OUTSIDE DIRECTORS IN PRIVATE COMPANIES

by Valerio Giannini, NewCap Partners, Inc.

One of the benefits of private companies is that compared to public companies they are pretty much left alone. So, why would a private company want to add outsiders to their board of directors?

The simplest answers are a) outside directors can be a low cost, low risk but valuable resource; and 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.).

A. WHAT IS AN OUTSIDE DIRECTOR AND WHAT IS THEIR ROLE?

An independent outside director of a mid-size private company is usually a business professional who is not an employee or major shareholder and whose duty is to represent the interests of all shareholders.

Their principal role, along with all board members, is to oversee and direct management, establish policies and strategies, approve major decisions, oversee implementation, and serve as a resource to the company in their areas of expertise.

B. HOW DO OUTSIDE DIRECTORS DIFFER FROM ADVISORY BOARDS, COACHES OR PEER GROUPS?

Advisory Boards, peer groups and coaches fill valuable but different roles**.** None, however, are accountable to shareholders or regulatory authorities.

1. Advisory Boards are observers and counselors more than participants in the corporate management process.

2. Coaches and peer groups such as "TEC" provide the CEO personal support, but usually don't actively participate in making or implementing business strategy and decisions.

C. WHAT KIND OF 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-size*, which requires converting from a relatively informal style to more structured practices.

2. *Companies committed to growth*, which means adding capital, management and infrastructure and developing and implementing meaningful 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, escalating energy costs or foreign competition.

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

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

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 markets.

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

10. *Companies in which some shareholders are not business professionals*, which is common in a second generation family company. Outside directors can validate the board's commitments to all the shareholders' interests.

D. WHAT ARE OUTSIDE DIRECTORS' GOALS & FUNCTIONS ?

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 a reasonable effort to assure that the appropriate governance practices are followed and that the company complies 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*, aka the "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 company must have a strategic plan, know where they are 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.* Smaller companies can't be expected to have, nor should they need, in house VP's for International Sales, P.R., M&A, I.T. or often even HR or Finance. Outside directors can help fill this gap.

6. *Look over the horizon* and, if necessary, sound the alarm. In short, try to prevent stupid mistakes, getting sued or running out of cash. Even very experienced management, pre-occupied with today's immediate needs, can get blind-sided.

7. *Create a discipline, structure and culture of third party accountability.* An advantage of a closely held company is the relative absence of pressure. A disadvantage is that it can also lead to procrastination resulting in expensive catch-up or missed opportunity. A Board with outsiders provides structure and a 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. Outside directors can give management and the board a taste of what it is like to be a public company and help them get ready.

E. HOW ACTIVELY INVOLVED SHOULD OUTSIDE DIRECTORS BECOME IN THE BUSINESS?

A board's primary responsibility is to oversee current operations and management on a policy level, but it is also appropriate for outside directors to participate in developing and implementing initiatives.

1. *Developing the strategic plan and infrastructure to fulfill it.* Such planning needs to be a standalone effort and requires thinking "outside the box" (even if the plan ends up *business as usual)*, and also include contingency options for what no one expects will happen, but might.

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, from financial records to internal controls and documentation, which don't happen overnight.

3. *Designing and monitoring financial reporting policies and packages*. The 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. *Finding, negotiating and consummating acquisitions.* Finding and closing acquisitions can be a fulltime job, and the consequences of oversights or mistakes can be serious. If the company doesn't have a corporate development officer, a qualified outside director can be an ideal candidate to take on the task.

5. *Overseeing other specific ancillary but critical initiatives,* such as obtaining government or customer approvals, lobbying, entering new markets, or even selling the company. An outside director experienced in such areas can contribute significantly to the process.

6. *Recruitment and screening of new management talent.* Even if outside 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. _Help design compensation, equity participation or ownership transition plans_. Compensation is a critical factor in attracting and retaining personnel. 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.

F. WHAT KIND OF PERSONS MAKE GOOD OUTSIDE DIRECTORS?

The criteria for outside directors depends on the type of the business and the skills that the company needs to achieve its objectives. These 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 by transferring experience and practices across industry lines.

3. _People with specific professional skills you need_, e.g. law, technology, finance, M&A, foreign markets, government procurement, regulatory compliance…

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 their relationship with other directors.

5. _Persons willing to step aside when and if the time comes._ It should be clear at the outset that an outside director is being elected for a specific term.

6. _Someone with whom your primary relationship isn't social or personal._ Consider the possible impact if the outside director candidate and the rest of the board were to reach an impasse.

7. _People who don't need the money_. The right directors will consider director's fees partial acknowledgment for 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 the business before accepting.

9. _People who add internal and/or external credibility_. The right directors can provide customers, investors, lenders and employees that 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 reduce or remove suspicion that the company is being run primarily for the personal benefit of an insider control group

10. *Consider two outside directors.* Two outside views are more valuable than one. Also a lone outside director can become frustrated if theirs is the only independent view.

G. 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 director's 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 phantom stock 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 are fees paid an attorney or investment banker board member for services beyond their duties as a Board member.

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 as compared to a public company, which is where the real liability risks reside.

H. 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 your strategic plan.

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 qualifications.

Valerio Giannini has served as a director of over a dozen private and public companies and is a principal of NewCap Partners, a private investment banking firm based in southern California. He was previously affiliated with the Ventana Growth Funds, served as CEO of Geneva Business Network, a subsidiary of Chemical Bank; a principal of Cumberland Investment Group and was with Kidder Peabody & Co. Mr. Giannini holds a BSE from Princeton University and is listed in Who's Who in America and Who's Who in Finance and Industry.

Newcap Partners, Inc. – 1122 Bristol – Costa Mesa, CA 92626
714 241 8686 – giannini@newcap.com   www.newcap.com

As published in ***Directorship***®