Forming a private company's first fiduciary board: step-by-step

The first time formation of a fiduciary board of directors involves a somewhat more complicated process than simply filling a board seat on an already existing board. The formation of a board for a private company can also vary in certain ways from the formation of a public company board. A high-level view of some of the important elements necessary to form a board, arranged in a simple critical path format.

By Dennis Cagan

A client recently retained me to educate him on considering whether or not to install a fiduciary board of directors. This young man had founded a high-technology company and still owned controlling interest; he was no longer active in management, however his minority partner was the CEO. The company was over one hundred million in revenue, and being very smart, analytical and inquisitive he asked me, "How do you actually form a board." Although I had explained this many times, he wanted it from me in writing, and with a flow chart no less.

Well, there are a myriad of considerations for a private company, where do you start? Certainly you know people, and you even know some people who know some people. Do you just ask? What about your corporate documentation? Are you even properly incorporated? How do you determine what skills you need? Here are the basics.

Step-by-step

This article will go through twenty-seven steps leading up to conducting your first board meeting. Many of these steps can be undertaken in parallel. One could undoubtedly come up with other points, and variations of these, but these basics will get you through the basics.

1. Incorporate in an appropriate entity (C or LLC).

It is becoming much more common for privately owned enterprises to want to take advantage of the tremendous value-addition that a top-flight board can provide. Even those that do not envision an eventual exit by way of an initial public offering or acquisition are forming fiduciary boards. In order to have a legal fiduciary board of directors (board) the company must have a corporate structure, as opposed to a partnership one. Typically it would be a C corporation, especially if a sale or public offering is envisioned eventually. However, an LLC (limited liability corporation) may also have a board, although the structure and implementation are much less well defined by corporate case law (see sidebar).

LLC vs. C corporation

Laws in every state require that a corporation have a board of directors elected by the shareholders. An LLC (limited liability corporation) does have some of the same characteristics as a corporation, however they are not required to have a board of directors. Rather, in most states, the regulations allow an optional board if the members (owners) so choose. This governance arrangement would be part of the document filed to create the LLC, typically known as a Certificate of Organization, Articles of Organization, or Operating Agreement. Articles of Organization must designate which of two types of management structures the company will have – it will either be Manager-managed, or Member-managed. Manager-managed means that the power and authority of the company's management rests with the Board of Managers, which is similar to the Board of Directors of a Corporation. If Member-managed, the LLC has no Board of Managers, and is managed directly by its Members (owners), with authority in proportion to their ownership.

2. Gain the consensus of majority of ownership and decide if a board is appropriate for your company.

The formation of a board can initiate a very positive chain of events. Those outside the company – customers, vendors, strategic partners, competitors, bankers, investors, etc. - will view the firm differently, usually as more professional and better managed. Inside the company, employees will also sense a difference and tend to feel that the company is more serious and respectable. However, with all the benefits and dividends that a board can provide, it can be problematic without the full support of ownership. Of course it is possible, depending on the details of a company's shareholders agreements and structure, that a simple majority of ownership could establish a board. However, the outcome is much more likely to result in all the positives if the move has the support of all the owners. With a private company, moving to seat a board always brings up issues of potential loss of control. While fundamentally this is not the case, the perception still lingers and can create discord and contention. I would rarely recommend the creation of a board unless an overwhelming majority of ownership endorses the concept.

3. Brief all key parties on the plan to form a board, including a clear majority of shareholders (if closely held), the CEO, other key employees, advisors, and if appropriate strategic partners, major customers, key vendors, etc.

Once the owners have made this decision, or at least a decisive majority of them, it is helpful to engage a broader audience. This should by no means involve 'everyone', but rather key folks. The company's C-level management, if it is not already part of ownership, your attorney, accountant, primary banker (especially if you have any debt), and possibly even some key customers or strategic partners. This has several benefits. First, you begin to build your company's credibility and respect even before the board is actually organized. Second, this select group of close 'friends of the firm' could well have some insights that might be helpful, and they may have some recommendations for director candidates. You should begin your list of potential directors as soon as possible, and with the most desirable and qualified candidates possible.

4. Fully understand the process and ramifications of a board.

Of course all the details of forming and administering a board will effect the final decision on whether or not to have one. However, it is not necessary to understand all this unless the owners fundamentally agree that they want one. Then considerations like time commitment, cost, politics, governance impact, legal liabilities, etc. will come into play. Generally these do not really change someone's mind, but should be fully understood at this stage regardless.

