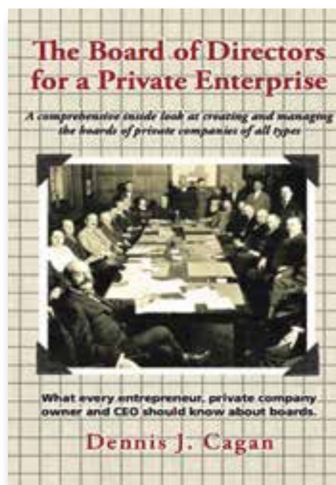
# Company to Director: You're Fired!

How do you fire a director? If you have been a fan of Donald J. Trump's TV show *The Apprentice*, you know that you just have to say, "You're fired!" While that might be just fine for The Donald [now the 45th president of the United States], and for firing an employee, for some reason firing a board member can often be much more intimidating. Perhaps this is because, unlike a subordinate, many directors are often more senior and successful in their career than the company CEO. They are likely to be highly respected leaders in their field, which may be why they were invited to join the board in the first place. Regardless, all directors serve at the pleasure of the owners of the company, whether that means public shareholders, private owners, family members, a private equity group, or one individual.



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These days and for any company, there are a multitude of federal and state laws and regulations as to why you may or may not terminate an employee. Issues must be carefully documented in order to ensure that you are in compliance with myriad rules governing employment. With directors, however, to the best of my knowledge, there are no laws regarding their termination. The only exception would be any terms of service within the corporate articles, such as a morals clause.

Directors are rarely employees, but typically they are the elected representatives of the voting shareholders in the firm. As such, no justification, reason, or transgression is required to justify termination. It may be with or without cause, which really only affects severance issues that may be part of the corporate charter. The shareholders (read owners) may terminate a director's service at will, only based on the timing stipulated in the company charter or articles of incorporation, with proper notifications, board and shareholder votes, and required regulatory filings.

The termination vote would usually be at a regularly scheduled, or specially called, shareholders meeting. In a private or closely held company, this can be called most any time by the majority ownership. The board can recommend this, or controlling shareholders can demand this based on the company's terms of incorporation. No reason for termination need be given, although of course one usually is.

### Private Versus Public

The differences between private and public board terminations are primarily in matters of the details of incorporation, including the state regulations, those associated with the Securities and Exchange Commission (SEC) and listing exchanges (if public), and, of course, the increased sensitivity to public relations due to the effect of material events on the stock. Under all circumstances, whether the company is private or public, corporate counsel should provide appropriate advice in advance of any actions.

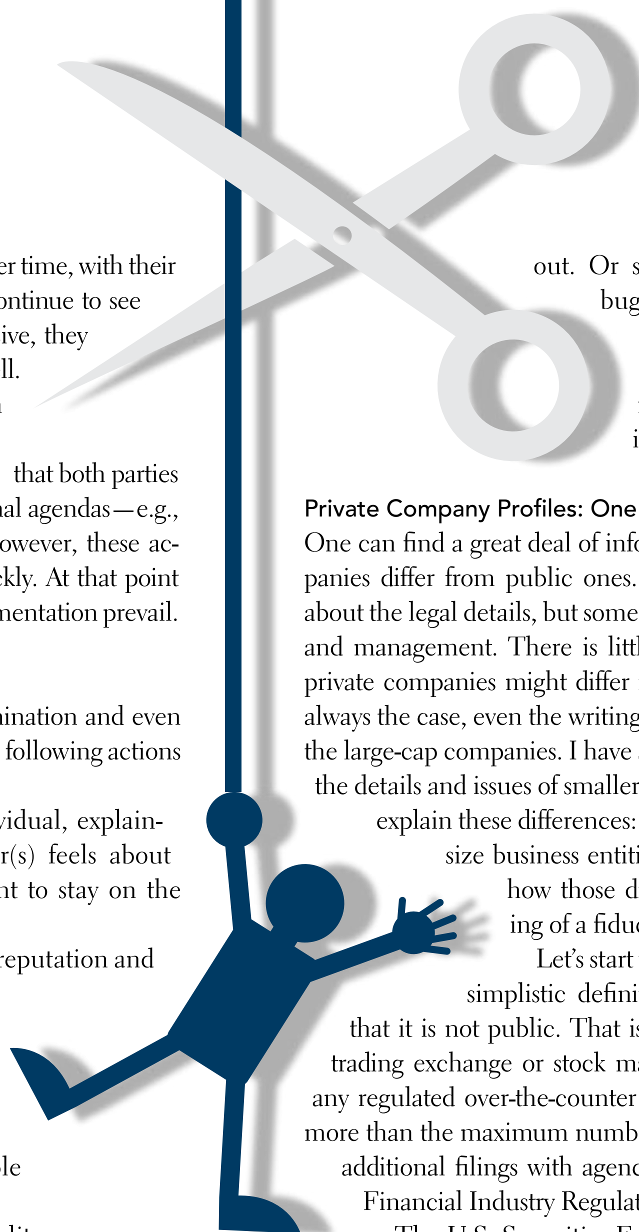
In a privately owned firm, the process may be simpler, although the board should still at least discuss the above considerations. In this case, the initial discussions about terminating a board member can be initiated by a director, senior executive, or, in fact, any shareholder.

