HOW VENTURE BOARDS INFLUENCE

AFTER THE

THE SUCCESS OR FAILURE OF

TERM SHEET

TECHNOLOGY COMPANIES

A White Paper by

DENNIS T. JAFFE, PH.D.,
Saybrook Graduate School

PASCAL N. LEVENSOHN,
Levensohn Venture Partners

November 2003

TABLE OF CONTENTS

EXECUTIVE SUMMARY

This white paper discusses the proper corporate governance role a Board should play in a start-up venture capital-backed organization. It is a best practices document designed to facilitate trust between CEOs and venture Board Members while keeping clear the unique and valuable role each plays in the life of a start-up.

Venture capitalists' ("VCs") wide experiences, social network, mentoring and other resources are of at least as much value as their capital in nurturing new ventures. We believe that the quality of the interpersonal relationships between VCs, other Board Members and upper management is the key to enterprise success.

HOW A VENTURE BOARD ADDS VALUE TO THE ENTERPRISE

From the beginning, a Venture Board should be designed to add value to the enterprise. In addition to crucial start-up capital, the best venture capital Board Members provide three additional kinds of capital:

- Social capital — access to networks they can tap for recruiting or business services or partners;
- Intellectual capital — providing insight from experiences that will help the CEO navigate complex situations and anticipate challenges and crises;
- Interpersonal capital — the willingness to serve as a sounding board and/or mentor to the CEO.

ATTRIBUTES OF SUCCESSFUL VENTURE BOARDS

Boards that provide the greatest value to their companies have the following qualities in their operation:

- Company-first governance
- Focus and narrow vision
- Customer-focused point of view
- Complementary mix of talents
- Decisiveness
- Mutual respect and regard
- Strong communication with the CEO

THE ROLE OF THE VENTURE BOARD AT DIFFERENT STAGES OF DEVELOPMENT

The Board, and the roles and behavior of its members, evolve with the venture in three developmental stages:

- **Start-up/Seed:** An embryonic Board assembles as soon as capital is invested and VCs join the Board as preferred shareholders. Their first joint task is to recruit talented employees and define their roles. The optimal size of a start-up Board is between three and five people. This breaks down into one management representative and two venture investors, or two management representatives and three venture investors.
- **Early Commercialization:** A typical commercialization-stage venture Board has three VCs representing the largest investor in each series of preferred stock offerings (the A, B, and C rounds) and two insiders (the CEO and one other member of the management team, possibly the CTO or a co-founder). As a company grows, a successful Board adds new members with management and financial experience. As it enters the early commercialization phase, the company continues to demand active participation from the Board. Often the participation required is of a different and expanded scope than when the company was in pure research and development mode. Committees may form on an as-needed basis, including strategic review, merger and acquisition, and management integration.
- **Productivity/Expansion:** At this stage, typically three to five years after inception, the company has successfully launched its product and attracted customers. The VC Board Member is now looking ahead to exit options and helping the company become self-sustaining. While the CEO may be occupied with the company's performance, the VC Board Members are motivated to look for exit options, such as a sale, an IPO, or a merger, and must also be looking for their own replacements on the Board. Independent directors who are likely to remain on the Board after an IPO often become more active at this time. Board Members skilled in structuring exits through mergers and acquisitions also may play an increasingly important role.

DESIRABLE PERSONAL ATTRIBUTES OF STRONG VENTURE BOARD MEMBERS

To effectively address the needs of the emerging enterprise, the most effective Board Members exhibit the following personal qualities:

- Emotional stability
- Strong interpersonal communication skills
- Pattern recognition skills
- Ability to partner
- Investment and operating experience
- A strong network of business contacts
- Ability to mentor the CEO

THE TEN COMMON PITFALLS OF VENTURE BOARDS

There are many causes of failure in a new venture, but some of the preventable ones include the following pitfalls that belabor Venture Boards. This white paper includes a self-test for the presence of these negative qualities in a Board:

1. Complacency
2. Inability to confront difficult issues
3. Distraction and over-commitment
4. Misalignment of interests between Board Members and investors
5. Divisiveness on the Board
6. Paralysis over liability issues
7. Board Member role confusion
8. Leadership vacuum
9. Loss of trust in the CEO
10. Resolution to fail

KEY RELATIONSHIPS OF THE VENTURE BOARD

The success of the venture board rests on how it develops three sets of key relationships:

- The Board/CEO Relationship: Two aspects of the Board/CEO relationship are essential: that the CEO keeps the Board informed and that the VC Board Members mentor and support the CEO. The pendulum now is swinging toward the CEO keeping the Board more informed, and Boards are engaging in a more hands-on, consultative style. Because of their level of experience and role as investors, VC Board Members may be the only ones who can develop the trust and the credibility to mentor a CEO.
- The Board/Company Relationship: In the best companies, CEOs do not limit access to their teams. A Board Member should be free to contact employees and managers directly, and to visit the company. Effective CEOs encourage Board Members to communicate directly with managers (provided of course that the CEO is informed that such conversations are taking place), both formally and informally. In many cases, VCs are instrumental in recruiting key executives, and they tend to keep in touch with these recruits. The CEO should know about contacts by a Board Member, and should be generally informed if issues arise.
- Board Accountability To Shareholders: In a successful venture, investors achieve a win/win perspective that fairly balances the interests of all stakeholders, rather than having one set of investors fight against others to secure its own position on top of the pile. However, given the inherent conflicting interests of large shareholders, senior management and employees, this is often very difficult to accomplish and remains a source of tension on most venture Boards.

CONCLUSIONS AND RECOMMENDATIONS FOR VENTURE BOARDS

The challenge for a new venture is to be aware and sensitive to the issues we raise. This paper concludes with several concrete suggestions that Boards can implement, including:

- **Developing a self-assessment and performance tool:** Boards must assess not only the company, but also how well they are performing as a collaborative team. The Board should look at itself both as a whole and in terms of the performance of each individual.

- **Creating an open information-sharing system:** The CEO and the management team must trust and feel comfortable with the VCs and Board Members, so they can share their questions and concerns. At every point, the Board must enforce the open exchange of information and ideas in the enterprise.

- **Facing emotional dynamics as they arise:** Tensions will arise between the Board and the CEO, the Board and the management team, and among the Board members themselves. Usually these stresses are clear to everyone, but too often the tendency is to avoid the issue. The path to resolution is through direct confrontation of the issues.

- **Holding a Board retreat:** The most successful retreats retain an outside facilitator or consultant whose role is not to be an expert or content provider, but to assist the Board and the CEO to deal with the critical issues. Successful retreats require preparation and commitment to drive to resolution, evidenced by an outcome like a strategic plan or strategic decision.

INTRODUCTION

Most of the literature we read about entrepreneurial ventures and business start-ups comes from the perspective of the company founder and CEO. Books and articles chronicling the early days of companies from Apple to Amazon are presented as the sagas of visionaries who forge a dream, idea, or technology into business reality despite waves of setbacks. In these tales, the heroic CEO brings together talented individuals to form a management team that works day and night to craft an idea into a viable product and makes the business work.

For venture capitalists and other directors involved in these start-ups, such accounts often have a distinctly *Rashomon*-like feel; the facts are familiar and the names are the same, but just as in *Rashomon*, Kurosawa's classic film exploring different points of view, the interpretation can differ markedly.

This paper discusses the development of a start-up through the lens of the venture capitalist ("VC") and the board of directors, rather than the traditional lens of the CEO and management team. The popular casting of VCs in minor (or even "un-supporting" roles) overlooks the essential contribution active VCs can and do make in emerging companies. VCs' wide experiences, social network, mentoring, and other resources are of greater value than their capital in nurturing new ventures. We believe that the personal relationships and how the key people work together—the process—is the key to enterprise success. Consequently, we feel that the inability or unwillingness of a CEO to accept and utilize the value VC board members bring to a new venture can contribute to the downfall of an otherwise viable company.

