Director's Guidebook

How to be an Effective Board Director in Early Stage Companies

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Director's Guidebook: How to be an Effective Board Director in Early Stage Companies

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This eBook is brought to you by the founders of **Seraf.** Seraf is a web-based portfolio management tool for investors in early stage companies. Seraf's intuitive dashboard gives angel investors the power to organize all of their angel activities in one online workspace. With Seraf, investors can see the combined value of their holdings, monitor company progress, analyze key performance metrics, track tax issues, store investment documents in a cloud-based digital locker, and more. Seraf's easy interface enables investors to track their angel portfolios as efficiently as they track their public investments. To learn more, visit **Seraf-Investor.com**.

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Preface

Hambleton Lord &
Christopher Mirabile
CO-FOUNDERS

Angel investing, as a form of early stage company financing, has been around for centuries. Within the past two decades, more formal angel groups began to take shape, and the angel group ecosystem established itself as an important source of capital for startup companies around the world. Through organizations such as the Angel Capital Association, a number of best practices were established to help angel groups form, evaluate deals and make investments. Entrepreneurs are eager to take advantage of the growing access to angels and their financial capital.

Over the past few years, there is much talk about the importance of investing both financial and human capital into the rapidly expanding entrepreneurial ecosystem. From our vantage point running Launchpad Venture Group, human capital is as important as financial capital in driving the long term success of startup companies. So how do we go about the job of applying human capital to foster this success?

Often when angels come together in groups and join their forces in a deal, they will ask for and receive board representation and this director becomes a key element of the human capital equation. The director serves not only in a governance role, but also as a coach, mentor, cheerleader, investor relations liaison, fund-raiser and head-hunter. It is an extremely important role in those early years.

The purpose of this book is to outline a set of behaviors which have been tried and tested, and which allow investors to be more effective if they choose to take on the responsibility of becoming a startup company board member. You will find discussions on how a director can add value, how to communicate with the CEO, and how to run a great board meeting. The contents of this book do not represent legal duties on the part of early stage directors. In many cases, the approaches suggested go far beyond what is required of directors by law. Instead, these approaches are ways in which involved directors serving early stage companies add business value by helping to improve CEO effectiveness, drive company performance, and increase shareholder value in these nascent undertakings.

Angel investors are most active with early stage companies, but early stage companies can range anywhere from two people with an idea to a revenue generating business that is growing rapidly. The director's role needs to evolve as a company goes through this evolution. You can think of a director's role changing in the following ways:

- **Pre-revenue and super-early stage** …. This is the Mentor phase of the board. In general, these are very fragile companies, so you are trying to help with traction on meaningful business activities. This phase is all about determining if there is a real business within the founding team's concept.
- **At market entry** …. This is the Metronome phase of the board where it is important to set the interval for achievement (1mo, 2mo) and measure what happened during that interval. The board should be looking for patterns in the company's results from doing lots of small trials. And, can the company set goals and then hit those goals?
- **After market entry** …. This is the Feet-to-the-Fire stage. The company should be acting like a venture-backed business. The company is working towards creating a repeatable business model and building a team that can execute on this model. The board moves to a more formal relationship evaluating, governing and focusing toward possible exits.

This book covers multiple topics which focus on the "after market entry" stage of building a company. A board with a formal relationship to management is more appropriate with later stage companies. In the early days of a company, your role will feel more like a traditional mentoring role. That said, there are many useful director concepts in this book that can be applied in the first two stages of a company.

Many people have written articles and books on early stage company board practices. In this book we gathered in one place some great advice from both our personal experience of sitting on company boards and from some very successful VCs, angels, and advisors, including: Jean Hammond, David Hornik, Ed Sim, