Private company profiles: One size does not fit all

Private companies - this is such a broad category! When looking at their origin, their growth process, and their hoped-for 'end-game', there are actually many varieties – just like flowers. There are many different looks, different sizes, different shapes, and certainly different smells. These differences play a big part in determining which format for a board of directors would be the most effective and create the most value for a company's ownership.

By Dennis Cagan

One can find a great deal of information on how private companies differ from public ones. Much of this information is about the legal details, but some addresses the motivations and management. However, there is little if any information on how private companies might differ from each other. As is almost always the case, even the writing on this tends to focus on only the large cap companies. I have seen almost nothing exploring the details and issues of smaller private firms. Here we seek to explain these differences: those between small and mid-size business entities, across several criteria, and how those differences effect the functioning of a fiduciary board of directors.

Let's start with the similarities. The most simplistic definition of a private company is that it is not public. That is to say, it is not listed on any trading exchange or stock market, it is not listed in or on any regulated over-the-counter market, and it does not have more than the maximum number of shareholders that require additional filings with agencies such as the SEC (Securities and Exchange Commission) and FINRA (Financial Industry Regulatory Authority).

The U.S. Securities Exchange Act of 1934, section 12(g), generally limits a privately held company to fewer than 500 shareholders. One of the reasons for this may be that the SEC considers 500 shareholders to actually be quasi-public anyway, and for shareholder protection should be required to provide the same shareholder information and disclosures as a public entity. The JOBS (Jumpstart Our Business Startups) Act, which became law in April 2012, raises the maximum number of shareholders a company can have before it's required to register with the SEC—from 500 to 2,000. While technically private, companies in this category still must adhere to governance principles that base their fiduciary responsibilities on the rights of those smaller minority shareholders anyway.

With this in mind let's continue to narrow our definition down further. For the purposes of a board of directors I would exclude any type of business whose sole purpose is to provide a basic income to a single owner or family – *basic* here arbitrarily meaning under $1,000,000 per year. This includes your corner bakery, a sole or small practitioner professional (consultant, doctor, lawyer, etc.), most single-location businesses - like a retail store, etc.

We do however want to <u>include</u> start-ups, and early-stage companies whose plan and goal is to grow much larger than the aforementioned ones – regardless of whether they were financed by founders, venture capital funds, angels or others. This leaves us with any company having fewer than 500 shareholders, un-registered securities, and intending to provide enterprise value beyond (hopefully far beyond) basic income for one family.

Now with this definition in mind, we can further differentiate these private companies from each other in four categories: number of shareholders, controlling interest, stage of development, and management structure. The different combinations of characteristics from each of these groups will suggest differing approaches to a board of directors. Let's dig a little deeper.

How many shareholders are there (and who are they)?

Since a fiduciary board's *fiduciary* responsibility is to the shareholders or owners of the company, how many there are and who they are dictate certain policies, procedures and concerns. Starting with numbers, I will arbitrarily divide the categories up as follows:

1. One to six mostly unrelated individuals,
2. An extended family (related individuals),
3. Six to 50 unrelated parties,
4. Over 50 individual shareholders.

If another company owns the private company, then I would typically look to the ownership of that firm.

Although the 'who', and more importantly 'who has control', are two separate questions, each type of owner normally exercises their control in different ways. Ultimately, how owners exert their control of a private company has a dramatic effect on selecting a board style, the board's decision-making process, the directors themselves, and ultimately their authority and responsibilities. Are the shareholders mostly employees or mostly non-employees? A family? Are the outside investors angel's, a venture capital firm or firms ('VC'), private equity investors (financial investor), or strategic investors (e.g. another company)?