This paper will discuss the proper role a board should play in a start-up organization. It will trace the three primary development stages during which the venture board adds its most critical value. It will also address the classic challenges that bedevil boards and CEOs, such as communication and trust issues, effective meeting management, and handling a change at the top of the organization. This paper is designed as a best practices document to facilitate trust between CEOs and venture board members while keeping clear the unique and valuable role each plays in the life of a start-up. While many of our comments are aimed at illuminating the responsibilities and roles of a board for CEOs who may tend to chafe at attentive supervision or resent the checks and balances a board must offer against their authority, we also have tried to balance this discussion with a frank analysis of where boards overstep or shirk their responsibilities. VCs must mediate between safeguarding their personal investments and simultaneously exercising their fiduciary duty to consider the best interests of all of the company's shareholders. Unfortunately, many venture boards are reluctant to confront their own shortcomings, leading to potentially onerous consequences affecting all of their constituencies.

With the downturn in financial markets that began in March 2000 and the extraordinary contraction in venture investing, it's never been more important for venture boards and management to embrace fundamental governance processes to maximize the probability of a successful outcome for their portfolio companies. What's more, few VCs see a clear "Next Big Thing" on the technology landscape. That means they are looking for companies that are attacking important, existing problems with solutions that deliver measurable return on investment (ROI) to customers. Clearly, execution, discipline, and efficiency have replaced sizzle and big budgets as the hallmark of the best start-ups. Just as clearly, those qualities rarely develop without an engaged and attentive board.

As part of our research, we interviewed a group of experienced players in the Silicon Valley venture capital world. These included venture capitalists with extensive board experience, lawyers, and CEOs of both start-ups and companies in turnaround stages of development. These players have been involved with the launch of scores of successful companies. They have also witnessed first-hand the devolution of companies that did not survive the intense, harrowing early development phase. One of this working paper's authors (Dennis Jaffe) is a consultant who has worked with many start-ups and closely held businesses in areas of governance, strategy and leadership. The other (Pascal Levensohn) is a venture capitalist widely experienced in funding start-ups and serving on venture boards.

PART 1:

HOW AND WHY A VENTURE BOARD ADDS VALUE TO THE ENTERPRISE

Business visionaries live in a universe that orbits around their inventions or ideas. Founders imagine that their innovations are primed to transform entire industry segments, markets, and even society. These entrepreneurs typically are talented, dogged, persistent, and creative. They form the core of the business growth engine.

But their strengths can also be their weaknesses. Their belief in the vision can obstruct their appreciation of the details and processes necessary to make it happen. Their optimism can lead to over-promising and under-delivering. They often lack perspective yet chafe at oversight.

Persistence and perseverance, qualities vital for success, can kill a venture if the visionary surrenders good judgment to his will to succeed. That's why one of the most crucial developmental steps in the life of a good company is the assembly of a good board to complement as well as counterbalance the CEO. "A CEO has to be a person who follows a very deep and narrow path, and focuses on one issue, a single set of objectives. The board member, on the other hand, is a person who likes to take a broad view, has a lot of interests and wants to do several tasks at once. It is a different style. The board provides a check and balance on the skill and intensity of the CEO," observes Andy Rappaport, a partner with August Capital, a Silicon Valley based venture capital firm.

Indeed, however talented and visionary its founder may be, a company that aims to pioneer or exploit big, exciting markets must ensure that it has access to wisdom and experience beyond that of a single individual or small group of founders. In addition to crucial start-up capital, the best venture capital board members provide three additional kinds of capital: **social capital**, in the form of access to networks they can tap for recruiting or business services or partners; **intellectual capital** in terms of providing insight from their experiences that will help the CEO navigate complex situations and anticipate challenges and crises; and **interpersonal capital**, or a willingness to serve as a sounding board and/or mentor to the CEO[1].

1. Every CEO should serve on a board separate from his or her own company. This helps CEOs take a broader, more strategic view and also understand why board members act as they do. CEOs become better operators when they have experience of their own at the board level.

Not only are there different dimensions to the roles the board members play, their roles shift and grow as the company develops. "A great board cannot make a great company but a bad board can kill a good company," notes Andy Rappaport. A bad board can be characterized by meddling or, conversely, indifference; by letting personal agendas overwhelm the board's fundamental charter to represent and protect all shareholders; or by not having the courage to face crises head-on and make hard decisions – including the removal of the CEO or other management personnel when necessary. Moreover, what represents a crucial board or management asset in one phase of a start-up's life may be eclipsed in the next by a new and overarching need. A board must constantly perform self-checks to ensure that it is keeping up with the real-time needs of the company – not rewarding past efforts.

We will discuss the roles of the board during those three distinct phases at some length. But before we get into the phases and evolution of a start-up, let us start with a wish list based on attributes we have identified as the hallmarks of effective board members of start-ups:

Attributes Of Successful Venture Boards

1. **Company-first governance**. Great boards have an interest in seeing the company succeed, not just in meeting the board members' personal financial agendas and goals.

2. **Focus, narrow vision**. While many paths are promising, the company must start with one good direction that offers maximum leverage of resources. The board helps find this path.

3. **Customer-focused point of view**. Board and management must relentlessly monitor how the company's product or service is meeting a clear customer need.

4. **Mix of talents.** Good boards assemble a mosaic of talents and knowledge bases from different constituencies over time.

5. **Decisiveness.** The board members must not avoid conflict with a CEO or each other, but rather must develop mechanisms that productively manage their conflict toward consensual action.

6. **Mutual respect and regard.** Good boards overlook interpersonal issues and agendas to pursue the best outcome for their common investment. Respect for individual areas of competence should promote, not stifle, dialogue about issues affecting the company.

7. **Strong communication with CEO**. The CEO and board members must be in constant touch, both at formal meetings and informally. The CEO should have what author Michael Useem calls the skills of "leading up," and he should never shield the board from bad news. A common problem in crisis situations is that CEOs will shut down, turning away from resources that could be helpful.

Boards consider and advise on all kinds of different situations that a company faces. However, Russ Siegelman, a former Microsoft executive who is a partner at the venture capital firm Kleiner Perkins Caufield & Byers, offers a more fundamental comment on the role of boards. He points out that at its most basic level, "The board makes only three types of decisions—to invest, to hire the CEO and to fire the CEO." In other words, the bulk of a board's work is advisory, not operational. The board is not a shadow management team waiting in the wings to rescue the existing management team or roll up its sleeves and actually operate. It is there to offer guidance – but also to pull the plug when necessary if management cannot act on that guidance or assemble its own effective team to get the job done.

The Evolution Of A Successful Venture

Venture backed startups evolve over time and the roles of both management and the board must adapt as well. Each stage demands a more complex mix of personal and business skills in the company and from the board. This section explores the stages of venture development from the perspective of the required skills, capabilities, and contributions of the board.

Many VCs view the developmental process as having three stages:

First, the **seed/startup** stage, when a company has no revenues and is principally engaged in research and development and organization- building. In this stage the goals are to define target customers, craft a business model, and develop the competency to execute it. It is usually a technical, inward-focused stage. This initial stage is the time to establish a cost-conscious culture.

Second is **early commercialization**, which includes pre-commercialization, working product refinement, and initial revenues. This stage continues to require a high level of active VC involvement as the company executes on its business plan. At this stage, the focus is on developing relationships with customers, entering the marketplace, and testing the product or service. During this stage the company is also adding capabilities such as sales and business development to the management team.

Third is the **productivity/expansion** stage, when a company has significant revenues and an expected liquidity event for investors is less than twenty-four months away. At this stage the company develops cash flow, production capability, and tests the product in the marketplace on a large scale. It also prepares for the exit of the initial investors.

Complicating this model, every company will face some sort of crisis as it moves through each of these stages. Spotting, defining and resolving these crises are often the work of the board.

