GOVERNANCE[14]

In the first 100 days, a new CEO should set the stage for the governance of the company. The first component is the day-to-day governance of the company. This entails evaluating the company's systems, checks and balances, and availability and flow of information. In order to effectively manage the company, it will be important to determine what information the CEO and his management team need to receive, how often, and from whom.

The second key component is establishing a board of directors. Most likely, the new CEO will have given significant thought to his ideal board and recruited the directors, or at least key directors, prior to closing. The first board meeting will be held within weeks of closing, and there are likely to be 2 to 3 more board meetings within the first 100 days. Below are some considerations for the search funder in building an effective and helpful board. This *Primer* focuses specifically on boards for search fund-backed companies, and does not take up commonly examined issues of boards of publicly listed companies or venture-backed enterprises.

ROLE AND RESPONSIBILITY OF THE BOARD

Before discussing how to recruit and use a board, this *Primer* will address the basic roles and responsibilities of a board:

- <u>Overall legal responsibilities</u> – Even with a private company, the board of directors has a fiduciary obligation to the company and its shareholders under state law. The two basic duties are a duty of care and a duty of loyalty, but there are other legal tenets relating to self-dealing, disclosure, conflicts of interest, business judgment, etc.

- <u>Practical implications</u> – From a practical standpoint, these legal duties boil down the directors' responsibility to pay attention, make decisions that are not completely irrational, and to avoid conflicts of interest.

- <u>Specifically defined duties</u> – Directors may have specific duties defined in the company's incorporating documents or partnership agreements. Further, directors may be officially appointed or elected to serve on committees of the board, such as the Audit Committee or Compensation Committee.

- <u>Common obligations</u> – the board will typically formally evaluate the CEO on behalf of shareholders, discuss strategy, understand the company's operations and judge operating performance, approve budgets and compensation, and consent to major corporate events that affect shareholders (e.g., acquisitions, sales, investments, issuances of debt or equity, etc.).

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[14] Much of the information in this section was compiled by Rick Taketa, June 2008. Sources behind the work include: "Notes on Boards of Directors," Stanford GSB, Case E-175, September 22, 2004; "Building Better Boards," David A. Nadler, *Harvard Business Review*, May 2004; and "Some Thoughts on Board Governance," interview with A.J. Wasserstein, March 2008.

- Value-added activities – the board also acts as a sounding board to the CEO on tough managerial and tactical issues, provides encouragement and mentorship, and contributes business understanding and input and potentially industry-specific knowledge.

- Accountability – The board holds the CEO and the management team accountable for the company's performance. One CEO expressed that the board creates a bond among the management team by "making it clear there is a 'force greater than us' accountability.

BOARD COMPOSITION

Ideally, as a searcher progresses through the initial fundraising, search, and second fundraising processes, s/he will identify and recruit individuals who would be suitable to serve on the new board of directors. Most of the board members will come from the investor base and some investors, particularly private equity funds, may have a contractual right to a board seat (or more than one seat depending upon the percentage of ownership).

The first step is for the searcher to determine the size of the board. Common corporate governance suggests an odd number of board members; for search fund-acquired companies, a five- or seven-person board is most common.

The search funder will take one seat on the board, or two if a partnership. If the seller retains a meaningful equity position, he may remain involved as a member of the board. Other members of the management team may join parts of board meetings, but do not sit on the board. The searcher will tap the investor base to fill additional seats, and may extend beyond this group to include at least one "independent" director. One difficulty in recruiting directors from outside the investor base is the limited compensation available for them. The searcher may have a former mentor who is willing to fill the role, or perhaps a former colleague or classmate. Customers or suppliers typically do not make good board members because they have specific objectives and potential for conflicting loyalties.

