (as well as private class action lawsuits) to allege a failure to disclose known material trends (see discussion *supra*), or other information. Additionally, the same documents and analyses can demonstrate knowledge of material, nonpublic information, the possession of which should cause the company, directors, officers, and insiders to refrain from trading in the company's securities.

B. How to Read Minutes in Due Diligence

Any standard IPO or M&A due diligence checklist will have a line entry that indicates that committee minutes and board minutes will be reviewed. There may be some minor differences as to the historical time period for which such minutes are deemed relevant (i.e., the "last 3 years" or "forever"). It's almost, however, as if this is a mere formality to be gone through as part of an underwriter's Section 11 and 12(2) defense strategy rather than because the exercise provides genuine information and raises or alleviates substantial concerns.

Virtually every matter requested on a due diligence list, and which will be reviewed, references items that classically either were (or should have been) discussed at least once at a board meeting: (1) reports to management from accountants; (2) status of the Company's standing under (and covenant compliance with) its loan agreements and credit facilities; (3) the appropriateness of a poison pill or other defense corporate structural mechanisms; (4) other "material" business contracts; (5) stock options or other equity compensation plans; (6) intellectual property; (7) regulatory investigations or inquiries from local, state or federal regulators; (8) off-balance sheet liabilities and (9) asset impairment.

Numerous other topics more specifically required for corporate governance under Sarbanes-Oxley and other self-regulatory organization rules including Chief Executive

Officer and Chief Financial Officer Certifications under §§302 and 906 of Sarbanes-Oxley, respectively, internal accounting procedures under §404, “whistle-blowing” procedures, any related party transactions, and reports from each of the company’s standing or special committees. These latter due diligence items, primarily stemming from post-Sarbanes-Oxley corporate governance, was the precipitating factor in my revising my historical approach to preparing Board minutes –and for preparing for Board meetings.

Activist shareholders’ letters frequently urge sale or divestment of certain assets, raise concerns about potential regulatory issues, and other indicia designed from the activist’s standpoint to create pressure, thereby forcing a company to take actions which it otherwise would not.

Like almost everything else in the securities world, judgment is required. Not every activist letter deserves to be mentioned or discussed at the Board level, nor every phone call or meeting request from a potential buyer to management needs to be recorded in detail. But there should be general agreement by the Board with management as to when the level of activity requires Board discussion and involvement; otherwise every board meeting could consist of nothing but useless reports on both topics. The Board are overseers; not micro-managers.

Most minutes are, to some extent, self-serving, and many different "accurate" minutes could be prepared for the same meeting by competent counsel acting in good faith. Sometimes, however, they are written as if a recording secretary were present at the meeting, i.e., what's recorded is literal rather than conceptual. All comments are dangerouly recorded with attribution to a specific individual as if a tape recorder were running inside the Board Room, needlessly exposing an individual Director in litigation.[18] Board minutes should <u>not</u> be mechanical. They are conceptual. Boardrooms, like life itself, are messy. The same topic may be discussed several times at a single board meeting. From my view, despite the lapse in chronology, minutes combining discussions about a single topic are appropriately discussed in a single place in the minutes. Votes shouldn't be recorded by individual director unless specifically requested by a Director who wants to create a record that they disagreed with the Board's conclusion.

C. WHO SHOULD READ THE MINUTES IN DUE DILIGENCE

Many law firms, accounting firms, or investment bankers assign their respective due diligence obligations of reading minutes to junior members of their firms. This may signal that the institution regards it as a mechanical function that simply needs to be crossed off of the list of things that have occurred, rather than an integral, critical element in the process. The concern is raised not by intelligence, but simply by experience. While some may have unusual background or experience, generally the less experience someone has, the likelier it is that the only problems that such individuals would recognize will be of “atom bomb” quality. Many issues are “obvious” to an experienced practitioner simply because of experience, and the ability to draw inferences from less data.