Equity control – controlling interest

When looking at equity or voting control - legal majority ownership control, it is worthwhile to differentiate between dominant control (e.g. usually over 66%) and barely controlling interest (e.g. just over 50%). It is also worth understanding whether one must combine several like-minded owners to achieve either of these levels, or can one person vote the entire stake. Variations in the combination of ownership constituting control will often lead to nuances in the way a well-designed and well-led board will deal with various types of issues. One important and little acknowledged subtlety has two opposing perspectives. In my experience, many company leaders, who do not themselves have equity control, are uncomfortable when a board vote is anything less than unanimous. Regardless of the governance reality that the majority prevails, they feel that they have failed in some way if anyone disagrees. On the other hand an exceptionally close vote on an issue can put the validity of the decision in question. Keep in mind that each director likely has skills and experience that differ to one degree or another from their colleagues. Yet they all get the same single vote. What if the directors that might be deemed to be more knowledgeable on the topic in question vote in the minority? It can lead one to question the wisdom

A majority of one

Many years ago I sat on a nine-member board as the sole independent director. In addition to the company founder/CEO/chairman there were seven directors each representing a different investor. The CEO did not like non-unanimous votes. He always sought to compromise and get everyone to come to agreement. Even when voting with the majority was not in the founder's best interest he would often do so the make it unanimous. Well, there were times I could not do that. Even though he voted with the majority I considered the issue so important that I could not do so. I can recall at least twice during the twelve years I served on that board, when we were completely stalemated at 8-1. I was always the one. But I would not change my vote. On these two occasions the CEO would not call for a final vote. He kept the discussion going, and I kept arguing my points. Both times, hours later when we voted, it was unanimous - I had successfully convinced everyone else to vote with me.

of the majority decision. There are very few absolutes in board deliberations and decisions. Most activities are very subjective – relying on the knowledge and judgment of the directors. Once, after delivering a keynote address at a conference on private company governance, I was asked what I thought of the presentations by the other 35 speakers at the event. My immediate response was positive. I said that I was impressed, and did not actually hear anyone say anything wrong. When asked what I meant by that I commented that there were some statements made, and concepts presented, that I did not agree with – but they were not *wrong*. There can be multiple *right* answers and approaches.
Boards are like a chemistry experiment - you mix different chemicals in different amounts to arrive at some useful solution. It is the same with public and private boards, however private boards start with a somewhat different chemical base.

I would summarize these thoughts by noting that in a private company the control that the majority ownership exerts, effects the balance the board can strike between advising and governing. In the extreme, in a company owned by one-person, the board is elected, and can be fundamentally terminated, by that person at will. This in practice makes it an advisory board, even if it was legally formed as a fiduciary board. In a venture capital controlled company there is usually some agreement on board composition that was part of the terms of the investment – perhaps even changing over subsequent investment rounds. The VC(s) will usually appoint a certain number of directors and agree to a certain number from management and other owners, or even some independent directors. The balance of power is dictated by these dynamics and legal agreements.

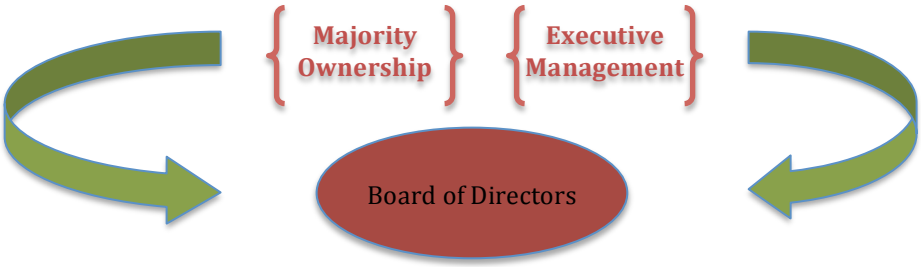
Company stage of development
Adding further to the matrix of board considerations is the stage of development the company is in. This can sometimes equate to age, but not necessarily. Is the company a start-up, with no revenue? Is it operating, generating revenue, and approaching cash flow neutral – regardless of age? Is it cash flow positive? Here age does enter into the equation. A young company that is profitable is different than an old one that may have struggled previously and is now profitable, or one that has been profitable for a longer period of time. Is the company likely to experience fast or slow growth going forward? Is the company being positioned for long-term ownership, or being groomed for sale or an IPO (initial public offering)?

