Problems With Boards Of Small Companies

Based on real experience, here is a litany of dysfunctional behavior on small-company boards and what can be done about it.

by Harry Edelson

Help is what small companies with revenues of zero to $50 million need from their directors. Monitoring and oversight are not enough. Neophyte CEOs, even those with prior executive experience, often do not understand the efficacy of structuring a sound board. Even if they do, it is an uphill battle. Investors often require board seats as a precondition, and competence is not a requirement.

For this and other reasons, diversity of talent is difficult to achieve. For one thing, there is little money to attract talented independent directors. Another problem in small companies is that boards are heavily stocked with founding management personnel, and removing one of them, even after he or she is no longer important to the success of the company, is often traumatic. Founders do not easily perceive that the infusion of outside capital requires a change in thinking about corporate governance. No longer can the company be managed solely for the benefit of founding management. It is no small leap of thinking for management to switch allegiances and respect the rights of outside shareowners before the rights of co-workers.

Edelson Technology Partners is a venture capital firm. As such, my partners and I have served on dozens of boards involving intimate contact with scores of CEOs. My rating of the CEOs of small companies, based on a sample of about 60 companies, is as follows:

Crooked	10%
Incompetent	15%
Stay past their time	25%
Good	25%
Excellent	25%

In reality, my ratings are almost surely positively biased, since we are professional investors, do extensive due diligence, and often invest alongside other professional investors. It may seem startling to suggest that 10% of the CEOs of small companies are crooked, but I wouldn't be surprised if the IRS agreed with me.

The typical crooked CEO may not have started out that way. Larcenous activity may have begun by taking liberties with cash before outside investors were attracted — something like stealing your own money. But then, all those years of hardships and suffering and all that money from fat-cat investors often leads to a philosophy of "I *deserve* a Persian

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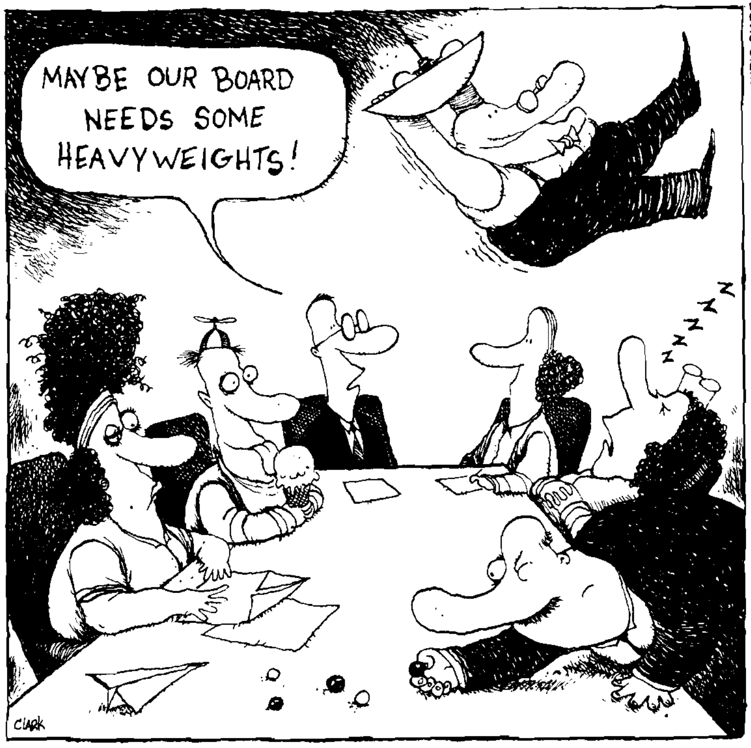

rug, or a home gym, or a Mercedes, or even cash." In our portfolio of investments, approximately 6% of CEOs have been removed for unethical conduct — in other words, stealing. I figure that we haven't caught the other 4% yet.

Replacement of a CEO is always an unpleasant task and is most difficult in a small company, where in all likelihood the management team founded the company and is intensely loyal to the CEO. Key people may threaten to walk if the CEO is axed. If unethical conduct is involved, more than just the CEO might be involved.

To compound the problem, the CEO and early investors (possibly management and relatives) may own a majority of the stock. In that case, the only recourse may be lengthy legal proceedings. Sometimes the CEO holds vital information and, to protect his job, will be unwilling to share it with a new CEO from the outside. This is particularly disturbing when the technology is so unique that few outsiders believe in it or understand it. It is also helpful for the outgoing CEO to properly introduce the new CEO to important customers and suppliers.

If 10% of CEOs of small companies are crooked, 15% are incompetent, and 25% stay past the time that they should turn it over to another, how do boards compare? In my experience, boards can be divided about equally in three categories:

— terrible,
— mediocre, and
— good.

Why not upgrade the former to the latter? If only it were so easy. Many obstacles stand in the way, including investment agreements, lethargy, questions of control, factions, and ignorance.

Putting aside the difficulty of changing a board, what about improving a board? What follows, based on real experiences, is a litany of what is wrong with the boards of small companies and what can be done about it:

The Do-Nothing Board

Problem: Outside members listen to the presentation of management, ask a few questions, and go home. In many cases, management may actually prefer this type of passive board.

Solution: Place items that you think are important on the agenda. Make sure that the agenda and a briefing book are sent to board members in advance. Work with management to replace "do-nothing" board members with talented replacements.

Have you tried firing the wife of a CEO? I have.

The Stacked Board

Problem: Outside members are paid as consultants or for other services. It is amazing what a stipend will do to foster loyalty. Board members on retainer have a habit of always voting with management.

Solution: Board members should not be paid annual retainers without specific board approval each and every year. Before investing in a company with evergreen payments to board members or consultants, make your investment conditional on cancelling those agreements.

