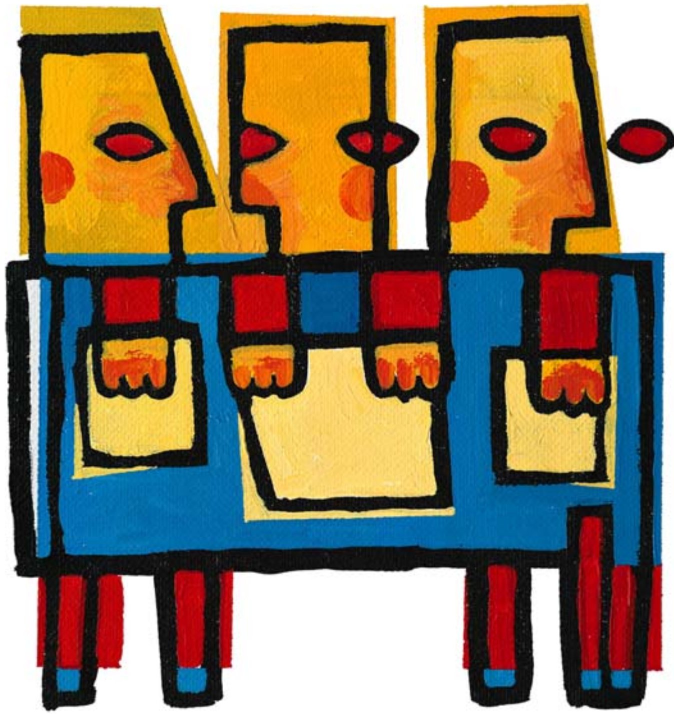

THE ROLE OF THE BOARD OF DIRECTORS IN AN EMERGING GROWTH COMPANY

A Guide for Management

Kenneth H. Marks

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The Board engages in supportive oversight. Whether a company is decades old and multinational in scope, or in its infancy, inspired leadership is a common need. Ira Millstein, the noted corporate governance lawyer, and Professor Paul MacAvoy of the Yale University School of Management recently conducted an extensive study that found a substantial and significant correlation between active, independent boards and superior corporate performance (Governing Entrepreneurial Companies, Fall 1998). A good governance agenda is thus not only important in theory but may positively impact the bottom line.

A key reason for sound corporate governance practices at emerging growth companies is about the businesses' present and its future. The investment community throughout the world has begun to insist on strong, independent, equity-holding boards as a precondition to investment. Initially the trend began with the venture capital community, whose investors insisted, prior to committing capital, that they have strong representation on the Boards of the companies in which they invested. The accountability to the shareholders that such investor-peopled boards created had obvious appeal, and it was not long before the institutional investor community, led by the public pension funds, began to call for structural reforms of the boards of the large public companies whose shares they held.

In the most basic and still most effective scenario, shareholders elect the Board of Directors (“Board”); the directors set basic corporate policy and evaluate the performance of senior management; and senior management operates the business. A Board's primary function is to oversee the management of a company and to assure the company acts in the best interest of its shareholders. At a minimum, directors are expected to show loyalty, diligence and care to the company by attending meetings (quarterly meetings are the standard), keeping informed on issues relevant to the company's activities and remaining responsive to the needs of shareholders and management. Besides these basic monitoring roles, directors should be active mentors, helping to guide a company's managers in their own areas of expertise. Specifically, the Board’s primary responsibilities are:

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1. Recruit the officers of the Company; at a minimum the President / Chief Executive Officer.
2. Establish the compensation for the officers of the Corporation.
3. Assure the financial integrity of the Corporation and approve the hire of the Company's auditors.
4. Approve fundamental corporate policies.
5. Contemplate, approve and in certain cases recommend to the stockholders, significant actions of the Corporation, including but not limited to:

    a. Execution and/or change of the strategic plan of the Company.
    b. Issuance of securities.
    c. Increase the number of authorized shares of stock.
    d. Create additional classes of securities.
    e. Sale of the corporation or its assets.
    f. Merger of the Company.
    g. Acquisitions of significant assets.
    h. Payment of dividends.
    i. Repurchase of stock.
    j. Settlement of material lawsuits or grievances.
    k. Commitment to material liabilities.
    l. Engage in inter-related party transactions.
    m. Restructuring or reorganization plans.

In the event of insolvency, in the legal sense, the Board actually becomes accountable to the creditors of the corporation vs. the stockholders. A Board that believes that it is in this situation should seek legal counsel to discuss the ramifications.