STAGE 1: Seed/Startup

The embryonic venture chiefly focuses on research and development. Before a venture gets funded, the structures of the board and management team are fluid, emergent, informal, and incomplete. At this earliest stage of a company's evolution, it is essential for a positive relationship to develop between the founding entrepreneur (who may represent several co-founders as the designated board representative and CEO) and the key lead venture investor(s): we believe this is a key success factor for the company. The goal is to establish a level of trust between the founder and the lead venture investor that equates to alignment of purpose.

A delegation, often including the founder and a key manager, may present an idea or a prototype to the VC firm. While some entrepreneurs start this process believing they are seeking only funding, the meeting and relationship-building with the VC should be a window into other potential resources that the VC can provide. For example, the venture capitalist may know talented executives looking for new positions who would be good fits for the start-up's growing list of needs; or, the venture capitalist may have experience in the business segment the start-up hopes to address, and can offer new and valuable insights.

The process of shopping the idea helps the founder and the team develop their ideas into a business plan. These presentations are not just sales sessions: they are also explorations of feasibility. The prospective VC can add value to the venture even at this stage by asking questions and exploring different possibilities. It can be uncomfortable for an entrepreneur, but a founder benefits from the more distant and even critical perspective of the prospective investor.

There's no question that this stage can be an exhausting and frustrating experience for the company founder. It is a fact of the marketplace that desperate entrepreneurs see money as something rare and valuable, and VCs see good ideas as commodities. The VC is in the business of turning down hundreds of people a year. The CEO may be facing criticism and disinterest from many funding sources. However, when a VC says "No" to a prospective portfolio company, it can be a positive learning experience for the entrepreneur if the VC provides constructive and concrete reasons for passing on an investment. It's important for an entrepreneur to listen carefully rather than defensively, even when the news or feedback is hard to hear. Steve Larsen, formerly of St. Paul Venture Partners, who has been both a CEO and a VC, says he makes a point of giving a prospect clear, direct, and honest feedback about his reasons for rejecting a given deal – thus giving the entrepreneur the chance to either adjust the business plan or prepare more effective counter arguments to the same objections at the next meeting with a different prospective investor.

Let's assume for now, however, that the parties find mutual benefit in deciding to work together. In the ideal scenario, the VCs and CEO push forward in a spirit of respect, collegiality, and honesty. Very commonly, however, the seeds of trouble are already brewing. The negotiations may have been difficult and frustrating for the CEO. Very likely, he or she had hoped to retain more equity or raise more funding in the seed round. For example, the former CEO of a retail franchise venture in which one of the authors was involved, felt from Day 1 that his venture investors took too much equity, and also were planning to push him out. In fact, his investors were trying to help him learn about retailing, a domain in which he had virtually no experience. They encouraged him to take the role of technology visionary. However, the CEO maintained an attitude of resentment and kept the investors at arm's length. He was negative with the board, and ultimately that did lead to his removal.

There are plenty of cases where both parties have behaved in a mature, professional manner and wiped the slate of whatever power plays and disappointments may have occurred during courtship, however. The authors are aware of another start-up whose seed round negotiations were filled with acrimony as the founder played rival firms against each other, almost to the point of driving the lead investor away. The VCs were concerned that the company was going to be a management headache, but pushed ahead because the technology was so exciting. At the first board meeting, the CEO made a point of stating that he had been aggressive in working for the best deal because he believed so strongly in the company and wanted it to succeed. Now, he said, he was prepared to go forward as a team. His willingness to make such statements in a forthright manner set an excellent tone for the company and for what became a no-nonsense, very effective board.

After completing a first institutional round of financing, VCs typically join the board as directors elected by the preferred shareholders. The first joint task of management and VCs is to staff up the company by recruiting talented employees and defining their roles, and attracting one or two other investors to syndicate the risk of the newly born enterprise. The optimal size for the start-up board in the seed stage of development is between three and five people. This breaks down into one management representative and two venture investors, or two management representatives and three venture investors.

According to VCs with whom we spoke, several characteristics are essential to the successful growth of personal chemistry between the entrepreneurial CEO and the VC board members. Most importantly, both sides must be open to listening to the other. This is what lays the foundation of a good board and a good working relationship between management and the board. While confident, each must have the ability to see that the other party has resources, experience, and ideas that might represent acceptable or even preferred ways of doing things. These qualities of personal maturity cannot be wished into reality or legally compelled. A passive or uninvolved investor not willing to commit the time to prepare and give the best thought to a variety of concerns is a real liability in the cause of forming an optimized relationship between management and the board. However, so is an overly defensive or arrogant business founder/CEO unwilling to candidly confront problems, listen to counsel, and use other resources that might divide or limit his power over the company.

When such qualities are apparent early in the relationship, the parties observing the negative behavior should be up front and assertive in pointing out the problem and urging frank discussion aimed at diffusing it. The VC/founder relationship is not a direct authority relationship in that the power to make most decisions still resides with the founder/CEO. But the board has the power, and indeed the duty, to hire and fire the CEO if it believes he or she is not acting in the best interests of the shareholders.

Similarly, a CEO faced with many business challenges but an indifferent or disengaged board member must be prepared to confront that board member and ask for the board member to discuss his or her intended commitment and engagement. If the CEO does not feel he is getting what he needs from his board, it is the CEO's responsibility to press the issue. CEOs need to work cooperatively with lead investors to either replace non-performing board members or to break the pattern of passivity. More often than not, these board members need to be replaced, using the next financing round as an opportunity for them to exit gracefully. If these problems appear this early in the relationship, they can only get worse unless both parties confront and resolve the situation.

STAGE 2: Early Commercialization

As a company recruits the next layer of management (including the sales and service organization, the chief financial officer, and a senior marketing officer), the process of building a real company out of a promising idea or technology begins. As the company enters the early commercialization phase, it continues to demand more active participation from the board.

In the aftermath of the technology bubble bursting, a fundamental shift has occurred in the venture capital industry toward greater risk sharing in various financing rounds. While this has created new alliances among venture firms, it has also created unlikely co-investors in some cases. Often, venture investors seek to not only syndicate risk but also to obtain independent valuation validation by a new venture investor. As a result, subsequent financing rounds often create a situation where the company is revalued and where a new VC joins the original seed investors. With the new VC's investment may come a board seat and new expectations or changes to the company business plan or strategy.

It is not unusual to see a commercialization-stage venture board with three VCs, each representing the largest investor in each series of preferred stock offerings (the A, B, and C rounds); plus two insiders (the CEO and one other member of the management team, possibly the CTO or a co-founder) whom the common shareholders elect. As a company grows, a successful board is likely to add new independent members with domain expertise in the company's industry sector or with financial experience. Sarbanes Oxley requirements have accelerated this process among private companies, particularly if the company contemplates an Initial Public Offering (IPO) in its future.

According to Rick Fezell, who is the San Jose Office Managing Partner and Emerging & Growth Markets Leader for the Pacific Northwest practice of Ernst & Young, "the trend of establishing private company audit committees in response to Sarbanes Oxley has begun. This subset of the board should consider fulfilling its responsibilities as required by public company audit committees under Sarbanes. A premium is being placed on recruiting private company board members who are both willing to serve on audit committees and who qualify as 'financial experts' under the guidelines."

To be effective, the board must draw on resources from individuals with the appropriate skills—for example, the VC who is a brilliant software engineer may not be the best choice to lead a merger and acquisition evaluation or build complex models that analyze capital structures. In this phase the networking expertise of a VC can come into play. Steve Larsen recalls being recruited to serve on a company's board by a VC investor. "The VC and I knew each other and had previously worked together. When she put money into the company she felt the company needed an A+ marketing executive. . . The CEO was a techie, who didn't know how to recruit a marketing executive. The CEO just didn't know that side of the business. I came on and did a bunch of things the CEO would not have known how to do."

