STARTUP BOARDS

Every company has a board of directors — but few founders and entrepreneurs give the matter of board composition much thought.

Start-ups that are backed by professional financial investors almost always have a Board of Directors that consists of some set of founders, investors and sometimes independent directors.

While the management of a startup company deals with the day-to-day decision-making within the company (strategy, budgets, goals, tasks, compensation) ultimately the Board of Directors has the legal governing responsibilities for these things. This is often called "corporate governance" — in case you've never heard that term.

Investor Governance

- Fund Raising, M&A, debt
- Scope and structure of Business
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Board of Directors

- Annual Budget, quarterly financial reviews
- Strategy, assessing performance, executive team efficiency
- Fund raising, M&A, audit, executive compensation
- Exec team hiring/firing

Executive Management

- Strategy, monthly budget, hiring / firing, financial results
- Sales, marketing, pricing, product, support, HR, finance

It is worth pointing out that there are actually three levels of governance in venture-backed startups. What most founders think about is the daily management of their businesses and they realize that they periodically need to check in with their board of directors to get buy in for key decisions.

But there is ultimately another level of governance I might call "investor governance" in that once a board of directors has decided on an action there are times where the company still needs "shareholder consent" in order to achieve their objectives. This is often true when the action of the board could dramatically affect shareholders such as raising new capital, acquiring new businesses (that drain existing cash or dilute shareholders), selling the company or raising a lot of debt. You will often find these governing conditions in the "protective provisions" section of your company's legal documents.

These are truly protective even though sometimes founders find them to be an unwelcome level of approval required. Without these protections there is little to stop a board, for example, from issuing new cheap stock that dilutes all of the shareholders so that certain individuals could take control of the company. Equally

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without protective provisions a board could vote to load the company with a ton of debt that can't be repaid and thus diminishes the value for shareholders. Equally it could vote to increase the stock option plan to 99% of the company. These are edge cases that would be fought in court regardless but they speak to why protective provisions exist in the first place.

If you're going to be effective as a founder you need to understand what rights and expectations you have in daily decision-making, what issues are relevant for a board to decide and what your limitations are in your legal governing documents and what votes are required to achieve big changes.

What exactly is the purpose of a Board of Directors and how do boards best function?

Roles:

- **The role of management** is to run the day-to-day business and make key decisions within the framework agreed between management and the board.

- **The role of a board** is to agree an annual operating plan (budget) and strategy and to periodically (usually quarterly) review progress and make adjustments when necessary. The board's job is also to confirm the financial results (audit), to manage the compensation of key executives including the CEO. Finally, the boards job is to vote on key considerations including budgets, financings, legal issues and on rare occasion — hiring & firing the CEO.

In many cases management teams confuse the roles and responsibilities. At times this means management teams brining issues that a board isn't required to weigh in on and thus subjecting everybody to meaningless debate and unnecessary arguments when a certain board member disagrees with a decision that could be handled by management all along.

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At other times boards try to micro-manage details that should be left to management teams and therefore offer "helicopter advice" without having to actually own the results or knowing the daily idiosyncrasies. Don't confuse "advice from a board member" with a "board matter."

The basic important points need to know about startup Boards:

Do I have to have a board of directors?

Yes. Every company is required by law to have a board of directors. The board doesn't need to be elaborate, or even more than one person, but every company must have a board in place.

When do I need to start a board?

A board must be put in place when you start a company. Interestingly, it is ok for the company to have only one board member, and it may be you. You must have a board to handle corporate matters like issuing stock, setting up a stock option plan, authorizing a fundraising or getting loans. In most startups, the founder will typically appoint himself or herself to the board. From there, others get added to the board as the company grows.

What should I do when starting a board?

To create a board, you should hire a lawyer experienced in board setup. There are many other factors to consider, so we've included other resources at the end of this article.

Who else is on the board and why does it matter?

The board will ultimately be responsible for making the critical decisions for the company, like whether to raise money, whether to be acquired, whether to enter into important strategic transactions and whether to hire or fire senior management. So make no mistake — who sits on the board is critical. It's important to ensure these major decisions are made by smart people who are knowledgeable about the company and the industry in which it operates.

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While the composition of the board can and likely will evolve over time, and certainly will vary from company to company, standard approaches for startups do exist, depending on the stage of the company.

While it isn't necessary, many companies choose to have an odd number of directors. This reduces the risk of a tie vote, which equals a "no" vote in the board room.

After your initial seed round, you'll usually have to allocate a board seat to the firm or person who led that seed round. To ensure that the founding team still remains in control of the board, a fairly typical setup at this stage would be for the common stockholders (i.e. the founders) to retain two board seats and your new investor to have one seat.