The more closely held the ownership, the less complicated the process of gaining appropriate consensus. When determining a course of action, the person initiating the movement to terminate a director should consider the composition and personalities of the board. If there were a clearly dominant shareholder, then I would recommend approaching them first with concerns. If there were a clearly dominant personality on the board—chairman or not—I would recommend them as the next logical choice. It is more complicated if the director in question is the founder, or a substantial shareholder, or plays an active and important role in managing the company.

This is usually encountered in a company that has obtained institutional capital, most likely venture capital. In this situation, it is not uncommon for the investors to have acquired voting control through one or more preferred funding rounds. When these investors feel that it is not in the best interest of the company for the founder to continue in their current role, they may seek to oust them completely from the company. It is

typical for the founder's role to be diminished over time, with their board seat being the last step. If the investors continue to see the founder's participation as disruptive or divisive, they will attempt to eliminate their directorship as well.

It is preferable to try reason and negotiation in arriving at the terms of departure, doing it honorably and professionally. This assumes that both parties put the value of the enterprise above any personal agendas—e.g., they exercise their fiduciary responsibilities. However, these actions can turn emotional and contentious quickly. At that point only voting control and existing corporate documentation prevail.



### Shoot Straight

Since firing a director can easily end in recrimination and even lawsuits, I recommend great care be taken. The following actions may achieve a satisfactory resolution:

- Have a candid discussion with the individual, explaining the issues and how the decision maker(s) feels about them, noting perhaps, "Why would you want to stay on the board under the circumstances?"
- Coax them to resign for the sake of their reputation and the best interests of the organization.
- Be prepared to offer some incentives to ease the move, like some accelerated vesting on unvested stock options or the continuation of some benefits (if they are currently receiving any) or even just a favorable press release
- Agree to a mutual release and confidentiality agreement.
- If the timing permits, you may want to ask for their resignation as part of a broader adjustment or announcement such as a new financing, new investor, upgrading the board with a new member, reducing board size, or other reasonable trigger.

### Needs Change

Over time the needs of any company change. There may come a time when the company needs to add additional skill sets or experience. There are also times when the behavior of a single board member may be an obstacle to the board's best performance. In my experience, being involved at the board level with an interesting company can be rewarding and educational. However, it is always worth remembering that the role of the board director is not a lifetime position. Be prepared to roll with the circumstances. This may mean that sometimes you may be the automobile's windshield—the one needing to diplomatically ease another director out. Or sometimes, you may be the bug—the one being unceremoniously ousted. Good advice to everyone involved is to maintain your professionalism and sense of humor.

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### Private Company Profiles: One Size Does Not Fit All

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 of it addresses the motivations and management. 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 affect 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 and the Financial Industry Regulatory Authority (FINRA).

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, and 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 that has the sole purpose to provide a basic income to a single owner or family—basic here arbitrarily meaning under $1 million per year. This includes your corner bakery, a sole

or small practitioner professional (consultant, doctor, lawyer, etc.), and most single-location businesses, such as a retail store.

I do, however, want to include start-ups and early-stage companies with a plan and goal to grow much larger than the aforementioned ones—regardless of whether they were financed by founders, venture capital funds, angels, or others. This leaves any company having fewer than 500 shareholders, unregistered securities, and intending to provide enterprise value beyond (hopefully far beyond) basic income for one family. These private companies can be further differentiated from each other in four categories:

1. Number of shareholders
2. Controlling interest
3. Stage of development
4. Management structure.

The different combinations of characteristics from each of these groups will suggest differing approaches to a board of directors.