Similarly to Sherlock Holmes’ in “The Adventures of the Silver Blaze,” over time the critical due diligence may be to notice that the dog <u>never</u> howls at night.

[Inspector Gregory]: “Is there any other part to which you would wish to draw my attention?”

[Holmes] “To the curious incident of the dog in the night-time.”

[Inspector Gregory] “The dog did <u>nothing</u> in the night-time.” [emphasis added.]

[Holmes] “That was the curious incident,” remarked Sherlock Holmes.

Thus in industries in which disposal of waste is a well-known and common problem, it should cause considerable concern if in 20 years of minutes, there is no reference in the corporate minutes to how the company disposes of its waste. The key to successful due diligence frequently consists not of reading what <u>is</u> written, but knowing what <u>isn't</u> written. What's conspicuous is not that the dog barked; what's conspicuous is that the dog did <u>not</u> bark.

People frequently pick relatively short time periods in which to read due diligence. The last three years; the last five years; or the last ten years. Liabilities tend to exist for extremely long periods of time. There may have been an approach to antitrust discussions that occurred 20 years ago, and that has been essentially adopted and maintained by the company ever since with no further references to them in minutes. There may have been discussions that occurred with respect to the acquisition of real property and the risks attendant to it stemming from a wide variety of environmental realities, which are just as pertinent today as they were then because the liability was assumed and still exists.

Every company has a "story." Listen not just to the words but also the rhythm and the melody. There's no reason to limit the review of Board and Committee minutes. There are too many liabilities with incredibly long lives, i.e., real property that is or may be a superfund site, concerns expressed over intercompany product pricing between subsidiaries located in different countries and the related tax issues, and other matters. Read all the minutes.

V. BEST PRACTICES

Best practices for minute-taking necessarily requires a Board to have followed best practices in governance. Even the most eloquently drafted minutes cannot substitute for a substantively defective or inadequate process. Actions taken in anticipation of a meeting, and every sentence of the minutes, must be mindful of the twin goals of satisfying prospective due diligence (establishing the availability of the

Business Judgment Rule) as well as the impact on SEC disclosure and compliance. The goals of the process and the minutes must be clear to all involved in the Board preparation and Disclosure Team.

The language used in minutes should be direct, and business-like; designed to be comfortably read by a jury, not a lawyer, accountant, investment banker, or business executive. That necessitates using sentence structure, grammar, and defined terms in a way calculated to reduce, and preferably eliminate, ambiguity. The drafter's conceptual perspective needs to be that the minutes are going to used either as an exhibit to plaintiff's or defendant's litigation to establish that the Board fulfilled or failed its duties. The average juror's reading comprehension is frequently found at the junior high school level. That's one of the audiences that may reach critical decisions based on their understanding of the documentation.

The drafter of the minutes has the opportunity to tell the Company's and the Director's story, choosing words that can help or hurt. The story may be created (<u>not</u> invented) and told consistently over many Board meetings and minutes as well as concurrent SEC periodic reports. The decision to make an acquisition doesn't usually happen in a single meeting. The transaction was reviewed and developed over time based on changing facts and additional analyses.

A. The SEC's Approach to Plain English

Since much of what the premise is based on is for the purpose of satisfying due diligence in connection with an IPO, it may be helpful to turn to the SEC for guidance on drafting minutes.

The SEC's requirement that offering documents use "Plain English"[19] was driven by a regulatory desire to make disclosure information accessible to all readers, and purchasers of securities. Applying the same approach to minutes is both good litigation protection and liability minimalization, as well as consistent with the overall statutory scheme and legislative goal.

In 1998, to make prospectuses readable, the SEC adopted rules requiring issuers to use "Plain English." The six simple rules the SEC enunciated are:

1. Short sentences;
2. Everyday words;
3. Active voice;
4. Tables or bullet lists for complex material, whenever possible;
5. No legal "jargon" or highly technical business terms; and
6. No double negatives.

