

## Even Private Company Boards of Directors Are Changing

By William M. Sinnett

A question on private company boards to Financial Executives List Exchange for Private Companies - known as FELIX PC - has given Financial Executives Research Foundation (FERF) some interesting insights.

The notion that it's easier being private - since private companies are not obligated to conform with the tons of U.S. regulations that public companies must adhere to - has also changed, along with much else, thanks to the Sarbanes-Oxley Act of 2002. Since the law's goal is to greatly increase regulation of public companies in the interest of their outside shareholders, and privately held companies do not have outside shareholders, you might conclude they could safely ignore Sarbanes-Oxley. Not so.

What about future shareholders, whether or not a company ever plans to go public? Today's private companies are adding outside directors to their boards, and some are even establishing audit committees. These companies are closely reading the provisions of Sarbanes-Oxley, which requires, among other things, that audit committees of the boards of directors of public companies include a financial expert and approve all auditing and non-auditing services provided by the external auditor.

So, what should privately held companies do? First, there's general consensus that companies should have a board of directors with outside directors. Don Munchrath, CFO of Omaha-based Carlson Systems Corp., gives two primary reasons for having outside directors: 1) to gain business expertise and insight (an advisory role) and 2) to hold accountable the top management - who often are family members, major shareholders and employees.

"When you look for outside board members, be certain the shareholders are clear on which is the most important objective," Munchrath advises. "If it is the number two item just stated - holding management accountable - it is important to sign up board members who take that responsibility seriously, and are not such good friends with top management that they cannot be objective and ask the tough questions.

"What they know is important, but who they know may be more important, so check their connections," he adds. Deal-making attorneys, CPAs, investment bankers, executives from other non-competitive firms and even former public officials can be excellent choices - particularly if they have prior experience serving on a board. But, Munchrath advises, "shy away from existing advisors such as your corporate legal counsel or CPA."

Carlson Systems, a wholesale distribution company with manufacturing subsidiaries, has been family-owned for 56 years. Its board of directors is comprised of seven members: three family members who are also employees, one non-family executive manager and three outside board members.

While not much has changed in at least 10 years, Munchrath notes that the board has much more interest in the details of the business these days, such as its internal controls and the integrity of the financial statements. He also expects to see some "trickle down" effects from lenders, insurance companies and suppliers, because of Sarbanes-Oxley provisions. "If lenders see public companies doing things differently, they may expect us to do them differently also," he says.

Peter Baudoin, a partner in Cambridge Solutions, would argue that a third objective for having outside members on a board of directors is to provide good corporate governance and a decision-making structure for succession planning. "In essence, you are treating the private company as publicly owned for family members who have not yet reached maturity, or who have not yet even been born," he says, adding that this means viewing them as its "future shareholders."



A partner for five years with Cambridge Solutions, a firm that is developing software for managing private wealth, Baudoin previously spent 18 years as "interim" CFO for a number of privately owned, family "intergenerational" businesses, acting as CFO for as many as four companies at any given time. As CFO, he helped the families establish boards of directors and recruit qualified outside directors.

"In order to keep these businesses in the family in perpetuity, you need a board of directors that will provide a governance structure that will transcend a number of generations," he argues. Outside directors are crucial in this regard.

Baudoin welcomes the provisions of Sarbanes-Oxley, which, he says, provide a standard of performance for both management and the board of directors, whether they are family members or outsiders. He observes that, in the past, the directors of small family or privately held business did not have much to talk about. If the business was well-established and profitable, the board of a private company tended to default to an advisory board. Now, Sarbanes-Oxley requires that board members at public companies raise issues and questions they did not raise before, and Baudoin believes that directors of private companies should be raising these same issues.

Based on his experience, Baudoin says he is always looking for what could go wrong, especially if a family member feels slighted. "Compliance with Sarbanes-Oxley provides a level of security for private company boards. Not complying with the provisions could expose the board to some nasty liabilities in the future," he warns.