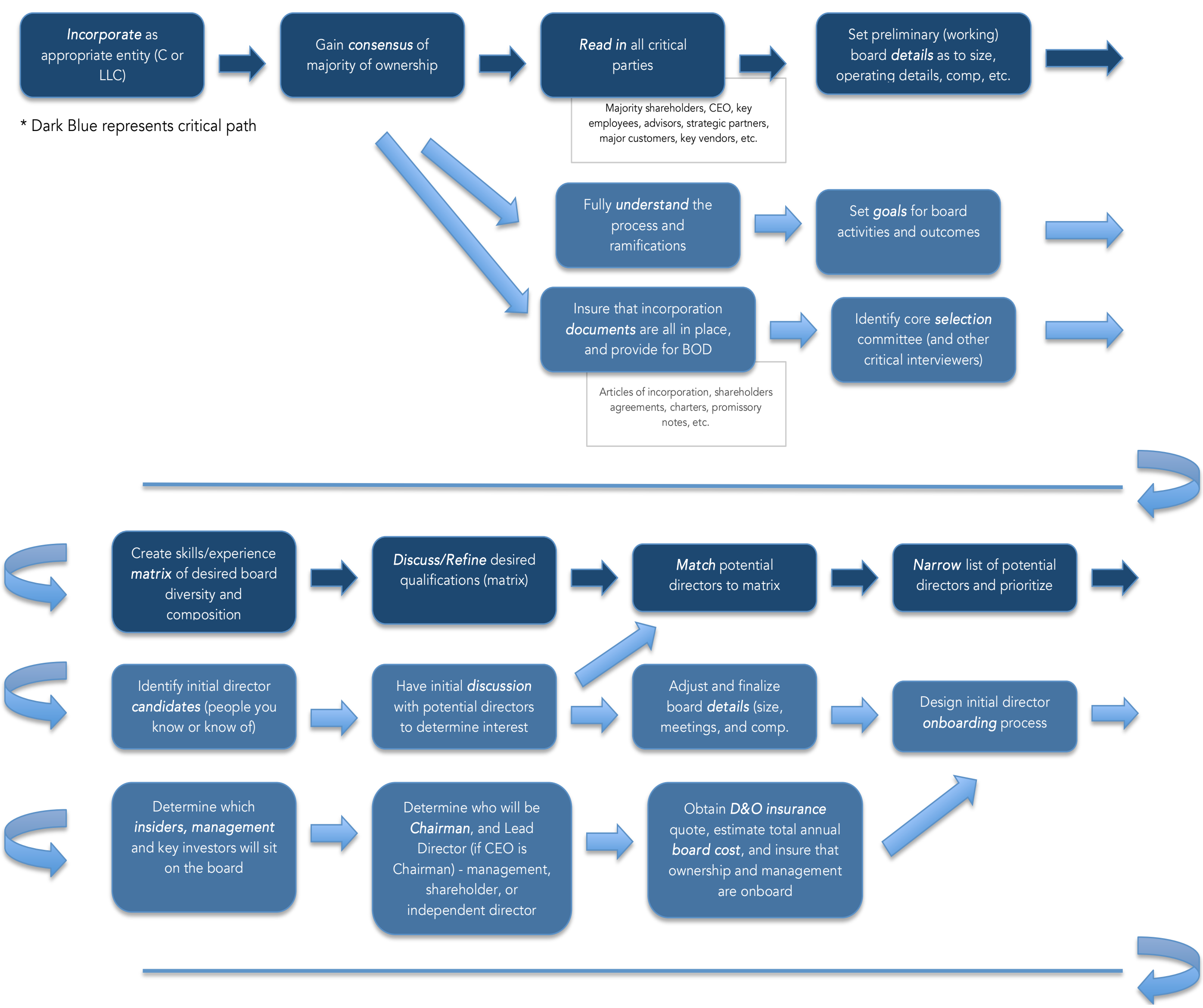
5. Set goals for board activities and outcomes.

As with any corporate undertaking there are expectations to manage and results to be measured. It is no different with a board. I am not reviewing examples of board goals here, however without articulating and documenting them it is harder to communicate with stakeholders, including potential directors, and the results of your recruiting and board activities as a whole will be far less satisfactory. The best goals have to do with improving the company's performance and enterprise value, however even something as simple as needing a qualified fiduciary board to fulfill SOX (see sidebar) compliance for an eventual IPO is valid.

