



**Executive Leadership Series 2003 – Session 1  
Case Study 1: Board Communication Issues**

**WHAT'S INSIDE OUTTEL?**

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OutTel is an 802.11 wireless switch and management systems company formed 3 years ago. OutTel is a mature company with revenues of \$20m and profits of \$2m. The Company has achieved success with proprietary leading edge technology, several key OEM partnerships, and brand recognition in an increasingly competitive market. Surprisingly, the Company has achieved all of this with a young management team consisting of John Wayne – the COO, Steve McQueen – the VP of Business Development, Michael Fastow – the CFO, and Larry SonGenie – the VP of Legal Affairs. There is no CEO. The Board consists of 5 members, including the COO, the representatives of 2 venture funds, the representative of a New York institutional fund, and Larry Smellison – the representative of Comical, one of the Company's principle strategic partners.

**Act One – Who's Running the Ship?**

John Wayne and Steve McQueen both have aspirations to be the Company's CEO. Wayne has an operations background, he is in fact running the Company day-to-day with considerable success...and has managed costs tightly to conserve cash. Steve McQueen is a charismatic visionary who is responsible for successfully identifying the Company's product placement and development roadmap...and for designing and executing on the OEM strategy that has distinguished the Company from its competitors. Wayne and McQueen hate each other...but for the sake of the Company have tolerated each other to date. Tim Raper, one of the VC Board members, has raised with the other directors the need, in his view, to find a permanent CEO. Both Wayne and McQueen have confided in Larry SonGenie their respective desires to be CEO...and have asked SonGenie for advice, and told him not to discuss the views of each with anyone.

- 1 Tim Raper has no idea that there is a power struggle going on inside of the Company. Management hasn't discussed the CEO issue with the Board, and Tim Raper has not asked management whether a new CEO is even needed. Should Raper ask management about the CEO issue? How should he do this and who should he talk to? Should Raper do this on his own, or with other directors? Should he set up a committee to do this? Should Raper find out if a new CEO is even needed? If things are going

so well, why even contemplate changing the team? Is this an example of unnecessary and disruptive director meddling...or is it appropriate for Raper to encourage the Board to fill this spot?

Steve McQueen decides to take matters into his own hands, and speaks directly with Arthur Crock, the other venture investor on the Board with whom McQueen rides dirt bikes on the West Coast racing circuit. McQueen tells Crock that he will leave the Company unless he is made CEO, that Wayne has no strategic vision for the Company, and gives Crock a “concept paper” that lays out McQueen’s vision for the Company’s future. McQueen doesn’t talk to Wayne or any other management team members about McQueen’s views. McQueen asks Crock to talk to the other directors. Is McQueen out of line? If he feels strongly about his vision, doesn’t communicate with Wayne, and believes sincerely he is acting in the interests of the Company...are his actions justified? Would it be better to discuss his concerns and plans in front of the Board at a regularly scheduled meeting with Wayne present? What should Arthur Crock do? Given his friendship with McQueen, is he too close to the situation? What should Wayne do about this once he finds out? If both Wayne and McQueen report directly to the Board...and one doesn’t report to the other, what duty does either of them have to discuss (i) Company vision, and (ii) personal career plans with the other?

- 3 As mentioned, John Wayne and Steve McQueen have each discussed their views and plans with Larry SonGenie in confidence. After McQueen talks to Arthur Crock, Crock talks to Larry SonGenie and asks him, as corporate counsel, for advice. Should SonGenie discuss with Crock what he knows...or act dumb and provide advice as objectively as he can? If Wayne and McQueen each hold 25% of the issued shares, for a total of 50%, other employees hold 10% of the stock, and the investors all hold 40%...does that change what SonGenie says to Crock? What kind of advice should SonGenie give to Crock...what are the responsibilities of the Board in a situation like this...should SonGenie do what he thinks is in the best interests of the Company? What if Crock favors McQueen and SonGenie favors Wayne...and SonGenie thinks he would eventually be fired if he told Crock he favored Wayne...should SonGenie be honest with Crock?