### Who Are the Shareholders?

Since a 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:

- One to six mostly unrelated individuals
- An extended family (related individuals)
- Six to 50 unrelated parties
- 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 au-

## Director Firings: War Stories

Sometimes the firing of a director can be sad, humorous, and strange, all at the same time. Here are several such cases that I have been involved in.

**You're Out…Oops, Maybe Not.** In the mid '90s I was on the board of a private Internet company. There were seven directors: the founder/CEO (who directly and indirectly voted a majority of the stock); a friend of mine who was chairman and had recruited me; a high-level technology company executive who represented his company as a strategic investor; three other stellar execs that I personally knew and recruited to join this board; and me.

One day, amid a regularly scheduled board meeting, with no warning, the CEO asked three of us, including the chairman, to resign. He simply said that he did not want us on the board anymore. We knew that it was a result of a difference of opinion on certain strategic issues—including when to target an IPO. Having majority control, he called the shots.

The remaining three directors had no choice; however, the strategic investor informed the CEO that the remaining board would not support him as chairman, and none of the other three were willing to assume the role. This created a snag. Therefore, the founder must retain one of the three of us deposed directors as chairman. He then asked the three of us to step out of the room while the board discussed the chairmanship.

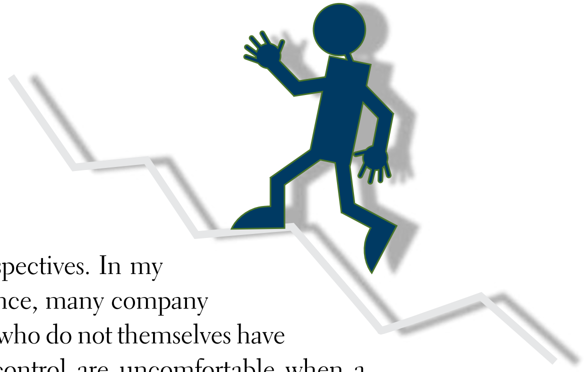
When we were invited back to the meeting, the CEO had selected the colleague that I had recruited (who had actually previously been CEO of one of the fastest companies ever to go from zero to public on the NYSE). The new chairman promptly quipped, "This is the strangest board meeting I have ever been in. One minute I'm being fired, and the next I'm the darn chairman."

**A Founder's Dilemma.** I was once on the board of a healthcare technology company that I had originally conceptualized and for which I was the seed investor. I even recruited the founder to leave the company he previously founded, which was then public. (He was no longer its CEO.)

Things progressed well with him as the CEO of this new firm. We soon raised venture capital, and the CEO was pressured by the new investors to add a director of their choice. All of the other outside directors had seats tied to their investment; I did not. Also on the board was a nominal cofounder. As the vice president of engineering, he was a terrific technology manager but a poor director. He never spoke a word outside of his specific presentation on the progress of the product.

Given that a new class of preferred institutional investors was making a move to consolidate their control of the board, and given that in the future good governance would dictate eliminating the vice president from the board anyway (as a second employee inside director), the best governance decision would have been to keep me (his chosen outside director) and remove the VP, but he did not. He chose to keep the weaker and vulnerable director, and keep "harmony" with his investors, which can come back to haunt a CEO sometimes.

He "fired" me by simply saying that he wanted me to resign.



thority and responsibilities. Are the shareholders mostly employees or mostly non-employees? A family? Are the outside investors angels, a venture capital (VC) firm or firms, 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 (usually over 66 percent) and barely controlling interest (just over 50 percent). 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 of the majority decision. There are very few absolutes in board deliberations and decisions. Most activities are very subjective—relying on the

He gave me the reason, but there was little discussion. He kept me on the advisory board for a while and continued some vesting of options.

**A Tale of Two Founders.** Entrepreneurs who succeed in starting companies and securing outside investors often face a challenge when their firm grows and, in the investors' opinion, the founder's skills are no longer up to the requirements of their current position. This scenario is often profiled in the business press. Here are two such tales.

Lance founded his firm with a partner. He was the business brain and his partner was the technical talent. The company had about nine different rounds of venture capital investment. There were almost 20 different VCs involved. The board of nine was Lance, seven VCs, and me.