Friction commonly arises at this stage in the company's growth, and by far the most significant source involves adding or replacing team members. The CEO often wants people who make him comfortable, or executives with whom he has worked in the past. However, it is the board's role to broaden the CEO's perspective and add talent that the CEO might not be able to envision. Successfully recruiting the most effective executives for the business execution and revenue growth phases of a company's evolution often requires moving founding entrepreneurs out of senior management and senior operating positions and into more supporting roles.

Replacing personnel or adding a COO is a very delicate and thorny process, often fraught with emotion. Many founders find it particularly galling to be passed over or found wanting in their skills at precisely the time when their fledgling companies experience rapid revenue growth and performance above plan. It is an emotionally difficult time for founders because the sweat they have poured into the research and development phase is the foundation for the success the company is currently enjoying. They may view the situation as one of betrayal by the VCs. This is a delicate inflection point in a company's history where VCs' intellectual capital comes into play.

The VC who has seen time and again what young companies need as they develop can anticipate the next phase and its challenges, while entrepreneurs envision the company's success as the inevitable result of them personally shepherding the start-up to the finish line. To manage this transition process successfully, the VC board members must focus everyone's attention on the necessity and inevitability of change. Business reality is far less orderly and never as sequential or neat as an engineer or software programmer would like. It is messy and requires adapting to shifting dynamics of the marketplace and within the company's own ranks.

We have found that focusing the management team on the alignment of economic interests between investors and entrepreneurs is essential to managing this process successfully. As long as the VCs protect the economic interests of the founders who have made major contributions to the company, the blow to the entrepreneur's ego can be softened by the recognition that the best team in business execution may not necessarily be the founding team. It is the combination of the two, and the successful hand-off from the first to the second, that can generate substantial economic rewards for all of the constituencies involved.

The VCs are not the only players actively preparing the company for success at this phase: Best of breed venture companies have strong CEOs with strong personal contact networks. In the commercialization stage they, too, can make a significant addition to the long-term health of the company by recruiting one or two notable independent board members with real industry standing and relevant capabilities. It's important to point out that it has become difficult to recruit high caliber independent directors. In the late 1990s, independent directors used to be lured by very attractive stock option grants in the seed round, but today they will serve mainly out of respect for the company and its CEO. These recruited members can provide additional balance on the VC perspective. We typically regard that as a good thing, although some VCs resist it.

Steven Bochner, a partner with Silicon Valley law firm Wilson Sonsini Goodrich & Rosati who has recently worked with NASDAQ on applying governance reform to public companies, sees pro-active companies seeking independent directors earlier in their development. "What you are starting to see is more sensitivity to the concept of board independence, at an earlier time. Directors who can provide an independent perspective and also insulate the board from liability." Bochner agrees, however, that it is difficult to find the incentives to recruit truly independent directors who have no tie to the VCs or to the CEO.

As we've seen, the transition out of the early commercialization stage can be a tumultuous time for the company. Typically, there has been a significant increase in personnel, many of whom have come from beyond the founders' circle of contacts. Similarly, as the board develops, the skill set required from VC board members will also develop. The board should bring in members with complementary, not competing, skills. The effective venture board thus polices its own composition as well as that of the management team.

STAGE 3: Productivity/Expansion

At this stage, typically three to five years from inception, the company has achieved significant levels of revenue and perhaps achieved profitability The VC board member has been rewarded by the success of the company and is now looking ahead to exit options and helping the company become self-sustaining. While the CEO may be occupied with the company's performance, the VC board members are motivated to look for exit options, such as a sale, an IPO, or a merger. Therefore, they must also be looking for their own replacements on the board. Independent directors who are likely to remain on the board after an IPO often become more active at this time. Board members skilled in structuring exits through mergers and acquisitions also may play an increasingly important role.

When a liquidity event is achieved through an IPO, some VC board members may continue on the board while others may exit. While the path VCs take may often be a function of their skill sets (VC seed investors often prefer to spend time with younger companies), the decision to stay on a public board has become more complex for VCs across the board given the director liability and other provisions of Sarbanes Oxley.

It is not uncommon for the period surrounding the exits to be characterized by developments some would term crises. These can take any number of forms. Most recently, for example, thousands of venture companies have required triage and complex financial engineering to reset management equity option incentives, realign the interests of venture investors, and attract new capital for mere survival. In other words, the collapse of the IPO market and declining investment in technology across the board created widespread financial crises. Patching up and bailing out enterprises that have taken on red ink is a time-consuming and difficult challenge that has stretched the resources of many venture capitalists. In some cases, the best option ends up being liquidation at cents on the dollar. In others, it becomes clear that while a company has valuable technology or market share, its prospects are limited by what it doesn't have – say distribution, or access to global markets, or a more complete product line. In those cases, company founders may vow to hold on and keep building, while more experienced VCs may feel that the time has come to sell.

Any of these situations can be termed crises—or opportunities. Good boards constantly and proactively assess viable exit options. For example, we are aware of a company that had limited cash resources but a robust customer pipeline. However, there were no guarantees that the customer pipeline would convert to cash and accounts receivable before the company either ran out of cash or required another equity infusion. The problem the company faced was that, despite solid prospects, none of the existing investors were prepared to write another check to fund the company's operations. Management felt uncertain about the future, and key executives were at risk of leaving the company for fear of their own financial security. One board member focused the board and management on an analysis of the reality of the situation. The board developed the consensus that an orderly sale of the company prior to reaching the crisis point was the only realistic way to move forward. Disagreements among investors were settled as everyone realized that no financing support existed around the table and that any new investor would most likely penalize all of the prior investors. As a result, a far more serious crisis at the company was avoided.

A critical point about crises is that they tend to trigger defensive behavior at just the moment when a team effort is needed. The CEO may want to protect the board from the information, feeling he or she can turn things around. Too often, entrepreneurs and VCs alike get hung up on hoping for a low probability event to occur that will shift the balance of a bad situation. When the board indulges in such hope-based behavior, it's ignoring the reality that pursuing too many options simultaneously reduces the likelihood of an outcome that minimizes downside risk. Even experienced investors sometimes forget that failing to make a choice and maintaining the status quo is a choice in and of itself.

Personal Attributes Of Strong Board Members

At heart, a board is a team. And just as any team is influenced and enhanced by certain types of personal qualities and skills, there are certain personality traits that tend to be highly correlated with good board members. Among them:

- **Emotional stability.** Neither volatile nor hyper-responsive to environment changes and crises, they have emotional maturity as expressed through patience, self-control, and persistence under pressure.
- **Strong interpersonal skills.** To successfully manage the dynamics of a board, individuals must have strong communications skills and be able to read other people's non-verbal cues. Executives sense when the VC is sincerely interested in them and open to their point of view. As a result, they will be comfortable seeking out the receptive VC, calling them when a problem arises.
- **Pattern recognition.** They are able to make correct decisions, sometimes with little information. They "see it coming" through their experience.
- **Ability to partner**. Most ventures today are syndicated with two or more investors. VCs must be open and interested in working with partners to exploit all the resources and talents on the board for the best interests of the company.
- **Experience.** An attractive board member has the benefit of experience working with many firms, and can quickly see patterns and know what tends to work. Inexperienced board members inhibit the company, as their lack of sophistication may bog down board meetings, lead to misunderstandings, and waste valuable time on trivial matters. Yet this is a problem with VCs and boards today. The venture board member needs the perspective and standing to be able to spot issues and know what can be done.
- **Strong network.** Recruiting key personnel is so critical to new ventures that a VC's skills and contacts in this arena may prove more valuable than the VC's financial contribution.
- **Ability to mentor the CEO.** A peer cannot do this, and it is difficult to find an outside coach to act as mentor. A board member has the experience and motivation to take on this role and the status to do it effectively.