The Cozy Relationship

Problem: An outside director is elected chairman at the urging of the CEO. Annual compensation is a significant percentage of the chairman's total income. The CEO then leans on the chairman to recommend overly gracious stock options and bonuses for the CEO and staff each and every year.

Solution: Reduce the salary of the chairman to the point where it is no longer meaningful. Alternately, replace the chairman with another board member or even the CEO, either of whom would not require additional compensation.

The Ignorant Board

Problem: Some board members take up much of the available time to ask questions that do not improve oversight but are intended for self-education or merely for self-expression. Asking questions to learn about the business is fine but when it becomes a habit, meeting after meeting, it is appropriate to learn about the business on one's own time.

Solution: Convince those people to leave the board or, if possible, vote them off. If that fails, convince management to reply to time-wasting questions by suggesting that answers would be forthcoming one-on-one after the board meeting.

The Panicky Board

Problem: There is usually one board member who suffers from "lawsuit shock syndrome," the translation of which means "don't do anything or we will be sued." Needless to say, all boards and companies are worried about lawsuits, but this type goes beyond the norm.

Make routine contact with more than one executive. It is always wrong to depend solely on the CEO for information.

Solution: Advise the risk-averse board member that resigning would bring relief from anxiety. If that fails, have outside counsel explain the necessity to bear some risk, because virtually every action or inaction entails risk.

The Gutless Board

Problem: The CEO is incompetent but the board is worried that if he or she is fired, one or more of the following may occur: Key management will walk; the CEO will unload stock (public company only); a new CEO will be hard to find and require exorbitant compensation; lawsuits will result; and customers may defect.

Solution: Some board members will change wives more readily than CEOs. Campaign with other board members to achieve your goal. Solicit and interview potential candidates and introduce them to other board members. Mount a proxy fight if the company is public and all else fails.

Self-Interest

Problem: Unlike large companies, boards of small companies are usually composed of major shareowners. The interests of management and the holders of common, debt, and different classes of preferred are often at odds when it comes to pricing an investment or selling the company. Board members who are major shareholders have a primary fiduciary responsibility to all shareowners of the company. Holders of common stock are particularly vulnerable because of the lack of protective covenants ordinarily provided to holders of preferred and debt. In one recent situation, a board member represented a small-business investment company (SBIC) and refused to participate in the conversion of debt to equity because he needed the appearance of an incoming dividend stream to satisfy the requirements of the SBA. The company's balance sheet was so laden with convertible debt that suppliers refused to ship and new investors refused to commit.

Solution: This is a tricky subject that requires the advice of outside counsel. Extensive board deliberation on important matters generally tends to protect the rights of investors unrepresented on the board. If a board member is not performing in accordance with fiduciary responsibilities, provide enlightenment and if that fails have outside counsel buttress your view.

Information Freak

Problem: Some board members demand monthly meetings and voluminous budgets and forecasts. All meetings are spent going over missed forecasts in great detail. The big picture is all but forgotten.

Solution: Small companies with three to five people in management need to spend time developing products and finding customers. When a company is beyond the start-up stage it should hold board meetings quarterly, not monthly. Committees can meet more frequently. Question the wisdom of receiving voluminous reports from understaffed early-stage companies.

The Carpetbagger as CEO

Problem: The board brings in a new CEO and loads him or her down with stock options that are accelerated if the company is sold. I have experienced more than one incident in which the hidden intention of a new CEO was not to build value but to find a buyer ASAP so he could return to his home state with a handsome and swift reward.

Solution: If the value of a company can be greatly enhanced over several years, do not permit the options granted to a newly recruited CEO to be accelerated for a period of two years, unless approved by the board.

The Furtive Board

Problem: The company could be going down the tubes, but you wouldn't know it by attending the board meeting. Management is either afraid or too embarrassed to relate the bad news. Besides, by the next board meeting, *everything is going to be okay.* Yeah, sure.

Solution: Do your homework, ask embarrassing questions; you may even learn the truth. The questions are not embarrassing if the answers are comforting and forthright. Make routine contact with more than one executive. It is always wrong to depend solely on the CEO for information.

The Nepotistic Board

Problem: Blood is thicker than water. Officers who are related take advice from each other, not from the board. Their mutual bond is far stronger than with mere board members. Sometimes it is not evident that one officer is related to another because the names differ. If this situation is not disclosed, expect problems later on.

Solution: When I see relatives in management, I almost always turn down the investment. Independent judgment is a valuable attribute for an officer and is a lot better than blind loyalty. Have you tried firing the wife of a CEO? I have.

The Gullible Board

Problem: "The engineers will finish development of the product on schedule, Beta testing will be a snap, and the market is huge, so let's not scrimp on spending."

Solution: Ask for a budget that allows for the absence of a perfect world, just in case the one chance in a million occurs and the optimistic views of management do not come to pass. Ask for milestones, and if they are not met, adopt a more conservative approach.

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The Battling Board

Problem: Normally, outside board members do not associate enough to develop an intense hatred for each other, but it is a different story for members of management or for an officer and an outside board member. I attended a board meeting with three others in a small conference room where the chairman and president got into an all-out fist fight, knocking over the table and chairs.

Solution: When officers despise each other it is time for the board to fire one or both. Incidentally, if you think a fist fight is likely, make sure that the conference room is large enough for innocent board members to avoid injury and gain a good vantage point.

Undoubtedly, there are many problems with boards not covered in this article. In fact, very few boards are so good that they could not be improved. A useful topic for discussion once a year at board meetings should be: "What can be done to improve the meetings?"

One final suggestion: If you want to accomplish something at a board meeting, do the work in conjunction with other members before the meeting. The board of directors will function best if it is prepared, not surprised. ■

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