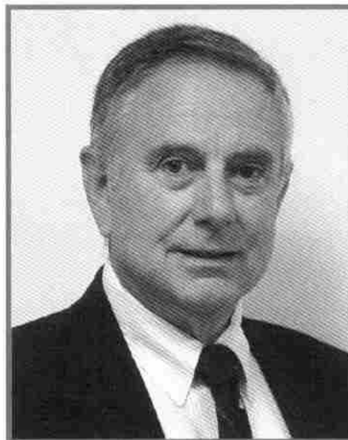
How do outside directors add value to private companies? Q&A with a California investment banker



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One of the benefits of closely held private companies is that, compared to public companies, they are pretty much left alone. So why would a private company ever want to stir things up by adding outsiders to its board of directors?

The simplest answers are: a) Outside directors can be a low-cost, low-risk but valuable resource; b) outside directors are on *your* side, unlike numerous outsiders to whom even a private company must answer, e.g., the IRS, OSHA, banks and insurance companies, not to mention the EPA, FTC, FDA, etc.; and c) when and if it comes to seeking financing, selling the company or an IPO, outside directors add credibility.

What are outside directors, and what is their role?

An independent, outside director of a medium-sized private company is usually a business professional who is not an employee or major shareholder and whose duty it is to represent the interests of all shareholders. Along with all members of the board, their principal role is to oversee and direct management, develop strategy, oversee implementation, approve major decisions and serve as a resource to the company in their individual areas of expertise. Similar to a public company director's role, albeit without the issues of public securities regulations or responsibility to public shareholders.

How do outside directors differ from advisory boards, peer groups and "coaches"?

Advisory boards, peer groups and coaches fill valuable but different roles:

1. Advisory boards are observers and counselors more than participants in the process. They are not responsible to shareholders and don't provide the "accountability factor."
2. A peer group, e.g., The Executive Committee ("TEC") can provide personal support to the CEO but usually doesn't actively participate in making or implementing business strategy and decisions.
3. A "coach" typically focuses on a CEO's personal goals and strategies.

What companies should consider outside directors?

The following are examples of companies for which outside directors' experience and resources may be able to provide meaningful guidance and value:

1. *Companies going through a transition from small to mid-sized*, which requires converting from a relatively informal style to more structured practices.
2. *Companies seriously committed to growth*, which means

adding capital, management and infrastructure and developing and implementing meaningful and achievable goals.

3 *Companies in an industry or market that is changing or expected to change,* for reasons that may range from evolving technology to shifting demographics.

4 *A business subject to increasing external influences,* such as environmental regulation, a hostile press, skyrocketing energy costs or foreign competition.

5 *Companies going through internal changes,* such as a generational transfer of management or an internal transfer of ownership.

6 *A company wanting to increase shareholder value significantly,* whether in anticipation of selling or an IPO or just increasing distributions to shareholders.

7 *A company anticipating major outside debt or equity financing,* which requires a lot of advance preparation to obtain competitive terms.

8 *Businesses with needs or plans outside their past experience* for which special expertise is needed, such as foreign sourcing or international marketing.

9 *A company contemplating growth or diversification through acquisitions,* but which has not been down that road previously.

10 *Companies in which some shareholders are not business professionals,* a common situation in a second-generation family company. Outside directors can validate the board's commitments to all shareholders' interests, especially when other board member/shareholders are running the business.

What should be the outside directors' functions and goals?

Outside directors' functions and goals can include the following:

1 *Responsibility with the rest of the board for the integrity and survival of the company.* This includes making a reasonable effort to assure that the appropriate governance practices are being followed and that the company is complying with all applicable laws and regulations.

2 *Raise issues, ask questions and provide feedback that most employee directors won't.* Given a choice between speaking up and job security, more often than not most employees will chose the latter.

3 *Provide independent insight, perspective and judgment on new and ongoing issues,* sometimes also known as a "sanity check." Someone removed from day-to-day operations and with experience in other business arenas will often see implications or possible consequences that may not be obvious to management.

