

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. banks and insurance companies, not to mention the IRS, OSHA EPA, FDA, FCC, 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 and hold management accountable.

Their principal role, along with all board members, is to focus the conversation to or over the horizon, establish policies and strategies, review and approve major decisions 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 governance process.
2. Coaches and peer groups such as Vistage 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 and/or ownership.
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 significant advance preparation to obtain competitive terms.
8. Businesses with needs or plans outside their past experience, such as foreign sourcing or international markets, for which special expertise is needed.
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 tough questions and provide feedback that most employee directors won't. Given a choice between speaking up and job security, many or most employees will choose 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 insiders.

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 necessarily need, in-house senior executives for international sales, P.R., M&A, 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 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 or distractions, which can result in expensive catch-up or missed opportunities. A Board with outsiders should provide 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 ?

A board's primary responsibility is to oversee current operations and management on a policy level, but outside directors can also assist in developing and implementing initiatives. e.g.

1. Developing a strategic plan and infrastructure to fulfill it. Such planning should be a standalone effort thinking "outside the box" and include contingency options for what is hoped won't 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 get created overnight.
3. Designing and monitoring financial reporting policies and packages. The financial reports that work for a smaller 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 assist.
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 an extra set of seasoned 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. *Anticipation of an unexpected liquidity opportunity.* Even if a sale 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.* Surprising results can come from 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, corporate governance, ...
4. *Persons who will work harmoniously with other Board members.* Good "chemistry" is important, but the individual should also be up to constructive disagreement without destroying their relationship with other directors or management.

5. Persons willing to step aside when and if the time comes. It should be clear at the outset that an outside director serves at the pleasure of the shareholders.
6. Someone with whom your primary relationship isn't social or personal. Consider the possibility that the outside director doesn't work out.
7. People who don't need the money. The right directors will consider director's fees acknowledgment for their time, but not as an important 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 give customers, suppliers, investors, lenders, and employees an extra measure of confidence and comfort.
10. More than one. A lone outside director can become frustrated if theirs is the only independent view. Also, multiple outside views are more valuable than one.

G. HOW DO YOU COMPENSATE THE RIGHT PEOPLE TO SERVE?

1. Equity in some form. One of Directors' primary motivations is to enhance shareholder value,
2. Outside director "equity" need not be direct ownership of shares. It can also be in the form of a profit sharing or option plan, or phantom stock/SARs.
3. Compensation for non-director services, e.g. fees paid an attorney or investment banker board member for services beyond their Board duties.
4. Make it challenging, interesting and fun. Ultimately the best motivation for the director who doesn't need the money is the intellectual and professional stimulation.
5. D&O 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 and the ownership, the potential liability for a director of a closely held company may be negligible.

H. HOW DO YOU FIND GOOD OUTSIDE DIRECTORS?

1. *Inventory your general goals and the skill sets needed to accomplish them.* Adding outside directors can be 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.
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