An example of what could go wrong is provided by Bob Don, who serves as the non-executive chairman of Edward Don & Co. (His oldest son, Steve Don, is president and CEO.) The company, based in a Chicago suburb, is a distributor of food-service equipment that caters to the hospitality industry - its motto is: "Everything but the food." Edward Don, one of 12 children, founded this family business in 1921 with five brothers and two sisters, one of the brothers being Bob Don's father. When Edward passed away in 1956 - with no succession plan in place - the result was what Bob refers to as "horrendous family litigation."

Bob Don went to law school and joined the family business in 1964, later becoming the chairman and CEO, and says he "just wanted to find a reasonable settlement." By the late 1960s,

there were six family groups with different ideas for the company's future, but still no appropriate succession plan in place.

The "cousins consortium" finally decided to recruit their first outside director. Unfortunately, it took a business downturn in the mid-1980s, an LBO by Bob Don in 1988 and three successive business restructurings before a formal succession plan could be developed and put in place.

Today, Edward Don & Co. has a five-person board of directors: Bob Don, two outside directors and two inside directors. Bob Don describes a hypothetical company in which all the family members work at the same level as a company with few potential governance problems. But issues can quickly escalate in a family-owned company in which family members work at different levels or are not active at all. "These family members need to be assured that the board is looking out for their interests as well," he asserts, adding that this is the case today at his company.

Besides a board of directors with outside members, a privately held company should have an audit committee that includes outside directors, especially if it hopes to go public some day in an initial public offering (IPO). Steven Horan, the CFO of Arsenal Digital Solutions, says planning for an initial public offering should start years in advance. He advises, "If a company is even considering an IPO in the future, it should begin now to comply with Sarbanes-Oxley, just as if it were a public company."



Arsenal Digital Solutions, a storage management services provider, was recently included in Gartner Inc.'s first "Storage Services Magic Quadrant." Arsenal is the only private, venture-backed company among the 11 vendors assessed.

With its audit committee comprised primarily of outside directors, Arsenal was commended by its "Big Four" auditor for this segregation of investor and board member interests. Horan says, "Good risk management should be a private, as well as a public, company objective."

He says he is always thinking about what will be required of the company should it go public - such as thinking about its future outside shareholders. In discussing the SEC's final rule #33-8238, Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, the SEC's response to Section 404 of Sarbanes-Oxley that was issued in June, Horan says, "We are looking at what parts of the rule we can implement now, even though it is not required of a privately held company."

There are benefits for private companies that comply with Sarbanes-Oxley's provisions. "People sense that you are in control of the business," says Horan. "Our directors' and officers' (D&O) insurance increased only a fraction of the standard increases this year. In contrast, I have heard about companies getting hit with 30 to 60 percent increases."



Mike Kaul, president and CEO of San Carlos, Calif.-based software developer diCarta, agrees. DiCarta, a contract management technology provider, has recently introduced a Sarbanes-Oxley compliance application.

DiCarta has five members on its board of directors, with Kaul the only insider. The other four members are venture capital investors in diCarta, including Don Valentine, the chairman. Valentine is the founding partner of Sequoia Capital and is also the vice chairman of Cisco System Inc.'s board. The audit committee has two members, both outsiders. "Investment bankers have told us that we have a better board than some public companies," Kaul says proudly.

Kaul has an unique perspective, since he has sat on the boards of other venture-funded software companies for four years; besides diCarta's board, he currently serves on another company's board. Kaul says that one of the changes he's seen during the past three years is "the realization of the need for board committees, the need for good board oversight and, in particular, the need for a strong audit committee."

Like Arsenal Digital Solutions, diCarta plans to go public someday. "Today, the marketplace looks for predictable, solid growth, with at least three years of clean financials," Kaul explains. "So we have made the decision to run this company like a public company."

Thus, whether a privately held company is thinking about an IPO, or is a family-owned business that will never go public, there are ample good reasons to consider the needs of future shareholders, who will expect the same good corporate governance in place in well-run public companies. Achieving this level of good governance may require including outside directors on the board and deploying a strong audit committee.

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