KEY RELATIONSHIPS OF A VENTURE BOARD

A successful start-up is a smoothly functioning network of relationships. In defining the effective start-up, the venture board must develop strong working relationships with each of the key stakeholder constituencies that form the enterprise: the CEO, the top executive leadership team, and the other shareholders. They must also develop a positive internal climate in their own relationships. An effective venture balances, respects, and draws upon each of these groups, while also maintaining proper boundaries and appropriate roles for each one.

Board Process: Personal Dynamics Of The Successful Board

Some issues transcend the company's stage of development. Not addressing them sooner can create big problems later. As we've discussed before, the quality of relationships among board members may do more to determine the success or failure of a company than the level of individual skills and capabilities. The board needs to come together as a team working with the CEO and management. A key element of a successful board is its ability to manage the relationships among board members in order to utilize and direct their talents to maximum effect. In addition to personal chemistry and having respect for each other, there are some elements of the process of board meetings that help a board perform optimally.

We've identified several aspects of the board process that make a difference, plus several common pitfalls of board dynamics, which are listed in the sidebar.

<u>Leadership, preparation and direction</u>. A leader emerges on every board. The board leader may not necessarily be the chairman, especially if the chair is the CEO. Most often the leader is the senior or lead investor.

Ideally, the board leader assumes responsibility for making sure the board is comfortable with the background materials and preparation that the CEO provides in advance of board meetings. This may not sound significant, but it is crucial. The board must maximize every minute of its time together. If it does not have adequate materials and background in key issues that come before it, it cannot have meaningful conversations and make good decisions in real time.

Some CEOs consider this role of preparing the board to be too time-consuming. More than one CEO has mentioned to us that the time needed to prepare for board meetings took time away from operations. In general, CEOs want less frequent board meetings and more informal contact with board members. Frankly, we view such complaints with skepticism. Start-up boards are not regulators, simply making sure all the permits have been filed and the paperwork is up to date. They are collaborators, partners, and allies who also have the duty as fiduciaries to make sure the company's capital is being spent appropriately. CEOs who can't make the time to prepare materials for board members are typically not, in our experience, CEOs who are sufficiently well organized or open-minded to suggestion. They are precisely the kind of CEOs whose behavior the board should be monitoring even more closely than it otherwise might.

The board leader should insure that there is time to explore issues, that board members have the information they need, and that decisions are not only made, but enforced. Most critical, the leader should make sure that the board stays in focus and talks about the issues that really matter. One of our colleagues was involved with a networking start-up up company where the CEO would rush the board through operational issues and then try to dominate the time allotted to question and answer by bringing in various technology specialists from the company to sketch visions of interesting future products. The CEO wanted to put on a show for the board, keeping them dazzled rather than inviting exchange or drawing on their expertise. He tried to make it seem like every issue was solved or cut and dried. Instead, the board became frustrated. The board members talked among themselves, and they all felt that the CEO was actually terrified of handling unscripted questions and insecure about his own management style. A venture capitalist on the board called the CEO and confronted the issue directly. He pointed out that the CEO should not schedule guest speakers during board time, as board members wanted concentrated time to discuss the issues that arose. That led to a conversation about the nature of board meetings that ultimately produced a much more efficient and open style for the meetings.

In another company in the telecommunications space, the CEO would invariably overwhelm board meetings with dense PowerPoint slides. Advance materials were typically available no more than 48 hours prior to the meeting, and few board members could adequately digest the content in advance of the meeting. As a result, the financial implications of the company's slow sales progress were often obscured, and useful information was buried under mountains of minutiae. The length and opaqueness of the board packages became a running joke in one VC partnership and among the board members.

To address the problem, a board member took it upon himself to provide a post board meeting analysis to the rest of the board and to management, raising specific questions for the next board meeting and requiring that these questions be addressed in writing in advance of the next meeting. This process sharpened everyone's focus and forced, in a constructive manner, the discussion to turn to the most relevant aspects of the company's strategy and financial condition. As a result, management was more accountable to the board, the entire board became more in tune with the company's real issues, and nasty surprises were avoided.

Open to diverse viewpoints. It is easy for any team to become a victim of groupthink and not only ignore minority views, but also turn away from conflict. It is easy to be overly optimistic and complacent. This is another important role for a board leader – short-circuiting denial, avoidance and hidden issues by contacting the CEO and managers and persuading them to deal with issues when necessary. He should make sure he knows the opinions of the other board members, coordinates communication, and ensures that the CEO has kept everyone informed. He may sometimes have to probe or challenge information. For example, one VC reports that after several meetings where the CEO presented rosy customer prospects and meetings, the VC finally challenged his assessment, and began to surface his concerns and doubts. The result was that the CEO's rosy picture did not withstand this scrutiny.

Effective boards maintain open communication channels to the company. Scheduling managers to give presentations and get to know the board are ways to do that. But this should not mean that executives feel they have to perform a "show" for the board. The board should ask them to present as they would internally to their peers. Key point: a board needs to make it clear to a CEO as early as possible that it will enforce its right to talk directly with employees and hear from other executives besides the CEO.

This will prevent later questions about the board "going behind the CEO's back" or other such accusations. The company does not belong to the CEO, it belongs to the shareholders, who are represented by the board. The board has the right to pursue any information or data it deems necessary to understand the company's business and progress. Legitimate differences of opinion can and do exist within companies and the board has the right to understand and weigh those differing opinions.

Ability to resolve conflict. When faced with differences, some boards seem unable to resolve them constructively. Individual board members plot against each other outside the meeting, or push conflict under the table. A skilled leader, an ethic of mutual respect, and a willingness to push to resolution are important components of managing conflicts in this area. But another useful tool boards can and should use to force more straightforward conflict resolution is meeting regularly without the CEO present. At first, this might seem like secret plotting. But in fact, it is critical that the board accept that one of its roles is to regularly assess the performance of the CEO. The CEO is accountable to the board, but board members are often reticent to raise concerns about the CEO or the CEO's program with the CEO in the room. This is human nature. Unfortunately, if the board waits until there is an obvious problem before it begins meeting in private, the very fact of suddenly meeting in private can send a vote of no-confidence to the CEO during a difficult time. So, it's a good idea for the board to establish a precedent of having some private meeting time from the beginning.

Willingness to replace a CEO or key officer. Venture boards face their greatest challenges when they must change the operating and governance roles of founders. There is no point arguing that this process is something other than difficult, painful, and awkward. It's a rare CEO who can step forward without prodding to raise the issue of whether he or she is still the best person to lead a fast-changing or growing company. Rather, founding CEOs often fail to see that they are less skilled at running a management-intensive organization than they are in cultivating the initial seeds and shaping the vision for growth. At the same time, they find it difficult to let go of their growing "child" and this creates a fundamental tension with the board.

The board may recognize the shortcomings of the CEO, but be torn between recognizing the CEO's early contribution and addressing the need for change. For these reasons, many boards fail to act decisively even when the need is clear. For example, in one Silicon Valley software company, the founder raised the initial capital for the company and created a viable technology product. But he had trouble facing the realities of the market. He believed his product was so great that it would sell itself with minimal marketing and sales effort. As a condition of an additional financing round, a new VC investor required that the company start a search for a COO, which would turn into a CEO search if results fell short of plan. Even when the numbers lagged, the board still hesitated to make a CEO change. Nobody on the board was willing to be the bad guy, confront the CEO, and make a change. In the end, the new investor forced a vote to get a new CEO. Subsequently, results have been positive, confirming that the board should have acted sooner.

Replacing the CEO doesn't necessarily mean having the CEO leave the company. For example, the technical founder might become Chairman, or take on a non-CEO creative/technical role. The board has to make sure that the founder won't become a spoiler if he stays on in a lesser role, or as a director. If the former CEO's perspective prevents the company from pursuing a new direction, keeping the CEO in any role is an untenable option.