The searcher should strive to build a balanced board, creating a mix of members with deep operational experience, specific industry or business model experience, and financial expertise. Smart entrepreneurs are not afraid of recruiting board members with specific expertise for fear of looking too inexperienced, but rather look for complementary skills to the areas in which they are weakest. For example, someone with a background in investment banking and finance may recruit board members with expertise in sales management and operations. Someone with a background in operations may recruit board members with stronger finance and accounting acumens. If the searcher does not have experience with hiring, a board member may be helpful in recruiting and hiring key team members. For a relatively inexperienced searcher, having one or two board members who could act as mentors to be consulted outside regular board meetings can be extremely helpful. Regardless of the board member's experience, the most important aspect is that the board comprises people trusted and respected by the CEO. Board members are in a position of power and authority within the company, and the CEO should ensure his or her values and belief systems are aligned with the board's.

The board often has set committees comprising a subset of board members who focus on specific topics with the goal of accomplishing more in less time. The most common committees for a search fund-backed company are an Audit Committee and Compensation Committee.

Each board seat should have a specific term. This structural mechanism allows the CEO to continually assess whether the board has the right skill set, and can be a good way to gracefully jettison semi-productive directors. Bear in mind that it may make sense to start with a smaller board of people who are likely to be truly be helpful, rather than trying to build a "full board" that may become a burden for reporting. The size of the board can subsequently be increased as appropriate.

Sometimes, lenders receive board observation rights and will join the board meetings. The CEO has the right to ask them to solely observe or may welcome their participation and question. Board observation rights do not convey a right to vote on any matters, and the CEO may hold an "executive committee" session as part of the board meeting in which no observers are included.

COMMITMENT OF THE BOARD

To create an effective board, the CEO needs to articulate expectations of board responsibilities, behavior, and level of engagement. Talented directors are often busy people. Before formalizing the board seat, the searcher and potential board member should have an explicit understanding of the expectations of the directors, as well as the CEO's commitments to them. The following questions are a guideline:

- Is participation required in person, or can the members join via conference calls?
- How often will board meetings be held? (This answer may vary over time, with more frequent meetings in the first year and less frequent meetings thereafter.)
- How long will the board meetings last?
- When will information be sent to the board members in advance of the meetings?
- Will there be formal committees on which the member is expected to serve (e.g., Audit Committee, Compensation Committee)?
- How will board members be compensated—cash and/or equity—for service, if any?
- Who pays the expenses of board members, such as travel to board meetings? Are there limitations on travel expenses (e.g., only pay a coach ticket, limit on meals, etc.)?
- What directors and officers (D&O) insurance or other protection will be established to protect the board members?

The search fund entrepreneur's legal counsel can provide information and guidance about good corporate governance for private companies as the searcher seeks to determine the appropriate structure for his board.

It is strongly suggested that board members are compensated, at a minimum by covering their expenses, even when the director is an investor. Some search funders also advocate that additional compensation is provided to all the directors, usually an annual fee and a fee for each meeting attended (the exception to this may be if the individual, such as a private equity investor, is being paid by his company/firm to sit on the board); the amount need not be large or place an undue burden on the business. The company will pay the expenses of the CEO, who should not need to be compensated for his service as that would be factored into his overall compensation. Paying the directors can demonstrate that the CEO values their time. It also can serve to professionalize the relationship and create an obligation for the director to perform, giving the CEO the moral high ground to insist on certain behaviors (e.g., to attend all meetings, come on time and stay for the scheduled duration, prepare in advance, not use cell phones). Many searchers will emphasize that, even if a director is an investor, individuals agreeing to serve on the board are contributing above and beyond other investors to the benefit of all, so incremental compensation is justified. Having said this, some search fund entrepreneurs believe that search fund investors will already feel the obligation to perform, and their willingness to serve and reputation as a valuable board member should be part of the evaluation process before the board is selected. It is unlikely that the compensation a search fund-backed company could afford to pay would be a true motivator for this group.

BOARD MEETINGS

Most past searchers and search fund investors suggest approximately 6 board meetings, some in person and some via conference call, for the first year. Too many meetings are a distraction to the new managers, who may spend too much time preparing for and responding to board meetings. After the first year, board meetings should typically happen quarterly, mostly in person; annual schedules should be established to avoid scheduling conflicts. To the extent there are major developments at the company, such as an add-on acquisition, refinancing, significant new product launch, or reorganization, more frequent board meetings may be necessary. Alternately, the CEO may call upon select board members for their involvement and guidance outside a formal board meeting.

