A Differentiated, Practical Methodology for Analyzing Public Company Board Seat Opportunities (public)

By Small-Cap Institute 2020

Conspicuously lost in the dialogue about getting a coveted public company board seat is how to decide whether to accept one if it is offered. As we have discussed elsewhere within Small-Cap Institute, Inc., public company board service – particularly in the small-cap ecosystem – carries with it potentially serious risks. Despite that, far too many prospective board members fail to undertake even minimal diligence into a given board opportunity, and rarely utilize a thorough, repeatable process. After reading the methodology suggested below, we hope you'll better understand why the approach taken by some prospective small-cap board members is not only risky, but far less likely to result in a successful directorship.

Level Setting

Today, most boards of exchange listed mid- and large-cap companies are predominantly appointed by the nominating and governance board committee ("Nom/Gov"), which is staffed by independent board members (i.e., non-employees of the company). CEOs have input into the process of course, but it is secondary to the Nom/Gov committee.

Despite what you might hear at boardroom continuing education programs – which are predominantly created by large-cap professionals – this is not how board members are chosen at most small-cap companies. In reality, most small-cap boards are still chosen primarily by the CEO. This has enormous ramifications for those considering a small-cap board seat.

When CEOs Choose Boards

When boards are predominantly curated by CEOs, it means that the CEO's personal views can often shape governance effectiveness.

If a CEO feels that objective, proactive, courageous governance is important, then it has a much better chance of being just that. As you might expect, the opposite is also true.

When CEOs believe they get little benefit from an objective board, they tend to install board members who will default to "oversight-lite;" i.e., their friends.

So, what does that mean for the prospective small-cap director? It requires asking some unique questions and listening intently to the answers (as well as the omissions, mind you).

Diligence Through a Buy-side Lens

Reasonable people can differ as to whether it should be this way or not, but there is really only one constituency that judges the efficacy of boardrooms – institutional investors. Accordingly, prospective board members should consider analyzing a board through the same buy-side prism.

1. ***CEO's corpgov IQ***. Small-cap boardroom diligence all starts with the CEO. Spend some time trying to understand not only how the CEO feels about governance, but also try and discern how much they actually know about the board's role in a public company. But here's the tricky part: if a CEO doesn't care about corporate governance or knows very little about it, they are unlikely to be forthcoming about either. Accordingly, savvy prospective small-cap directors adopt a "trust but verify" comportment for the remainder of their diligence.
2. ***Who invited them?*** When you meet individually with each board member, consider asking the independent directors: "Who first approached you to be on the board?" The CEO may talk a good game regarding governance best practices, but if the CEO was the main director recruitment conduit, then you're on notice that the Nom/Gov committee is inert.
3. ***How do you know the CEO?*** It's a rare CEO who will openly admit that their board is comprised of their friends, and annual proxy filings are typically silent on preexisting relationships. Accordingly, consider asking the independent directors individually if they knew the CEO socially or professionally prior to joining the board. And, if so, how? If board members all knew the CEO prior to joining the board, then it doesn't matter whether the CEO's comments or the company's filings depict an objective, arm's length board; it's decidedly unlikely to be so.
4. ***Shared history?*** It's not only important to determine if the independent board members are the CEO's friends or business colleagues, but also to determine whether the board members all have worked together previously. Why? When independent board members are all friends with a history of working together, it's less likely they will vigorously disagree with each other on behalf of shareholders. Moreover, if the independent board members are all "old friends," query whether you'd like to be the odd person out?
5. ***Strategy analysis.*** Outstanding boards thoroughly review management's recommendations regarding corporate strategy, and then spend time amongst themselves – and perhaps with third parties – to independently assess management's data and conclusions, and seek out additional, relevant information to aid in their decision-making process. Accordingly, it's important to ask the independent directors individually to explain the process they undertake to analyze management's strategy recommendations and listen carefully to the answers.
6. ***Same sheet of music?*** Experienced investors will tell you that one common practice they often employ when meeting with board members is highly indicative of engagement and objectivity: ask each independent director what the key strategic imperatives of the company are, and what the key impediments are to achieving them? The answers should be the same (or substantially

similar). If they are not, then prospective directors are on notice that the board is potentially either disengaged or too deferential to the CEO, or both.

7. ***Try before you buy.*** Provided that relevant legal issues can be addressed, prospective directors should consider attending a board meeting as an observer prior to agreeing to join the board. Observing the tone of the CEO and of board leaders (i.e., chair and/or lead independent director) can speak volumes about whether it is a board that welcomes and encourages open, objective discussion, or whether it's a board that is conditioned to nod deferentially. What's important to keep in mind is that whatever you observe as a prospective director is likely going to be challenging for one person to change if they joined the board, i.e., "what you see is what you'll likely get."
8. ***Composition.*** Every company has a handful of strategic imperatives, a handful of key impediments to achieving those objectives, and a handful of key customers or verticals they are focused upon. Many experienced investors compile these three buckets – goals, risks, and opportunities – vertically on one side of a white board, and then summarize the backgrounds of existing board members vertically down the other side of the white board. What ensues thereafter is like the "matching" tests we all did as kids; director skills should map directly to what's in those three buckets. Where there are gaps, bright red circles are drawn. Investors are typically of the mind that boards can't possibly create value for shareholders if they are asked to oversee strategies, risks, and opportunities they know nothing about. If you undertake the same analysis of a prospective board, would their board composition – with you included – pass investor scrutiny?
9. ***What questions are you being asked?*** It's often said that the hallmark of a high-quality dog breeder is that they extensively question those who would like to purchase one of their dogs, because they want to confirm that the potential owner is going to provide a safe, loving environment, i.e., the ability to pay is the least important qualification. Similarly, you can judge the quality of a board by how thoroughly they have assessed and qualified you for membership. When you meet with each independent board member, were you met with informed, appropriate, and thoughtful questions? Was it clear that each board member was tasked with probing a different part of your background? Were their questions the result of a complete understanding of your career, and how your expertise could benefit shareholders? If not, this board is sending you a clear message: either we don't care who joins the board or we realize that the CEO's decision-making isn't likely to be influenced by our feedback, or both.

Some Concluding Thoughts

Those of you who attended law school or who otherwise studied business law might recognize the phrase: “totality of the circumstances.” Often times, the law requires judges to consider a number of factors in assessing liability, and when no single factor is dispositive, they are asked to weigh all of them together, or the “totality of the circumstances.”

Ultimately, none of the factors set forth in this methodology are dispositive in and of themselves. Rather it’s the weight of all of the factors that will guide you either towards or away from a board opportunity. Accordingly, stay open minded during the process so you’re able to objectively assess the totality of the circumstances like a judge would.

A few final pieces of advice: (1) don’t skip any of the steps or allow your diligence to be rushed; (2) when situations permit, err on the side of in-person meetings so you can assess “body language;” and (3) no one ever got in trouble with regulators for passing on a board opportunity, so follow your gut.