Ten Common Pitfalls Of Venture Boards

When business is booming, there is less of the natural tension that commonly percolates through top-level teams. But when resources are constrained and prospects are less certain those pressures can disable or break apart a board at just the time the company needs leadership the most. These are some of the common pitfalls that plague start-up boards. It serves as a useful self-check for both board members and managements concerned about how well the board is performing.

These pitfalls can be used as a self-test of board performance. Members of a board can confidentially assess the degree to which each of these factors is present in their board, and tally the results. Each item has some questions that can open dialogue on these issues. The process of candid self-assessment is a key ingredient of a board that is open to learning. If a board cannot look at itself, then it will likely never ask the CEO and management team to look at themselves. Some boards ask a consultant, maybe the same consultant who works with management, to interview each board member and assess their performance each year.

1. Complacency. Larger boards may have misaligned investors who take a stance of excessive complacency and self-satisfaction. Complacent boards are comfortable and don't go after, seek out, or act on tough issues. They enjoy the power and perquisites of their role, without challenging the company. This attitude has been deadly to some public companies (such as Tyco, HealthSouth, and Adelphia). ***What are the top three toughest issues facing your company? Is the board actively monitoring and focusing on those issues?***

2. Inability to confront difficult issues. This can be common with long-serving board members who are tied to initial or previous perspectives and who make it hard for new members to make important observations. Any group can benefit from new perspectives. ***Is your board willing to take a step back from time to time and challenge old assumptions about chronic difficulties? Do you face up to issues when they arise, or avoid dealing with issues where there may be disagreement?***

3. Distraction, over-commitment. VCs may serve on too many boards to be productive, or they may have written down their investment in the company and lost interest. The CEO faces a dilemma if that board member has priorities ahead of this particular company. The CEO is best served if he can ask the VC to consider appointing a colleague who is less burdened to the role, or freeing up more time for the effort. ***Is each member of your board prepared, available and helpful in the issues the board is facing?***

4. Lack of alignment of board members and investors. This has evolved into a major problem in Silicon Valley as a result of the technology capital market downturn. For example, many VCs and others, including passive angel investors, have invested in seed and "A" rounds and expected to see their investments appreciate. Instead, since mid 2000 these early round investors have experienced significant dilution of their ownership stakes due to subsequent financings completed at lower valuations, often with special liquidation preferences attached to the most recent investment capital. At the same time, these early investors have no assurance of near term liquidity. The early and later investors have different financial concerns that often do not align. They must resolve difficult competing agendas or else remain deadlocked and severely compromise the future of the enterprise. This is why some CEOs find it hard to trust their VC board members. VCs need to adjust their attitude and get realistic. We are back to business basics. ***Are board members open about their agendas, and willing to work together to forge a position on key issues of valuation?***

5. Divided boards. The best CEOs lead both the company and the board. The CEO brings the right information and helps get the entire board on his side rather than just counting on a majority of allies. ***Does the CEO of your company work with all board members, or does he or she say: "I have three votes, I don't need the others." The latter approach will polarize a board. Does the board strive for consensus on issues, or rely on the votes of a majority for decisions?***

6. Paralysis over liability issues. Sometimes boards become so cautious that they cannot act at all. In the world of venture capital, where the competitive environment is extremely dynamic, inactivity is as apt to generate a negative outcome as making the wrong move. Moreover, liability concerns have become so strong for some directors that in one start-up, a director feared liability issues and litigation from other shareholder groups if he agreed to sell the company at a substantial loss, even though this was the most likely way to ensure the company's solvency. Instead, he advocated the liquidation of the assets through a third party in order to avoid the liability risk even though liquidation would result in an even worse financial outcome with no chance for future gains. ***Is your board succumbing to irrational worries about liability? Should your corporate counsel make an appearance to give a realistic picture of reasonable versus low probability concerns? Does your board balance risk prudently but take action when it is warranted?***

7. Board member role confusion. Board members with operating experience in the company's domain may become over-involved and advance personal ideas without support from the rest of the board and without trying to generate consensus. This approach often leads to interpersonal conflict and accentuates board divisiveness. It is crucial in these situations that the board leader step forward in conjunction with the CEO and address the board member's over-stepping. ***Are your board members maintaining an appropriate boundary between board and operating roles?***

8. Leadership vacuum. A company may need to restructure its balance sheet, the composition of the senior management team, or both, but the board may lack a leader who will rise to the challenge. Consequently the entire board may conclude that chance no longer merits the effort. Before giving up, the board must draw on its experience in companies where new management was able to bring positive and restorative change and look beyond the short-term pain to the possible pay-off. The answer may be that the effort is truly not warranted, but the board must consider its duty to shareholders to weigh every option. ***Does the board have a clear leader who attends to board business, and draws out the best advice the board can offer?***

9. Loss of trust in the CEO. There are myriad ways a CEO and board can lose faith in one another; miscommunication, board meddling, and high-handed behavior by the CEO that ignores a board directive, are just a few. If the board loses trust in the CEO, the CEO may respond by becoming even less responsive. This sets up a cycle of phone calls, secret conferences and plotting. ***What are the trust issues playing out on your board? Given that active distrust is untenable, how can you move to put issues on the table for resolution?***

10. Resolution to fail. Sometimes, directors don't see a clear way to proceed, so they lose interest in new thinking and begin plotting an exit strategy to the exclusion of forging a viable path for the company. Board members may subconsciously resolve to see only negative consequences in any turnaround plan, in hopes of clearing the company off their list of concerns. ***Is your company actively weighing its options, or is the board deciding in advance that nothing will work?***

Managing The Board/CEO Relationship

The CEO is the company leader to the employees of the company, the public, customers, and shareholders. But as we have seen, behind the scenes the board exerts a great deal of control and collaboration with the CEO. Two aspects of the relationship are essential—the way that the CEO keeps the board informed, and the way that the VC board members mentor and support the CEO.

The pendulum now is swinging toward the CEO keeping the board more informed, and boards are engaging in a more hands-on, consultative style. As a benchmark, several VCs noted that the successful board meeting is the one with no surprises. If the CEO has not called and briefed the board prior to the meeting regarding expected difficult questions or issues, then he has not done his job. Advance knowledge allows more time for consideration and compromise, shortening the duration of the board meeting. Also, advance knowledge reduces the formal "airtime" for divisive discussions that would ultimately come to resolution anyway.

Several issues are perennial problems. For example, CEOs should alert board members about management disagreements over cash and stock option compensation in advance of board votes. This is important because these can be emotional or high stakes issues; board members need to talk to others and reflect on what to do, not jump to impulsive action. Customer pipeline issues and revenue milestones progress reports are also in a category requiring full briefing of a board in advance. Another classic issue is when a CEO suspects a key executive is going to quit or is not performing or going to make a deliverable. The tendency is for the CEO to hope and pray that the issue resolves without the board needing to hearing about it. This is a big mistake. A CEO who repeatedly delivers surprises in these areas whittles away the confidence of the board.

It's fair to ask how tight a rein a board should keep on a CEO. After all, it's only natural that a passionate entrepreneur with the moxie and drive to start a company and build it past an idea tends to see the company as his or her baby. No parent appreciates unsolicited advice from somebody who's not there every day. As we've discussed, however, the CEO has to realize that as soon as he or she seeks outside investors and a board of directors is formed, the CEO is accountable to the board.

Certain types of CEOs seem to have the most trouble with this. The first kind sees the company as a sole proprietorship, with the board and investors just incidental players who've only contributed money. In our experience, few companies with CEOs with this attitude succeed. Another problematic group are large company executives who have never worked with a board and don't see them as colleagues. Some CEOs are insecure and just not comfortable with close accountability. Promod Haque, Managing Partner of Norwest Venture Partners and also a former CEO, notes, "When I encounter a CEO who doesn't want involvement, I need to determine why. For example, is he extremely capable and doesn't need much guidance; or is he just afraid of it?"