When feasible, holding the board meetings at the company's headquarters or at field locations can be highly beneficial for educating the board.

The CEO needs to develop a formal agenda for each meeting, providing a judicious balance of information to maximize productivity. Most of the board meetings should be spent discussing "meaty" issues, not giving high-level reviews. Other members of the management team, and periodically outside experts, are brought in to parts of the meeting to provide specific information and help deepen the conversation.

The CEO should set the tone of encouraging questions and debate of key issues. "Show-and-tell" presentations can serve specific purposes (e.g., initial education of directors), but are often of limited use.

To ensure the directors are prepared, a package of information should be distributed no fewer than 3 days, and ideally at least a week, in advance of the meeting. Useful ideas for the board package include highlights/lowlights, key takeaways, background for focused discussion with developed alternatives, transparent financial reports and key operational metrics, and procedural documents (e.g., minutes, resolutions). The operating and financial reports used to manage the business are often of limited use to the board.

Executive sessions, where the board meets without the CEO (or partners), serve to provide directors with a forum to see and discuss issues not through the eyes of the CEO. Best practice is to have at least one executive session (even if it is only 10 minutes) in each board meeting. The executive session can also be used for formal discussions on the review of the CEO (or partners) and compensation.

THE FIRST BOARD MEETING

Once the transaction is closed, the first board meeting should occur within 2 to 4 weeks. The first board meeting is essential in setting the tone and structure for subsequent meetings, the relationship the CEO will have with his board members and the relationship members will have with one another. In advance, the CEO should send the board members a detailed package of information; some of the information may be duplicative for the directors who are also investors, but it is important to thoroughly educate the outside directors. The following list is not comprehensive, but a base guideline:

- Company overview – lines of business/products/service offerings, locations, key operating metrics, profit drivers, and historical financial information.

- Overview of the transaction – major diligence findings, sources and uses of funds, key terms, post-closing considerations (e.g., earnouts, post-closing working capital adjustments), and breakdown of transaction costs.

- Management – the seller's ongoing involvement (if any), an organizational chart, and the initial management responsibilities being assumed by the new CEO (and the division of labor if a partnership).

- Post-closing activities to date – a recap of the communication made to each stakeholder group, the CEO's activities to learn and evaluate the company with any major findings, and major departures from expectations based on due diligence.

- Preliminary concerns – an objective reporting of the issues and potential options to mitigate the issues.

- Financial results – recent financial results compared to historical results, compared to budget (which could be the company's budget), and compared to projections (as formulated by searcher during transaction).

- Operating plan – focused on the next 3 months, with specific activities and benchmarks identified.

- Opportunities – specific short-term and longer-term opportunities to improve or grow the business. Board members neither expect nor want the new CEO to present a full strategic plan at this stage.

BEHAVIORS AND PRACTICES OF EFFECTIVE BOARDS

As a searcher begins to develop and interact with his board, the following behaviors and best practices are useful to consider:

- Open communication – Effective boards interact openly and directly; they constructively debate key issues with candor and without overly formal rules of order or fear of offense or retaliation. No important information is ever hidden from the board, thus avoiding surprises. Bad news is communicated quickly and without sugar-coating. The CEO can admit s/he does not have an answer. All this said, the CEO should also feel comfortable disagreeing with directors and disallowing directors from "highjacking" his agenda.

- Owning the company's strategy – While strategy development is the responsibility of management, it is not enough for the board to "rubber stamp" management's plans. Instead, the board should understand and insert itself at critical junctures in the continuing process of strategic development. That said, it is the CEO's job to develop strategy and management's job to execute, and overly intrusive or tactical boards can become a hindrance to the company.

- Understanding the company's business model – A high performing board understands how the company makes money, as well as the company's organization design and key processes. The board should encourage the development of a few key performance metrics.

- Aligning performance and compensation – A board must not only establish CEO compensation, but should match rewards to performance.