Definition: **board**, as favored by a venture capital investor: a group of persons having managerial, supervisory, or investigatory powers <~of directors>, comprised of one founder and a minimum of two investors.
- from an experienced entrepreneur

Management
The next consideration that impacts the board dynamics is management. Specifically who is the most senior manager – chief executive officer, president, principal, managing director, executive director, or manager? Is this individual the founder, a founder, a non-owner promoted from within the company, or a professional manager recruited from outside the company? How experienced are they? Have they run an independent company of the same or larger size? Have they reported to, or managed a board of directors? All of this detail is like spices in a stew – or elements in a chemistry experiment.

Pulling it together
So far we have explored a number of variables - how many shareholders and who they are, who has controlling interest, the stage of development, and the management of a private company. These are set against the foundational framework of the details of incorporation – sole proprietorship, partnership, Sub S (Sub Chapter S IRS designation), LLC (limited liability corporation), or C (traditional) corporation. All these elements combine to create a unique environment requiring an optimal balance of considerations in forming a board of directors.

Each of these characteristics will slightly change what I consider to be the key governance dynamic within any private company - the majority ownership / the executive management / the board of directors.



There are of course stakeholders in the company beyond these three. These include employees, customers, vendors, financial and strategic relationships, and perhaps others. However, as much as these constituencies are affected by the governance decisions, none generally enter into these decisions. The only exception here is where there are specific contracts or agreements granting them a say so, for example as might be found in some bank lending covenants.

The philosophy of decision making - checks and balances

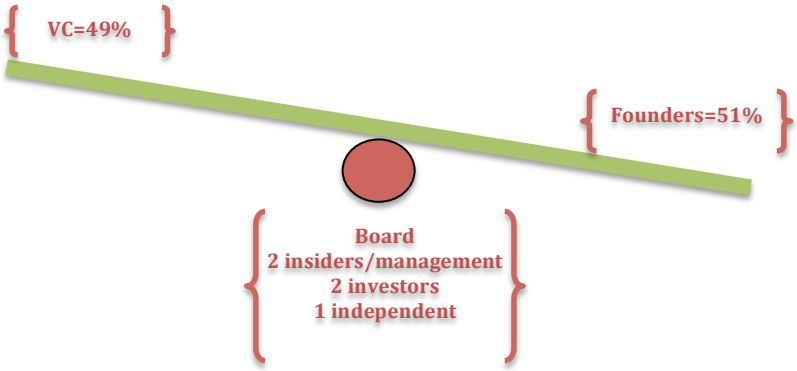
The dog in the boardroom

I was the chairman of a tech company. The board also included a CEO that I had recruited from the outside, two independent directors and two VCs. The company was forced to do a slightly down investment round (a financing at a valuation below the previous round). This new round included a new VC fund. At the start of the first board meeting after the closing the managing partner representing the new fund on the board entered the room. He proceeded to circulate all the way around the room, greeting and making comments to each person. One director turned to another and asked, "What just happened?" They replied, "Oh, don't mind him. As the newest investor he is just figuratively urinating in the four corners of the room and on the board table to mark his territory.

As we have discussed, each detail and variation in the ownership of the company will contribute to forming its composition – or DNA. This profile will usually tend to lend itself to different paths through the governance process. Keep in mind that this process is not static. It starts with the formation of the board, but winds its way through all the trials and tribulations of the company's existence - through good economic times and bad. Through missed and maximized opportunities.

The more ownership in the company any individual director, or group of directors has (founders, family, VC, PEG, strategic investor, or outside individual) the more difficult it becomes for an independent director to balance their fiduciary responsibilities. When a majority owner's best interests diverge from those of the minority shareholders', an independent director has to carefully weigh their advice and decisions and focus on 'enterprise value.' Any CEO who has managed a company through the *Zone of Insolvency* (a pre-bankruptcy period) will tell you that one of the best ways to test your actions is to be informed and act in good faith on behalf of building 'enterprise value'.