The VC board member may be the only one who can develop the trust and has the credibility to mentor a CEO. This is especially important when the CEO is young or relatively inexperienced. Craig Johnson, chairman and co-founder of Venture Law Group (now Heller Ehrman Venture Law Group), shares a positive experience of mentoring a CEO. A senior, highly respected VC was involved with a company facing a lot of pressure for short-term strategic moves by anxious board members. The young and inexperienced CEO was tending to react to market pressures, rather than have the patience and faith in his product to wait until the company was ready to respond. The VC mentor helped him withstand the pressure and push to create a longer-term strategy. The mentor was able to support the CEO to resist the others' requests to move quickly, quietly but firmly making his case to the board to stick with their original plan.

Promod Haque gives another example of how CEO mentoring made a difference in a company:

> *"We funded a software company with a first-time CEO who had been a sales manager. Frequent communication with this CEO was critical, so we created a weekly half-hour call on Monday mornings, with the entire board. This lasted more than a year.*
>
> *This weekly call gave us a clear pulse on the company. The CEO was able to obtain feedback regarding what was emerging, and brainstorm on whatever issues he was facing. This also helped save the board members time. We didn't have to call him up separately. Instead, we had a place to provide him with resources and ideas, and we knew we would have a dialogue.*
>
> *Start-up companies need that sort of regular involvement. It reduces the burden on the CEO to keep up with the board. The members then don't have to call and take up CEO time individually. It uses them productively and in an orderly way."*

Board-Company Dynamics: Getting Past The CEO

A new venture cannot be structured as a traditional pyramid. By its very nature, it must be less hierarchical and more team-oriented. There are only a few employees, and they are usually of a high enough level of awareness and capability, that the board should be able to solicit input, discuss issues, and encourage participation throughout the company. Command and control structures do not allow the openness, innovation, flexibility, and quick response to change that a new venture must embody.

In the best companies, CEOs do not limit access to their teams. A board member should be free to contact employees and managers directly, and to visit the company. Directors should have opportunities to meet the functional heads of each area—to quiz them, look at their body language, and see how they work. It is hard for the board to assess "people issues" if the CEO has a problem allowing board access to the team, especially if the problem is the CEO. It is counter-productive CEO behavior to insist on being present at all board interactions with their team. Effective CEOs encourage board members to communicate directly with managers (provided of course that the CEO is informed that such conversations are taking place), both formally and informally. In many cases, VCs are instrumental in recruiting key executives, and they tend to keep in touch with these recruits. The CEO should know about contacts by a board member, and should be generally informed if issues arise.

One might think that these methods indicate a lack of trust in the CEO and the company, but prudent boards exercise oversight in this way. The key is for the board member to directly share the information he or she gathers with the CEO in order to check its validity and explore together its import. For example, in one company, the VCs developed relationships with some of the second tier of managers. In talking to several of them, they heard that the CEO had a tendency to hire consultants to do projects that were appropriately the domain of the executives, which undermined their authority and morale. They felt that they were constantly having their actions reworked by actions of the CEO. By learning this, the board member was able to gently push the CEO to make sure that he gave the proper authority to his staff. Like a good executive coach, the board mentor gathers information from 360 degrees around the CEO, in order to help the CEO better learn and grow.[2]

Boards frequently participate in hiring key executives. Board members commonly interview prospects to appraise their skills and make sure the company is not getting a crony or clone of the CEO. In addition, experience makes some VCs good judges of character, or of the necessary skills, which the CEO may not see as clearly.

2. In some instances, CEOs have been known to exact retribution upon those who share information with directors. Boards must view such actions as an assault upon the board, itself, and take appropriate steps to make sure the employee is not penalized for offering honest commentary.

Board Accountability To Shareholders: Conflicts Of Interest And Fiduciary Duty

"I have a test I use. Can I explain my decision as reasonable and fair to any shareholder group, not just my own." – Andy Rappaport, August Capital

The board is a complex entity, even in a start-up, as it represents several types and classes of shareholders with different rights and preferences. **Common shareholders** are company founders, executives and employees. They receive equity for their sweat over time and according to the board's assessment of their respective contributions to the success and growth of the enterprise. **Preferred shareholders**, as capital investors, structure their invested capital to protect themselves against adverse performance and to participate side by side with management in the upside above certain targeted return objectives.

How do VC board members represent the interests of these different owners in a fair and objective manner? Frankly, this is an inescapable source of tension and conflict on the venture board. This led to some of the following observations, some of which are quite controversial.

The largest active shareholders and those who elect the board are in fact the same people. Therefore, the VC board member is less compelled to listen to the voice of other shareholders than his publicly traded company counterpart, but the VC board member is a fiduciary with the obligation to consider these different constituencies, even when those constituencies include secured lenders that have legal preferences superior to those of the most senior preferred shareholders. While they represent these constituents in a larger sense, VCs don't feel they have to continually talk to them, call them, or keep them informed.

This view by VCs – who consider it the CEO's job to speak with those groups -- is controversial, especially from the perspective of other shareholders. The authors believe that it is, indeed, the CEO's job, supported by the general counsel to the company, to keep these constituencies informed. VC board members should always make themselves available for a group phone call or, in rare cases, calls with non-professional individual investors. The reality is, however, that the best VCs are well known to bankers and other investors for their exercise of fiduciary duty and for their general business judgment. Successful ventures require bold leadership and decisive actions must be taken by the lead investors that they judge to be in the best interest of the enterprise. It is a fact of life that not all investors are created equally, and the investors that do the most work, have the most money at risk, and have the best track records will continue to drive the venture company's agenda. Attempts to "level the playing field" in the name of good corporate governance are surely inapplicable to venture capital.

Brooks Stough, a partner with law firm Gunderson Dettmer, stresses that the company must achieve a balance between informing investors and keeping proprietary information confidential. One of the competitive advantages of a private company is operating in "stealth mode". Investors generally have clear contractual and legal rights to information. However, he recommends that "a company should be cautious about providing sensitive information to a large number of investors, because it may be disclosed to other people who the company might not want to receive it. For this reason, fewer investors and informal lines of communication are often better for a start-up company." He notes that angel and small investors are usually associated with a VC or company founder, and he suggests that these people be kept informed informally by the person who introduced them to the company.

In a successful venture, investors achieve a win/win perspective that fairly balances the interests of all stakeholders, rather than having one set of investors fight against others to secure its own position on top of the pile. In the current environment, having invested early capital in a company has proven to be a liability and not an asset because of dilutive follow-on financings. So typically, the newest VC money to invest in the company may attempt to fully exploit their position of strength by severely diluting both management and their prior venture co-investors. Common stockholders and the friends and family of management, may be effectively wiped out in this scenario. We view this approach as extremely shortsighted and guaranteed to create deep patterns of divisiveness and ill will at the board level. We believe boards must find win/win scenarios for divergent interest groups. Pascal Levensohn in particular notes, "When we invest in a company with this profile, everyone has to take some pain together, and we have to be comfortable investing at a valuation that is reasonable, but not the absolute lowest price possible, in order to maintain the positive bond between investors that is required to create a harmonious working board relationship. As a result, we have to walk away from some potentially attractive investments because we can't overcome the gap between entrenched divergent groups to forge a win/win solution going forward."

Another common source of misaligned boards comes from different levels of risk tolerance and patience. Craig Johnson recalls a company where the lead investor was anxious, and the company had the opportunity to cash out the investors who would get a bit more than their money back. The company had long-term capability, good leadership and potential, yet the VC did not allow it to take the risk.

Johnson sees many difficulties arising from shifts in valuation at different stages of development, particularly when those figures decline. "There is pressure if you are a first investor to stay in at later rounds, even if your interest in the company has waned. This means that founders—both CEOs and VCs—must have more of a long-term outlook and commitment, and a willingness to conserve cash to avoid more rounds of financing. The VC has to stick with the company longer. And the founder, with less opportunity for a huge windfall, has to really love the company."