4 *Steer policy focus to longer-range objectives, challenges and implications.* Day-to-day survival is a necessary management priority, but the ultimate success of a business depends on shaping events, not just reacting to them. A medium-sized company must have a strategic plan, know where it is going and have internal agreement on the priorities and issues that must be addressed to get there.

5 *Supplement management's experience in areas outside their core expertise.* Most small- to medium-sized companies can't be expected to have—nor should they need—in-house counsel, VPs for international sales, public relations, M&A, information technology or often even human resources or finance. Outside directors can help fill this gap.

6 *Look over the horizon, see pitfalls earlier than management might* and if necessary sound the alarm. In short, try to prevent stupid mistakes, getting sued, inadequate insurance or running out of cash. It's amazing how often experienced management can get blindsided because executives are preoccupied with immediate needs.

7 *Create a discipline, structure and culture of third-party accountability.* One of the advantages of a closely held company is the relative absence of pressure. The disadvantage is that it can also lead to procrastination resulting in expensive catch-up or missed opportunities. A more formal board with outsiders provides structure and schedule to the decision-making and implementation process.

8 *Prepare for a future life as a public company.* A successful IPO requires years of preparation. Having outside directors can give management and other directors a taste of what it is like to be a public company and help them get ready.

To what degree should outside directors become actively involved in the business?

Board members' primary responsibility is overseeing current operations and management on a policy level, but it is also appropriate for outside directors to participate actively in developing and implementing initiatives within their areas of expertise. Here are some ways:

1 *Developing the strategic plan and infrastructure to fulfill it.* Such planning needs to be a cooperative standalone effort and involves "outside the box" thinking,

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even if the plan ends up as business as usual. It should also include milestones and contingency options for what no one expects will happen, but might happen.

2. *Financial planning and obtaining the external resources required.* If plans call for outside debt or equity financing, preparation must begin well before it's needed. Financial sources have exacting criteria that need to be met, from financial statements and records to internal controls and documentation, which don't happen overnight.
3. *Designing and monitoring financial reporting policies and packages.* Simple financial reports that work for a small company may not be adequate as growth or unexpected events put new demands on resources or as outside financing sources require them.
4. *Identifying, negotiating and consummating acquisitions.* Finding and closing acquisitions can be a full-time job, and the consequences of oversights or mistakes can be serious. If the company doesn't have its own corporate development officer, a qualified outside director might be an ideal candidate to take on the task.
5. *Overseeing other specific ancillary but critical initiatives,* such as obtaining government or customer approvals or certifications, lobbying, entering new markets or even selling the company. An outside director with expertise in such areas can contribute significantly to the process.
6. *Recruitment and screening of new management talent.* Even if outside executive recruiters are used, a director intimately familiar with the company but above the fray can be a valuable resource and second set of eyes and ears.
7. *Design of compensation, equity participation and/or ownership transition plans.* Compensation is a critical factor in attracting and retaining personnel at all levels. What is best for any one company, however, is a function of its culture, organization, type of business, future plans, etc. Board members with experience in different businesses can provide insight to alternatives and how they may or may not work.
8. *Preparation for a future liquidity event.* Even if a liquidity event isn't planned, the best time to sell a company is when someone wants to buy it, which may come when it's least expected.

What kind of person makes a good outside director?

The criteria for outside directors is a function of the type of the business and the skill sets that the company needs to achieve its objectives. These criteria can include any of the following:

1. *Senior executives, perhaps retired, from a large but similar company,* e.g., a CEO of a non-competitive company serving the same market.
2. *Someone with experience in a variety of different businesses.* Sometimes the best results come from transferring practices across industry lines, or, conversely, knowledge of the failure of practices in other industries can save the day.
3. *People with specific professional skills you need,* e.g., law, technology, finance, M&A, foreign markets, government procurement, regulatory compliance, etc.
4. *Persons who will work harmoniously with other board members.* Good "chemistry" is important, but the individual should also be up to disagreeing, albeit without destroying relationships with other directors.
5. *Persons willing to step aside gracefully when and if the time comes.* It should be clear from the outset that an outside director is being elected only for a specific term.
6. *Someone with whom your primary relationship isn't social or personal.* Consider the possible personal impact if the outside director candidate and the rest of the board were to reach an impasse on a business issue.
7. *People who don't need the money.* The right directors will view directors' fees as at least partial acknowledgement of the value of their time, but not as a vital source of their livelihood.
8. *People who ask good questions before agreeing to serve.* The right candidates will want to meet other board members or shareholders, to see financials and will ask detailed questions about all aspects of the business before accepting.
9. *At least two outside directors should be considered.* Having two outside views can be much more valuable than one. Also it is easy for a lone outside director to become frustrated if his is the only independent view.
10. *People who add internal and/or external credibility.* The right directors can provide customers, investors, lenders and employees the extra measure of confidence and comfort that can make a difference. They also signal that the company has graduated from the small-business category, and reduces or removes suspicion that the company is being run primarily for the personal benefit of an insider control group.

How do you compensate the right people to serve?

1. *Outside directors' primary motivation should be to enhance shareholder value,* although they should also

receive directors' fees and perquisites.

2 *Outside director equity participation need not be direct ownership of shares.* Participation can also be in the form of a profit sharing or option plan, or a "phantom stock" plan whereby they participate in gains but don't actually own shares.

3 *Directors can also receive additional fees for non-director services.* The most common example is fees paid an attorney or investment banker board member for services beyond their duties as a director.

4 *Make it challenging, interesting and fun.* Ultimately the best motivation for the director who doesn't need more money is the intellectual and professional stimulation.

5 *Directors liability insurance may not be an issue.* Do not assume that any outside director will require a liability policy. Depending on the nature of the business, the potential liability may be negligible compared to that in a public company, which is where the real liability risks reside.

How do you find good outside directors?

1 *Inventory your general goals and the skill sets needed to accomplish them.* Adding outside directors is the first step in developing the strategic plan for the company.

2 *Inquire among your advisors and business associates.* Using the results of your inventory, canvass people whose business experience and judgment you respect.

3 *Try to stay within "two degrees of separation."* Ideally someone with whom you have had professional or business dealings should be able to vouch for a candidate's integrity and qualifications. D

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or heeding their past opposition to any merger. Pfeiffer had announced that Compaq's quarterly earnings were half those expected, he initially refused to explain them, and he then blamed an industry slowdown at the very time when IBM and Dell were reporting strong sales. Ayling had presided for four years over an airline that was highly profitable when he took control, asserting that it would also be the "best-managed company in Britain in 2000," but in 2000 he announced that it had plunged into the red, its first annual loss in years.

All three were shocked by their sacking. Wyman was serving not only as chief executive but also as chairman of the CBS board. Pfeiffer had grown Compaq ten-fold in eight years. Ayling had a commitment from the British board to back his long-term restructuring of the carrier. Each had wielded enormous power, and they were as dumbfounded as any when the board pulled it from under them.

The three executives had faced exceptionally powerful overseers of the type that most CEOs will never see. Wyman reported to two directors—Lawrence Tisch and William Paley—who together owned a third of the company. Pfeiffer reported to venture-investor and Chairman Ben Rosen, who had seeded the company and served as chairman since its inception. Ayling reported to two directors—Lord King and Lord Marshall—who themselves used to run the company. Few executives will ever have to contend with such commanding figures, but as boards become more sovereign worldwide, executives can expect to face more demanding directors than in the past.

A first principle, then, is to remember that you have superiors, even if your business card combines both chief and executive. A second is to remember the cardinal tenet of the capitalist universe, on a par with nature abhorring a vacuum in the physical universe: Never ever surprise your directors. That is when you are most vulnerable, as Wyman found when he startled his board with a takeover proposal, and as Pfeiffer and Ayling discovered when their rosy financial projections inexplicably turned to ash.

A third principle is to remember that retaining your directors' confidence depends on maintaining credibility with your investors and faith with your employees. Languishing short-term performance had weakened investor appetite for Wyman, Pfeiffer and Ayling. Troubled internal relations damaged their employee confidence as well. Both developments undermined the ample director support with which each had started.

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