Article

Setting Up and Working with a Board of Directors: A Guide for Startups

James F. Jordan
Sr. Director, Healthcare & Biotechnology Programs, Distinguished Service Professor in Healthcare & Biotechnology Management, Carnegie Mellon University

ABSTRACT

Commercializing the idea behind the next big thing is only the first step on a long road to success for a company founder. Facing a myriad of regulatory obstacles, funding challenges, and other seemingly insurmountable roadblocks, every startup needs the support and guidance of an experienced board of directors. A board of directors' most important function is to provide a continuous give-and-take discussion with management regarding strategy, funding, and governance while representing the shareholders and stakeholders.

Journal of Commercial Biotechnology (2019) 24(4), 86–90. doi: 10.5912/jcb921

INTRODUCTION

While the board of directors represents the shareholders and stakeholders, it is the President and the management team that do the actual work. Management at every step of the development process is making critical decisions, the board of directors is one step removed from the actual 'how's' of the day-to-day work. As they also represent the shareholders, they can offer a fresh "set of eyes" to possibilities and challenges. It is the communication loop between management and the board of directors that result in the best choices. It would be incorrect to assume that startups don't need a board of directors, or that they are only useful at the later stages of financing and scaling-up. Startup founders often are too eager to plow full-speed ahead into development and production, and in turn sacrifice the objectivity and wisdom that a strong governing body provides.

The bottom line is this: Better boards make better companies. For the sake of unity and organization, a board of directors, even one comprised of only a handful of founders and investors, is essential for success and growth. Understanding what boards do, where their loyalties lie, and how they are comprised is the first step toward ensuring your company is governed responsibly.

Contrary to popular belief, there is more to a board than just deciding where the money goes and who gets hired or fired. Boards of directors are comprised of legal, financial, and corporate experts who make crucial decisions that steer the company forward in all areas. Put in place by shareholders, they are the cornerstone and bedrock of every organization that provides not only guidance but have fiduciary responsibility. If there is disunity in a board of directors, then the entire company can stumble, jeopardizing its growth and ultimate success. Because of the strategic importance, it is vital that founders dedicate the necessary attention and care to developing a healthy and functional board of directors.

The following is an overview of the role, importance, responsibilities, and risks of boards of directors.

OVERVIEW OF PRIORITIES AND RESPONSIBILITIES

Startups by their very nature are smaller organizations, and to be successful, they must borrow brand reputation from a network of partners and attract leadership to grow, reduce risk, and prosper.

Therefore, their broad relationships and domain experience are a vital tool to impact growth and profitability. If we look at the Due Diligence Social Network (see Figure 1), we can see how the Board of Directors is a key part of the extended Management Team. And finding those Board Members who can help positively influence or have a keen understanding of and network connections to, other parts of the 'Social Network' is critical.

Board members frequently assist the President in acquiring other C-suite executives, vendor networks, and funding sources. Often the President, and sometimes the Chief Financial Officer, serves a dual role as day-to-day management and board members. Although they may have their own roles and priorities within the company where they technically serve under the board as a whole, they also serve on it. The difference is that while these individual officers govern the company's