Director conflicts of interest that can lead to litigation may arise as a result of a new financing round. For example, a VC director may be independent from a general governance perspective but become conflicted when his VC firm may want to lead and define the terms of the next financing. Steve Bochner notes, "This is where independent directors come into play, not only looking out for the interests of all shareholders, but helping to insulate the conflicted directors from liability." Concerns regarding VC board member liability have been fueled by a well-known case involving networking equipment maker Alantec, where the founders sued their venture backers over issues relating to the dilution of their equity ownership in an insider-led, "wash-out" round of financing.

Tracy Lefteroff, Global Managing Partner, Private Equity and Venture Capital, at PricewaterhouseCoopers, sees little protection in the current system for common stockholders, who often include early founders who have made an important contribution to the company's early success but who have moved on to another project. There is no place for them at the table in follow on financings, so they get their shares devalued. They are supposed to be represented by the CEO, but in effect they are not. This is a difficult problem to resolve. One alternative Lefteroff suggests would be for the common shareholders to be allowed to participate in new financings under the same terms and conditions as the VCs through a Rights Offering, so that they could at least maintain their pro rata ownership in the company. VCs and board leaders must exhibit statesmanship and leadership even when it is not in their narrow self-interest. Lefteroff feels that too many board members do not appreciate their fiduciary duties and do not act in the best interests of the entire enterprise.

Andy Rappaport adds, "Our role as VCs is to grow some companies to greatness. If we are about to lose some money on an investment we still want the people who are talented and may be available for another venture, to feel that the outcome was fair. In one example I gave 10% of the money that we received as preferred shareholders in selling the company to management, who had done a great job. Their own stock was basically worthless. I see that as enlightened self-interest."

The most effective leverage for fairness among all the parties is the continuing role of the VC in the wider community. The VC community remains small and will contract even more over the next several years as the downturn in venture capital continues and weaker funds collapse. VCs today are more sensitive about working together and are becoming more aware of conflicts of interest, fiduciary obligations, and the need to craft win/win outcomes for their companies. Second in importance only to the integrity of a venture company's product or service is the integrity of its board. The challenge of creating an effective board is substantial, as the board is not only the conscience of the CEO and the arbiter for disagreements among different factions, it is the difference between success and failure for many emerging companies.

CONCLUSIONS & RECOMMENDATIONS

The premise of this white paper is that no story of how a start-up makes it – or doesn't – is complete without considering the role of the venture board. There are specific factors that create synergy between board and company and there are best practices that have evolved in the experience of thought leaders in the VC arena. Their perspective more fully articulates the start-up venture as a community comprised of several stakeholder groups including the board, CEO, management team and other investors, who must collaborate on the basis of personal trust and good governance processes. All parties must interact effectively to create a complete and successful company.

The best way to put these new perspectives to use is through the processes of board self-awareness and self-assessment. Specifically, we suggest that a venture board can undertake the following activities:

- Develop board self-assessment and performance evaluation. A CEO and other managers must be accountable in terms of performance. Often the board initiates and conducts these appraisals. But the board should not be immune to this process. Periodically, boards must assess not only the company, but also how well they are performing as a collaborative team. As criteria, the board can use the qualities and areas that we have highlighted in this working paper. The board should look at itself both as a whole and in terms of the performance of each individual.
- Create an open, information sharing system. In a crisis, the first casualty is clear information about what is happening. In better times, there are warning signs of challenges on the horizon. The various governance elements each have some unique capabilities to spot these challenges, but only if the whole organization is organized to share information. The CEO and the management team must trust and feel comfortable with the VCs and board members, so they can share not fully-formed conclusions, but their questions and concerns. While each part of the venture has its own responsibilities, boundaries between groups should be open for information exchange, even as the integrity of each group to make certain kinds of decisions is respected. At every point, the board must enforce the open exchange of information and ideas in the enterprise.
- Face emotional dynamics as they arise. Tensions will arise in relation to trust between the board and the CEO or management team, or within the board. Usually these stresses appear clearly to everyone. But too often the tendency is to avoid the issue. The path to resolution goes through direct confrontation, not indirect resolution.

- **Hold a board retreat**. One tool that is quite familiar in the organization, but less familiar to a typical board, is the retreat. The most successful retreats retain an outside facilitator or consultant whose role is not to be an expert or content provider, but to assist the board (often joined by key executives at certain points) and the CEO deal with the critical issues. The retreat is somewhat different from a normal board meeting in that it usually lasts longer (a day or more), and takes place at a crucial juncture in the development of the business. Successful retreats require preparation and commitment to drive to resolution, evidenced by an outcome like a strategic plan or strategic choice. All must assume each participant is open to new ideas, and arrives without a personal agenda.

Boards and companies can use other paths to ensure that they function effectively. They can build on the personal resources that they add to their valuable financial and technical contributions. This discussion expands the understanding of these many resources to help more companies grow to achieve their potential.

BIOGRAPHIES OF CONTRIBUTORS

STEVE BOCHNER, ***Partner at Wilson Sonsini Goodrich & Rosati,*** has practiced corporate and securities technology law for more than 20 years. He is a member of the NASDAQ Listing and Hearing Review Council where he has been heavily involved in the development of NASDAQ's corporate governance reform. www.wsgr.com

RICK FEZELL, ***Office Managing Partner of Ernst & Young LLP*** in San Jose, California and is the Leader of its Emerging & Growth Markets practice in the Pacific North West. He has provided assurance and advisory services for over 18 years to technology and life sciences clients and several early stage venture-backed companies. www.ey.com

PROMOD HAQUE, ***Managing Partner of Norwest Venture Partners***, focuses on enterprise software and communications investments. Prior to Norwest, Haque spent 18 years in various technology company operational roles. www.norwestvp.com

DENNIS JAFFE, ***Professor of Saybrook Graduate School in San Francisco***, is a world-recognized leader in management and organizational change. As a visionary for programs in corporate governance, executive development, mastering change, career building, and succession planning, he has helped companies all over the world realize the potential of their work-force. He has also co-authored several books on organizational change. www.saybrook.edu

CRAIG JOHNSON, Of ***Counsel at the Heller Ehrman law firm***, represents technology emerging growth companies. He is a co-founder of Heller Ehrman's Venture Law Group. Johnson has been involved with technology companies for decades. www.hewm.com

STEVE LARSEN, ***former CEO of Big Fix,*** and former venture partner with St. Paul Ventures, has been both a CEO and venture capitalist. Larsen, a 20-year-technology-industry veteran, has impressive management experience, playing key roles in marketing and business development and sales. www.bigfix.com

TRACY LEFTEROFF, *Global Managing Partner, Private Equity and Venture Capital, of PricewaterhouseCoopers*, is in charge of services to publicly held, privately owned and venture capital-funded life sciences companies worldwide. Mr. Lefteroff has been significantly involved with services provided to a number of the firm's life sciences companies and venture capital firms for 14 years. www.pwcglobal.com

PASCAL LEVENSOHN, *Founder and Managing Director of Levensohn Venture Partners,* has been a professional investor for more than 20 years and has worked actively with private and public companies at the board level since 1990. He has published two articles on corporate governance since 1999. www.levp.com

ANDY RAPPAPORT, *General Partner of August Capital,* has more than 15 years experience as a founder, investor and/or director of venture-backed startups. He has served on more than 30 public and private company boards. www.augustcap. com

RUSS SIEGELMAN, *Partner, Kleiner Perkins Caulfield & Byers*, joined KPCB after 7 years at Microsoft. Mr. Siegelman invests in software, electronic commerce, Web services, media and telecommunications. www.kpcb.com

BROOKS STOUGH, *Founding Partner of Gunderson Dettmer*. His legal practice focuses on the organization and representation of startup and emerging growth companies with an emphasis on technology companies. www.gdsvfh.com