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BOARD OF DIRECTORS

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Quick Summary: Understanding how to operate under the supervision of a Board of Directors is critical.

Abstract:

The composition of a Board of Directors and the motivations of each Board Member must be carefully understood. Boards of Directors can exercise their governance responsibilities only through one avenue – working directly with the company's CEO. For private companies, the time to begin to operate under a Board of Directors, the form and format of the Board, and the selection of Board Members is a significant activity that will have many long-term impacts.

Although the same label is given to a Board of Directors for either private or public companies, there are significant differences between them. At the highest level, they are charged with the same overall responsibility: To provide overall direction and management of the company that is in the best long-term interest of the shareholders. Further, they provide this direction through the company's CEO and not by directly interacting with the company's employees.

Aside from this common responsibility, the actual interaction of the Boards of private and public companies varies widely. Through various laws and regulations at the State and Federal level, public company boards have very specific duties. We have all heard stories about shareholder lawsuits against companies and their boards by disgruntled shareholders, regulators themselves, or law firms that specialize in filing suits based on, sometimes real and sometimes trumped-up, charges of misconduct. Private company boards operate with much less oversight and stringent requirements. All public companies operate with the authority and responsibilities outlined in their Articles of Incorporation and other mandated compliance and reporting regulations. The Sarbanes-Oxley Act of 2002 (SOX) is a good example of some compliance requirements intended to prevent fraudulent accounting practices. Unfortunately, it has morphed into such an overwhelming and cumbersome nightmare that has stretched the financial limits of many smaller public companies. In fact, many private companies have registered in other countries to avoid the need to comply with SOX. Private companies operate with far more degrees of freedom often covered by simple Operating Agreements.

Aside from the legal and regulatory requirements, there are two significant and fundamental differences between public and private boards of directors. They are the board member composition (types of members) and the material and issues discussed and resolved by the boards. Public boards typically are comprised of a higher percentage of Outside Directors – individuals who are not affiliated with the company as opposed to Inside Directors – individuals who are employed by the company (ex. CEO) or

represent shareholders. Outside Directors, due to their many other commitments, do not have nor are they expected to have, an intimate knowledge of the company, its current internal operating state, or market and competitive positioning. Public company boards operate at a much higher level than private company boards. In fact, anyone who has worked with a large company will think of a private company board meeting as analogous to a division operations review meeting in which far more tactical details are discussed.

The remainder of this article is focused on private company Boards of Directors.

Entrepreneurs and very early-stage companies rarely form a Board of Directors in their pre-revenue days. A "board" evolves with board meetings starting as informal gatherings of people involved with the company. They can involve the founder and a few other senior-level employees (if there are any), a mentor, and a few advisors. Fractional financial specialists and attorneys may also be involved from time to time. These meetings focus on what the company is doing and what it should do. They are tactical in nature, focusing on the next several months' activities. When Angel Investors are added to the mix, the same arrangement may continue, or a simple Operating Agreement may be created. The complexity of the Operating Agreement can be as basic as a two or three-page document that covers only a few areas such as percent ownership and rights to review financial results. As other Angel Investors are added, a more complex Operating Agreement may be adopted. Finally, if Venture Capital Investors invest, a Term Sheet describing more details is executed and used as a placeholder until a more elaborate Operating Agreement is executed. That agreement will specify the board composition, voting rights, and most importantly, the issues that require board approval. Once executed, the CEO will have to adjust to operating under the control and scrutiny of the Board.

Formal board approval will vary significantly between companies and is specified in the Operating Agreement. The following is a list of the common areas that typically require board approval.

- Hiring of senior-level executives
- Annual budget approval
- Issuing of stock, stock options, and warrants
- Stock option plans
- Fair market valuation
- Debt financing
- Major capital acquisitions
- Long-term contractual commitments (leases, outside development, etc.)
- Hiring of external auditors, legal counsel, and other professionals
- Executive team compensation
- Employee bonus plans and payments
- Beginning of or responding to any litigation issues
- Pursuing patents or other optional significant financial commitments
- Transfer of IP or other significant company assets
- Retaining an Investment Banker
- Pursuing any merger or acquisition discussions

Virtually the entire list can be summarized as the Board of Directors wants to approval over any financially-material transactions or other areas that could impact the long-term viability of the company. For an entrepreneur or new company CEO, accepting that they need to ask for permission may take some getting used to. They must make the mental transition and begin to think of their responsibility to the shareholders as opposed to their focus on the company's operations.

To be sure, boards do not want to run the company; they simply do not have the intimate day-to-day knowledge required, nor do they have the time, interest, or perhaps the skill sets required to run the company. Instead, the Board wants to exercise its mandated control through the CEO. Realistically, they have only one recourse if the company is not operating consistently with their desires: to replace the CEO. It is not uncommon to see public company CEOs replaced by boards, usually because of falling stock prices or disagreements in the long-term strategy. Private company CEOs probably experience the same turnover rates as their public company counterparts. A primary reason for the higher turnover is that many companies "outgrow" the current CEO. This often happens when an entrepreneur, with the original vision, transitions to the role of CEO. Over time, the skillset required to run a growing company may simply be beyond the capability of the original CEO. As the company progresses, a private company CEO may be not equipped to run a publicly traded company, necessitating a change before an IPO.

As previously mentioned, private company boards typically are dominated by Inside Directors who are in some way affiliated with the company – most often as employees or shareholders. One or two Outside Directors that are typically domain experts or management coaches may be asked to join the Board to provide more insight and objectivity.

The company is represented by the CEO and generally one other person, perhaps a co-founder or CFO. Other high-level employees can also attend board meetings but act as observers or "non-voting" Board Members or attendees. An attorney, usually a Board Observer, should be present at meetings to provide legal counsel to the Board and to properly draft and record any board resolutions required. The attorney involvement can occur after the fact, but this arrangement can lead to misinterpretations of what was said or what can be resolved that is consistent with applicable laws and regulations.

Most other Board Members will be investors (Angels) or other investors (Venture Partners) that represent the interests of other investors ("Limited Partners"). Some boards also include Advisors, Mentors, or Sponsors that have issued Warrants or Stock Options. When Warrants or Stock Options are granted to those individuals, they become Inside Directors because they are now financially affiliated with the company. Advisors, Mentors, and Sponsors may choose to participate as observers or as Outside Directors with no financial ties to the company. They accept a zero-compensation role in order to be able to represent themselves to others as "unaffiliated" with the company and have no financially vested interest in its success.

Interactions with Advisors and Customers and the associated boards are much less formal than with a Board of Directors. The interaction with Board of Director members requires a number of special considerations and approaches. The entire next chapter in this collection is totally focused on and is titled "*Board of Director Interaction*," Chapter 7.02.