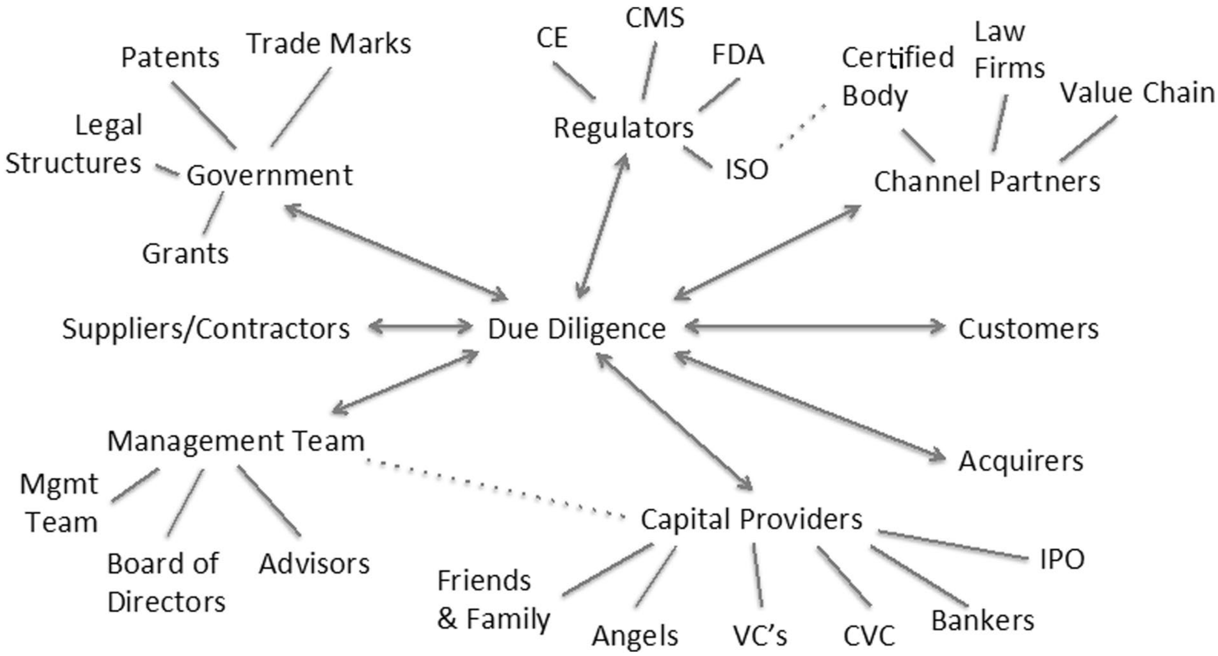

Figure 1:

day-to-day responsibilities and actions, their board priorities are strategy, funding and governance. Obviously, these responsibilities overlap.

Because board members have varied backgrounds and expertise, they are often responsible for different functions. Each member has separate skill sets and may sit on different subcommittees, such as audit or compensation, to use their expertise to set guidelines in specific areas to which the company at large must adhere. Together, each individual board member has their voice heard and works to ensure that the company is operating in a unified fashion. When a coherent board of directors is at the helm, each separate part moves as one.

In terms of governance, a board of directors oversees policies such as signing authority, determining and implementing a budget, and other matters of compensation. Much of a board's function hinges on finances, as many members of the board may be investors from the various rounds of funding the company has undergone. Boards will grow with their companies, and in turn their activities will grow in intricacy. The board is responsible for keeping the company financed through loans, devising an employee stock ownership plan (ESOP), which allows employees to buy stock in the company, and breaking down the shareholders' equity through a capitalization table.

As the chief governing body within a company, a board resolves matters of networking, partnerships, funding and hiring/firing senior management. When the opportunity arises for founders and other board members to cash in on investments, or if the company has been unable to make a profit (though many other factors can trigger this), the board makes the key decision to pursue an exit strategy—the contingency plan for liquidating assets, whether it be in the form of an acquisition, merger, or IPO.

Though a board of directors exists to make tangible decisions that impact a company's growth and profitability, it is also a network of mentors and experts who can provide guidance and support for a company's leadership every step of the way. This is especially valuable for startups that may not have extensive business experience or expertise.

COMPOSITION OF BOARDS

A startup company, particularly, is a complex organization. As it is frequently not self-funded by its management or founders, the company must attract investors. As investors are interested in knowing how they are going to get a return on their investment, referred to as an exit, they want to know how the company is going to get them their money back along with an expected return on investment (ROI). Will this event occur due to an IPO or an acquisition by another company? Commercializing a product to serve a customer (and return a profit) is the means by which this relationship is complete. Because of this, the board of directors is very focused on balancing customer, with investor, with acquirer needs. Meanwhile, the individuals in the company below the c-suite may be focused on the activities associated with commercialization.

