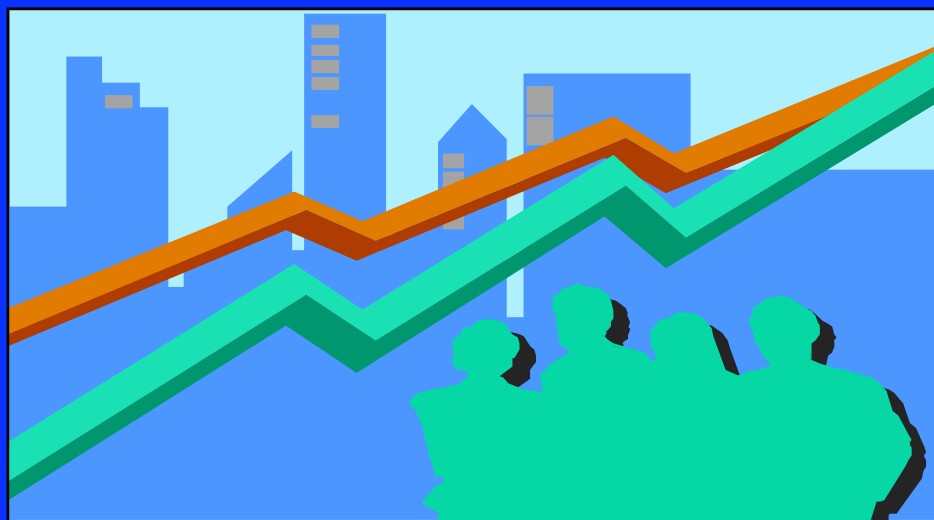


Kent State ESOP Governance Conference



Avoiding the Bumps in
the road to Effective
ESOP Governance

By Jack Veale, PTCFO, Inc

Transitions in Governance

- Avoiding the bumps is about the pitfalls of the governance transitions
- Governance involves the founder(s), trustee(s), a board of directors, and the employee owners
- Let's take a quiz to understand this transition

Let's cover more theory

- Charles Darwin is famous for what?
- Theory of Natural Selection
 - Living beings will modify/adapt to survive
- Albert Einstein is famous for what?
- Theory of Relativity- Mass, Energy, space and time - A flashlight loses weight when the light is on.. mass declines as energy is expended

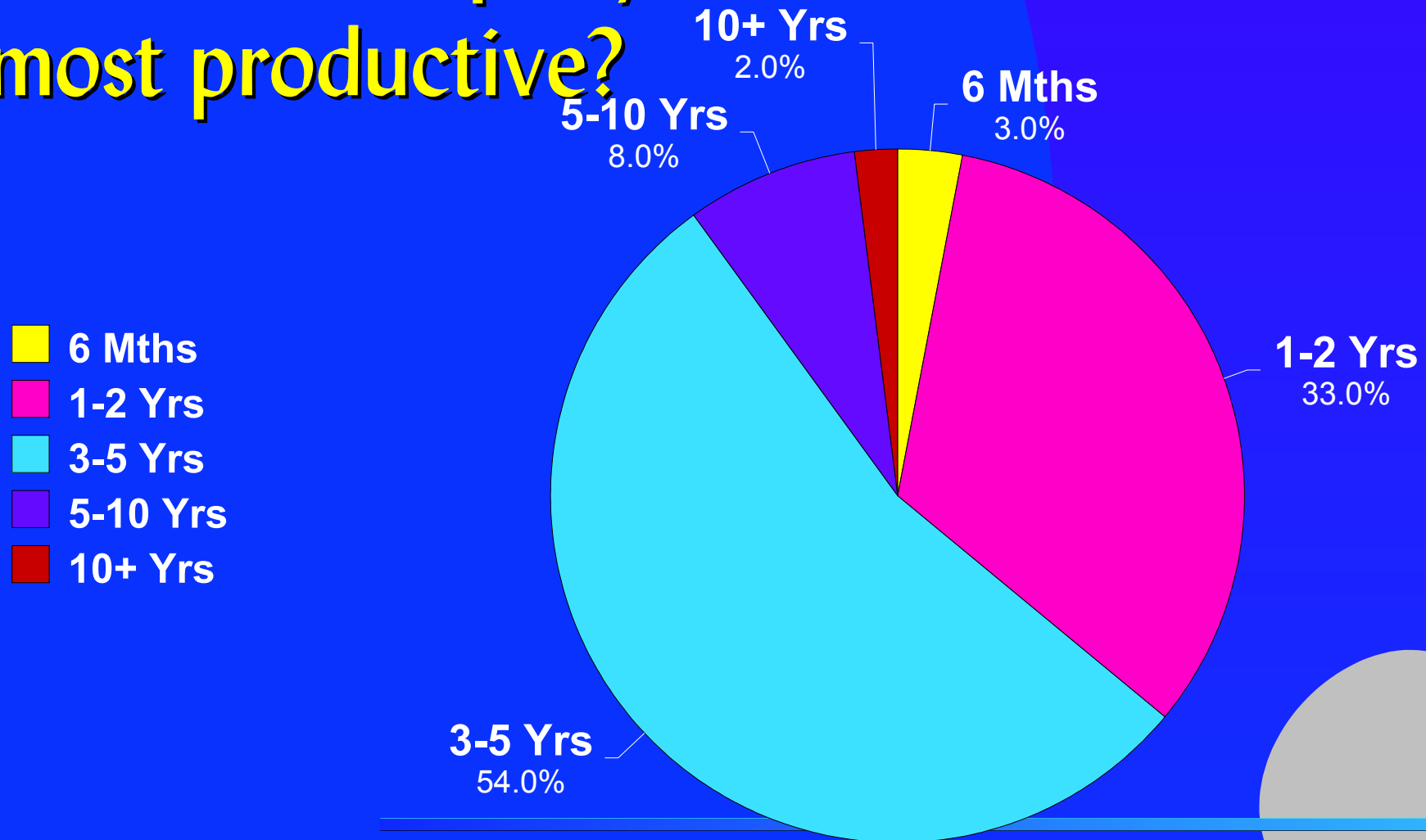
What does Darwin, Einstein and Soduko have in common?

