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Center for Board Effectiveness

On the board's agenda | US

An alternate universe: The small, young company board

Directors are treated the same, but their companies differ

Corporate law treats all directors alike; the same standards apply to all directors, regardless of the size, maturity, or other characteristics of the companies on whose boards they serve. All directors have the same fiduciary duties of due care and loyalty, are protected by the business judgment rule, and are expected to engage in rigorous oversight.

However, all companies are not created equal. Size and maturity are among several significant differentiating factors among companies. There are many ways in which small, young companies differ from large, mature ones. Small companies have far fewer resources and may therefore find it harder to be resilient when faced with regulatory, economic, and other challenges. In addition, small companies—particularly those in early stages of growth—may need ongoing infusions of capital to stay alive, much less to grow and thrive. And they may also have less mature and robust systems and processes, including those relating to internal controls.

If these and other characteristics of smaller, less mature companies differ from those of their larger, more mature counterparts, does this mean that their boards have different roles and responsibilities?

Small companies, big challenges[1]

Small, growing companies can be faced with numerous challenges in addition to those noted. These challenges may include:

- Thin trading volume
- Limited or no interest on the part of equity research analysts
- The absence, or the immaturity and/or lack of sophistication, of internal controls, disclosure controls, and other processes for timely, accurate, and complete financial reporting
- A limited ability to forecast and prepare forward-looking financial plans
- Limited or no C-suite experience in leading a public company[2]
- Inadequate understanding of regulatory matters, including SEC and stock exchange rules, or accounting principles and what they require, including the costs of compliance and/or the consequences of noncompliance
- A lack of attitudinal preparedness for being public and the many corporate and personal matters that need to be disclosed—the "goldfish bowl" syndrome
- A lack of understanding of fiduciary duties and to whom they are owed

The impact of these challenges can be significant. For example, a company that fails to submit a periodic SEC filing, such as quarterly report on Form 10-Q, in a timely manner may find it harder and more costly to raise capital in the public markets because a late filing can render the company ineligible to file so-called short-form registration statements for a 12-month period. As a result, the company will be required to file longer, more costly registration statements, which can, in turn, lead to delays and associated market risks. Moreover, a late filing or an accounting error that requires a restatement of financial statements can lead to a loss in credibility and other reputational damage, including causing analysts who may be following the company to drop or curtail coverage. Larger, more established companies may also lose credibility and/or suffer reputational damage in a similar situation, but smaller and younger companies generally lack the "reservoir" of goodwill and positive reputation of their larger, more established counterparts. And a loss in credibility can be much more difficult, and/or much more time-consuming, to remedy than a prohibition against using a short-form registration statement.

The lack of resources discussed previously can also pose major, long-term challenges for boards of smaller, early-stage companies. Limited resources can negatively affect a company's ability to respond to a macroeconomic development, such as the ongoing COVID-19 pandemic, or to the development of a new technology that alters the competitive landscape and can have other adverse consequences as well.

For these and possibly other reasons, smaller companies are much more likely than larger companies to be subjected to another type of challenge: activist campaigns. As noted in a December 2020 report on activism:[3]

> "Smaller companies tend to be targeted in greater proportions relative to larger companies, with companies whose market cap is between $100 million and $500 million representing 45% of campaigns…in 2020 and 43% across the past six years, while representing only 26% of Russell 3000 companies. In contrast, companies with market caps between $1 billion and $10 billion are less likely to be targeted…. On average, approximately 10% of campaigns in each year targeted companies with market caps of greater than $10 billion, with companies with market caps of greater than $50 billion making up around 3% of total campaigns aside from a one-year increase in 2017. These trends have been even more pronounced than usual so far [in 2020], with a six-year high of 65% of campaigns occurring at companies with market caps of less than $1 billion, compared to 58% on average and 39% of total companies in the Russell 3000."

In other words, despite extensive media coverage of and investor interest in activist campaigns against larger, better-known companies, the overwhelming majority of such campaigns are waged against smaller ones.

1. As used in this *On the board's agenda,* "small" or "small-cap" refers to public companies with a market capitalization of $2 billion or less. The small-cap designation also includes companies with a market capitalization of $50 million to $300 million, often referred to as "micro-caps," and those with a market capitalization below $50 million, called "nano-caps."
2. Some small companies are not only operated by executives who are comparatively new to public company management, but are also governed by those who are new to public company oversight. In such situations, having an experienced chair or lead independent director can be transformative. For an investor perspective on this common small-cap fact pattern, see Small-Cap Institute, Inc., "Investors' Favorite Small-Cap Boardroom Hire."
3. See Sullivan & Cromwell, LLP, "Review and Analysis of 2020 U.S. Shareholder Activism and Activist Settlement Agreements."

What this means for boards

In facing the challenges outlined above, a small, growing company should consider how those challenges might impact its board of directors and how the board can affect the company's ability to address the challenges. Such consideration may lead to departures from "typical" practices in the following areas, among others.

Board composition: Different types of experience or qualifications may need to be sought when a small, growth-oriented company considers the composition of its board. For example, while independence is generally regarded as an important qualification for board service, it can lead to the selection of directors who have little or no experience in or knowledge of the company's industry and drivers. As a result, an "independent" board may not have the level of industry knowledge needed to more effectively guide, oversee, and challenge management.[4]

Another example is financial markets experience. A director whose investment banking experience in this field is limited to larger companies that access the capital markets infrequently (and that have stronger credit histories and ratings) may not provide the optimal level of assistance to a smaller company that needs ongoing capital infusions and may also be unfamiliar with the terms on which smaller companies are required to obtain capital.

More generally, in seeking directors for a small, growing company, it may be desirable to seek individuals with skills that management lacks, such as public company experience, long-range planning, and investor relations.

These and similar considerations should be taken into account when selecting a company's initial directors. Subsequently, boards, as well as their search firms and other advisers, should take these factors into account as part of ongoing board succession planning.

Board oversight: Conventional wisdom is that boards oversee rather than manage; oversight is sometimes described by phrases such as "noses in, fingers out." However, boards of smaller companies may need to roll up their sleeves and be more involved in the company's day-to-day activities, particularly if the C-suite lacks public company experience or other attributes. This may mean that directors, instead of or in addition to management, may need to be accessible to investors, lenders, and other stakeholders, as well as to auditors and other external advisers, and may need to take a more active role in seeking capital and other activities than might be the norm for directors of larger, more mature companies. In this regard, it is important to note that corporate law does not preclude boards from managing the companies they serve. For example, the Delaware General Corporation Law states that the "business and affairs of every corporation…shall be *managed by* or under the direction of a board of directors" (emphasis added).[5]

The dynamics of the board-management relationship may also need to be adjusted for smaller companies. Directors may need to challenge management more often and more persistently, rather than giving management the customary degree of deference in many areas of decision-making. For example, boards may want to be more skeptical when considering budgets and long-range planning, including whether assumptions and projections are sound and realistic. And they may want to question management more rigorously on a variety of topics, particularly where the CEO has limited experience leading a public company.

Thinking outside the box: Directors of young, less mature companies can also consider supplementing traditional board processes in a variety of ways. For example, a company might consider outsourcing or cosourcing additional skill sets through the engagement of outside advisers, the formation of advisory boards, and more informal discussions (as distinguished from formal board and committee meetings) to provide greater opportunities for board and management coordination.

One size does not fit all

The term "best practice" is often applied to corporate governance, but to the extent that the term suggests that there is just one way of doing things, it's of questionable value. Each company is different in terms of its history, culture, and other qualities. In particular, practices that work for larger, more mature companies may not work well (or at all) for smaller, younger companies. Accordingly, boards should adjust their practices and procedures to achieve their goals.

4. "[B]oards of directors may well be more effective when they include inside directors or other non-independent directors who have a business relationship with the corporation because such directors have a more extensive understanding of the corporation and its businesses." John F. Olson & Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates*, The Business Lawyer, 2004. Another report expresses concern that unless the board knows and understands the company's industry, "the independent board members may be…deferring to the CEO, particularly as to decisions that require a deep knowledge of the industry or industry risk." Ann C. Mulé and Charles M. Elson, *A New Kind of Captured Board*, Directors & Boards, First Quarter 2014, https://pdfs.semanticscholar.org/f111/6e91a95e7d2e16042f0ffa5a3a6cbd979b90.pdf.

5. Delaware General Corporation Law, Section 141(a).

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