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Corporate Governance for Commercial Telcos

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Disclaimer

This presentation is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.
Introduction

Business Corporation
- A statutory entity having authority under law to act as a single person distinct from the shareholders who own it
- As a business, owned by shareholders seeking financial return on investment
- The “interests of the corporation” are primarily defined in reference to enhancing corporate profit and shareholder return in the long run
- Shareholders vote based on % of ownership
- Directors and officers subject to fiduciary and statutory duties, as defined by state statute and case law
- Subject to tax as a “C” corporation or “S” corporation

Cooperative
- A statutory entity having authority under law to act as a single person distinct from the members who own it
- As a business, owned by members who purchase its products or services
- “Interests of the cooperative” primarily defined by cooperative principles, including principles concerning user ownership, control and benefits
- 1 vote per member
- Directors and officers subject to fiduciary and statutory duties, in many cases identical or similar to corporate directors and officers
- Subject to cooperative tax treatment under Internal Revenue Code Subchapter T
Introduction

• There are inherent conflicts of interest in corporations, because ownership and management are separate.

• Corporate governance is the system of legal principles, responsibilities, policies, and processes used to identify and more effectively manage these inherent conflicts of interest.
Introduction

- Breakdowns of corporate governance create risk and jeopardize the value of a corporate enterprise
  - Legislative and regulatory risk
  - Legal risk
  - Reputational risk
  - Operating risk
  - Financial risk
Introduction

• This presentation discusses:
  • Legal framework of corporate governance
  • The role of fiduciary (and other?) duties
  • Protection for directors
  • Corporate governance best practices
  • Specific governance issues for commercial telcos

• Feel free to ask questions as we go …
Legal Framework

• Advantages of corporate form
  • A corporation can raise capital
    • Debt or equity
  • Owners don’t need to know how to run the business
    • Corporation hires experts to manage the business
  • Ownership interests are transferable
    • Private vs. public markets
Legal Framework

• Disadvantages of corporate form
  • Relatively heavy state and federal regulation of internal governance and external investment
  • Separation of ownership and management
    • Corporate ownership is an agency relationship in which the board of directors and management (the agent) acts on behalf of the principal (shareholders)
    • There are “costs” to this agency relationship, arising from conflicts of interest
      • Management – shareholder conflicts
      • Director – shareholder conflicts
Legal Framework

• Management-shareholder conflicts
  • Shareholders entrust management with funds from corporate earnings or new stock issues, which management invests
  • The overarching objective is to maximize shareholder return on this investment
• Managers are human
  • May be more focused on expanding the size of the business, bonuses based on earnings, taking excessive risks or job security
  • Managers may consume excessive salary or perquisites
  • Agency costs arise whenever managers do not act in the best interests of the shareholders
Legal Framework

- **Director-shareholder conflicts**
  - The board of directors is the intermediary between the shareholders and management
    - Monitoring managers
    - Approving strategies and policies
    - Approving mergers and acquisitions
    - Reviewing and approving audit and financial contracts
    - Establishing management compensation
    - Evaluating and disciplining poorly performing managers

- **Directors are human**
  - A conflict may arise if the board aligns too much with management and too little with the interest of shareholders
Legal Framework

- Corporate governance standards evolve over time:
  - Statutory law of the state in which the corporation is incorporated
  - Federal, state and market-specific securities regulations
  - Common law rules
  - The corporation’s articles or certificate of incorporation
  - The corporation’s bylaws and governance policies
  - Corporate scandals and shareholder activism and litigation
Fiduciary Duties

- There are two core fiduciary duties:
  - The duty of care
  - The duty of loyalty
- Directors owe these duties to the corporation and its shareholders
- A corporation does **not** owe fiduciary duties to its shareholders
- In closely held corporations, controlling shareholders **may** owe fiduciary duties to minority shareholders
Fiduciary Duties

• The duty of care requires that directors be informed of all material information reasonably available to them when making decisions for the corporation.

