PRIMER FOR BUILDING AN EFFECTIVE BOARD FOR GROWING STARTUP COMPANIES

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Having lived through two successful exit strategies in the last four years, served on a few startup boards, and mentored numerous budding entrepreneurs, I have concluded that putting together a board of directors for new companies that are beyond proof of concept often is not a top priority, but it really should be. In the span of my career, I have witnessed firsthand both functional and dysfunctional boards. This article is a distillation of lessons learned and meant to be a guide for founders of entrepreneurial startups.

This article provides a high-level overview of some key questions and issues that may confront startup founders, and are in no manner meant as a substitute for recent literature available in the market, such as the excellent comprehensive book on this subject, *Startup Boards: Getting the Most Out of Your Board of Directors*, by Brad Feld and Mahendra Ramsinghani. Nor should the company's founder fail to consult the regulatory framework established by the SEC, or seek legal and financial advice offered by a general counsel or a management services firm.

WHY SHOULD A FOUNDER CREATE A BOARD?

Establishing a company requires a lot of human capital and financial resources, as well as time and effort to make it successful. Nobody can build a successful business alone. Even the most successful entrepreneurs need experienced, invested people to offer insight and advice. When the company's founder is fully immersed in the daily details of running the business, it can be easy to lose sight of the big picture. Quite simply, smart founders should recognize that embarking on an entrepreneurial venture is a roller coaster ride, and a board with a vested interest in the company can be a game changer. The board can assist the CEO and management team, both formally and informally, with acumen and discerning judgment about the way the venture operates and how it best can achieve its long-term goals.

An effective board, composed of experienced and dedicated individuals from varied backgrounds and skill sets, can be invaluable in guiding and mentoring founders and CEOs in their quest to build a viable business and create value for all stakeholders. The board plays a critical role in charting the strategic direction, assuring accountability, and maintaining good governance. Building a board can be an intimidating process, but with thoughtful planning one can build an effective board that will greatly contribute to the startup's success.

WHAT ARE THE PRIMARY FUNCTIONS OF THE BOARD, AND HOW DOES IT WORK WITH THE CEO?

First, some background. A board of directors is a group of individuals that "has a set of formal duties, which are often referred to as corporate governance."[1] Corporate governance is a set of guidelines to direct the way a company is governed, so that the board can add value to the company that will be beneficial to stakeholders in the long term. A board in a startup has the following five critical functions:

1. Nominate and, if needed, hire the CEO and provide mentoring support.
2. Work with the CEO and management team to help develop a clear strategic direction and business focus.
3. Approve the operating budget based on market readiness of company's products and technology. This entails the board working with the CEO, CFO, and management team to ensure that the company is adequately capitalized and the proposed plan is achievable with the funds available.
4. Monitor organizational performance and advise the CEO and management team on significant issues, investments, M&A activity, strengths, weaknesses, opportunities, and threats, and mobilize resources where needed to get the company moving in the right direction.
5. Fiduciary responsibility to provide general oversight of the business on behalf of all the shareholders, not just the founders, principle investors, or management team. This necessitates that the board ensure good governance practices so that the organization conforms to legal and ethical standards.

WHO SHOULD BE ON THE BOARD?

The first step is determining what type of board the business needs. This involves coming up with well-defined and legally constructed roles and responsibilities for the board in overseeing financial plans/operations or making business decisions. I cannot overemphasize that the board must be cautious and diligent to avoid meddling in the company's day-to-day operations or undermining the role and responsibilities of the CEO. Clearly defined roles establish the proper channels of communication to address issues during conflicts and promote transparency throughout the organization.

The next step is to select the people who would form your board, giving consideration to the following criteria:

- Assemble a diverse group of board members. Diversity means a range of different demographic and professional backgrounds, expertise, and skill sets. The idea is to choose candidate directors who will make themselves available, and prevent the frequent error of selecting like-minded individuals or persons of the same age or with similar backgrounds and interests. To do so misses the point of what a good board can do for the entrepreneurial startup. The key,

[1] Brad Feld and Mahendra Ramsinghani, *Startup Boards: Getting the Most Out Of Your Board of Directors* (New York: Wiley, 2013).

rather, is to decide on candidates with the know-how needed in the company's technology and vertical markets, finance, and governance. The founders and CEO should proactively seek out candidates who have had experience in these areas, selecting individuals from different backgrounds who can bring their unique expertise to bear when making decisions for the company's future.