A commonly overlooked use of the board is in leveraging management team accountability, especially in emerging growth companies where the CEO may wear numerous hats and actively participate in the operation of the company. One technique is

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to have the management team present its performance during the Board meeting. The process of preparing for the meeting is valuable, forcing management to take the time to articulate and clarify their issues; and to measure and report their performance against previously established objectives. Many times in fast growth companies with limited management, strategic and macro issues get lost in the day-to-day operations and fires. Additional benefit is derived by allowing non-Board management team members to interface directly with the Board and by allowing the Board to hear non-filtered responses from management to performance issues and opportunities. The result is usually a higher performing team and company.

In privately held companies with minority stockholders, the board provides a check on management (whom one is usually the majority stockholder) to assure that the interests of ALL stockholders are being considered in significant transactions and in the strategic direction of the Company. The Board provides a certain level of legal protection for the majority stockholder in his role as an executive by providing disinterested third party representation for the other stockholders; thus minimizing the effects of the inherent conflict of interest of the executive / majority stockholder.

Once established, the typical Board of an emerging growth company will be comprised of three to seven members. Usually the President / CEO and another senior executive will represent the management of the Company on the Board. Other members of the Board will usually fall in one of the following categories:

- Affiliated with the outside investors of the Company.
- An industry expert or someone who has certain technical knowledge or perspective significantly valuable to the Company.
- Represent a non-management founder of the Company.
- Have significant or relevant business experience.
- Have financial expertise.

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The Board will usually assign several members to act on two standard committees. The first is the compensation committee; responsible for researching, evaluating and recommending officer compensation to the Board. The second is the audit committee; which is responsible for recommending the accounting firm to audit the Company's financial controls and statements. In addition, they usually interface directly with the auditors to negotiate the engagement and resolve reporting issues. Special committees are sometimes established to address certain situations that arise that need unique or detailed attention. An example situation would be due-diligence of an acquisition. In any event, the committee(s) reports to the Board for final discussions and decisions.

"Today's directors are offered increasingly competitive compensation packages in exchange for their board participation. This is appropriate, considering the amount of time most board members are expected to commit and the level of responsibility they are willing to accept. Typical board compensation packages include an annual retainer and a per-meeting fee, plus reimbursement for all board activity-related expenses. Stock-based compensation is another alternative, one that may be favored by shareholders who believe that director compensation should be tied to company performance. Generally, companies don't offer compensation packages to management directors, who are paid as employees."

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References:

- *"How to Use an Outside Board in a Family-owned Business"*, Glen Ayres, Fredrikson & Byron, PA, 1991.
- *"Selecting a Board of Directors for the Emerging Company",* Glenn C. Faulkner, Vice President, The Nasdaq Stock Market.
- *"Corporate Governance and the Entrepreneur: Get it Right From the Start",* Charles Elson, Professor of Law, Stetson University College of Law.

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About the Author

Kenneth H. Marks is a Principal and Managing Partner of High Rock Partners, Inc. (www.HighRockPartners.com) providing strategic advisory and corporate development services. We are value creators serving emerging growth and middle-market companies… with a focus on growth, finance, exit strategies, M&A, new business development, corporate partnering, problem-solving, and turnarounds.

High Rock Partners provides resources and executive bandwidth to plan and pursue strategic opportunities and undertake strategic initiatives. We are value creators serving emerging growth and middle-market companies… with a focus on growth, finance, exit strategies, M&A, new business development, corporate partnering, problem-solving, and turnarounds.

Marks' past positions included President of JPS Communications, Inc., a fast growth technology subsidiary of the Raytheon Company and President / CEO of an electronics manufacturer that he founded and grew to $22 million. He work for a local investment bank focused on debt for early stage companies during the late 1990's. Prior to that position, he was the President of a small publicly traded company and President and CEO of an electronics manufacturer he founded and grew to $20 million in revenue.

He has been involved as management, advisor or board member with over a dozen and a half emerging growth and middle market companies ranging from a venture backed software startup, INC. 500 staffing firm, environmental construction company, safety products distributor….to a middle-market insurance services provider.

He was a member of the Young Presidents Organization (YPO); the founding YPO Sponsor of the Young Entrepreneurs Organization (YEO) in the Research Triangle Park, North Carolina Chapter; a member of the Council for Entrepreneurial Development, a member of the Association for Corporate Growth; and a member of the board of directors of the North Carolina Technology Association.

He is the lead author of the "Handbook of Financing Growth: Strategies & Capital Structure" published by John Wiley & Sons, and he authored the publication "Strategic Planning for Emerging Growth Companies: A Guide for Management".

Mr. Marks obtained his MBA from the Kenan-Flagler Business School at the University of North Carolina in Chapel Hill, and his undergraduate studies were in electrical engineering at North Carolina State University.

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