Over the course of about 10 years the board fired Lance as CEO three times. Each time he reverted to the chairman of the board and a replacement CEO was brought in. Lance still worked hard and constructively on business development and strategic alliances. Twice the new CEOs did not work out, and twice Lance was brought back as CEO. Lance stepped up. The third time the replacement CEO succeeded in taking the company public and all were rewarded accordingly.

Sal founded his firm alone. He recruited a good team, developed their product, and got traction with some customers. The company then attracted term sheets from two pairs of VCs. He selected the pair that I felt would be the less forgiving under pressure. He found out what that meant. Things were not going well at one point. The board "promoted" Sal to chairman and relieved him of his CEO duties. He remained active in a business-development role; however, his actions proved disruptive to operations and he did not cooperate well with the new CEO. He frequently interfered with both sales and operations employees. After being reprimanded a few times, the board had no choice but to terminate him completely. The company was ultimately sold, but failed to return anything to shareholders.

**I May Ask You to Resign.** With a small, private, or early-stage company, when it starts to grow or mature, it is often advisable to "upgrade" the board with a director to someone with more experience or stature. This is a common occurrence.

I recently recruited a C-level executive from a $14 billion technology company to join the board of a small but profitable software development firm. In the process the executive said to me, "Our company policy will only allow me to sit on one outside board. Why should it be yours?"

After a moment's pause my response was, "Do you have any other offers?"

"No."

"If you join ours now, you can always resign if something else comes along. In the meantime, we can work together and learn from each other. But…if I ever have the chance to get your CEO on this board, I will be asking you to resign." He joined and continues to be a tremendous asset.

## Stages 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?

In the last example, 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 initial public offering?

Each of the answers to these questions should help to inform board composition.

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 some 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 affects 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.

### The Dynamic of Management

The next consideration, which impacts board dynamics, is management. Specifically, who is the most senior manager—CEO, president, principal, managing director, or executive director? Is this individual the founder or cofounder, 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 similar or larger size? Have they reported to or managed a board?

### 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 alter what I consider to be the key governance dynamic within any private company: the majority ownership, the executive management, and 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. 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.

### Checks and Balances

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 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 percent. A venture capital firm, or a combination of firms in a single class of stock, owns the rest. The terms of the venture capital investment include 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 allocates one seat for an independent director, mutually agreed on. Who recruited the independent director? What is their 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)?

**Boards are like a chemistry experiment—you mix some different chemicals in different amounts to arrive at some useful solution…however, private boards start with a somewhat different chemical base.**

In every 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 (the collection of board director's backgrounds and perspectives).

Beyond the numerical majority voting control of the board, or the underlying shareholders or unit holders themselves, there is the value of outside perspective. Does the board represent a balance of interests, viewpoint, and foundational experience?

In the end, it's a numbers game. At every stage of the formation of a company—the establishment of a board and the involvement of outside investors—there are strategic actions that can be taken that may well have significant implications in the future.

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 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 and that might not get decided or acted on in the same way when requiring post-investor approval.

### It's About Ownership

While there are a wide variety of types of private companies, they will all generally have concentrated and clearly defined ownership; it is that ownership that directly elects or appoints a board. Therefore, the directors have very clear guidelines for their fiduciary duty.

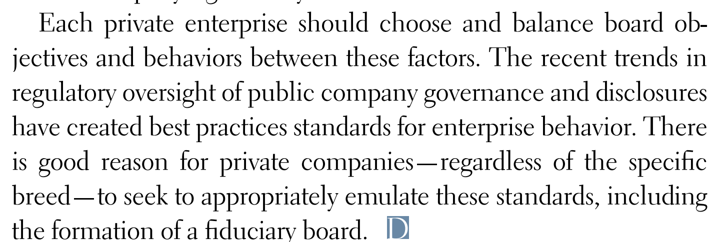
For a privately held company, the real purpose of a board is to provide management with the broadest and deepest perspective and advice possible for them to effectively run the business. The board should also augment the skills and experience of management, assist in assessing and addressing the risks to the business, provide insights into strategic direction, and enforce checks and balances over the judgment, ethics, and actions of management.

In a private enterprise, the right board agenda will be a reflection of the number and nature of the owners or shareholders, taking into consideration the best interests of controlling shareholders, but giving adequate consideration to those of minority shareholders. Even the terms "owner" and "shareholder" reflect differences.

**Owners** give the impression of an entity, closely held by a single (or very small number of) individual(s).

**Sbareholders** (or unit holders) give 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.



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