- Ensure that the board candidates have distinct business experiences and strengths and understand the nuts and bolts of the business. Their abilities should be complementary to the existing skills of the founders and provide extra support in areas where the executive team is deficient. Fundamentally, an effective board will establish good corporate governance practices and prevent costly mistakes that can lead to avoidable crises or even sink a company.
- Take special care with the composition of the board so that it includes individuals other than just the founders/CEO and major investors. This means having independent directors with no conflicts of interest, who can provide balanced and independent judgment, and who can protect the interests of all shareholders. When the Series A round for capital infusion is under way and the term sheet is being negotiated, it would be judicious to discuss with investors the board structure and rationale for having a specific number of outside directors. If the startup board has five members, I would recommend that at least one or two be outside or independent directors. In case of a seven-member board, it would be desirable to have two or three independent directors.
- Look for board members with relevant experience and contacts. A board should always bring innovative, big, and grand ideas and leverage their experiences to help the CEO plan strategically for the company's future. Smart founders know that these individuals will enhance the reputation of the business by bringing their own credentials and business contacts.
- While a well-heeled board member can provide introductions, do not fall into the trap of bringing on potential board members solely to raise money or use their stature to lend credibility. Attempting to use board members for name-dropping purposes only can easily backfire. While they can help your startup get a foot in the door, smart investors will see right through this ploy. A note of caution: regardless of their stature, highly acclaimed and accomplished individuals from the private equity world ideally should not be part of the board of a startup venture. While it may be tempting to recruit them, the business model of private equity is markedly different, and this experience would not be relevant for mapping out the right vision for a startup. They can, in fact, get in the way and adversely impact the business trajectory.[2]
- Beyond the 'hard' skills, it also is important to recruit members who are agile, able to invest time, and can respond swiftly to market conditions and the inevitable emergencies that come up in the life of a startup. A board must be able to respond intelligently and quickly without getting mired in internal gridlock.

[2] Dane Stangler, "Why Private Equity and Entrepreneurship Don't Mix," Forbes.com, October 4, 2012, http://www.forbes.com/sites/kauffman/2012/10/04/why-private-equity-and-entrepreneurship-dont-mix/.

HOW DOES A BOARD FUNCTION?

Once the board has been assembled, the next step is to set up guidelines. Dealing with this aspect is the trickiest part of the entire process. If done well, it will give the startup a strong added advantage. The process for establishing guidelines includes:

- Draw up an official set of bylaws that specifically lays out responsibilities and commensurate authority. When writing bylaws, be sure to clearly state who has the ultimate responsibility for making decisions about the company in areas such as compensation and employment decisions of corporate officers. Also, spell out clearly if that responsibility would be delegated fully or partially to the CEO. The CEO should consult a board when it comes to the hiring and firing of corporate officers. The board should have a compensation committee to ensure that the compensation and incentives for key executives are equitable and correct.
- With the exception of life sciences and similar disciplines that require a longer gestation period, the time it takes for startups to become viable often is four to five years. Board members should be rotated if the opportunity presents itself (for example, when a member is not able to contribute effectively). This keeps the cycle of fresh ideas generating as well.
- During the early phase of the company's development, the board can collectively engage and address issues such as the value proposition, target markets, sales and marketing, organization development, and overall strategies to build the business. However, as the company grows, it is necessary to have three standing committees that can devote the required time and energy to analyze issues in depth and make recommendations to the board. The three recommended standing committees are finance and audit, nominations and governance, and compensation. Board members on the finance and audit and nominations and governance committees should meet twice a year. Those involved in the compensation committee should meet every quarter in the case of a growing entrepreneurial venture. The board and CEO should have the compensation committee review the compensation and incentives for key executives and ensure they are equitable. They also should annually ascertain adequacy of the option pool and the fair market value, consistent with Section 409A of the IRS code, of the options to be granted.
- As for the size of the board, there is no one size that fits all. It really depends on the company's needs, and the most important thing is to make sure to find the right balance with the size of your company. Having said that, my recommendation for a startup board is between five and seven members. If the size of the board is too small (for instance, three members), it would not have the diversity or bandwidth needed. This is especially important when the committees are formalized and functioning. If the board is too big—ten or more members, say—it could become unruly and difficult to manage.
- In a growing startup, establishing a schedule of meetings and clear lines of communication to capitalize on the board's experience, contacts, and strategic insights is critical. Since CEOs often are busy, it is advisable to have an experienced director or chairman to help with the functioning of the board. This

lead director or chairman can serve as a sounding board for the CEO, set up the right processes for scheduling and establishing the board meeting agendas, and keeping all board members informed and accountable.

