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How and Why You Should Add Your First Outside Directors

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HOW AND WHY YOU SHOULD ADD YOUR FIRST OUTSIDE DIRECTORS

Panel: *Steven Barth, Foley & Lardner LLP*
Maureen Hurd, Beal Associates
Neville Byford, Eversheds
Laurie Benson, LSB Unlimited
Roger Crockett, R.O. Crockett Leadership Advisory

Time: *10:20 a.m. – 11:20 a.m.*

I. Why Your Private Company Should Have an Independent Board of Directors

A. Why Have a Board with Independent Members if You Are a Private Company?

B. When Do I Need a Board With Independent Members?

C. Who Should I Ask To Be On My Board?

D. Where Do I Get Directors?

E. How Many Directors Should I Have?

F. What Do I Discuss With My Board?

G. How Do I Allow My Board to Help Me?

H. How Do I Compensate My Board?

I. What makes a “Good Board”? The Six “Rights” From NACD.

II. What You Should Consider Before Joining A Board Of Directors

A. Post-Enron/SOX (et a1.) - Much More Scrutiny Now by Individuals Before Joining Board – Applies to Private Companies Too

B. Before Joining a Board - Questions to Ask

Why Your Private Company Should Have an Independent Board of Directors

A. Why Have a Board with Independent Members if You Are a Private Company?

1. First and foremost, it will help you make more money and create more value

   - Both near-term and long-term

2. A great source of diverse experience, perspective and wisdom

3. Provides you with "intellectual capital" – broadens your knowledge and information base – real, honest, concerned and objective input from non-self serving individuals

   - People who already have "been there, done that"
   - Gives you ideas you haven't thought of
   - A different, thoughtful perspective
   - Insights into people/problems
   - You don't know what you don't know!
   - Shared experiences/lessons learned/mistakes made from other companies
   - Specific knowledge base that may be "ancillary" to your business
   - e.g., if your business is highly regulated, perhaps an attorney on the board would be useful; if your business is about to expand into a new area, perhaps someone with experience in that new area would be useful

4. Expands your network of useful contacts for financing and other business needs

   - Bankers, accountants, lawyers, insurance agents, real estate agents
   - Even customers

5. Keeps you sharply focused on your business's strategic goals and objectives

    - Forces you to be "accountable" and maintain an updated and organized view of your business and to ask yourself tough questions

    - Preparation for your Board meetings will help force you to address macro-level/strategic issues that might get lost in day-to-day business

6. Enhances your critical business decisions by rigor of constructive analysis, insights and experience

7. Raises the bar of "expectations"

8. Provides you with independent "credibility"

    - Important to banks, investors, customers, suppliers

9. Helps attract top talent

10. Can bring objectivity and independence to otherwise difficult decisions

    - Hiring, firing, promotions and compensation (particularly in family businesses)

    - Fresh perspective to business run in the "traditional" way (i.e., "this is just how we always did things")

    - Impartial "middle man" between owners and managers

11. While public companies are generally required to have a certain number of independent directors, the justifications for having independent directors remain the same for private companies

    - Just because it isn't "required" doesn't mean your company can't benefit!

B. <u>When Do I Need a Board With Independent Members?</u>

1. First, get past the initial "survival" stage

2. You've got to be interested in growing your business

3. You've got to be interested in different perspectives and in receiving (and implementing) constructively critical advice

4. Why not rely on a tech group?

   - Not focused on your business – a Board is totally focused on you/your business

   - Can't really share confidential information

5. Why not an "Advisory Board"?

   - Many companies use this structure – it's not "fatal," but it's not best

   - Risks losing potential statutory liability/indemnity protection

6. Bottom Line: You've got to want one!

   - Time, information, effort, attitude

C. <u>Who Should I Ask To Be On My Board?</u>

1. Some members with experience in the industries you are in can be helpful

   - But <u>not</u> competitors, suppliers or customers

2. Some members having disciplines <u>complimentary</u> to your company's strengths

   - Not everyone should think the same way you do

3. Board should be well rounded representing multiple disciplines:

   - Sales/Marketing

   - Accounting/Finance

   - Engineering

   - Manufacturing

4. People who have run successful businesses make good Board members – good at a variety of issues

- Been there, done that

5. People whose values and beliefs are compatible with your company's

6. People who you respect and who respect you

7. People who are progressive, visionary, good strategic thinkers

8. People who will speak up, but not dominate the Board

9. People that will take an active interest in your company – want it to succeed and not be jealous of its success

   - Feel they are a part of your company – take a sort of pride of "ownership" – a "we" mentality

10. Good macro-level problem solvers

D. Where Do I Get Directors?

1. Must be outsiders (not other company officers)

2. Should preferably be local businessmen/entrepreneurs in noncompeting industries

3. Not your banker or accountant (but they can give you ideas and references)

4. Not your friends/family

5. Not your competition, customers or suppliers – avoid conflicts of interests or fear of disclosing confidential information

6. Should be local – ease of meeting quickly

7. Sources: IBAW/COSBE/MMAC/SCORE/MEDC/Rotary/Chambers of Commerce/tech groups/recommendations from your attorney, accountant, banker

8. Whoever you choose, make sure they have the time and commitment to be an energizing force

9. Selection process is critical

   - Approach like hiring a Vice President

E. <u>How Many Directors Should I Have?</u>

1. Needs to be big enough to provide you with diverse opinions, but not too big to be cumbersome

   - No need for an “odd number” – if you think an “odd number” might be necessary, it means the board may not be functioning correctly

2. Not less than 3 nor more than 7

3. Start with three outsiders, plus yourself

F. <u>What Do I Discuss With My Board?</u>

1. Remember – the board is not managing the company – it is not in the details of operations, and is not meant to run the business