Rule 421(b) requires securities documents to be written in a clear, concise, and understandable fashion. Guidelines apply throughout prospectuses. Paragraphs and sentences should be clear and concise. Headings and subheadings should serve an organizational function and be "descriptive."

Most of these rules simply embody solid business writing principles and should be applied consistently throughout a Company's Board and Committee minutes. Each individual guideline may not be appropriate for Board minutes; but collectively, the Plain English rules and commentary form a solid linguistic foundation consistent with the goal of establishing a due diligence defense for an IPO.

Using Plain English is intended to create a clear, ordered, presentation of complex information so that readers have the best chance of <u>understanding</u> the information. By necessity, the writer must consider the reading audience, and prepare information that all their audiences can understand. When creating defined terms, use definitions that are informative, persuasive, intuitive, and easy to understand by anyone. Consider the comparative usefulness of defining a company as "ABCT" (i.e. the initials of one of the parties, which while accurate, it is neither intuitive nor persuasive), with defining them as "Unsolicited Bidder." Which lets the reader most easily understand the story – and the Board's viewpoint?

Finally, have a corporate and securities litigator read draft minutes prior to presenting them to the Board for approval. The litigator's job may ultimately be to use the minutes, offensively or defensively. Let the litigator probe the writing for ambiguity; suggest a sentence which should be bulked up for clarity; or which screams out for an example. Because of their different training and legal operating environment, a litigator's language sensitivity is different from most transaction lawyers. Permit the litigator to provide input to the Company today, when the minutes are being prepared, rather than years from now when they casually observe how easily the litigation could have been defended or averted if only the minutes had been written differently!!

So long as their inclusion is not misleading, issuers are encouraged to use tables, schedules, charts, and graphic illustrations of financial data. All of this type of information is under the Company's control in preparing for the Board meeting, generating information for the Board Package, and getting advice from third-party expert advisers (lawyers, accountants, investment bankers, etc.) upon whom the Board can rely in demonstrating that the Company had adequate information on which to base a decision.

With a Plain English approach to minute-taking and Board preparation, it becomes easier to see how the Board Package, Board Procedures, and minutes all work collectively to create corporate and securities protection. The more cohesive and consistent these inter-related Board processes are, the greater the chance of achieving a due diligence defense. It also means that the minutes should flow smoothly into the SEC disclosure documents that reflect them.

B. How to Memorialize Business Judgment Rule Compliance

As discussed earlier, to satisfy the Business Judgment Rule the Directors must comply with the duties of loyalty and care. Performers of due diligence should be sensitive to this, just as drafters must be highly cognizant of how to prepare Board Packages and draft minutes to establish compliance.

1. Duty of Loyalty

Most state corporate statutes provide that a duty of loyalty means that each Director acted independently, in good faith, and in a manner the Director reasonably believes to be in or not opposed to the best interests of the corporation, and had disclosed any fact or circumstances which could impair the Director’s judgment. How best to demonstrate that? Easy measures are for the Chair to ask each Director to disclose any conflicts at the beginning of the discussion of each topic at the Board meeting. If there are none, then the minutes reflect that the question was asked, and all Directors confirmed that their duty of loyalty was unimpaired. This permits each individual Director to have a focused opportunity to disclose. It minimizes the chance that in the press of business someone fails to make a disclosure inadvertently or through mere inattention. Relying on last year's related party disclosure questionnaire for each Director is an invitation to disaster.

Why focus on conflict disclosure? Because failure to satisfy the duty of loyalty tends to arise: (1) when Directors have conflicts, generally, or (2) an interest in a potential transaction different from the interests of other shareholders. Contracts are not void (i.e., unenforceable) merely because the corporation and one (or more) of its Directors or other related to the Directors are parties to the contract provided that certain conditions are satisfied.[20] Contracts with related parties can be valid and enforceable if there has been a good faith disclosure to the Board of all material facts with respect to a conflict. All Directors are negatively affected if full disclosure is not made by another Director. The failure of a Director to fully advise the Board of another potential conflict may negate the ability of other Directors to rely on otherwise protective law because a fully informed decision by them may not be possible if it's based on the false premise that all Directors were independent with respect to the relevant decision.[21]

The predicate for reliance on the Business Judgment Rule is that "non-interested" Directors exercise reasonable care and good faith judgment. From a minute-taking perspective that suggests that establishing independence, and confirming that Directors are "non-interested" should be the first order of discussion on virtually any business topic.

