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Q & A

Even Small Businesses Need Corporate Governance

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For startups and family businesses, establishing a professionalized, independent board and other aspects of corporate governance tend to be far down the priority list. Two experts explain why investing in corporate governance is critical to long-term success.

ENTREPRENEURSHIP LEADERSHIP

For a newly minted startup scrambling for funding, staffing, and a product-market fit, best practices of corporate governance tend to be far down the priority list. At the other end of the spectrum, a successful, well-established, privately held family business with 15 years of growth may question the value of an independent board.

But Seán O'Dowd '03 and Robb McLarty '03 say that there are important legal, ethical, and fiduciary considerations for companies of any size. A family company should have an independent, professionalized board, not one made up of golf buddies, and a succession plan that allows family members to get the experience they need. As a startup grows, it quickly encounters obligations to investors and employees.

O'Dowd is the managing director and family business advisor at Silvercrest Asset Management Group, an investment advisor and family office service. McLarty is chief investment officer at Flow Capital. He has worked with and invested in emerging growth companies in the U.S. and Canada through venture capital and other forms of investment. *Yale Insights* talked with them about the pitfalls of poor practices and the benefits of well-structured governance.

Top Takeaways

- The importance of good governance increases linearly with the size of the business and the number of shareholders.
- Good corporate governance means the board is providing that an independent perspective and taking into account the interests of shareholders and stakeholders broadly.
- The minutes of board meetings make clear whether it's a real board or a rubberstamp. Financials, even if they're not audited, offer a strong indicator on governance.
- Regardless of the stage of the company, the board needs someone who can chair an audit committee and someone who can chair the compensation committee to avoid conflicts of interest.
- The role of management in executing good governance on a day-to-day basis is just as important as the oversight that's implemented at the board level.
- Diversity of thought in group decision-making—which grows out of from gender diversity, racial diversity, socioeconomic diversity, geographic diversity, and diversity of experience—leads to better outcomes.

Q: What is good corporate governance?

Robb McLarty: Much of my work has been with startups, where the companies are privately held and the shareholders are substantially the same individuals as management. In those cases, the role of the directors really is mostly to act as a sounding board, to provide different perspectives, to have a conversation about strategy and deliverables.

With a public company, even a small one, good corporate governance means the board is providing that independent perspective as well as oversight to make sure that the interests of shareholders and the stakeholders more broadly are being appropriately balanced with the day-to-day actions and judgments of the management team.

Seán O'Dowd: I look for a board that functions as an entity almost independent from senior management. My experience is with family businesses. Quite often a good portion of the board is tied to the CEO in one way or another. That doesn't allow for freedom of thought, for situations to be debated thoroughly.

On a board where it's the CFO, the CEO's attorney, and his or her old golfing partner—people who owe the CEO—they'll rubberstamp proposals. In those circumstances, why have a board to begin with?

On the flip side, a board with independent directors who have specific skill sets and expertise—finance if M&A is important, technology if you're considering making a technology investment—that professionalizes the board. Meetings have an agenda, things are debated, and if a decision can't be made in one meeting, there will be follow-ups to hammer it out once people have time to digest the materials. It's really night and day.

For a family business, that professionalism, knowing a board with independence and expertise has vetted and signed off on big decisions, provides comfort for the entire family. It gives credibility to senior management.

McLarty: It's an elevated process when the board is composed of super-seasoned directors, maybe even accredited through the Institute of Corporate Directors. They take the importance of governance and the proper processes very seriously.

In contrast, I've been on boards of small venture-backed private companies; it has been evident there are board members who don't really know much about governance.

Q: Are there other components to good governance?

O'Dowd: Ideally, you have a senior management team in place that reflects where the company is in terms of their stage of growth and size. A situation I've come across quite often is a family business that has seen 10 to 15 years of terrific growth. It's obviously successful, but they have outgrown certain positions. The person with the CFO title is really a controller. Or there's not really a head of HR or a head of operations.

McLarty: I agree. The role of management in executing good governance on a day-to-day basis is just as important as the oversight that's implemented at the board level.

Q: Does governance have a different role at different points of a firm's growth?

McLarty: With a startup, the number one job is to survive. The importance of governance is still there, but it is, in a way, demoted when you're still trying to find a fit in a market.

I tend to think the importance of good governance increases linearly with the size of the business and the number of shareholders. The public company with thousands of shareholders, possibly several different share classes, and lots of different lenders, that is the end state. For a small startup or a business with a sole owner, it's not unimportant, but it's less important than other priorities.

O'Dowd: Priorities or needs can also be industry dependent. In an industry that's consolidating at a rapid pace, you're going to want someone on the board who has M&A advisory expertise. If you're making an acquisition a year just to stay afloat, you want someone on the board with a very strong financial background to work closely with the CFO.

Maybe they need someone who knows how to access a different level of capital.

Whether turbulence comes from the economy, industry dynamics, or issues within the company, the composition of the board when everything was smooth sailing might have been great, but in survival mode, they may need a whole new group.

Q: Is that hard in family businesses?

O'Dowd: When it's a question of losing a bit of market share, interpersonal relations will play a real role. When the company has to figure out how to manage cash flows on a weekly basis, it becomes fairly straightforward. I've helped a family business hire a restructuring advisor to make those calls, someone who has been through it a million times and know what the board should look like.

Q: Are there skill sets that should be on every board, regardless of the phase the company's in?

McLarty: I'd recommend always having someone who can chair an audit committee that oversees the CFO and the financial side of the operation. And then someone who can chair the compensation committee. Regardless of the stage of the company, those are critical areas for third-party independent judgment to avoid a conflict of interest for the managers who are running the company.

> "The vast majority of early-stage companies are led by people who haven't yet had the opportunity to learn about governance. That's just the reality."

O'Dowd: I agree. I also think it's important for every board member to understand why they're there and what will be expected of them. It's not just, "Someone just stepped down. We have an open board seat, and you have a professional background in this industry." While you want independence and expertise, being able to play well in the sandbox matters.

An ex-CEO from an adjacent industry has a track record, contacts, understanding of how to navigate the process, but if their leadership style is to override others or to not listen, it may not be a fit just based on the interpersonal part. Being able to listen to other members, and being able to actually interact, it's crucial.

McLarty: I describe many small companies as Shakespearean dramas. It's tongue-in-cheek, but so much of what happens in terms of successes and failures is about the human beings.

That also applies to boards. If you have a good mix of people on a board, you can operate optimally. You want some debate and some tension, so long as everybody's objective is to get to the right place for the company, the shareholders, and the other stakeholders. Sometimes conflict and personality mismatch help get there. Getting the right mix really impacts the outcome to a large degree.

You need diversity of thought with any kind of group decision-making. It lets the conversation end up in different places, and probably with better outcomes. As humans we all have our own areas of expertise and our blind spots. So, how do you get diversity of thought? Through gender diversity, racial diversity, socioeconomic diversity, geographic diversity, and diversity of experience.

Q: Are there governance issues that are specific to family businesses?

O'Dowd: One that pops up quite often is the chair who owns and runs the company automatically putting their child who just finished business school on the board. The chair says, "They're going to take over the business one day; this will be a great learning experience."

From what I've seen, it actually undermines the child. A successful approach some families have as part of their succession structure is the next generation has a mandatory 7 to 10 years working in another industry to establish themselves, ideally to a C-level position.

At that point, they can join the board and immediately add value. Usually when they come in under those circumstances, the rest of the board is much more accepting and willing to listen to them. It makes succession, when it eventually happens, so much easier if they've earned their seat at the table.

Q: What's the model for governance in startups?

McLarty: When a startup shows promise, or even simply has an investor with a brand, that is a signal for top-notch executives to come in and play a role either on a board or as informal advisors. It happens quite frequently.

But the vast majority of early-stage companies are led by people who haven't yet had the opportunity to learn about governance. That's just the reality.

Plus, let's be honest, if you're a first-time entrepreneur setting out to conquer the world, it's way more interesting to be talking about your product or getting your first customer than corporate governance. It's kind of a dry subject. It's super important, because of the law, ethics, and fiduciary responsibility. But when you're struggling to survive, governance is not going to be your number-one priority.

Usually with early-stage companies it's part of the role of the first corporate lawyer to suss out whether the leaders may need help and guidance on governance. It is appropriate to learn on the job when you're a new entrepreneur or even a first-time executive, but to start with, most don't really know the first thing.

In my view, the moment you bring on outside money, even if it's friends and family, you're in a different realm of business from when it's just you and your dog in the garage. When people give you money, creating a fiduciary duty, it's time to move quickly up the learning curve.

Q: How do you know if a board is independent and effective?

O'Dowd: I find that the minutes of board meetings make clear whether it's a real board or a rubberstamp. I also think the relationship between the CFO and CEO, how they interact with each other, is very telling. If the CFO is able to have an independent view of things, if there are strong financial controls in place, it gives me a lot more comfort.

McLarty: Financials, even if they're not audited, offer an outside lender or equity investor a really strong indicator on governance. If they're sloppy or have incorrect numbers, that tells you a lot. If answers aren't readily available as to why revenue is recognized this way for this percentage of revenues and that way for that percentage of revenues, that's an indicator of concerns that might extend to the board and its governance.

One of the most telling conversations can be to invite the board of directors to constructively criticize management. If they're able to be objective and data oriented. If they talk about strong points and weak points, what's working and what needs to be worked on, those are really good signs.

If you're getting a feeling that it's a clubby atmosphere where the CEO and the management have their buddies on the board, that's usually going to be apparent.

O'Dowd: If you ask board members about key financial metrics, even if they don't have a finance background, they should all have a good understanding of where the company is. With good corporate governance, you'll find the board members are clearly engaged in all aspects of the company, financially, operationally, strategically, and can speak to any of the questions you may have. It's a very positive sign.

Q: Beyond meeting legal requirements, does good governance lead to better business outcomes?

O'Dowd: It's crucial for the long-term sustainable success of the business. You're not going to be as nimble in certain situations as you might be. But just in terms of pros and cons, the pros just far outweigh the small cons.

McLarty: Speaking as the CIO of a public company, we have quarterly board meetings; preparing for the meeting, having the meeting, and doing the follow-ups consumes several days of my time. It takes probably 5 days of our CEO's time, and even more of our CFO's time. It's a significant time commitment. But it's also an investment that repays us many times over given the value of the insights that we draw from our board. Good governance leads to better business outcomes.

Interview conducted and edited by Ted O'Callahan.

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