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PDA Newsletter November 2016

New Director Considerations During the Recruitment Process

Upcoming Events

How a Board Helps or Hinders the CEO in Growth Periods

November 16, 2016

Starts 5:30 PM

The Northern Trust Company
 50 S La Salle Street
 Chicago, Illinois 60603

Party with a Purpose
Private Directors Association
Annual Holiday Party
MEMBERS ONLY

December 7, 2016

Starts 5:30 PM

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Contributing Editor: Bruce Werner is the Managing Director of Kona Advisors LLC, and has served on private company boards for almost three decades. Kona Advisors LLC provides advisory services to the owners, investors and CEOs of private and family-owned businesses. Our deep experience with private company governance, capital structure, strategy and management issues, positions Kona Advisors to bring a broader perspective to understanding clients' needs, quickly develop meaningful solutions, and delivering results. Bruce@KonaAdvisors.com or 847-910-2025.



Introduction: Boards of Directors have the responsibility to translate the owner's mandate into action through the management team, while protecting the owners' best interests. In addition to extensive legal precedents, numerous publications have been written on the duties and responsibilities of directors. Organizations such as the Private Director Association and the National Association of Corporate Directors provide troves of relevant information. But where does the process start for the individual? Why get involved, especially if you are already short of time?

The benefits of being a director of a public company are well known: great business challenges, prolific networking opportunities, national prestige and substantial compensation. This is not so true with private companies. In fact, understanding the motivations of the candidate is one of the most common questions asked in the first interview.

Benefits: So what are the benefits of being an outside director of a private company? The benefits and motivations are, to a degree, quite different from those of a public company. There is an established market price for private director fees. Fees tend to compensate you for your time, but typically do not materially change your economic circumstances. Equity compensation is the exception, not the rule. Prestige is muted, since many private companies are focused internally only.

My observation is that the reasons to serve as an outside director for a private company are clear: (1) to have an impact on an organization you care about, (2) to expand your network, and (3) for those who are slowing down to stay engaged. I have found that the compensation respects your time, but is not the biggest motivator over the long-term. Risk/reward is more important than just looking at the reward.

So why do it? Only because you really want to! A key question you need to ask yourself is: "Do I want to spend a lot of time with these individuals?" I call it the airplane test. If you would not fly across country sitting next to the other directors, you probably should walk away. Over the course of a typical three-year term, there will be enough late night flights, early wake-ups, unpleasant conversations and calendar conflicts to force you to reconsider this decision more than once. How you view these relationships should be a key part of your evaluation.

Obligations: Each state has a standard for fiduciary obligations. Years ago, as a new director, I was advised by counsel to always remember the "Prudent Man Rule". (Harvard College vs. Amory, 1830), that being, in any given situation, what would a responsible person do to fully exercise his fiduciary obligation? You can consult your attorney for specific details. I have found this advice to be useful in forcing me to ask a few key questions in each Board situation, such as: (1) What are the critical questions I need to ask to make sure I fully comprehend the situation? (2) Do I have all the data I need? (3) Can I trust my sources? (4) Have I consulted with qualified individuals (experts) to the extent needed to give me comfort that I understand the decision I am about to make? After going through these questions several times, I find that I can determine what is needed to have confidence in my decision.

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Remember, as a director, you are not expected to always be correct. But the law expects you to have spent enough time, energy and intelligence to have reasonably examined the situation and apply good judgment for the benefit of the shareholders.

In July 2016, a group of public company CEOs recently released a nine-page document titled "*Commonsense Principles of Corporate Governance*." This document is "intended to provide a basic framework for sound, long-term-oriented governance" and is broken into eight sections, including board composition, shareholder rights, board leadership, compensation, and more.

While much of this is commonsense, the document provides a framework for new directors to have a scope of their responsibilities. This document is intended to set a standard for public company directors. Some of the topics discussed do not apply to private companies, or should be scaled back for private companies. While these Principles provide clarity on a range of issues, they have been criticized for what was excluded. Compliance and certain regulatory topics are missing. You can find the commentary online, and interpret the Principles according to your needs.

Risks: So having reviewed the benefits and obligations of being an outside director, what are the risks? Quite literally, everything you own. As a fiduciary, you are personally liable for your decisions. The law assures that you have "skin in the game." For this reason, you must insist on full indemnification (typically in the By-Laws) and sufficient D&O coverage. You should consult your P&C insurance adviser to determine what limits and policy terms are appropriate for you. For additional protection, some directors restructure their estate to move assets out of their name.

In this country, lawsuits are, unfortunately, a cost of doing business. It doesn't matter if you made the right decision or not, anyone can file suit if they have a grievance. Typically, the company counsel will manage the suit. You may need to hire your own attorney to help you manage a claim. If you have not been a defendant before, talk to your attorney about what to expect. A tough case could stretch for years, and often feels like a cloud over your head that will not go away. You need to be prepared for this in the unlikely event that it happens.

To fully assess the risks, I treat each new directorship as a serious diligence obligation, just as when I am investing capital for investors. While there are an unlimited number of questions you can ask, I have prepared this list as a starting point for my diligence. *Board Diligence & Information Requests*

Risk/Return: My recommendation is that when you evaluate a new director opportunity, you use a risk/reward analysis to determine your level of interest. Do the rewards (mainly intangible) outweigh the (mainly financial) risks? Even if D&O insurance insulates you financially, is the uncertainty and intrusion of a lawsuit something you can accept? There is no right answer for this, only the answer that is right for you.

Summary: Most business people look at directorships as a move up the professional ladder, and that is correct. It is a higher level of responsibility, requiring judgment, tact and considerable effort. As a director, you are not part of the management with a clear mandate to force action through subordinates, you are not a consultant, and you are not the owner. You are in the middle, and need to have tact and skill to navigate material, intangible issues through a diverse group of stakeholders, and get to the best end-point despite constraints, most of which are beyond your control.