2. DUTY OF CARE

The duty of care may be more complex to analyze, enunciate, and establish and is less subject to a single, definitive approach. The substantive legal goal is to establish that the Board's decision: (1) was informed; (2) was based on good process; (3) involved full disclosure; and (4) reflected care and thoroughness. With those elements established, a fully informed opinion reached by non-interested Directors will not be examined by the courts since the Board is protected by the Business Judgment Rule. An informed decision is only possible if the Board understands a proposed action or transaction, has fully evaluated the available alternatives, weighed the advantages and disadvantages, and considered the cost-benefit analysis.

Since virtually nothing in corporate life is perfect, the Board's goal is to conclude that "on balance," having reviewed all applicable facts and competing views, the transaction to be approved benefits the Company and its shareholders.

As an example of an approach to lengthier minutes, that better protect the Board, but that still well protect the Director, would be the following:

Each Board member confirmed that they had no personal interest in the proposed transaction other than their interest as a Director and/or Shareholder of the Company.

The Directors considered the risks and rewards, and advantages and disadvantages, to the Company of entering into a proposed distribution transaction (the “New Distribution Agreement”) with a Hong Kong-based public company (the “Distributor”). Among other factors the Company considered were: (A) geopolitical issues; (B) applicable regulatory issues; (C) the consequences to the Company’s financial statement as a result of the transaction; (D) recent consolidation changes in the industry, (E) the macro-economic environment, (F) expressed needs of its customers; (G) long-term and short-term costs and pricing issues; and (H) the terms and conditions proposed for the New Distribution Agreement. Each Director confirmed that they had read the New Distribution Agreement prior to the meeting, as well as the associated analysis prepared by the Company’s outside, independent logistics

> expert (Beth Howell from the nationally-recognized firm of U.S. Logistics) contained in the Board Package for this meeting.
>
> After extensive discussion, the Board concluded that, on balance, the New Distribution Agreement would be in the best interests of the Company and its shareholders.

Protective minutes can only follow from good process. The goal of the Company and its Board should be to create a Board process and environment in which satisfaction of the Business Judgment Rule is the intentional result of the planning and meeting process. Before Director action is taken, the minutes should reflect how the Directors satisfied the Business Judgment Rule, i.e.: (a) there was a sufficient review of the facts, alternatives, advantages and disadvantages, and how the action helps the corporation and its shareholders; (b) that enough time was spent reflecting the degree of difficulty/seriousness of the action; (c) consideration of the action occurred, including involvement and review by appropriate internal and external parties; (d) clear references to documents, handouts, and/or reports relied on by the Directors; and (e) identification of the parties referred to in the minutes to characterize them and to demonstrate that they are individuals/firms that Boards can rely on (e.g., Bruce Johnson, the Company's outside auditor).

C. Some Mechanics

Ideally, each set of minutes should be fully self-contained so that the reader doesn't need to refer to other minutes to understand each meeting. (i.e., even though she and her company were identified in previous minutes, the drafter should re-introduce Mary Smith as the outside compensation expert hired by the Company six months ago to assist the Compensation Committee with its compensation process)

Who should sign the mintues: the Chair, the Secretary, or the Chair <u>and</u> the Corporate Secretary? Which best commits the most people to the accuracy of the minutes? My belief that people scrutinize any document more carefully if they have to sign it than if they don’t, causes me to conclude that the Secretary should sign the minutes, and the Chair should attest to them. Two confirmations are better than one.