Hungarian author and playwright Frigyes Karinthy introduced the concept of Six Degrees of Separation in his 1929 short story *Chains*.[1] The concept is that everyone and everything are six or fewer steps away from another person in the world via an introduction from any other person. The implications of this concept are important to the startup. Acquirers like to acquire from people they trust, and funders like to fund people they know. As the startup considers the people they are going to involve in their company, they should consider the relationships of these individuals to the customer, the acquirers and the funders. No company could function in a healthy manner without an organized foundation of balancing the customer, investor, and acquirer. A board can provide this network and stability.

A board of directors will look different depending on the stage of the company. Having an odd number of members is generally preferable to prevent ties when important votes take place. Founders who have only been in their industries for a short time will need the insight of seasoned experts to keep their heads above water. In most cases, startups will initially have a board of three, with one seat belonging to an investor. As the company grows, seats on the board of directors will be given to whoever is leading the current round. It is quite common for an independent board director to be brought in after the 2nd and 3rd rounds.

If a board begins to grow too rapidly, issues with scheduling and compensation may arise. Once the board becomes crowded, it is time to transfer the focus to recruiting "observers." Observers can be valuable for their additional knowledge, allowing for more participation without adding more voting power. However, board observers do not have the same fiduciary duties as other board members, and startups should exercise caution when allowing observers on at the risk of overwhelming a board. Setting guidelines outlining the terms for observer participation is highly recommended.

Another strategy to gain important input is to establish a Board of Advisors. The Board of Advisors is typically comprised of individual experts involved in the company's market segment(s), e. g. physicians, and can be established either formally or informally. It can be helpful in the eyes of funders, acquirers and customers to establish a formal structure. By having a more formal structure, it allows the management board and Board of Directors to have more 'market research' discussions. If established informally, it is used primarily as a sales process tool that can provide personal advocates for the company's products or services and accelerate product adoption. Just as LinkedIn creates a like-minded network, the informal advisory board establishes a network for expanding sales. Whichever the company chooses, an informal or formal Board of Advisors, it should be done with intention so information can be used appropriately.

A board that is disproportionately large for its current stage will have trouble reaching unified conclusions and decisions and runs the risk of alienating certain members. Inversely, boards that remain too small and insular won't have the ability to reach the right networks or have a suitable amount of outside insight to make unbiased decisions. Both of these situations are inadvisable and add the potential danger of an executive or executive committee that wields too much power, which can then lead to conflicts of interest. The makeup of a board of directors is directly proportionate to the company's success and how effectively they can address the mercurial landscape of a startup to a successful exit.

GOALS AND LOYALTIES

A board of directors has several duties of equal importance. It is a common misconception that the board's members care foremost about protecting their investments—they are held accountable for their actions by other members of the board; every member stands to gain and lose from their investments and time. All board members are fiduciaries who have duties to act responsibly and in the organization's best interests. The long-term goal of all fiduciaries on the board is to achieve the greatest value possible for the company and all its stockholders.

To ensure that no particular director acts irresponsibly or in their own interests, certain safeguards and responsibilities are in place to hold them accountable—the duty of care and duty of loyalty. If board members do not act according to these duties, they can be removed or face legal action, which would be highly disruptive for the other directors and the company at large.

The duty of loyalty is simple: It outlines where board members' interests should be—in the company, and not in themselves. Conflicts of interest and self-dealing transactions breach the duty of loyalty. When such conflicts arise, the board member in question must disclose it to the other directors and recuse themselves from the particular transaction in question, as they are unable to act in an unbiased and fair manner. In addition to the duty to avoid conflicts of interest, the duty of care outlines that board members have an obligation to stay informed about the company and the actions of the board. Members must make decisions using relevant facts and dedicate their full attention to the activities and discussions of the board when present.

Though not the day-to-day decision makers, board members are responsible for outlining the overall mission and priorities of the company and holding others accountable to ensure they act in accordance with these priorities. While these duties are vital for every organization, startups should exercise special care and devote attention to ensuring board members truly have the company's best interests at heart. To overcome all the hurdles of acquiring funding and working toward a profitable exit, the duties of a startup's board of directors must be strictly enforced, or they risk losing the investment and trust of all stockholders.