- Boards of directors should meet every two months to remain up to speed on business developments and identify the right opportunities to help solve challenging issues. Although I have attended many full-day meetings, I believe that with proper planning and focus, most board meetings should not exceed four hours. When conducting a board meeting, try to evenly divide the time for presentations, discussion, and decision making. Avoid spending the bulk of the meeting on presentations, and set aside some time for focusing on important strategic issues that need to be discussed for resolution in order to move forward. The key is having a set agenda for each meeting well ahead of time.
- To facilitate productive meetings, all board members should receive a board package, including an agenda and supporting documents, no less than 48 hours, and preferably one week, prior to the meeting. This gives board members a chance to cogitate and come to the meeting prepared. Once the quorum is established, the meeting should commence with an approval of the minutes of the previous board meeting, followed by the CEO and CFO reports and updates from executives responsible for sales, marketing, and product development. All formal board actions, including approval of the committee recommendations, such as option grants, should be carefully recorded and made a part of the board minutes.
- Chemistry and mutual trust among board members, and with founders and/or the CEO, is crucial. Board members must be able to collaborate and work together to reach rational decisions. The last thing a CEO wants is to have a dysfunctional board. Not only will it feel like that the CEO is flogging a dead horse, but the opportunity cost in managing the board will detract from the forward momentum essential to the startup's success. Create opportunities for board members to meet with the CEO and senior executives through semi-social activities, such as a board dinner before meetings to build rapport, or an annual retreat to review the state of the company and strategic direction. Ensure that board members who feel a sense of commitment to your business are passionately engaged in the company's mission.

HOW IS A BOARD OF DIRECTORS COMPENSATED?

Getting together a good board actually is not an easy feat. But once the CEO finds a group of good individuals, the next thing to think about is how to compensate the board members for their time and effort. For early stage companies, a good practice is to compensate outside independent board of directors with equity because cash is in short supply early on. Members of the startup board who are founders, the CEO, or represent major investors should not be compensated for this role.

Other considerations:

- Once a good and proactive board is in place, the board of directors should be compensated fairly for time invested. They should be offered between 0.5–1 percent of the outstanding shares vested over two, three, or four years. If an independent director serves on the board from start to finish (i.e. through an exit), his or her receiving 1 percent equity in the form of stock options is reasonable.
- The person selected as the lead director or chairman should be given 10 percent additional compensation relative to other board members.
- When a company transitions from a startup to one with real traction, and company executives no longer are receiving below-market compensation, the outside independent directors should receive cash retainers and refreshed equity incentives. Unless the company quickly enjoys explosive growth, the timing of this action should coincide with the Series B round of funding. Whereas the board’s compensation committee works with the CEO to determine compensation for key executives, the CEO should work with the board to determine equitable compensations for directors. There are many industry and geographic board compensation surveys to draw upon to ensure the appropriateness of compensation.
- While addressing the issues of board compensation, startups that have raised initial funding through a seed round grapple with the issue of a directors and officers (D&O) insurance policy. But the reality is that the startup venture has to conserve all available cash and spend it only on completing development of products and technology and their commercialization. However, once the Series A round is completed and capital is raised, a D&O insurance policy will be mandated by the investors. At this juncture, the company should purchase a basic insurance policy at the cost of about $5,000 that provides approximately $1 million in liability coverage.

Relevant to this discussion is the question of whether an advisory board is needed. Slightly different from a board of directors, advisory board members are recruited by the CEO and often have domain expertise that they share with the management team. Unlike the board of directors, who have fiduciary responsibilities, the advisory board has neither the authority to vote on corporate matters, nor a legal fiduciary responsibility to the company or its stakeholders. Some founders assemble an advisory board as ‘window dressing’ and believe they can build a company without a board of directors to whom they would be accountable and with whom they would share their equity. This, in my opinion, is short sighted and deprives the stakeholders of the mindshare and value a board brings.

In most cases, there is no need to have a board of directors and also recruit a separate advisory board, unless the entrepreneurial startup is in a knowledge-intensive industry such as life sciences or pharmaceuticals. These advisors should be appointed for a two-year term and given about 0.25 percent in stock options vested over two, three, or four years. Unless the advisory board is convened twice a year and effectively utilized, it is best not to have one.

SUMMARY

It is my belief that a strong board can contribute greatly in helping a business grow and thrive. A well-functioning board's activities can result in a well-timed exit strategy that creates an opportunity to sell the company, make an Initial Public Offering (IPO), or further scale and grow the business.

Smart founders and CEOs have to map out the requirements and expectations of a board and be firm in sticking to those criteria. The specifics for the board will be unique to each company, but look for people who are able and willing to devote time, bring diversity, flexibility, solid working relationships, a long-term vision, and relevant experiences. A capable board of directors is an invaluable asset, one that may be key to the kind of wealth creation envisioned by every entrepreneur.