VI. CONCLUSION

An effective due diligence defense can be established by an issuer or seller through a continuous, consistent, and conscious series of choices reflecting style (Plain English), substance, and a thorough knowledge of corporate and securities law. As the underwriting or buyer's team performs their own diligence, they should be alert to deviations from the best practices in preparing minutes recommended herein. Finally, never forget the danger that the most important information communicated in many minutes if what they **don't** contain rather than what they **do** contain.

ENDNOTES

[*] Mr. Morgenstern is a veteran deal lawyer and strategic counselor for emerging growth (public and private) companies and entrepreneurs. He's also the co-founder and a General Partner of CT Access Ventures Fund (an early stage technology fund) as well as the founder and Managing Partner of Blue Mesa Partners, a venture capital and private equity fund. He has served on (and represented as Corporate Secretary or Counsel) the Boards, Committees, and Boards of Advisors for numerous public and private companies.

[1] David Katz, "Due Diligence in Acquisition Transactions," *PLI Conducting Due Diligence in M&A and Securities Offerings* (2007), p. 577.

[2] For a good example, see, Valerie Ford Jacobs, "The Due Diligence Process from the Underwriters Perspective," *PLI Conducting Due Diligence in M&A and Securities Offerings*, (2007), p. 47, Curtis L. Mo, "Corporate Governance: A Checklist for Initial Public Offerings," *PLI Conducting Due Diligence in M&A and Securities Offerings*, (2007), p. 1185.

[3] Appropriate due diligence reflects the nature of the transaction and the industry involved and will vary significantly from one transaction to another. In an IPO, growth prospects for the issuer over an extended period of time is generally more important than next quarter's cash flow. Conversely, in an offering of debt securities, purchasers of the securities will focus on the company's historical, current, and projected cash position and cash flow. Management's Discussion and Analysis due diligence has changed to reflect the changes mandated by Section 401(a)(j) of Sarbanes-Oxley, which requires the disclosure and treatment of off-balance sheet liabilities. (**See**, Morgenstern,

"Off-Balance-Sheet Disclosure Rules in MD&A." *The Review of Securities and Commodities Regulation* (January, 2004); Morgenstern, 'MD&A 2003: The Off-Balance Sheet Rules: A Mid-Cap Perspective," 35th Annual PLI Institute on Securities Regulation (November 2003).

[4] **See** Sarbanes-Oxley Act of 2002, P. L. 197-204, 116 Stat. 745 (codified at various sections of 11, 15, 18, 28, and 29 U.S.C.). Also, see generally, Morgenstern, "The Impact of Sarbanes-Oxley on Mid-Cap Issuers," PLI Advanced Securities Law Workshop, p. 451 (2004); Morgenstern, "Sarbanes-Oxley: A Law of Unintended Consequences," *Smart Business Magazine*, p. 477 and "Going Private: A Reasoned Response to Sarbanes-Oxley," p. 483, text available at http://www.sec.gov/infosmallbus-toc.htm.

[5] **See** Morgenstern "Sarbanes-Oxley's Subtle Disclosure Costs," *Insights: Corporate and Securities Law Advisor* – Vol. 21, pp. 2-8 (January, 2007).

[6] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

[7] The Delaware rule is codified in Delaware General Corporation Law, §141(a) which provides that the business and affairs of a Delaware corporation are managed by or under its board of Directors. As the *VanGorkom* court expressed it, "…The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware corporations."

[8] *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. 1996); *Abbott Laboratories Derivative Shareholders Litigation*, 299 F.3d 898 (7th Cir. 2002); *In re the Walt Disney Company Derivative Litigation*, 906 A.2d 27 (Del. 2006).

[9] *In the Matter of Sony Corporation and Sumio Sano*, Release No. 34-40305 (Aug. 5, 1998); *In the Matter of Caterpillar, Inc.*, Release No. 34-30531 (March 31, 1992).

