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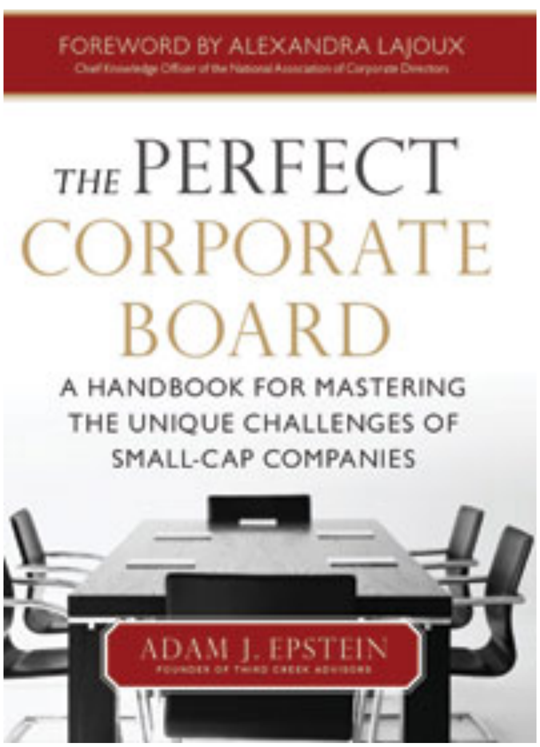
Governance Dysfunction and Small-Cap Companies

by **Jeffrey M. Cunningham** I November 27, 2013

Running a small business is a lot like owning a boat. The two best days are supposed to be the day you buy and the day you sell. That's why Adam Epstein's book, *The Perfect Corporate Board* (McGraw-Hill, 2012), is such a welcome addition to the governance literature. His book is written specifically for directors who oversee small-cap companies and their hardworking management. With more than 80 percent of all boards in charge of small-cap companies and the median U.S.-listed security at $450 million, Epstein has found a huge target for the improvement of board governance.



Epstein is a former attorney and hedge fund guru who today runs Third Creek Advisors, working with small-cap companies on finance-related matters and the capital markets. (In the interest of full disclosure, he also writes a regular column for this magazine and is a frequent speaker at NACD educational events.) He looks at small-cap governance challenges realistically, and, most important to those trying to improve their governance game, he advocates taking an operational approach even at the board level. The specifics to watch for are train and educate, implement systems to assure consistency, and carefully review results for future optimization. It is a refreshing take on the all-too-often philosophical debates that are typical of the larger-cap species.

F. Scott Fitzgerald might have said that large cap companies are different than you and me, and Hemingway would have agreed: “Yes, they have more money.” Epstein makes the point that this is exactly what makes the small caps so challenging to govern—they have limited resources but often are dealing with issues that are just as complex as the billion-dollar babies. It is critical for boards of smaller companies to realistically assess what they can deal with effectively and what is beyond their ability.

Each element of a small-cap director’s board experience is covered in topic-specific chapters. In corporate finance, he writes that directors should get to know the face their management is presenting to the capital markets. He suggests smartly that board directors go on the road with the management team to see firsthand how the company shows itself—especially important as small caps are serial capital raisers. He points out that in some cases small caps wastefully present to investors whose style doesn’t even permit them to invest in small caps.

In a chapter devoted to the capital markets, Epstein covers why “bad stocks happen to good companies.” This ranges from a lack of good communication to the sell-side vacuum, where the buyer is just not interested but not saying exactly why. He writes with authority on the ins and outs of hiring professional service providers in investor relations, legal, and auditing—all essential advisors for the small-cap company.

Epstein concludes that the great recession was an example of boards and management making decisions on issues they didn’t fully understand. With small caps, so much is going to be outside the board’s comfort zone, it pays to be proactive.