6. Insure that incorporation documents are all in place and provide for a board, including articles of incorporation, shareholders agreements, charters, promissory notes, etc.

Too many times I have seen this step short-changed. When the documentation is not in order on the front end, it leads to confusion, discontent and wasting substantial time at minimum in the future. Worse results can include inadvertant illegality, lawsuites and at worse abandon M&A or financing transactions. Make sure you have properly established the necessary incorporation structure. Take the time to create or restate the Articles of Incorporation (or Organiation). The document(s) needs to include proper designation for a board, the number of directors, the term and other similar elections. It is not unheard of for errors in these to go undetected for years, only to surface in the middle of an important transaction – like selling the company or an IPO. It is

Formation of a New Fiduciary Board of Directors: Critical Path



unlikely to derail a deal, but for example it does add a loss of confidence and substantial delays when the buyer or an investment banker points out that the board did not in fact have the legal authority to approve the deal. All this will surface during due diligence and could even result in a reduced valuation.

7. Set the preliminary board details such as to size, operating details and compensation. Please note that I say preliminary. These details can change before the board is fully seated, and thereafter. There is no one – or even best – model here. It is very subjective, but there are some hints that will keep options open going forward. Set some parameters rather than fixed numbers – e.g. authorize for nine directors, but with the intention of only having five to seven to start; plan on meetings every month to six weeks, with two out of three by phone and the third in person; or peg the compensation within reasonable dollar range, but do not fix it until the board meets (allow for equity or profit sharing options, but don't fix the form or amount). It is not mandatory that all potential issues are covered up front. Experienced directors will tolerate the ambiguity and help walk the management through the process.

8. Create a skills/experience matrix of the desired board diversity and composition. Start by looking objectively at the horizontal and vertical (domain) skill set and experience of the management team. Look also at the major potential risks and potential for the firm. Then consider, in light of these risks and rewards, which talent, experience and skills, are the most needed and in the shortest supply within your existing team. These are part of the basis for your matrix. Add to that the traditional best-of-class items that might strengthen your roster – e.g. qualified financial expert, highly regarded former CEO, noted industry or academic authority, etc. This creates a somewhat objective basis on which to compare and balance candidates to form the most diverse and relevant board you can.

9. Identify initial director candidates. These are people who are known directly, recommended or known of.

So often I talk to owners or managers who don't know where to start. Just start writing down names! Who do you or your colleagues know, or simply know of, that might be a potential candidate. Ask your trusted advisors like your attorney or accounting firm for recommendations. Build your list. (Note: see my article *Finding directors for the smaller and early-stage company,* Directors & Boards Magazine, Second Quarter 2012.) Do not be timid in exploring a variety of sources for your candidates. Call industry leaders. Check with industry associations. Use LinkedIn to its fullest potential. Call colleagues at other companies, in other industries, in other geographies. Talk with leadership at local University business schools, or your own alma mater. Be creative; perhaps a senior executive recently retired from a significant competitor, or some other industry figure, and they do have any anti-competitive restrictions. Reach far and wide in your initial thinking. If there is a specific skill set that would really make a big difference, search for it. Executive search firms that recruit directors are very good. However, I have never found it necessary to use one. It is always more compelling for a director to be solicited by a member of the ownership or the CEO, then an outsider.

10. Identify the core selection committee. Also identify others who are critical to include in the interviewing process.

Who is going to make **the** decision on who gets invited to join the board? Who's imput will be important, even if they do not necessarily get a vote? Who will take the lead in the process of contacting the prospects, reaching out to them, informing them of the opportunity, initially convincing them to consider it, and collecting their relevant personal information and questions? Choose carefully since this individual is the first person they will build their impression of the firm on. A fumbled approach can cost a potentially valuable director. Remember that often the best you could get will be the hardest to recruit.

11. Have an initial discussion with all potential directors to determine interest.

After your list is refined, and ranked by preference, reach out. There is a balance here. It is very productive to meet as many of these folks as possible, yet it is time consuming and you don't want to set any false expectations. The process of meeting a highly qualified group like this can be fun, stimulating and educational. Don't short-change the benefits. It is advisable to have your proposed engagement well prepared. Be ready to give them the key points of your request and simply determine their interest and availability. Can they afford the time, and are they interested in talking further? That's it for now.

12. Refine the matrix of desired qualifications.

After initially talking with the candidates you have identified, consider their qualifications and re-examine the best potential mix to gain maximum board diversity across all the critical areas. If necessary refine your maxrix based on any new knowledge or awareness.