It is common to allocate a new board seat for the lead investor for each new round of investment. Keep in mind that when you accept an investor, you also typically will be bringing on a new board member. Some investors will attach a board seat to their terms of investment. If you do not want a certain person on your board, you may have to turn down that person's investment. If you need the money, welcome your new board member.

After the second round of financing, it is fairly common to also designate one seat as an "independent" seat. This person is typically not an investor or a founder or an employee of the company, but should have industry knowledge and valuable contacts. By appointing an independent after the second round, the composition of the board would be the two founders, the two investors and the independent. Hence, the independent potentially serves another important role — tiebreaker.

While each "series" of investors typically get to appoint a board member, it's important to know that the representative of that series represents all investors — not just that series.

At some point, if the board is getting too big or if the investment size doesn't merit a board seat, instead of giving out more board seats, the company might allow investors to act as "observers." That is, they can come to and participate in the board meetings, but they do not get a formal vote. Sometimes the later investors become the observers, and sometimes earlier investors will become observers. (More about observers later.)

What does a board do?

The board is responsible for the overall direction of the company and for making major decisions, such as hiring and firing senior management, approving a budget and keeping the company financed through equity investments and debt financing. Key hires will need to be approved by the board, along with salary and other compensation, like stock. This last one includes your salary as CEO.

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Finally, board members provide connections with other helpful companies, individuals and resources, as well as offer overall advice and guidance.

I don't understand where the loyalties of board members lie.

Board members are "fiduciaries" because they are entrusted with managing the business that is owned by different people — stockholders. Hence, they have what are called "fiduciary duties" to the company's stockholders. In short, fiduciary duties are the obligations that the board has to act responsibly and in the best interests of stockholders. It's a common misconception that the official role of board members is to protect the value of their own or their firm's investment. In fact, the fiduciary duty of board members is to maximize value for all stockholders.

The board can get sued by stockholders if board members do not satisfy their fiduciary duties, resulting in time-consuming and expensive litigation, potentially major damages and otherwise disturbing the business. To comply with fiduciary obligations, directors must satisfy what is called the duty of care and the duty of loyalty.

The duty of loyalty states that the director must act in the best interests of the company and stockholders and not in his or her own self interests.

The duty of care says that directors must be informed about what is going on and make decisions armed with the relevant facts. In other words, pay attention and don't just show up for the quarterly meetings and do the crossword puzzle. Keep involved between meetings and stay abreast of what is going on with the company. The duty of loyalty states that the director must act in the best interests of the company and stockholders and not in his or her own self interests. If the director has a conflict of interest — for example, the company wants to sign a major contract with another company owned by one of its directors — the conflict must be disclosed to the other board members and the conflicted board member should recuse him/herself from the discussion and approval process.

How often do boards meet?

How often a board meets depends on the stage of the company, the needs of management and other factors. It is fairly typical for startup boards to meet in person once a quarter, toward the beginning of the quarter to review the prior quarter's results. Early-stage companies might also hold more frequent informal board meetings, either in person or by phone. The more frequent, informal board meeting can be beneficial because the strategy at early-stage startups changes more often (such as the pivot Zeel undertook in fall 2012, culminating in a new launch in April 2013).

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During particularly intense times, such as crisis situations or when the company is being acquired or is acquiring another company, the board can meet much more frequently, possibly every day or multiple times per day.

A typical, regular quarterly board meeting lasts about three hours, but some go much longer.

Problems and issues:

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My board is trying to get rid of me!

As companies grow, it is fairly common for founding CEOs to move to different roles — or even get fired from the company. In such a case, the founder may find himself or herself removed from the board of the company he or she founded if that founder does not control the common stock vote. In such a case, the founder may find he or she does not have a voice in the direction of the company.

When creating a board, assuming that you want to remain involved, try creating a permanent role for the founder separate from the CEO. That way, even if you, as the founding CEO, are removed from your position as CEO, you can remain on the board. This position is often a hotly contested point in a financing.

My board members disagree

Board members should work cooperatively and have vigorous discussions prior to any vote. Ideally, however, consensus will be reached before any vote.

If you have a board where votes are frequently divided and contentious, then ultimately you have a serious problem at the company itself.

That said, the issue may sit with one particular board member, in which case you should address that member's issues separately, and not as part of a group meeting.

Some of my investors want to be observers. Do I let them into board meetings?

Often angels or other investors have invested a substantial amount, but not enough to merit a board seat. If these investors are nonetheless demanding a board seat, or otherwise to attend board meetings, you might want to compromise and make them board observers.

True to their name, observers attend board meetings but do not have a formal board vote. There are other major differences between observers and board members — for example, directors are bound by confidentiality requirements and have fiduciary duties and are covered by attorney/client privilege, while observers are not. So make sure you have counsel involved to put the proper agreements in place for observers in order to protect the company properly.

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