• A director must act with the care that a person in a like position would reasonably believe appropriate under similar circumstances.
Fiduciary Duties

• The duty of loyalty requires directors to act in good faith for the benefit of the corporation and its shareholders, not for their own personal interest

• Corporate opportunity doctrine: an officer or director may not divert to himself or his relatives or affiliates any business opportunity presented to, or otherwise rightfully belonging to, the corporation
Fiduciary Duties

- Directors’ duties may be adjusted or heightened in certain extraordinary situations
  - Defensive measures
  - Interference with shareholder vote
  - Sale of control
  - Controlling shareholder transactions
  - Insolvency
Other Duties?

• Good faith
  • Good faith is not a separate fiduciary duty, but is a component of the duty of care and duty of loyalty
  • To act in good faith, a director must act with honesty of purpose and in the best interests of the corporation
Other Duties?

• 3 scenarios implicating bad faith
  • An intentional failure to act in the face of a known duty to act
    • Ex. A director knows management is violating a corporate policy but takes no action to change the situation
  • A knowing violation of law
    • Ex. A director approves a plan for removal of environmental waste, knowing the plan violates environmental laws
  • Acting for any purpose other than advancing the best interests of the corporation and shareholders
    • Ex. A director votes in favor of a sale transaction only because he or she wants to sell his or her stock
Other Duties?

• Duty to obey the law
  • Directors have a duty to comply with the law
  • Breaking the law to advance the interests of the corporation and its shareholders is no excuse
Other Duties?

• Duty of oversight
  • A corporation may be held responsible for the actions or omissions of its management and employees
  • Because the board of directors is responsible for overseeing management and employees, the board needs an appropriate oversight and compliance system in place
Other Duties?

• Duty of disclosure
  • Directors owe a fiduciary duty to communicate honestly with the shareholders and to make full and fair disclosures
  • The board is not obligated to provide all of the corporation’s financial or business information to shareholders, but is required to disclose all material information
  • In some circumstances, the board may have fiduciary or other duties not to disclose information
Other Duties?

• 4 scenarios implicating duty of disclosure
  • When the board seeks required shareholder approval, directors have a duty to disclose fully and fairly all material information that the board controls
  • When the board seeks shareholder ratification of a conflict of interest transaction, the board must disclose all material facts known to the board
  • When a director communicates publicly or directly with shareholders, with or without a request for shareholder action, any information the director discloses must be truthful
Other Duties?

• 4 scenarios implicating duty of disclosure (cont.)
  • When a director buys or sells shares in a private stock sale, the director must disclose any material information that qualifies as “special facts or circumstances,” including knowledge of important transactions, prospective mergers or probable sales of material assets or lines of business
  • Duty to disclose in this scenario may only arise if the director also deliberately misleads the shareholder about these facts
Protection for Directors

• The law recognizes that directors sometimes must take business risks to promote the best interests of the corporation and its shareholders

• Business judgment rule presumes that disinterested and independent directors comply with the duty of care

• Courts focus on an analysis of the process used in making business decisions and not on second guessing the substance of those decisions
Protection for Directors

• Most states allow a corporation to eliminate or limit directors’ financial liability for breach of fiduciary duties, with exceptions (examples):
  • Breaches of duty of loyalty
  • Intentional misconduct, bad faith or knowing violation of law
  • Unlawful payments of dividends or unlawful stock purchases
  • Actions involving any improper personal benefit
Protection for Directors

- Most states allow corporations to indemnify and advance expenses to directors if the director acts in good faith and in the best interests of the corporation and has no reasonable cause to believe his or her behavior was unlawful.
Protection for Directors

- Most states allow corporations to insure directors to cover losses (such as settlement costs, fines and attorneys’ fees) resulting from a breach of the duty of care
- D&O Insurance
- These policies typically will not cover losses from fraud, dishonesty or violations of criminal law
Governance Practices

• Principles of corporate governance
  • The rights of shareholders
  • The equitable treatment of shareholders
  • The role of other stakeholders (???) in corporate governance
    • Officers and employees
    • Creditors
    • Regulating agencies (competitors?)
    • Communities
• Disclosure and transparency
• The responsibilities of the board
Governance Practices

• Responsibilities of the board of directors
  • Establish corporate values and governance structures
  • Ensure that all legal and regulatory requirements are met and complied with in a timely fashion
  • Establish clear lines of responsibility and a strong system of accountability and performance measurement
• Hire the CEO, determine the compensation package and periodically evaluate performance
Governance Practices