BOARD MEETINGS

As with board size, the frequency and run time of board meetings will depend on the stage of the company and the funding acquired. Startup companies in the seed or pre-seed rounds generally would meet once every month for 60 to 90 minutes. The early stages of funding will lead to longer meetings every quarter, lasting three hours or longer. Regardless of the funding round, executive sessions are valuable, and should be incorporated into every meeting. An executive session is a closed discussion of all board members except those members who are management such as the President and CFO. The executive session may include invited guests such as such as external auditors. As it is the board's job is to manage the CEO performance, these sessions generally occur at the end of a board meeting, or separate from a board meeting. They are intended to be a safe place where any member of the board can discuss and calibrate on matters of success and areas of improvement for management. Although not always practical due to the tight timelines associated with board meetings, it is also good practice for the chairman of the board to provide both positive and negative feedback to the President after the meeting. Any board member has the power to request a meeting for any concern, and the other members should honor those requests.

Board meetings function as the crucial space for directors to hold each other accountable and strategize as a unified group. Some bylaws may require an agenda to be set before a meeting takes place or minutes to be taken, though not always. Having structured and organized meetings, however, allows for the most productive discussions. Board meetings present the best forum for the most vital debates, decisions, and conversations that impact the company.

Though a board meeting is the best place to share critical data, structuring your meeting like a lecture tends to keep engagement low. The most productive board meetings promote spirited debate and creative brainstorming. Among other things, effective board meetings feature transparent objectives, detailed presentations, and a clear company story. With conflicting views on the best path forward for the company, compromise and problem solving are key components of many board meetings.

COMPENSATION AND COMMON ISSUES

Compensation varies by stage, as well as the type of board member in question. Directors who represent their own funds generally do not receive any compensation from the board, though all are reimbursed for expenses that arise from travel. Other board members may receive compensation, but it should be standardized across all members and explicitly documented as part of standard policy and procedures. Independent board directors also typically receive compensation for their place on the board, usually in the form of equity. At the early stages of the company, independent directors will usually receive .5 to 2 percent equity, which will reduce over time as risk wanes.

Board directors have an interest in protecting their investments, should the company not reach the desired exit. They also face a certain amount of risk. Indemnification and D&O insurance provide members with protection from some liability and exposure. These policies typically cover damages up to $1 million per board member.

Common points of contention for boards of directors include: board members disagreeing, investors wanting to become observers, and the board wanting to remove a member. Issues of removing board members are not uncommon. In a survey by PwC, 45% of directors felt that at least one member needed to be removed from the board[2]. In addition, it is not unusual for boards to vote to remove founders. As boards grow, they increase in complexity, which requires more experience to manage. If founders want to maintain a role in the company in the future, they should conceptualize from the early stages what that role would entail.

CONCLUSION

The greatest benefit of having an experienced, supportive board of directors is the expertise of each member, all of whom having achieved success in their respective fields. Seasoned CEOs with entrepreneurial expertise, professionals with capital-raising experience, venture capitalists, and experienced board members from the industry are all good candidates to incorporate into a board of directors. Startups are in the unique position to benefit from the expertise of board members, as they can also serve as mentors for founders who simply do not share the same level of experience.

Peter Drucker once said, "The ability to make good decisions regarding people represents one of the last reliable sources of competitive advantage since very few organizations are very good at it." If there is one lesson to take away from this, it is that the board of directors is the central nervous system of the organization. Our central nervous system controls our mind and body and alerts us to problem and keeps us in balance. With the founders as the brains and employees as the heart and soul of any organization, all parts are valuable and must work together. Just as with our body—each organ must function for the whole to be healthy. Therefore, each board member must function effectively together and individually if the company hopes to stay on track for success. The best competitive edge will not be from your product, but from the people at the heart of the company, defining and enacting its vision.

REFERENCES

1. Karinthy, Frigyes, "Everything is Different, Chains" (Láncezemek), 1929
2. PwC 2018 Annual Corporate Directors Survey, October 2018