[10] The discussion and analysis roughly parallels the "save" or "discard" arguments considered in the offering process discussion, *infra*, Section III(C).

[11] Obviously, in an online electronic world in which prior versions remain in electronic fashion in numerous computers, it's no longer possible to entirely eliminate the electronic drafts and discovery gets more sophisticated with respect to electronic documents for use in litigation at an accelerating rate. All that can be effectively purged is everyone's questions and marginal comments written on each hard copy draft, frequently generated during a drafting session.

[12] See generally, Morgenstern, "Sarbanes-Oxley's Subtle Disclosure Costs," *Insights: Corporate and Securities Law Advisor*, Vol. 21, pp. 2-8 (January 2007).

[13] **See**, Morgenstern, "Sarbanes-Oxley's Subtle Disclosure Costs," *id.*

[14] The Disclosure Team consists, at a minimum, of management, the Chief Financial Officer, inside counsel, outside lawyers, and the issuer's independent accountants.

[15] *In the Matter of Caterpillar, Inc., op cit.*

[16] In the *Disney* litigation "[l]aywers for the shareholders say that only 10 minutes was spent on the approval process, as indicated by the two sentences devoted to it in the minutes of the board meeting." But Mr. Russell (Chairman of the Compensation Committee) disagreed, saying that was "a very

fallacious means" of determining how long a topic was discussed. Rita Farrell, *New York Times*, Nov. 4, 2004, C-2.

[17] For a good discussion of director oversight of management functions *see, Saito v. McKesson Corporation*, Civil Action No. 18553. *Saito-McKesson* was a books and records case wherein the court did permit production of documents, it imposed severe restrictions. Plaintiffs successfully appealed and the document received in the books and records resulted in the filing of a derivative complaint, of Saito *v. McCall* (Del. Ch. Civil Action No. 17132). The derivative suit was recently settled and the settlement won approval by the Court of Chancery. The settlements provided for a $30 million payment to the Company by the insurance carriers for the directors and the implementation of important corporate governance reforms. The *Saito* court imputed knowledge to the Board (as a whole) from knowledge possessed by individual Directors. **See** also, Pamela S. Tikellis information at www.chimicles.com/partners/ptikellis.php. The *Saito* case involved analysis under *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2nd 959 (Del. Ch. 1996), which has been one of the seminal cases for Director oversight obligations.

[18] Without digressing into war stories, while still in acquisition negotiations by a public company of a private company, I was granted (and read) the corporate record book of the target. The recent meetings indicated the precise description of approximately 20 shareholders' disparate views on a potential sale to my client. It recorded: (1) the reasons why certain individuals were in favor of it, (2) why others were opposed to it, and (3) the vote on a shareholder by shareholder basis favoring a sale by slightly more than 51% of the shareholders.

After reading the minutes, we were able to understand the internal dynamics of what were otherwise incomprehensible events and discussions occurring in the negotiations. Unusual barriers to "bland" requests were being raised, and there was considerable, unusual unresponsiveness by certain employees. After identifying those individuals who favored the transaction, the buyer was able to further solidify the intention of those who favored a sale to sell, address matters that would otherwise have been impediments to some of the unhappy shareholders, and figure out how to speed up (and ultimately close) the deal. Other than intuitive analysis, these were matters we would have had no other way of knowing about. The deal was so fragile that without reading the minutes, the deal would probably have simply "stalled" because of internal dissension – and the buyer's inability to address the issues of those employee-shareholders with whom there was little or no contact because they were not part of seller's negotiating team.

[19] The Plain English Rule became effective October 1, 1998. Rule 421(d) of the Securities Act of 1933.

[20] ORC § 1701.60.

[21] The existence of conflicts or financial interests may shift the burden of proving that a transaction was fair to the "conflicted" defendant-Directors. Moreover, this shift may occur even as to the truly disinterested Directors if they were not fully advised of the conflict. Delaware courts view lack of knowledge as an impediment to making a fully informed, reasoned decision.