- Protect financial flexibility – A board should ensure that the company's capital structure and balance sheet are sufficient to execute strategy, and discourage the CEO and management team from taking unnecessary risks.

- Key risks – The board should identify and understand major risks and risk mitigates, including commercial, operational, regulatory, financial, managerial, and legal risks.

- Power sharing – A CEO's open attitude towards sharing power (compensation, executive sessions, approving key decisions, etc.) is necessary to maximize board effectiveness. The CEO and the board should discuss the appropriateness of direct interaction between the directors and non-CEO management; this is typically encouraged, but there are situations where cons outweigh pros.

- Being incorruptible – An effective board remains an incorruptible advisor for the CEO, helping balance short-term and long-term performance. As one searcher put it, "The board is the only body in the corporate pyramid that can tell the emperor he has no clothes."

AVOID THE TOP 10 TRAPS FOR NEW CEOS[15]

This list was developed for CEOs taking over major corporations; however, the lessons apply to search funders transitioning into the CEO role at their acquired companies.

The seeds of destruction for new senior leaders are often sown in the first 100 days. Being aware of the main causes of failure and trying to avoid these traps will make your assimilation easier. Learn from CEOs who have identified 10 major traps to avoid for the first 100 days:

1. Setting unrealistic expectations – 'The most universal trap for a new leader is wanting to do so much so fast that you over promise and over commit,' says GlobalSpec CEO Jeff Killeen.

2. Rash decisions vs. analysis paralysis – In the first 100 days, new CEOs have more scope for taking action but it needs to be the right action. Sears CEO Alan Lacy says: 'If you can get something resolved quickly that is appropriate, go along with it. However, if you just act to act or make premature pronouncements you can set yourself back.'

3. Being a know-it-all – The danger of know-it-alls is that they don't know what they don't know. Pat Russo knew Lucent Technologies well when she came back to the company as CEO but made a decision to assume she knew nothing. 'I believed that before I made my own determination about what had changed the most and the least, the right thing to do was to be intentionally quiet.'

4. Living in the past – While your track record may have gotten you the CEO role, don't assume that what worked for you before will work in the new organization. You need time to assess for yourself the talent and resources you need to execute your agenda. Likewise, don't be trapped into adopting your predecessor's budget.

5. Ivory towers – 'Everything isolates you in this job. You're surrounded by people who want to make you happy. And you don't often get the nuance of what's going on. If you don't fight against isolation, you will be isolated,' says Amgen CEO Kevin Sharer.

6. Stifling dissent – One of the traps of new CEOs is to smother discord and create an environment of fear. In such an environment only the mediocre survive as talented employees head for the door. Stifling dissent can cost you some of your most talented staff.

7. Savior syndrome – It's a serious trap to try to — and believe you can — do it all alone. As Jim Kilts, CEO of Gillette, points out, 'You can lead, but ultimately it is the people in the company who have to deliver.'

8. Misreading real power sources – Don't ignore the unwritten rules about who really holds the reins. Sometimes a board can appear to give you a mandate, but if true power lies elsewhere, don't try to do too much too soon. Gauging the true source of power is critical in the early days, but it's also important to keep refreshing your assessments as you move forward.

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15 This entire section taken from http://8pointplan.spencerstuart.com/book/traps/, based on Thomas J. Neff and James M. Citrin, *You're in Charge. Now What? The 8-Point Plan,* (Crown Publishing, 2005).

9. Picking the wrong battles – Selecting the wrong priorities and concentrating on the big things at the expense of the little things is a common mistake, as Lawrence Summers, president of Harvard University, explains: ‘There’s a tendency in the beginning to think that it’s more important to be visible and out at functions than taking care of business. Truth be told, if I’d been sitting at my desk answering my mail, I probably would have been more effective.’

10. Disrespecting your predecessor – ‘There are lots of dumb mistakes new CEOs can make, but one of the most common is to blame your predecessor for everything that’s wrong. People forget that just about everyone who was there when the new CEO arrives has worked for the old CEO and probably has some loyalty to him or her,’ warns Leo Platt, former CEO of Hewlett-Packard.”