13. Determine which insiders, management and key investors will sit (or not sit) on the board.

Now that you have seen some candidates, and had time to think about a board, it is time to begin to nail down who among the existing stakeholders should actually sit as a director. Keep in mind that key executives below the CEO can attend meetings and give the board their imput, but do not necessarily have to have a vote. If there are co-founders, should they all sit on the board regardless of management position or equity percentage? Was anyone *promised* a directorship? Is there any preferred series of stock that needs or is required to have board representation? Is there a key investor or advisor that is so valued and respected that you want their balance on the board? All said, a qualifying fiduciary board should have a majority of independent directors, although of course this is not a mandatory requirement for private companies. Yet still, three inside and 4 outside is an excellent benchmark for starting out.

14. Determine who will be Chairman, and Lead Director (if CEO is Chairman) - management, shareholder, or independent director.

The board will need a chairman. Normally the board would elect one, however in a private enterprise it is more common for the primary owners to determine who this should be. It could be the majority owner or their designee. It could be the original founder, the CEO, or an experienced outsider. Who has the experience to do it, or who wants to fill the position and learn the ropes? If an insider is chairman, then best practices dictate the election or appointment of a presiding director, or also termed, lead director. If a less experienced insider is chairman then it would be to their benefit to have a more seasoned presiding director to back them up. There are duties involved. There is time involved. There is leadership and political considerations (even in an extremely cordial environment).

15. Match the list of potential directors to the qualifications.

The narrowing down process continues. Match up all the players, rank them by preference, catorize their skills, compare qualifications against your matrix, sort and shuffle.

16. Adjust the qualifications, if necessary, and finalize board details. Make your final determination as to size.

Continue the previous step to a conclusion. Make the final decision on size based on your view of the process and candidates at this time. It can be changed later. I always recommend initially authorizing more seats, filling the ones you feel good about, and planning on adding more folks later as you get a better understanding of your needs and dynamics. For example, authorize for 9, seat 3 management/ownership, and 4 independents. If anyone does not work out you can always ask someone to leave and reduce to 6. If you feel that you could use more expertise in a particular area, or you simply meet a dynimite person, you can add one to have 8. It is flexible and does not have to be an odd number. I believe in slightly more board diversity and balance, as opposed to keeping the board small. A good chairman or presiding director will manage the process and keep the wheels of governance greased.

Supporting Articles

For additionl information on various aspects of the board formation process please see articles written by Mr. Cagan. These include:

Finding directors for the smaller and early-stage company. Second Quarter 2012, Directors&Boards Magazine

Questions: what to ask a prospective board member, and which you are most likely to be asked by them. Third Quarter 2013, Unpublished

The ABCs of forming an advisory board. Fourth Quarter 2012, Directors&Boards Magazine

Company to director: 'You're fired!' Second Quarter 2013, Directors&Boards Magazine