• Responsibilities of the board of directors (cont.)
  • Ensure that management provides sufficient information to be fully informed and prepared to make board decisions, and to be able to adequately monitor and oversee management
  • Meet regularly to perform its duties
  • Have or acquire adequate and relevant experience or training
  • In making decisions, directors may rely on advice or reports from officers, committees or other internal or external experts
Governance Practices

- Corporate governance in a perfect world
  - The board should be comprised primarily of independent (non-management) directors
  - The chairperson of the board should be independent
  - Directors should be qualified
  - There should be regular election of directors
  - There should be regular self-assessment of the board
  - The board should hold separate meetings of independent directors
Governance Practices

• Corporate governance in a perfect world (cont.)
  • The board should require audit oversight by independent directors who have sufficient expertise in finance, accounting and the law
  • The nominating committee should be comprised of independent directors
  • The compensation committee should be comprised of independent directors
  • The board should be able to hire outside counsel
  • The board should adopt and disclose governance policies
Governance Practices

• Corporate governance in a perfect world (cont.)
  • The board should ensure adequate disclosure and transparency
  • The board should require disclosure of related-party transactions
  • The board should respond to appropriately to shareholder inquiries, proposals or votes
Sarbanes-Oxley

- Sarbanes-Oxley Act (2002) (SOX)
- Response to high profile public company failures: Enron, Worldcom, etc.
- Private companies are not required to comply with SOX
- Private companies may adopt “SOX-type” or “SOX-light” best practices
- SOX “raises the bar” for governance standards for all public and private companies and their outside auditors
Sarbanes-Oxley

• “Cherry picking” SOX best practices
  • Auditor selection and independence
  • Codes of business conduct and ethics
    • Emphasis on whistleblower policies
• Use of committees
  • Audit committee
  • Compensation committee
• Management responsibility for internal control over financial reporting
• Management certification of financial statements
In response to SOX, most public and many private companies have formalized (and publicized) their policies and practices concerning corporate governance:

- Corporate Governance Guidelines
- Code of Business Conduct and Ethics
- These policies are tools that can assist corporations with managing corporate governance conflicts
Sarbanes-Oxley

- Corporate Governance Guidelines
  - Composition of the Board of Directors
  - Functions of the Board of Directors
  - Business Relationships with Directors
  - Director Compensation
  - Board Leadership
  - Management Succession and Review
  - Board Meetings
  - Board Committees and Committee Membership
  - Board Materials
Sarbanes-Oxley

- Corporate Governance Guidelines (cont.)
  - Board Conduct and Review
  - Nomination and Election of Directors
  - Director Tenure
  - Communications with Shareholders
  - Community (or Social) Responsibility
  - Periodic Review of Guidelines
  - Implementation of Guidelines
Sarbanes-Oxley

• Code of Business Conduct and Ethics
  • Introductory Statement
  • Conflicts of Interest
  • Use of Corporate Information, Opportunities or Assets
  • Confidentiality
  • Compliance with Laws, Rules and Regulations
  • Fair Dealing
  • Accountability/Whistleblower
Sarbanes-Oxley

• Code of Business Conduct and Ethics (cont.)
  • Waiver
  • Periodic Review of Code
  • Implementation of Code
Share Liquidity

- Illiquidity of shares is a corporate governance problem
  - Lack of active trading in a free and open market
  - Rights of notice or approval, rights of first offer or refusal, rights of repurchase or redemption, etc.
  - Limits on % of ownership
  - Value and discount issues (ex. non-marketable control vs. non-marketable minority interest)
  - Tax implications of sale
Share Liquidity

• Thin market for private company securities
• Publicly traded securities
  • SEC regulation and compliance costs
  • Exchange-based regulation and compliance costs
• Private exchanges (Ex. SharePost, Nasdaq private market)
• Passive trading platforms
• Liquidity vs. raising capital
Share Liquidity

- IRS Rev. Rul. 59-60 identifies 8 factors to consider in determining “fair value” of privately held shares:
  - The nature of the business and the history of the enterprise from its inception
  - The economic outlook in general and the condition and outlook of the specific industry in particular
  - The book value of shares and the financial condition of the business
  - The earning capacity of the company
Share Liquidity