- Soduko demonstrated that having the right skills for the right challenge, allows faster action and results without a lot of information required
- Darwin's Theory reminds us that we must change to survive
- Einstein's Theory reminds us that without energy expended, successful change is less likely to occur
- Governance is about dealing with change and organizational energy

What Did You Learn?

- Members of the Board don't all have the same talents, time is required to educate
- Selecting the right members is not about board experience, it is about facilitating change
- Time, not talent is a key issue for board development

At what point, in the new CEO's tenure with the company, does he/she become most productive?



Source: USA Today 8/24/06 Pg B1

BOD Governing Issues- 50kFT

- Annual Capital & Operating Budgets
- Quarterly Results
- Financial Policy
- Mgmt Control Systems
- Senior Mgmt Performance & Compensation
- LT Agreements
- Development & Implementation of Strategic Plan
- Major Organizational restructurings
- Employee/Community relations
- Succession Plans
- Fostering Innovation
- Advising Management

Staying at 50,000 Feet

■ Five Types of Boards

1. Passive Board (Least Involved)
2. Certifying Board
3. Engaged Board
4. Intervening Board
5. Operating Board (Most Involved)

Passive Board

- Typical with few independent directors or Strong Founding CEO
- CEO controls function and actions
- Limited activities and participation
- Limited accountability
- Ratifies Mgmt Preferences

Certifying Board

- Certifies to shareholders CEO is performing as expected, Mgmt will take corrective action
- High need for independent directors
- CEO evaluation by external directors
- Established orderly succession process
- Willing to change management to be credible

Engaged Board

- Provides insight, advice, support to CEO & Mgmt, high level of interaction, discussion
- Takes time to define the roles and behaviors, boundaries and responsibilities of board and CEO
- Knows Ultimate responsibility to oversee CEO and company performance
- Will seek outside experts to add value to decisions

Intervening Board

- Usually found in Crisis... or
- Absent or dysfunctional CEO
- Frequent meetings, often on short notice
- Intense involvement with Key Issues
- Focus on achieving Action Plans

Operating Board

- Great for Start-ups, new divisions
- Makes Key Decisions that Management then Implements
- Fills in Management Experience Gaps
- "Hands on" on selected activities
- Usually developing product, market, systems, staff, and/or Financing

Governance Protection

- **Duty of Care: Business Judgement Rule**
- **Care: attend meetings, be prepared, seek outside advisors for complex issues**
- **Duty of Loyalty: No Conflicts of Interest**
- **Loyalty: Independence vs self dealing**
- **Process: Meetings, attendance, notices committees, documentation, reporting**

Stages of BOD's

- Early Stages: Advisory Boards
- CEO/Owner invites Friends and family to build Governing (not advisory) board
- Advisory Board forms with outsiders and meet separately, build board engagement
- Over time, Mgmt invited to Meeting
- Board and Mgmt's relationship evolves
- Integration begins with both boards

Stages of BOD's *(cont'd)*

- Middle Stage: Evolving Governing Board
- Family or management begins to resign
- Development of Governance Processes
- Determination of Shareholder Value
- Learning to "sniff, don't touch"
- Outside Directors evolve to a majority, can meet separately without Mgmt/CEO

Stages of BOD's *(continued)*

- Mature Stage: "Public Company" behavior
- Set and Monitor Goals, Mission, Mgmt Development & Performance Standards
- Functional and Performing Committees
- Directors represent Shareholder interests
- CEO reports to board, and can be fired
- Directors are collegial, engaged, proactive

Board Actions to Avoid Pitfalls

- Develop a Strategic Plan (15 Yrs)
- Have Independent Directors
- Create Committees and Charters
- Attract the Right Directors
- Stay at 50,000 Feet
- An Agenda is a guide, not a rule
- Governance is like baking a cake

Board Actions to Avoid Pitfalls

- Avoid Conflicts of Interest
- Typical profile
- CEO is trustee, board member, CEO, ESOP Committee
- Family members are board members, owners, managers, ESOP Employees
- ESOP Employee, trustee, board member

Board Actions to Avoid Pitfalls

- Avoid an internal director majority
- Engage with the independent Trustee
- Read the ESOP Trust Documents
- Prepare a Director's Orientation with a carefully developed board book
- Develop Founder's Intent to define Trustee's responsibilities

Board Actions to Avoid Pitfalls

- Founder/Family Transitions
- Founder Dies, what's the board's role?
- Founder sells all, what are the roles for ?
- 30% ESOP... family in control... what are the roles for all?
- What is the difference between shareholders and stakeholders?

Board Actions to Avoid Pitfalls

- Set the meeting dates far in advance
- Seek agenda items 3 weeks before meeting
- Send agenda with board package
- Use advisors when dealing with difficult situations
- Set time limits for non CEO internal directors

Finally, Things to Ponder

- What should the relationship be between the CEO and the board & Trustee?
- What about the Board and the Trustee?
- You are a board member, and the employees feel they should have more control over the management of the company. Now what?
- What about Candor?