Search Fund Alliance Roundtable: Why are Search CEOs being fired?

Attendance ~ 20 people

What is the Search Fund Alliance?

The SFA was founded in the fall of 2016 by a visionary group of search fund investors and experiences CEOs who desire to help search fund entrepreneurs build better companies. Membership is by invitation only, and our members represent the leading thinkers and practitioners in this expanding field of investment. As the number of participants in the search fund model continues to grow, the SFA will help to ensure that the traditional search fund ethos is retained.

Our broad goals include facilitating mentorship, leveraging shared resources and identifying best practices, all in the service of building better companies. The programs we have launched are in development, include:

- Annual SFA Summit & regional roundtable discussions
- Board director training
- Service provider directory

SFA's Mission: The Search Fund Alliance (SFA) promotes entrepreneurship through acquisition by providing information, resources and connectedness to global members of the traditional search fund community.

https://www.searchfundalliance.org

Next Search Fund Alliance Meeting is Monday, Nov. 9 in Boston

Dinner (location TBD): Sunday December 8.

Search Fund Alliance Summit: Monday December 9, 8:30am - 3:30pm at Goodwin Law in Boston, Mass.

- Board support for CEOs
- How IRS Code Section 1202 C Corp tax exemption works

Topics of the day

1. 🔥 Why are SF CEOs being fired? 🔥 When is it right to fire a SF CEO?
2. What can boards do to better support search fund CEOs?
3. What is the BOD’s responsibility to other investors when a SF CEO is in danger of being fired?
4. Best practices for good communication and governance.
5. Challenges for the community moving forward.

Key reasons CEOs are being fired

1. Lack of effort or ethics

2. Failed diligence leading to acquisition of a distressed asset.
   "Betting on the jockey is easier with a great horse."

3. Poor communication hygiene
   a. Relationship with board / investors
   b. Relationship with sellers

4. Partnership challenges

5. Ecosystem failures

Lack of Effort or Ethics

Examples of lack of effort

1. When a CEO treats their role as a lifestyle job, and works 10am - 4pm every day.

2. When one Co-CEO does not pull their weight. Usually lazy people do not wind up in the CEO seat, unless they partner up with someone exceptional who is individually capable of doing the work of both partners.

Lack of Ethics: Example #1

Ego: a CEO hid all bad news for 3 years, until enough bad news accumulated that the company started to break down.

Command and control culture: CFO of same company told board member in a car ride to dinner that senior management wasn't allowed to speak with the board, and all info had to be channeled through the CEO. The board didn't realize the extent of the situation until hearing from the CFO.

Result: The board launched an investigation, realized how bad things were, fired the CEO, and a board member stepped in for interim leadership while searching for new CEO.

Lack of Ethics: Example #2

A CEO shifted from a “deal evaluator” to a “deal advocate” and wound up “selling” the board and investors on a bad deal.

Investors all thought someone else was taking lead on diligence. As a result, there were major issues with quality of underlying assets and customer pipeline post-acquisition.

Poor judgment: CEO actually created a different LLC for themselves, and moved company assets to that LLC without informing board or investor group.

Solutions and Best Practices

1. Communicate bad news fast. It only gets tougher to communicate.

2. Work towards a more formal diligence process: one investor must take lead on diligence, and all investors must communicate actively throughout the diligence process.

3. CEO and Board to build alignment about board’s direct communication with senior management team, and why that is important.

4. Management should strive for a culture of empowerment, accountability, and results. Not to build a command and control culture.

Distressed Assets

"If you can just help me through the tough times, I can handle it from there."

Converting a stable company to software startup is challenging

Opco was making money on a service, had an early software component at acquisition. Management sold the service piece for cash to develop the software, and became a startup software company.

The partner in charge of sales made and missed projections and was ultimately fired. It took years to understand what wasn’t working, and why. After developing this understanding, the remaining partner was able to hit modest goals.

Opco then made an acquisition to bring in customers, burning more cash.

Board members didn’t bring a ton of knowledge about burning cash in VC style to bring in new customers. Management and board lacked the relevant skill set and perspectives.

Lessons learned

1. Buying a business and morphing it into something different makes it extremely difficult to track what is important.

2. Ensure that management + board have the relevant skills to execute on the plan to create value post-acquisition.

3. Criteria for search fund acquisitions were created for a good reason - stick to the center of the fairway as much as possible.

4. Failure is buying a mediocre business where you spend 7 years earning $1M.

Poor communication

Fundamental skills required to succeed as searcher and CEO

1. Ability to listen
2. Ability to take feedback
3. Ability to act on that feedback

Red flags indicating the entrepreneur doesn’t possess these skills

1. Poor judgment: when an entrepreneur insulted a book on an investor’s desk, when it had nothing to do with the topic of their conversation.

2. When the entrepreneur can’t, or won’t listen.

3. When the entrepreneur always has an answer, and isn’t interested in an investor’s view or perspective when it doesn’t align with their own view.

Communicate bad news early to avoid vicious cycles

When all the board hears for the first 3 - 6 months is that “everything is awesome” - that is a bad sign. If the entrepreneur doesn’t bring up a major issue in the first board meeting, they have to work harder in the next quarter to fix it.

If the problem isn’t fixed by the second board meeting, they will be even more reluctant to bring it up, because they didn’t bring it up in the first board meeting.

If you don’t deal with the bad news now, it will get worse and be harder to deal with later.

Partnership Issues

Forced partnerships can lead to bad outcomes, and firings.

Be careful about searchers who complement each other, but don’t know each other well.

Look for a life map, look for a pre-existing relationship.

Have they worked through a substantial challenge together?

Example: bad things happen in unequal partnerships

One partner did most of the work during the search, which was evident to the entire investor group. Main concern at acquisition was how much the “lazy” partner would contribute to operations. The lazy partner spoke more often and more loudly than the non-lazy partner.

The non-lazy partner’s name began showing up on lazy partner’s core areas of responsibility in quarterly and annual plans.

Outcome: lazy partner was fired while retaining their economics. The non-lazy partner continued to operate the business successfully, making good money for the partner who was fired.

Lesson: board members should check in with individual operators about the partnership to help facilitate partnership-level conversations.

Searchers should diligence partners as thoroughly as deals

These partners went to business school together, and were even in the same core group, but were never on a real team together. As such, they knew each other but had never worked through a real challenge together.

A former classmate later mentioned they were on a project with the lazy partner, and that the lazy partner didn't do any work in the school project.

Lesson: a bad partnership could have been avoided by conducting reference checks prior to partnering in search. Investors can help prompt partners with thoughtful questions to pressure test the relationship.

Questions coaches ask CEOs & partners to test for trouble

1. What is the toughest lesson you have learned?

2. Tell me about a time when you’ve been challenged together recently.

3. Why do you (both) want to work with a coach? What is your mission? *If you don’t hear about servant leadership and a desire to lead, that is a red flag.*

4. Tell me about your strengths and weaknesses, and those of your partner. *Do they respond with a personal weakness, or a weakness of the business?*

5. If you could change things about yourself (and your partner) what would you change?

Ecosystem failures

Distributed due diligence can be a double-edged sword

Despite the collaborative and supportive spirit of the search fund community, the distributed nature of diligence on searchers and deals means things occasionally fall through the cracks.

It can be just as challenging for board members to have difficult conversations with CEOs as it is for CEOs to have difficult conversations with board members. When one investor is a unit, they may not have the incentive or desire to have difficult conversations. If enough investors already support a searcher or deal, every additional investor may be less likely to raise questions, doubts, or concerns, even if they are valid concerns to raise. **It no longer works to wait to see what a major institution will do - investors need to ask their own questions.** Investors helping with diligence who decide not to invest should communicate why.

The ecosystem is failing when the board resigns on a CEO

Some board members abandon ship, even when management is still at the helm.

If someone commits to be on the board, they have an obligation to the CEO, even (or especially) when the going gets tough.

Some of the best board members have too many roles, and other board members are not engaged enough to actively coach first-time CEOs, who benefit from very engaged advisors.

Best practices

"No wonder the company is in trouble!"

CEOs can rely more on their board and investor group

CEOs think they have to spring forth ready to be a great CEO, but you have a few years of playing the novice card. Nobody expects them to know how to do it perfectly.

The best CEOs have no ego, and sometimes are on the phone with a board member or investor once per week for the first 4 - 5 years they operate their business.

The fundamental model was built to manage the risk of a lack of experience. Investors are ok with with lack of experience *as long as* CEOs ask the stupid questions. **Becoming a CEO is a lifelong journey. The learning never ends.**

Build 360s and coaching into your business model

Build line item into acquisition model which includes cost of executive coaching. Many CEOs with successful recent exits started with a coach on day one - some even established a relationship with their coach during the search phase.

Do a 360 with the CEO in Y1 and Y2 for good hygiene, not only when there is a problem. This helps to catch problems early on, and helps establish a strong culture.

Retaining a coach from the start is like having a vaccine. Retaining a coach after there is a problem is like undergoing chemo when the cancer is already advanced.

Questions to ask employees in CEO’s first 360 review

1. What do you appreciate about the CEO?
2. How could they be more effective?
3. What can you do to be more effective with the CEO?

Quarterly 360s are good hygiene. Easier to course correct on small issues early on than on big issues later on after they have built up.

Alternatives, or additions to coaching

- Entrepreneurial Operating System (EOS) Traction
- Rockefeller habits
- Management action programs (MAP)
- Leadership programs like this can be a great complement to executive coaching

Challenges for the community moving forward

The community needs a more helpful definition of success of and failure

Failure means spending seven prime years of one’s career earning $1MM.

Success means “doing the right thing,” even if it means walking away from a mediocre acquisition and closing your search fund without an acquisition.

Buying a small ($1MM - $2MM EBITDA) company that fits the search fund criteria is better than buying a larger company ($4MM+ EBITDA) that doesn’t fit the search fund criteria.

The search fund community is experiencing growing pains

How can a small number of core investors truly support a growing community of entrepreneurs with the same level of support received by early searchers?

Some investors have become more transactional, and are using the search round as a cheap option.

The model was super efficient 20 – 30 years ago and it won't ever be like that again. There was one lone voice 30 years ago that everyone knew they had to clear. That clearing doesn't happen today, and it scatters the activity of the community.

The solution is increased collaboration and engagement within the community.

Recently exited CEOs have capacity & desire to serve on boards

Many recently exited CEOs have capacity and desire to serve on boards, and mentor the next generation.

Sometimes those CEOs aren’t sure how to find opportunities to serve as board members.

Experienced board members within the community (and perhaps Search Fund Alliance) should make a point of inviting recently exited CEOs to participate and give active coaching for how to develop into outstanding board members to create more broad capacity within the system.

How can we best coach recently exited CEOs to become great on boards?

The transition from searcher to CEO requires intensive coaching, patience, and self awareness.

The transition from CEO to board requires similarly intensive coaching, patience, and self awareness.

Appendix: Board Best Practices Email

Email to CEO of OpCo about ten days after acquisition, January 2019.

Good first call this morning. You've got your plate full right now, so absorb and let's discuss this material later…it's important notes surrounding board make-up, functioning, etc from some top sources. These attachments and the below notes will help you and your board to support you in the highest achievements at OpCo. Also please see my suggestions for the April meeting below.

Notes to attachments:

1) Board is a "force greater than management" that can be used judiciously by the CEO to bring the team together to accomplish necessary tasks: Transition record-keeping, HR practices, etc from "Mom & Pop" to "Professional" company, setting the stage for tremendous growth. "Act like you're a $200M company to become a $200M company."
2) Define roles on the board:
    a. CEO runs the meeting, provides the agenda and board materials.
    b. Lead Director, who runs the executive session and provides feedback to the CEO.
    c. Comp Committee that sets up pay and bonus criteria for CEO
    d. Audit Committee that works with CEO on audit, hears and assesses audit results.
    e. Time keeper: Keep meeting from going astray-agenda sets times for each segment.
    f. Observers: Mainly observing, mostly holding comments for after meeting.
3) Make meetings effective: More looking out the windshield than the rearview mirror. Here's a few ways to get the past results reviewed quickly so we can move on to the future/strategy:
    a. CEO get materials out a week in advance.
    b. Board members review results and question in advance.
    c. CEO: Highlights and what you learned from them, and Lowlights and what you learned from them.
    d. Unlike this morning which was effective, I'm normally against reading slides---it's on us to have read them in advance and ask questions in advance. Hence the mutual commitments of you getting things out in advance and us reviewing them.
4) Keep meetings moving: Set times in agenda, and get through the material without too many diversions. However, allot time during meeting for "new business" or "open discussion" so that there is a forum for new issues to be brought up.
5) Run an executive session EVERY quarterly meeting. No exceptions. Use Stanford suggestions, which are included on p.10 in SFA survey.
6) Part of Executive Session: Board must assess itself, it's members, and our effectiveness. Set terms for each seat.
7) Set up frequency of meetings and calls, per Rich's suggestion, establish a cadence and maintain it.
8) Provide Directors and Officers insurance.

I will also send you two examples of recent board packets for your review. You will develop your own style, just as we all did. But some styles are more informative than others. I believe in a "metric driven" company—it's how Alan Mullaly drove Ford to the top of the heap, and how W Edwards Deming helped the Japanese manufacturing engine get restarted after WWII.

It might be immodest, but I've included a few pages from my own board packet (called "comparison formats") that graphically show monthly results of key metrics, normalized against previous years. Please note how the scales on each side by side pair of graphs relate so that you can visually check the monthly results against past year's. Also note that each slide has an owner—like Reggie Fernandez (aka

Mr. J) for shipping costs, which leads to engagement and ownership. Also note that if you can keep you contribution growing every year, you can earn your investors greater than 10x their money, and yourself a pile of money too!

Re: Team building and Engagement: Defining your leadership style…serving your team…building ownership and engagement…all key subjects for you, Jane and Tony to dive into and further develop. I'm betting that the company culture is not "top down" but is collaborative and matrixed with defined discretion rules that allow decentralized decisions within the framework of values. KPI's and Metrics help promote engagement, motivation, and ownership. What have you seen so far?

Finally, as a suggestion for the April meeting, I'd like to learn more about the software development process…how it's been done, what's next, etc. Following up on Tim's questions from this morning for the meeting…how are we pricing the sale of software? How is the cross sell completed between photo services and the software?

Looking forward to discussing with you.

Best regards

Appendix: Scrubbed Executive Coaching Session Feedback #1

February 21, 2019

To: Pistol Pete Maravich
From: Greg, Carlos, Hal
Subject: Executive Session Feedback

Thoughts/Observations/Strengths:

1) Much greater command of business and industry: You've learned a great deal in your first year, and have developed ideas about what and how to work "on the business."
2) Good job making it through the Busy Season with few hiccups, and with the new press installed, much less overtime, and with many more small orders!
3) You've made it over a year, through two busy seasons, and without losing a single member of the Lead Team: You've established a "new normal" for the team that recognizes you as the leader.
4) You established a cadence of 1:1 meetings with your Lead Team, and have developed systems to stick to agreed upon priorities without confusing your team. Your team members are performing at a higher level because you are doing this. Do you have vital few lists (or some other method to maintain priorities) with each lead team member?
5) You've maintained a great relationship with Greg, relying on him to act as your "backstop" when grounders get through your legs, while learning to be a better catcher.
6) You've put together some great Vital Few for 2019, and are building your ability to use agile development within your IT department.
7) Continue to use the Top Grading system for hiring—you're doing an exemplary job of building your team with A Players! Seriously…you're doing a great job hiring for a seasoned CEO, not to mention a new leader! Keep it up!
8) Board meetings have become better and better, along with board books. Examples:
    a. Greater use of KPI's and metrics, including down into the organization.
    b. Your board book tells a story, and leads us to conclusions about what's important and to decisions.
    c. Well thought out agenda, with times for each topic included.
9) Better Budget for the Income Statement, with Balance Sheets, Cash Flow Statements, green box for personnel changes, etc. Much improvement over 2018 effort when you were brand new.
10) Starting meeting at 8 an improvement, and new Hilton a huge improvement over other location: Please work with Catering to have coffee and fruit platter in the room for next meeting.
11) Accrual Accounting: Audit scheduled for March…congratulations to you and Melanie on keeping after this and getting it together!

Summary of Positives: We said that your biggest win for 2018 would be to establish yourself as the Company Leader/CEO in place of Greg…You've done a great job. Your enthusiasm, earnestness, character, work ethic, and caring for your team and business have shined through to your team…this gives you the time and flexibility you still need to continue to learn the business and build the team to achieve great results!

Opportunities for Improvement:

1) Continue development of your CEO/Leadership skills to evolve into the leader who can serve the team to help them achieve even more. Forever Goal: You must continuously improve yourself as a leader, understand your weaknesses, continually question yourself, and build the team with people with complementary skills who can help you overcome your weaknesses. This is a ten year project! Keep working with Jeff Silverman.
2) Dig in deeper with your key customers, Boxster and 911. We're concerned that Greg's long term relationship can't be fully replaced in one year! Boxster is too important to the Jazz.
3) Address the customer concentration in Boxster: Build the Biz Dev team and company to land additional POS and retail whales. And build the team and company to be able to handle the increased load.
4) Smooth out the Budget per emailed comments—make it GAAP even if you won't have GAAP monthly results, only quarterly. Budget should make sense even if sometimes results don't!
5) Your plans and budget for 2019 includes an assumption that we would like to "invest" for the future by adding people at the expense of 2019 EBITDA. You've selected your Vital Few for 2019 including a new website, software development, Jazz development, etc. that points towards development of the fintech aspects of the Jazz. These are probably correct assumptions and selections, but your unstated vision for your tenure leading the Jazz needs to be fleshed out…Please work with your lead team, Jeff Silverman, and board to develop a 5 year strategic plan. This plan will inform and discipline the projects you propose and get approved using:
6) Incorporate basic CFO functions into your planning process: Use the (AFE) project approval forms I emailed you and develop a list of capital projects. Get board approval for all projects over $100k. Resource planning: Capital and time allocation…use tools to evaluate and justify the options that you develop and choose for your years at the helm of the Jazz.
7) Must work "in the business" on the use of outside software developers: Greg observed that he had worked closely with Chetu to assure that they understood what they needed to do and when it was needed. Without this they tended to drift. Work closely with Andy to assure that you get your money's worth on things like "integrations" and development work! Is it true that POS integrations that used to cost us $5,000 each now cost four times that much?
8) Continue to build and improve metrics. While this board book had more metrics, there are still more to come. Become a data driven CEO in a data driven company with superior IT in the DNA of it's products and processes. You own a fintech company---how does a fintech company become super successful?
9) Develop a "training matrix" and professional development opportunities (Jeff Silverman, www.amanet.org, www.pryor.com) for your team members. This cross training will allow you to fill roles when people quit, are sick or on vacation, and gives your team members an opportunity to develop more skills, compensation, and to "stay fresh."

There are at least two interim calls to be made, and perhaps a third:

1) Budget approval, including Capital Projects.
2) Jazz Project description, features, alternatives, markets, and projected benefits from this development.
3) How about a 5 year strategic plan discussion…leading to the creation of a spreadsheet that reflects our strategic goals?

Appendix: Scrubbed Executive Coaching Session Feedback #2

February 22, 2018

To: Pistol Pete Maravich
From: Greg, Carlos, Hal
Subject: Executive Session Feedback

Thoughts/Observations/Strengths:

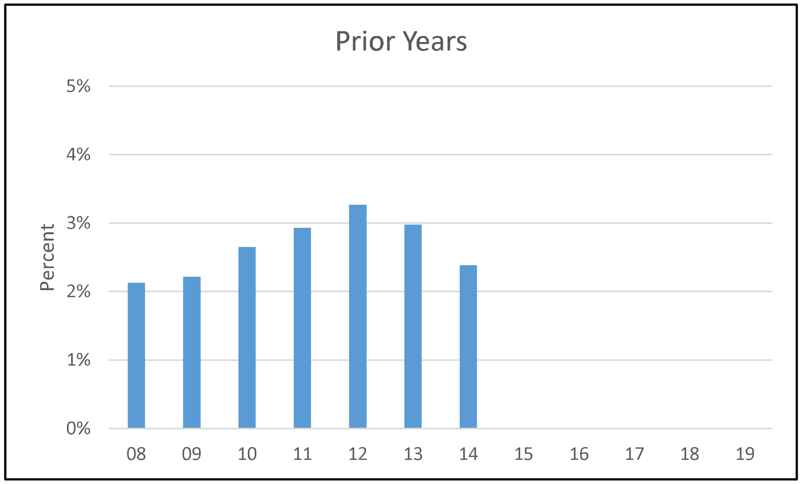
1) Values: Trusting and trustworthy, deals honestly and is straight forward. Humble, down to earth, without any hint of arrogance.
2) Work Ethic: Excellent work ethic, creating lists, working hard, following up, following through to reliably complete tasks. Excellent budget and board deck.
3) Intelligent: Analytical and thoughtful, and is able to defend his thoughts in an emotionally balanced manner without being defensive.
4) Steady, Reliable: Emotionally stable, with minimal volatility, able to maintain calm and decorum, even while dealing with interpersonal problems.
5) Motivated: Wants to see the Jazz, the team, himself, and the whole enterprise to which he is devoted become a success. Desires to become a successful, recognized, well respected CEO Leader.
6) Learning ability: Learns quickly through doing. Listens well, collects and retains details and facts.
7) Coachable. Willing to change his practices to help others and himself achieve success.

Opportunities for future growth: Your most important “win” for 2018 will be to begin to evolve into the CEO/Leader that will acquire the skills to lead the Jazz team to great success in the future. You and your team are going through a major leadership transition, so the following steps are important:

1) Over the next years, develop a vision for the team, products, company. Eventually, spend time working “on the business” as well as “in the business.”
2) Relax, and enjoy your development as a CEO. With the board, especially with Greg, accept that you’re a novice CEO and frequently ask for help, share issues, concerns, and questions! (Should we set up bi-weekly formal 3 Questions meetings?)
3) Continue to develop communication skills and methods: Servant leadership requires finding out what your people need, and giving it to them. This requires talking and questioning, and frequent checking in to learn what’s impeding them. Then flexing your style to create the skills and motivation to succeed. So…frequent meetings and interactions with your team come before tasks like board decks and budgets. MBWA=How are we doing today?
4) One of the competitive advantages of the Jazz is the ability to make money on $65 orders (BTW some companies spend $65 just to enter an order, much more to produce it!) Figure out the “operational excellence” side of the business: The people, processes, standards, and interactions that make this possible…how are people working together to achieve this and how do we continue to improve?

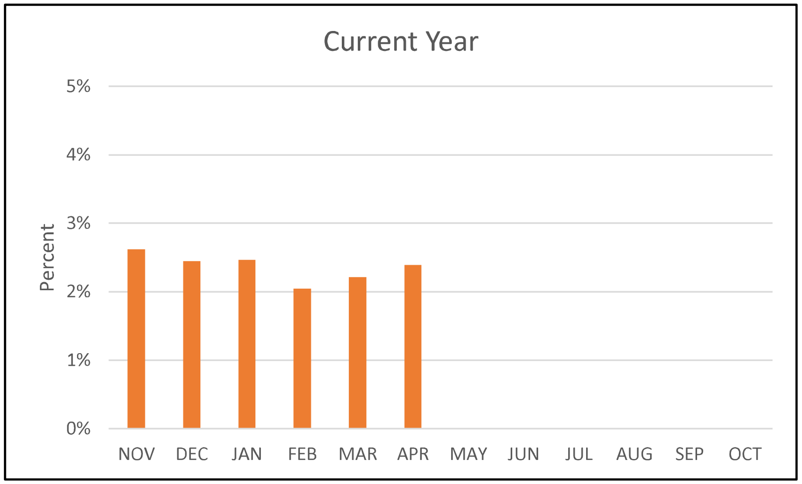
Appendix: Comparison Format for Board Decks - Graphical representation of results Alan Mullaly style

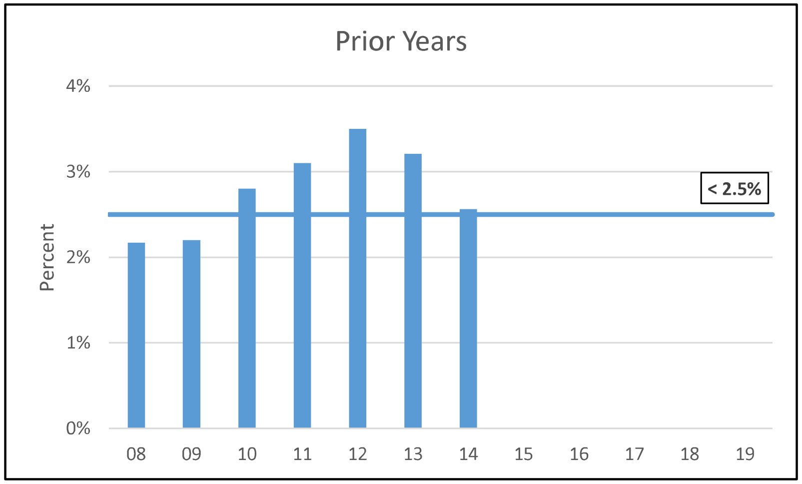
Shipping Expense Ratio



Shipping Expense
as a % of Net Sales

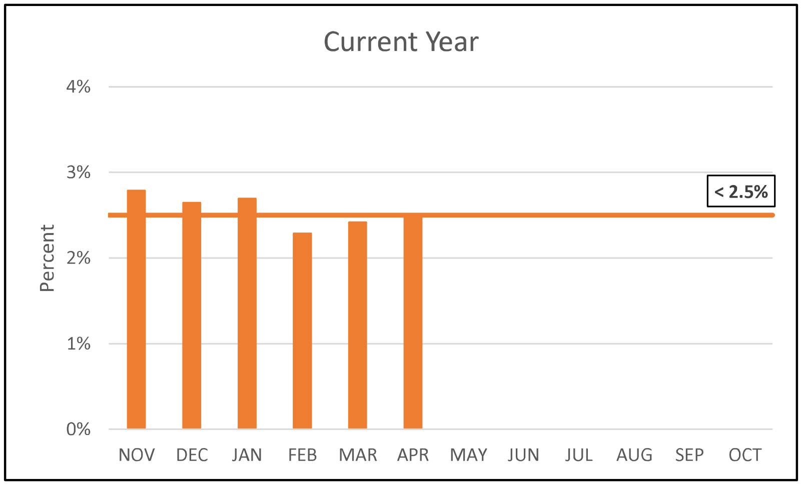
Lonnie





Shipping Expense
as a % of Net
Corrugated Sales

Lonnie



Appendix: Search Fund Bible Section on Governance

GOVERNANCE[14]

In the first 100 days, a new CEO should set the stage for the governance of the company. The first component is the day-to-day governance of the company. This entails evaluating the company's systems, checks and balances, and availability and flow of information. In order to effectively manage the company, it will be important to determine what information the CEO and his management team need to receive, how often, and from whom.

The second key component is establishing a board of directors. Most likely, the new CEO will have given significant thought to his ideal board and recruited the directors, or at least key directors, prior to closing. The first board meeting will be held within weeks of closing, and there are likely to be 2 to 3 more board meetings within the first 100 days. Below are some considerations for the search funder in building an effective and helpful board. This *Primer* focuses specifically on boards for search fund-backed companies, and does not take up commonly examined issues of boards of publicly listed companies or venture-backed enterprises.

ROLE AND RESPONSIBILITY OF THE BOARD

Before discussing how to recruit and use a board, this *Primer* will address the basic roles and responsibilities of a board:

- Overall legal responsibilities – Even with a private company, the board of directors has a fiduciary obligation to the company and its shareholders under state law. The two basic duties are a duty of care and a duty of loyalty, but there are other legal tenets relating to self-dealing, disclosure, conflicts of interest, business judgment, etc.

- Practical implications – From a practical standpoint, these legal duties boil down the directors' responsibility to pay attention, make decisions that are not completely irrational, and to avoid conflicts of interest.

- Specifically defined duties – Directors may have specific duties defined in the company's incorporating documents or partnership agreements. Further, directors may be officially appointed or elected to serve on committees of the board, such as the Audit Committee or Compensation Committee.

- Common obligations – the board will typically formally evaluate the CEO on behalf of shareholders, discuss strategy, understand the company's operations and judge operating performance, approve budgets and compensation, and consent to major corporate events that affect shareholders (e.g., acquisitions, sales, investments, issuances of debt or equity, etc.).

---

[14] Much of the information in this section was compiled by Rick Taketa, June 2008. Sources behind the work include: "Notes on Boards of Directors," Stanford GSB, Case E-175, September 22, 2004; "Building Better Boards," David A. Nadler, *Harvard Business Review*, May 2004; and "Some Thoughts on Board Governance," interview with A.J. Wasserstein, March 2008.

- Value-added activities – the board also acts as a sounding board to the CEO on tough managerial and tactical issues, provides encouragement and mentorship, and contributes business understanding and input and potentially industry-specific knowledge.

- Accountability – The board holds the CEO and the management team accountable for the company's performance. One CEO expressed that the board creates a bond among the management team by "making it clear there is a 'force greater than us' accountability.

BOARD COMPOSITION

Ideally, as a searcher progresses through the initial fundraising, search, and second fundraising processes, s/he will identify and recruit individuals who would be suitable to serve on the new board of directors. Most of the board members will come from the investor base and some investors, particularly private equity funds, may have a contractual right to a board seat (or more than one seat depending upon the percentage of ownership).

The first step is for the searcher to determine the size of the board. Common corporate governance suggests an odd number of board members; for search fund-acquired companies, a five- or seven-person board is most common.

The search funder will take one seat on the board, or two if a partnership. If the seller retains a meaningful equity position, he may remain involved as a member of the board. Other members of the management team may join parts of board meetings, but do not sit on the board. The searcher will tap the investor base to fill additional seats, and may extend beyond this group to include at least one "independent" director. One difficulty in recruiting directors from outside the investor base is the limited compensation available for them. The searcher may have a former mentor who is willing to fill the role, or perhaps a former colleague or classmate. Customers or suppliers typically do not make good board members because they have specific objectives and potential for conflicting loyalties.

The searcher should strive to build a balanced board, creating a mix of members with deep operational experience, specific industry or business model experience, and financial expertise. Smart entrepreneurs are not afraid of recruiting board members with specific expertise for fear of looking too inexperienced, but rather look for complementary skills to the areas in which they are weakest. For example, someone with a background in investment banking and finance may recruit board members with expertise in sales management and operations. Someone with a background in operations may recruit board members with stronger finance and accounting acumens. If the searcher does not have experience with hiring, a board member may be helpful in recruiting and hiring key team members. For a relatively inexperienced searcher, having one or two board members who could act as mentors to be consulted outside regular board meetings can be extremely helpful. Regardless of the board member's experience, the most important aspect is that the board comprises people trusted and respected by the CEO. Board members are in a position of power and authority within the company, and the CEO should ensure his or her values and belief systems are aligned with the board's.

The board often has set committees comprising a subset of board members who focus on specific topics with the goal of accomplishing more in less time. The most common committees for a search fund-backed company are an Audit Committee and Compensation Committee.

Each board seat should have a specific term. This structural mechanism allows the CEO to continually assess whether the board has the right skill set, and can be a good way to gracefully jettison semi-productive directors. Bear in mind that it may make sense to start with a smaller board of people who are likely to be truly be helpful, rather than trying to build a "full board" that may become a burden for reporting. The size of the board can subsequently be increased as appropriate.

Sometimes, lenders receive board observation rights and will join the board meetings. The CEO has the right to ask them to solely observe or may welcome their participation and question. Board observation rights do not convey a right to vote on any matters, and the CEO may hold an "executive committee" session as part of the board meeting in which no observers are included.

COMMITMENT OF THE BOARD

To create an effective board, the CEO needs to articulate expectations of board responsibilities, behavior, and level of engagement. Talented directors are often busy people. Before formalizing the board seat, the searcher and potential board member should have an explicit understanding of the expectations of the directors, as well as the CEO's commitments to them. The following questions are a guideline:

- Is participation required in person, or can the members join via conference calls?
- How often will board meetings be held? (This answer may vary over time, with more frequent meetings in the first year and less frequent meetings thereafter.)
- How long will the board meetings last?
- When will information be sent to the board members in advance of the meetings?
- Will there be formal committees on which the member is expected to serve (e.g., Audit Committee, Compensation Committee)?
- How will board members be compensated—cash and/or equity—for service, if any?
- Who pays the expenses of board members, such as travel to board meetings? Are there limitations on travel expenses (e.g., only pay a coach ticket, limit on meals, etc.)?
- What directors and officers (D&O) insurance or other protection will be established to protect the board members?

The search fund entrepreneur's legal counsel can provide information and guidance about good corporate governance for private companies as the searcher seeks to determine the appropriate structure for his board.

It is strongly suggested that board members are compensated, at a minimum by covering their expenses, even when the director is an investor. Some search funders also advocate that additional compensation is provided to all the directors, usually an annual fee and a fee for each meeting attended (the exception to this may be if the individual, such as a private equity investor, is being paid by his company/firm to sit on the board); the amount need not be large or place an undue burden on the business. The company will pay the expenses of the CEO, who should not need to be compensated for his service as that would be factored into his overall compensation. Paying the directors can demonstrate that the CEO values their time. It also can serve to professionalize the relationship and create an obligation for the director to perform, giving the CEO the moral high ground to insist on certain behaviors (e.g., to attend all meetings, come on time and stay for the scheduled duration, prepare in advance, not use cell phones). Many searchers will emphasize that, even if a director is an investor, individuals agreeing to serve on the board are contributing above and beyond other investors to the benefit of all, so incremental compensation is justified. Having said this, some search fund entrepreneurs believe that search fund investors will already feel the obligation to perform, and their willingness to serve and reputation as a valuable board member should be part of the evaluation process before the board is selected. It is unlikely that the compensation a search fund-backed company could afford to pay would be a true motivator for this group.

BOARD MEETINGS

Most past searchers and search fund investors suggest approximately 6 board meetings, some in person and some via conference call, for the first year. Too many meetings are a distraction to the new managers, who may spend too much time preparing for and responding to board meetings. After the first year, board meetings should typically happen quarterly, mostly in person; annual schedules should be established to avoid scheduling conflicts. To the extent there are major developments at the company, such as an add-on acquisition, refinancing, significant new product launch, or reorganization, more frequent board meetings may be necessary. Alternately, the CEO may call upon select board members for their involvement and guidance outside a formal board meeting.

When feasible, holding the board meetings at the company's headquarters or at field locations can be highly beneficial for educating the board.

The CEO needs to develop a formal agenda for each meeting, providing a judicious balance of information to maximize productivity. Most of the board meetings should be spent discussing "meaty" issues, not giving high-level reviews. Other members of the management team, and periodically outside experts, are brought in to parts of the meeting to provide specific information and help deepen the conversation.

The CEO should set the tone of encouraging questions and debate of key issues. "Show-and-tell" presentations can serve specific purposes (e.g., initial education of directors), but are often of limited use.

To ensure the directors are prepared, a package of information should be distributed no fewer than 3 days, and ideally at least a week, in advance of the meeting. Useful ideas for the board package include highlights/lowlights, key takeaways, background for focused discussion with developed alternatives, transparent financial reports and key operational metrics, and procedural documents (e.g., minutes, resolutions). The operating and financial reports used to manage the business are often of limited use to the board.

Executive sessions, where the board meets without the CEO (or partners), serve to provide directors with a forum to see and discuss issues not through the eyes of the CEO. Best practice is to have at least one executive session (even if it is only 10 minutes) in each board meeting. The executive session can also be used for formal discussions on the review of the CEO (or partners) and compensation.

THE FIRST BOARD MEETING

Once the transaction is closed, the first board meeting should occur within 2 to 4 weeks. The first board meeting is essential in setting the tone and structure for subsequent meetings, the relationship the CEO will have with his board members and the relationship members will have with one another. In advance, the CEO should send the board members a detailed package of information; some of the information may be duplicative for the directors who are also investors, but it is important to thoroughly educate the outside directors. The following list is not comprehensive, but a base guideline:

- Company overview – lines of business/products/service offerings, locations, key operating metrics, profit drivers, and historical financial information.

- Overview of the transaction – major diligence findings, sources and uses of funds, key terms, post-closing considerations (e.g., earnouts, post-closing working capital adjustments), and breakdown of transaction costs.

- Management – the seller's ongoing involvement (if any), an organizational chart, and the initial management responsibilities being assumed by the new CEO (and the division of labor if a partnership).

- Post-closing activities to date – a recap of the communication made to each stakeholder group, the CEO's activities to learn and evaluate the company with any major findings, and major departures from expectations based on due diligence.

- Preliminary concerns – an objective reporting of the issues and potential options to mitigate the issues.

- Financial results – recent financial results compared to historical results, compared to budget (which could be the company's budget), and compared to projections (as formulated by searcher during transaction).