- IRS Rev. Rul. 59-60 8 factors (cont.)
  - The company’s dividend-paying capacity
  - Whether or not the enterprise has goodwill or other intangible value
  - Historical sales and the size of the share block being valued
  - The market price of shares of corporations engaged in the same or a similar line of business having their shares actively traded in a free and open market, either on an exchange or over-the-counter
Share Liquidity

• Insider trading
  • Prohibited under state and federal securities laws
  • Directors and other corporate insiders cannot lawfully trade in securities while in possession of material, non-public information unless they have disclosed all such information known to them
  • Directors and other corporate insiders cannot lawfully pass material, non-public information or otherwise “tip” outsiders who may trade based on that information or tip
Share Liquidity

- Insider trading
  - Information is “material” if it would be considered important by a reasonable investor in making an investment decision (for ex.):
    - Earnings estimates
    - Significant write offs or increases in reserves
    - Significant new products or lines of business
    - Major changes in management
    - Proposals, plans, negotiations or agreements, even if preliminary in nature, involving significant corporate transactions
    - Significant litigation or governmental agency investigations
Share Liquidity

- Insider trading
  - Information is “non-public” if it has not been widely disseminated to the public
  - Q: How much material information does a private company generally make public?

- Insider trading policy
  - A insider trading policy should prohibit directors, officers and employees from tipping others or from trading when in possession of material, non-public information
Dividend Policies

• Dividends are a corporate governance problem
  • A dividend is a portion of corporate earnings that is not reinvested (retained) in the business in a given year, but is instead paid to shareholders in the form of current returns
  • When dividends are paid, shareholders enjoy their benefit and can pay their taxes and make alternative investment or consumption decisions
  • **Net cash flow** is the source of all (or at least many) good things generated by a business, including dividends
Dividend Policies

• Dividends compete with alternative uses of cash
  • Reinvest in future growth
    • Core business
    • New business
  • Repay long-term debt
  • Pay dividends or fund other distributions
Dividend Policies

- Every corporation has a dividend policy
  - The corporation earns money (or not)
  - The corporation generates cash flow (or not)
  - The corporation pays a dividend (or not)
  - Companies may pay regular and/or special dividends

- **Dividend yield**: a dividend expressed as a % of current share price
Dividend Policies

• Dividends and dividend policies influence return on business investment
  • All other things being equal, the dividend yield of a company growing faster than industry average will be lower than the dividend yield of a company growing slower than industry average
  • If earnings are reinvested in low-yielding assets, accumulation of excess assets will detract from return on equity (ROE) and may diminish overall shareholder return
Dividend Policies

• Questionable reasons not to pay a dividend
  • Our shareholders aren’t really investors
  • To accumulate excess or non-operating assets for the sake of personal pride or other non-business reasons
  • In companies with a controlling shareholder, to avoid paying dividends to minority shareholders
  • In family companies, to avoid paying dividends to shareholders in second or later generations
  • To build a large nest egg against possible future adversities
Dividend Policies

• Better reasons not to pay a dividend
  • Alternative uses of capital for favorable reinvestment
  • Lender covenants
  • Legal or regulatory restrictions
  • Stakeholder vs. shareholder approach
    • But remember, your shareholders really are investors
Dividend Policies

• Share repurchase is an alternative form of dividend, with its own set of issues
  • Price
  • Shareholder participation
  • Disclosure
  • Documentation
Looking Ahead

• Understanding company-specific impact of ongoing USF and ICC “transformation”
  • Choice between model-based incentives or deflated rate-of-return
  • New operational and financial reporting and recordkeeping requirements
  • Increased need to shore up business processes
  • Shift from cost-recovery mindset to market-based profitability model
  • Impact on net cash flow
Looking Ahead

• Trump tax reform plan
  • Tax rate for corporate businesses would drop from current 35% to 15%
  • Dividend tax rate for individuals would drop slightly, to 20%
  • Business AMT eliminated
  • Business interest deduction subject to phased-in cap
  • No move to full business expensing
    • Businesses continue to be subject to depreciation regime
Corporate governance problems are inherent in all corporate enterprises.

Corporate governance problems frequently cannot be solved, but they can be managed.

The most effective policies for managing corporate governance problems can be developed and implemented in ways appropriate to the size and complexity of your company.
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