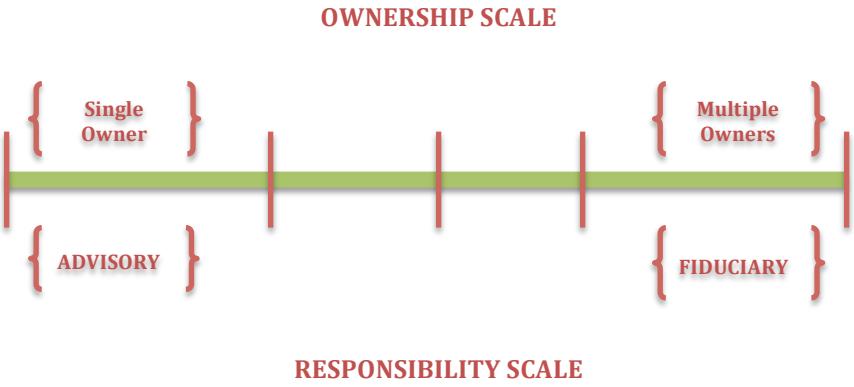
Let's look at just one of hundreds of potential situations. A founder/CEO owns 51%. A venture capital firm, or combination of firms, in a single class of stock own the rest. The terms of the venture capital investment included two board seats on a five-person board. The founder gets two, one for themselves and one for another member of management. The investment agreement allocated one seat for an independent director, mutually agreed on. Who recruited the independent? What is his/her background? Will they understand or relate more to the viewpoint of an entrepreneur or an investor? Do the investors own common stock or preferred shares? Are there any preferred terms that require approval of the entire class of shares before any specific action can be taken - e.g. acquisition or sale?



In every different situation there is a delicate balance between management, inside ownership, outside investors and the board - including these plus any independent (*independent* by whose definition?) directors. Any preference rights with a specific class of stock (typically later round investors, rarely founder's shares) can dramatically change the decision making process regardless of board composition. Beyond the raw voting control of the board or the underlying shareholders or unit holders themselves, there is the value of outside perspective. Is there a balance of interests, viewpoints and foundational experience? But in the end - it's a numbers game. At every stage of the formation of a company, the formation of a board and the involvement of outside investors there are strategic actions that can be taken which may have significant implications at some future time. One simple example is the timing and composition of an initial board. It can be a very savvy move to form a fiduciary board early in the company's evolution rather than waiting until you get outside capital and are required to add investors to the board. There is far more leverage and benefit to founders when new outside investor directors are added to an already existing board over configuring a board initially comprised of these investor appointees. Many decisions can be made by a board in advance of investor members joining that are completely appropriate, however might not get decided or acted on in the same way when requiring post-investor approval.

In summary

Since a privately owned company will generally have concentrated and clearly defined ownership, it is that ownership that directly elects or appoints a board directors. Therefore the directors have very clear guidelines for their fiduciary duty. For a privately held company the real purpose of a board to provide management with the broadest and deepest perspective and advice possible for them to effectively run the business. The board should also augment the skills and experience of management, assist in assessing and addressing the risks to the business, provide insights into strategic direction, and enforce checks and balances over the judgment, ethics and actions of management.



In a privately owned enterprise the right board agenda will be a reflection of the number and nature of the owners or shareholders. Even the terms reflect differences. *Owners* gives the impression of an entity, closely held by a single (or very small number of) individual(s). *Shareholders (or unit holders)* gives the impression of an entity that has 'outsider' investors or ownership, and therefore potentially more diverse interests.

This then creates a spectrum or scale of board responsibility bridging the extremes between individual and diverse ownership. This scale ranges between a maximum advisory role with a minimum fiduciary role, and a maximum fiduciary role with accompanying advisory role. Each private enterprise should choose and balance board objectives and behaviors between these factors. The recent trends in regulatory oversight of public company governance and disclosures have created best practices standards for enterprise behavior. There is good reason for private companies - regardless of the specific *breed* - to seek to appropriately emulate these standards, including the formation of a fiduciary board of directors.

■

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.