- Operating plan – focused on the next 3 months, with specific activities and benchmarks identified.

- Opportunities – specific short-term and longer-term opportunities to improve or grow the business. Board members neither expect nor want the new CEO to present a full strategic plan at this stage.

BEHAVIORS AND PRACTICES OF EFFECTIVE BOARDS

As a searcher begins to develop and interact with his board, the following behaviors and best practices are useful to consider:

- Open communication – Effective boards interact openly and directly; they constructively debate key issues with candor and without overly formal rules of order or fear of offense or retaliation. No important information is ever hidden from the board, thus avoiding surprises. Bad news is communicated quickly and without sugar-coating. The CEO can admit s/he does not have an answer. All this said, the CEO should also feel comfortable disagreeing with directors and disallowing directors from "highjacking" his agenda.

- Owning the company's strategy – While strategy development is the responsibility of management, it is not enough for the board to "rubber stamp" management's plans. Instead, the board should understand and insert itself at critical junctures in the continuing process of strategic development. That said, it is the CEO's job to develop strategy and management's job to execute, and overly intrusive or tactical boards can become a hindrance to the company.

- Understanding the company's business model – A high performing board understands how the company makes money, as well as the company's organization design and key processes. The board should encourage the development of a few key performance metrics.

- Aligning performance and compensation – A board must not only establish CEO compensation, but should match rewards to performance.

- Protect financial flexibility – A board should ensure that the company's capital structure and balance sheet are sufficient to execute strategy, and discourage the CEO and management team from taking unnecessary risks.

- Key risks – The board should identify and understand major risks and risk mitigates, including commercial, operational, regulatory, financial, managerial, and legal risks.

- Power sharing – A CEO's open attitude towards sharing power (compensation, executive sessions, approving key decisions, etc.) is necessary to maximize board effectiveness. The CEO and the board should discuss the appropriateness of direct interaction between the directors and non-CEO management; this is typically encouraged, but there are situations where cons outweigh pros.

- Being incorruptible – An effective board remains an incorruptible advisor for the CEO, helping balance short-term and long-term performance. As one searcher put it, "The board is the only body in the corporate pyramid that can tell the emperor he has no clothes."

AVOID THE TOP 10 TRAPS FOR NEW CEOS[15]

This list was developed for CEOs taking over major corporations; however, the lessons apply to search funders transitioning into the CEO role at their acquired companies.

The seeds of destruction for new senior leaders are often sown in the first 100 days. Being aware of the main causes of failure and trying to avoid these traps will make your assimilation easier. Learn from CEOs who have identified 10 major traps to avoid for the first 100 days:

1. Setting unrealistic expectations – 'The most universal trap for a new leader is wanting to do so much so fast that you over promise and over commit,' says GlobalSpec CEO Jeff Killeen.

2. Rash decisions vs. analysis paralysis – In the first 100 days, new CEOs have more scope for taking action but it needs to be the right action. Sears CEO Alan Lacy says: 'If you can get something resolved quickly that is appropriate, go along with it. However, if you just act to act or make premature pronouncements you can set yourself back.'

3. Being a know-it-all – The danger of know-it-alls is that they don't know what they don't know. Pat Russo knew Lucent Technologies well when she came back to the company as CEO but made a decision to assume she knew nothing. 'I believed that before I made my own determination about what had changed the most and the least, the right thing to do was to be intentionally quiet.'

4. Living in the past – While your track record may have gotten you the CEO role, don't assume that what worked for you before will work in the new organization. You need time to assess for yourself the talent and resources you need to execute your agenda. Likewise, don't be trapped into adopting your predecessor's budget.

5. Ivory towers – 'Everything isolates you in this job. You're surrounded by people who want to make you happy. And you don't often get the nuance of what's going on. If you don't fight against isolation, you will be isolated,' says Amgen CEO Kevin Sharer.

6. Stifling dissent – One of the traps of new CEOs is to smother discord and create an environment of fear. In such an environment only the mediocre survive as talented employees head for the door. Stifling dissent can cost you some of your most talented staff.

7. Savior syndrome – It's a serious trap to try to — and believe you can — do it all alone. As Jim Kilts, CEO of Gillette, points out, 'You can lead, but ultimately it is the people in the company who have to deliver.'

8. Misreading real power sources – Don't ignore the unwritten rules about who really holds the reins. Sometimes a board can appear to give you a mandate, but if true power lies elsewhere, don't try to do too much too soon. Gauging the true source of power is critical in the early days, but it's also important to keep refreshing your assessments as you move forward.

---

[15] This entire section taken from http://8pointplan.spencerstuart.com/book/traps/, based on Thomas J. Neff and James M. Citrin, *You're in Charge. Now What? The 8-Point Plan,* (Crown Publishing, 2005).

9. <u>Picking the wrong battles</u> – Selecting the wrong priorities and concentrating on the big things at the expense of the little things is a common mistake, as Lawrence Summers, president of Harvard University, explains: 'There's a tendency in the beginning to think that it's more important to be visible and out at functions than taking care of business. Truth be told, if I'd been sitting at my desk answering my mail, I probably would have been more effective.'

10. <u>Disrespecting your predecessor</u> – 'There are lots of dumb mistakes new CEOs can make, but one of the most common is to blame your predecessor for everything that's wrong. People forget that just about everyone who was there when the new CEO arrives has worked for the old CEO and probably has some loyalty to him or her,' warns Leo Platt, former CEO of Hewlett-Packard."