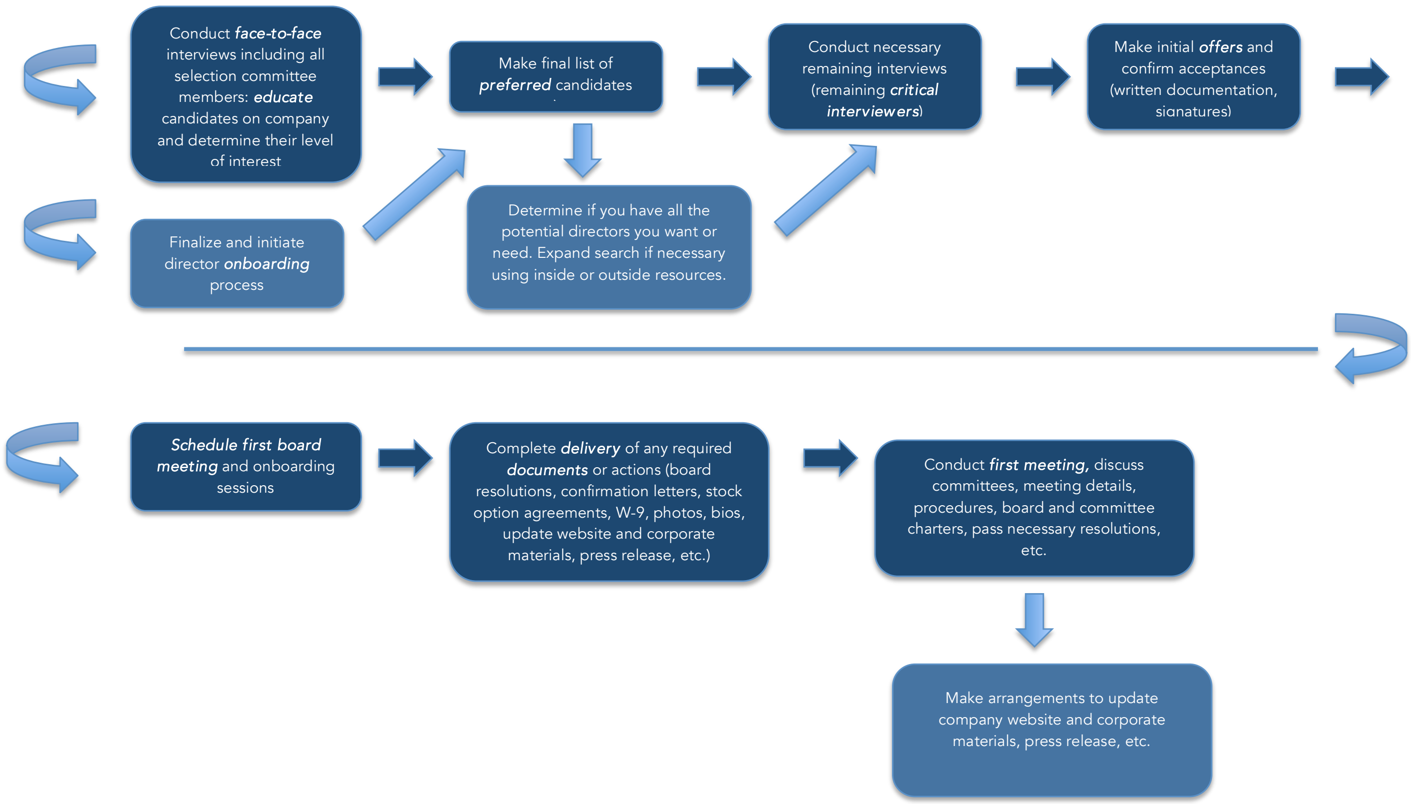
A primer: the ins and outs of board meetings for the small and private company. Fourth Quartr 2013, Directors&Boards Magazine

17. Obtain D&O insurance quote, estimate total annual board cost, and insure that ownership and management are onboard.

This step involves determining the entire overall monetary cost of having a board. This primarily includes the cash fees paid to directors. Typically only independent directors draw a fee. There is the base board fee, plus add-ons for committee assignments, special committees and other inreases in time, responsibility and liability. There are also T&E expenses for director travel related to their role. In addition there may be slightly increased legal or accounting costs related to both meetings and special reporting associated with board oversight. The time and cost of preparing for board meetings and making board arrangements is real, but it is usually absorbed in other administrative positions. A significant annual cost is Directors and Officers (D&O) insurance. It is very important to obtain this in the beginning. The limits vary and the fees vary accordingly. Poll your directors and corporate counsel to determine the best balance between coverage and fees based on the combined perceived liabilities and risks.

18. Design initial director on-boarding process.

In large part the value of your board will be based on their in depth understanding of your business. You cannot assume that they will start off knowing much about it. In order to derive the maximum benefit as soon as possible, it is important to have a somewhat formalized 'on-boarding process. This is best when not done ad hoc, but rather thoughtfully designed and



planned. This is typically comprised of some combination of written materials, educational sessions, meetings with key company personnel, visits to company facilities, and perhaps even meetings or conversations with key company customers, vendors, financiers, consultants, counselors, etc. The length of the on-boarding varies widely. Carefully matching your on-boarding plan to your directors time, availability and existing level of understanding is important. Assuming that you have recruited a very talented board, getting their best advice will depend on their understanding of your company issues, challenges and opportunities.

19. Narrow list of potential directors and prioritize.

This is self explanatory. Now that you have some visibility into who might be willing to join your board, make your final list in order of your preference. Eliminate some candidates if they do not meet your expectations.

20. Conduct face-to-face interviews including all selection committee members: educate candidates on company and determine their level of interest.

