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INVESTMENT BANKERS

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The Case for Independence in Private Company Boards

Independent directors can be a positive asset for private, family-owned businesses.

by William S. Hanneman

Having worked with hundreds of private, family-owned businesses over the years, we have found that the vast majority does not maintain active boards of directors or advisory boards that could be legitimately considered as independent. By that, we mean directors who are not employees or do not have another material (vendor or advisory) relationship with either the company or its principal shareholders. Indeed, if a functioning board exists, it tends to be populated with family members, company executives and/or rubber-stamping friends. Most would not come anywhere close to the standard of independence to which public companies are now held.

As corporate fiduciaries, directors and management are obligated to act for the benefit of all stockholders. Of course, there are instances in which the interests of corporate officers and managers are not necessarily perfectly aligned with the interests of shareholders that are not active in the company's day-to-day affairs. For example, a conflict can arise where financial results may affect the level of management's compensation.

We have heard any number of reasons for not building an independent board:

- Confidentiality; our affairs are private.
- It is expensive; directors need to be compensated for their time and effort.
- It is a time consuming hassle to keep the board well enough informed to provide meaningful advice.

We suspect that the principal reason why many private companies don't have functioning independent boards is that CEOs would rather not be scrutinized or have their business ideas challenged. Admittedly, the job of a private company CEO is lonely. Some family CEOs prefer it that way, as they do not wish to suffer the second-guessing or being called to account in the presence of family shareholders or management.

In lieu of an independent board, some private company CEOs often seek guidance from friends or outside professionals. While this counsel is certainly well intentioned, these advisors may be too close to the owner to provide impartial advice. Beyond the issue of objectivity, most service professionals are not qualified to provide the type of real-world business advice that CEOs often lack. To be sure, there are various organizations, such as TEC or YPO, where CEOs of private companies can get objective advice from business peers. These organizations, for those who take participation seriously, can be quite powerful.

GUIDELINES FOR PRIVATE COMPANY BOARDS

1. Appoint persons independent of management and shareholders who are free from material conflicts of interest.
2. Ideally, outside directors should have a degree of financial savvy and possess some knowledge that is relevant to the business.
3. Meet regularly and require that directors be well informed.
4. Ensure that financial reporting is accurate and that disclosure is routine.
5. The priority interest of the board should be the shareholders. The Board does not report to management.
6. Fairly compensate Board members for their time and effort in assisting the company.
7. Periodically, review the performance of the CEO, as well as the performance of each Board member.

When populated with directors who have insight into the industry and/or expertise in related disciplines, the board is an excellent forum for vetting management's business strategy.

RESPONSIBILITIES OF PRIVATE BOARDS

Although private companies are not (yet) subject to the stiff requirements of Sarbanes Oxley (SOX), we believe that these businesses benefit by adopting the spirit of board independence that SOX imposes on public companies. Outside directors can add value to the business in four primary areas.

Setting Strategy and Company Policy

When populated with directors who have insight into the industry and/or expertise in related disciplines, the board is an excellent forum for vetting management's business strategy. While management is immersed in the day-to-day tactical maneuvering of the business, a well functioning independent board should be focused on a longer-term perspective, assisting the management to clarify the vision of the business further down the road.

Advising, Evaluating, and Counseling the CEO

While private company directors serve at the pleasure of the owner, a board member who takes the role seriously can offer the type of coaching and constructive criticism that can help a CEO transition from the entrepreneurial skills needed to start the business to the leadership skills that are necessary to grow it. Outsiders are often well placed to act as a mirror, allowing the CEO to see how outsiders might perceive his actions and to provide both a sense of objectivity and a measure of accountability.

Resolving Conflicts Among Owners

Independent directors can play a pivotal role in mediating the agendas of the individual owners. All directors have a duty to act in the best interest of the corporation and all of its shareholders. We have often seen family disfunctionalities invade businesses. When it is allowed into the boardroom, it often contributes to an erosion of value. Independent board members are perhaps in the best position to assist in the resolution of such conflicts, especially if they have been around for a while and are judged to be impartial.

Overseeing Succession

Management succession can be a significant source of conflict within private companies, particularly family owned enterprises. Parents inevitably believe that their offspring are capable of taking the reins. Often, this

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notion is misguided. Professionals don't want to deliver this sensitive message, but an independent board member is much more likely to have the standing to help the owner objectively assess the impact on the business.

Accurate Information to All Shareholders

As ownership is passed from one generation to the next and the shareholder group expands to include multiple generations, shareholder communication and knowledge regarding company affairs invariably suffers. Independent board members can provide some comfort to those not actively involved in the business that they are getting accurate and timely information. Specifically, private companies should seriously consider the formation of an audit committee of the board, staffed predominately by outside directors, which is directly responsible for retaining and managing the company's relationship with its outside auditor. This step helps to blunt any claim that management and directors are not entitled to the benefit of the business judgment rule. It would also provide comfort to creditors, insurance companies, other service providers, and passive shareholders who will increasingly judge the actions of private company management against public company standards.

In the course of our work with private companies, we have observed a positive link between well functioning boards and company performance. Firms that invite independent directors to assist in their governance seem to benefit from that guidance as they seek to cope with external competitive challenges, and internal issues. A formal board of directors, or an advisory group without the same legal standing, can be a very powerful tool to foster business success. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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