Private Company Governance: One Size Does Not Fit All

Different types of private companies need different types of board structures.

By Dennis Cagan

Editor's Note: This article is adapted from a chapter in Dennis Cagan's forthcoming book *The Board of Directors for a Private Enterprise.* The book will be available through Amazon and Apple in June.

There are many types of private companies, based on their origins, their growth processes, their hoped-for 'end-game," as well as their different shapes and sizes. 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.

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 of the company and its 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 I 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 simple 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, and for shareholder protection, the company 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

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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 smaller minority shareholders.

With this in mind, let's continue to narrow our definition 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 in revenue. 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.

We do however want to include 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.

We can further differentiate these private companies from each other in four categories:

- *Number of shareholders*
- *Controlling interest*
- *Stage of development*
- *Management structure*

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

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:

- *One to six mostly unrelated individuals*
- *An extended family (related individuals)*
- *Six to 50 unrelated parties*
- *More than 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 angels, 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 whether one person can 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.

IN MY EXPERIENCE, MANY COMPANY LEADERS, WHO DO NOT THEMSELVES HAVE EQUITY CONTROL, ARE UNCOMFORTABLE WHEN A BOARD VOTE IS ANYTHING LESS THAN UNANIMOUS.

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 differs 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 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 thirty-five 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

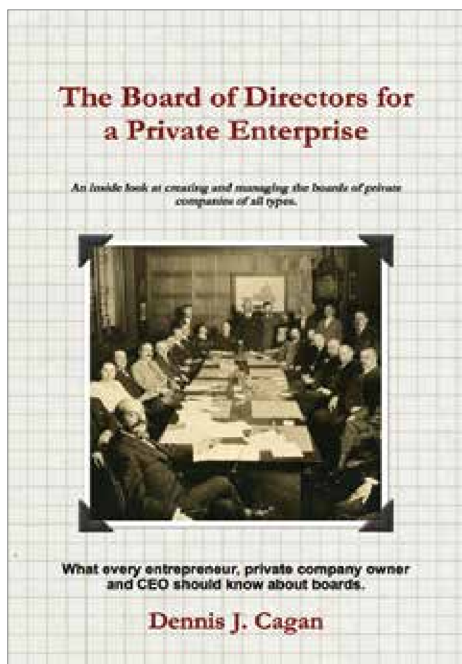
boards, though private boards start with a somewhat different chemical base.

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.



Company Stage of Development

Adding further to the matrix of board considerations is the company's stage of development. 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 IPO (initial public offering)?

Management

The next consideration which impacts 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?

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/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.

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 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'.

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.

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, 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 recruits 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?

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. ■