### **Act Two – Honesty Among Friends...**

OutTel is the most successful 802.11 systems company in the market currently, but with new competition its market share is shrinking and margins are diminishing. The Company faces a key strategic choice of selling itself to one of its OEM partners, or raising an expansion round and using the cash to buy competitors with interesting technology. Smellison likes the Company, and wants to acquire it – and if he can’t

acquire it he may start a competitive company. Not knowing Smellison's plans, the Board seems to be leaning in favor of a sale. In his capacity as a director, Smellison asks Michael Fastow the CFO to provide Smellison with the Company's market plans, projections and customer revenue breakdown...and he tells Fastow of Comical's interest in acquiring the Company.

If Fastow knows that Smellison is using Company information to explore an acquisition, should Fastow provide this? Should he confront Smellison or discuss this with other directors? If Fastow believes that his questioning Smellison will terminate Smellison's interest in the Company, and an acquisition is possibility in the interests of the Company....should Fastow quibble about providing information in this context?

2. John Wayne's employment agreement provides that on an acquisition of the Company the vesting on his shares completely accelerates, and he gets a cash bonus of \$100,000. British Telecom makes an offer to acquire the Company for \$100m, which appears to be an attractive offer. The Board is split on whether to approve the acquisition, with the 2 venture directors against the acquisition, and Smellison and Merrill Cynch, the NY financial services firm that is the 4<sup>th</sup> director, in favor of the deal. John Wayne is the swing vote. Is he interested, and should he not vote? What if, his personal gain aside, he believes the sale is in the best interests of the Company? Should Wayne offer to give up his bonus in order to vote? Does it make sense to call in outsiders to advise the Board? What about appointing a special committee of the Board...will that help here?
3. What if British Telecom insists that John Wayne sign a new 3-year employment contract as part of the deal, otherwise it doesn't happen....can Wayne say no? Can he negotiate very favorable terms for himself, if he knows this will result in a lower transaction price?
4. In every monthly Board meeting prior to the offer from British Telecom, the directors have discussed whether to sell the Company. John Wayne confides in SonGenie that he is tired of these discussions, and that he wants to hire Merrill Cynch to sell the Company – get a low price that the Board rejects (with Wayne as the swing vote) and then do an expansion round to grow the Company. SonGenie thinks this process is a waste of time and that Wayne should just tell the Board what he thinks...and because Wayne has the swing vote on the Board now, just settle the matter. Who is right? SonGenie reports to the COO and to the Board...if he feels strongly about this, should he talk to any of the directors? What if SonGenie talks to Tim Raper...who SonGenie knows doesn't want to sell the Company, and doesn't want to try. Should Wayne fire SonGenie? Should the Board fire Wayne? Should Merrill Cynch not participate in this discussion because it would benefit as the investment banker on the deal? If the Board decides, at the end of the day, to try to sell

the Company...should it find another banker other than Merrill Cynch? What if Merrill Cynch would give the Company the best economic terms (as Merrill Cynch can make this up on the shares its owns in the Company)?

### **Act Three – Michael Milkant Enters the Picture...**

Michael Milkant, a well-known corporate raider, believes in the future of 802.11, and buys all the shares held by Merrill Cynch – representing 30% of the Company’s voting shares, making Milkant the largest shareholder in the Company. Milkant uses his influence to hire Steve Jhobs as the new CEO, who is a friend of Milkant. Milkant now wants to conduct a proxy fight to replace the Board.

Milkant’s plans are well known. As a director and major shareholder he demands that management provide him with information about certain strategic plans it presented to the Board last year for approval. Had the Board approved these plans, the Company’s profits would have doubled. Milkant wants to use this information to embarrass the current Board in the proxy fight. What should management do? If this information is confidential...should or must it still be provided to Milkant? Should management confide and plan with the other directors?

- 2 Steve Jhobs’ resume says that he graduated from Stanford, when in fact he attended Stanford but never got his degree. Michael Fastow did a reference check and is aware of this, but believes that if he talks to the anti-Milkant directors, then Jhobs will retain his job...but Fastow will probably lose his. What should Fastow do?