2. Use your Board as a “working board” – not as a rubber stamp!

   - Spend your Board meetings getting advice – not “reporting” to the Board

   - This means you need to provide them with information in advance of meetings so you can most effectively use your meeting time

   - Agenda in advance

3. Matters that legally must be brought to your Board for action:

   - Dividend declarations/stock redemptions

   - Stock issuances

   - Officer elections

   - Charter or bylaw amendments

   - Mergers, acquisitions, liquidations

4. More importantly – matters that *should be* brought before your board; matters that add real value to you

- Strategic plan – most important!
- Succession plan
- Annual business plans
- Management changes – CEO/management accountability
- Key decisions
- Financings
- Major asset dispositions
- Major capital expenditures
- Budgets
- Acquisitions
- Real estate leases/purchases
- Hiring/firing professionals (attorneys, accountants)
- Major new contracts
- Changes in accounting practices

G. <u>How Do I Allow My Board to Help Me?</u>

1. Meet at least once a quarter – every six weeks is ideal

- Board meetings should be exciting, challenging and energizing
- Can hold by conference call, but face-to-face is far superior
- Set an annual schedule of meetings in advance – hold dates sacrosanct

- Make sure to send the agenda and background information to the Board well in advance of your meetings (1 week) concerning all agenda items

2. Keep meetings short (2 hours) and focused

3. Obtain your directors' advice on critical business decisions/strategy

   - Spend your Board meetings getting advice, not giving information
   - Focus on your problems and how to solve them
   - Discuss new ideas
   - Major benefit: Pick up the phone to ask advice!

4. Keep your Board informed between meetings - communicate and update them on major events and progress

   - The more information they know in advance (especially your company's key economic drivers), the better advice they'll give at your meetings
   - Business/strategic plan
   - Make sure your board has a thorough understanding of your business
   - Critical documents (organization chart; charter; shareholder agreements; loan agreements; leases)
   - Historical financials/projections
   - Facilities tours
   - Presentations by key managers (let your Board get to know your team; good experience for your key managers too)
   - Interim financials
   - Briefings on important new products, market developments, contracts, financings or borrowings, leases, investments or material changes in the business

- A descriptive overview of what is happening in the business (officer reports - marketing, finance, manufacturing)

H. <u>How Do I Compensate My Board?</u>

1. Money isn't (shouldn't be) the primary reason they'll do it (personal and business growth), but it's still important
   - Very important person
2. Don't be cheap - at least $1,000 per meeting/$500 committee
   - Mtg. fee/retainer
   - Retainer [$750-$2,500/quarter]
   - Don't want your directors to feel they are being taken advantage of
   - To some extent, you get what you pay for…
   - Company stock (still in game)
3. Expense reimbursement
4. A few "freebies"/a meeting followed by golf/dinner/social events

I. <u>What makes a "Good Board"? The Six "Rights" From NACD.</u>

1. The "Right" People (energized and committed – experienced "been there before" business people; directors who have their egos in check; desire to be "value-added")
2. The "Right" Culture (trust and openness – willingness to provide, listen and act on advice)
   - Chemistry is key
3. The "Right" Issues raised and discussed at meetings (big picture; not little picture)
4. The "Right" Information (both provided to the Board sufficiently in advance of meetings, as well as determined by the Board to be necessary as it identifies key issues)

5. The “Right” Process (focus on quality discussion and advice, not “reporting”)

6. The “Right” Follow-Through (accountability and a constant strive for improvement)

What You Should Consider Before Joining A Board Of Directors

A. Post-Enron/SOX (et a1.) - Much More Scrutiny Now by Individuals Before Joining Board – Applies to Private Companies Too

1. Substantial Additional Time Commitment

    - First year, can/should (depending on the business) be approximately 75-100 hours - learn the business
    - After the first year, can be approximately 40-60 hours

2. Duties/responsibilities have been dramatically expanded

3. Potential significant liability risk - financial/reputational

4. Compensation doesn't match the time/commitments/risk

5. Detriments can now outweigh the benefits

B. Before Joining a Board - Questions to Ask

1. What do the owners want to do with the company?

    - Dividends vs. Growth
    - What are goals/expectations/long-range plans
    - Do shareholders have divergent goals?

2. Why are you being asked?

    - What perspectives are you expected to bring to the Board?
    - What expectations does the owner have of you?

3. Why do you want to join? What benefits will you receive (other than money)?

    - Other experiences, ideas, intellectual capital that can help you professionally/your business
    - Contacts/relationships

- Don't do it as "favor" - or for the money

4. What time commitment will be required to be effective?

   - How often will Board meet and how long will they last?
   - Can you meet without feeling taken advantage of?
   - What committees will you be asked to join?
   - What amount of time will it take to learn the business/industry?
   - What amount of time between meetings will it take?
   - What amount of time will be needed to prepare for meetings?

5. Ask "the Basics" about the Company:

   - Business strategy – growth, etc. – Where is company going and how can you help?
   - Financial history/prospects
   - Any history of financial trouble, restatements, litigation?
     - Are financial statements audited?
   - Type of industry – risk levels – volatility
   - Integrity of CEO/management/financial staff
   - Shareholder demographics
   - Stock ownership of management
   - Other Board members – talk to them
   - Healthy atmosphere on Board? Can you be critical? Will your advice be appreciated/implemented?
   - Open/honest – sharing of opinions
   - Inside/outside mix – How will you fit in?

- Type of Board - rubber stamp vs. strategic asset
- Audit Committee? Other committees?
- Who are the Company's auditors/lawyers
- D&O insurance/indemnity/litigation history
- Compensation

6. Related party transactions/conflicts
7. Shareholder demographics – broadly held?
8. Trust your gut!
9. Limited service [one-year term?] Term limits?
   - How could you gracefully depart if desired