The real work starts now. Contact each one. Arrange interviews with key interviewers. These interviews can be one-on-one or with two interviewers. I discourage three. From my experience it simply gets too confusing for the interviewee to give meaningful responses to the demands of three people in one session that usually lasts only one and one half to two hours. Frequently over lunch or dinner. Give the prospects some idea of what they can expect. Tell them about the company, good and bad. Guage their interest. Circle back and share each interview with the rest of the selection group. Based on these first impressions determine who you want to have other interviewers meet. Arrange and conduct interviews for all viable candidates by all key decision makers if possible.

21. Make final list of preferred candidates.

Comprise your final wish list. You can have more than you need if you like. You need not actually invite them all to join.

22. Determine if you have all the potential directors you want or need. Expand search if necessary using inside or outside resources.

Have you satisfactorily met all the requirements of your skills/experience matrix? Are you missing anything important? Are you excited about the prospects of working with any and all of the candidates? Your should be.

23. Conduct necessary remaining interviews. Make certain to include all remaining critical interviewers.

Complete the interviewing process. Make certain that you have received input from all the necessary stakeholders. If your culture is such that family socializing is important, particulary the directors meeting your spouse, include the necessary interviews (or just an appropriate social get-together).

24. Make initial offers to the preferred candidates. The offer letter should include the key details of time expectations, term (if any) and compensation. Insure that a signed letter is returned confirming acceptance.

List and interviews done, it's time for the *ask*. Depending on the tone and details of your process to date, this might be a phone call, or a dinner, or anything in between. It's good practice to have an offer letter prepared. It would be signed by your primary executive or owner and it would list the key details of the directorship. The candidate would accept by signing two copies and returning one to you.

25. Finalize onboarding plan and initiate director on-boarding process.

Complete your plan, document it and distribute it to all the necessary personnel.

26. Schedule the first board meeting and the necessary onboarding sessions. Complete the delivery of any required documents or actions to the pending directors.

Schedule on-boarding for your new directors, together or individually. Collectively schedule the first board meeting. Tie up any loose ends.

27. Have all necessary board resolutions, confirmation letters, stock option agreements, etc. signed by the current board. Get any required documents from pending directors including W-9, photos, bios, etc.

This is a step where many boards fail – public, private or non-profit. The management drags its feet and procrastinates in putting all the documents and details in place. If there are any necessary resolutions, have them ready. If there is a stock option plan, then have the agreements for the directors prepared. If you require consulting, NDA or confidentiality agreements of the directors, have them ready to go. Get the copies of their identity documents that you need, along with completed W-9, photos, bios, etc. Be professional and get your new relationship with your directors off to a good start. Then, of course, prepare your agenda and presentation(s) for the first meeting.

28. Conduct the first board meeting.

This speaks for itself. Don't look here for any details on conducting the meeting however.

29. Make arrangements to update company website and corporate materials, press release, etc.

Take quick advantage of your new asset. There are many facets to having a fiduciary board. One important one is the public perception of best-of-class governance that comes with an impressive board. Move quickly to update company materials online and offline to reflect the status of the board.

The above steps represent only one view, although throughly tested over thrity-seven years. One will find other views. Regardless, you will find this to be a workable approach to implementing a fiduciary board, and to some extent an advisory board as well.

Recently during a worldwide teleconference including over 1,000 active board members in forty locations, attention was frequently drawn to a catch-phrase – *the new normal*. In this case referring to the increasing interest and effort directed at the highest level of good governance and best practices compliance, not only among public enterprises - by requirement, but also by private enterprises - by design and aspiration.

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Dennis Cagan *is a high-technology industry veteran and entrepreneur, having founded or co-founded over a dozen different companies. He co-founded his first software company in 1968. In 1976 Mr. Cagan founded his fifth company, and in 1980 it was ranked #32 on the first Inc. Magazine 'Inc. 100.' His first public board seat was when he took the company public in 1981. Mr. Cagan has served on almost 50 company fiduciary boards, both private and public, predominantly in early and mid-stage technology companies. Mr. Cagan is a seasoned CEO/Chairman and has been a c-level executive (both public and private companies), venture capitalist, private investor, consultant and professional board member for over 35 years. In 1979 he was the Keynote Speaker at the first COMDEX Show in Las Vegas. In 2011 he was inducted into the IT Hall of Fame - Channel Wing, administered by CompTIA. In 2013 the Dallas Business Journal and NACD selected him as one of 12 North Texas Outstanding Directors. Mr. Cagan consults on forming boards, and augments management as Shadow CEO™. He can be contacted at dennis@caganco.com.*