### **Act Four – But the Board Told Me to Do It!**

The Company is not sold and it does not do an expansion round. In fact, now the Company is down to 2 months of capital, it has terminated half of its staff, and its last best hope for survival is to raise a new round with Lastresort Capital. To make the Company look attractive, the Board has asked Fastow to do some creative book-keeping...including (i) capitalizing current expenses, (ii) reducing reserves for accounts receivable and (iii) recognizing revenue in swap transaction where the Company commits to purchase servers from a customer. The Board believes there is logic for these changes. Being uncertain, Fastow checks with Arthur Anderson...which assures him that all is OK. Fastow, still being uncertain, talks to Larry SonGenie...who doesn’t directly answer the question but reminds Fastow that he reports to the Board, and that the Board represents a majority of the shareholders.

Is this creative accounting, criminal accounting, or honest accounting? If Fastow is the only one who questions this (after all, Arthur Anderson

signed off on this. ) – should he change the books? Resign? Inform Lastresort Capital?

2. Fastow believes these changes are honest...but Arthur Anderson does not, and tells Fastow that it will not sign off on the audit for this year if the changes are made. The Board orders Fastow to terminate Arthur Anderson, make the change and find new auditors. What should Fastow do? Should he resign or become a whistle-blower. If he becomes a whistle-blower, who does he talk to....Lastresort Capital? FASB? The SEC? 60 Minutes?

Fastow tells Steve Jhobs about his dilemma. Jhobs reminds Fastow that last month Fastow's secretary complained to Jhobs that Fastow was sexually harassing her. Jhobs arranged to transfer the secretary to another department and gave her a bonus to buy her silence. No agreements were written, and no one except Jhobs and Fastow know about the incident. Fastow is in counseling for this type of behavior, and he is truly reformed. Jhobs now tells Fastow that if he doesn't "modify" the books as the Board has requested....then Jhobs will inform the Board about the "incident" and make sure the matter is in Fastow's personnel file. What should Fastow do now? If there is truly an issue on whether the accounting changes are appropriate, is Fastow off the hook if he goes along? How should Fastow rank his loyalties.....to himself, the Board, management, shareholders, outside investors?

### *Act Five – Blood in the Water...*

The Company does not receive financing from Lastresort Capital, which got cold feet after starting its due diligence. In order to meet payroll and keep the doors open, and to buy some time to salvage their investment, both Tim Raper and Arthur Crock convince their funds to loan the Company money under convertible bridge notes. The bridge notes are secured by all of the assets of the Company, subordinated only to a factoring agreement the Company has with Sillycon Valley Bank. The bridge loans are approved at a special meeting of the Board of Directors, with Raper and Crock abstaining, and Smellison voting against the resolution.

What alternatives did the Company have? Did Smellison have the duty to disclose Comical's interest in acquiring the Company and make a competitive offer?

2. Assume Smellison delivers a competing offer from Comical to acquire the assets of the Company for cash, but the purchase price is such that only the preferred shareholders would see a distribution, due to their liquidation preference, and even then would only recoup 40% of their original investment. How do the inside directors and the venture directors evaluate

the offer? What if the inside directors feel it is a low-ball offer, while the venture directors are tempted to cut bait? What if Comical has indicated that they might be interested in hiring some of the senior management to operate the new division? Should/can the Board excuse Smellison and conduct a closed session to evaluate the offer and perhaps make a counteroffer?

- 3 Smellison smells a bad deal, at least for now... The Board approves the secured loan from Raper and Crock, but doesn't really explore other alternatives under the view that there is not enough time to get serious offers. As a condition precedent to the loan, the term sheet from the inside venture funds requires (i) that the landlord cut the rent in half and reduce the term of the lease from 3 years down to 1 year, and (ii) the employees waive accrued salary from a 30% wage cut that they agreed to in order to keep their jobs. This accrued salary is only due on a financing of \$5m and the loan term sheet is for \$3m. The Company needs \$5m to become cash flow positive in 18 months. What is the Board's duty to the landlord, if any? Does the landlord have any claims against or leverage with Raper and Crock? What about the employees....do they have claims against the Board or Raper/Crock for offering a loan of \$3m and not \$5m? Should the Board accept the loan of \$3m and pay the employees anyway? What if Raper/Crock vote against this....are they interested and should they excuse themselves? What if the loan is made, the Company defaults, and Raper/Crock now conduct a sale under the UCC to foreclose on their security interest....and Smellison now participates in the public sale and bids against Raper and Crock....any issues here? If Smellison is prepared to bid, should he have not made an offer to the Company earlier to improve the terms of the Raper/Crock bridge loan offer?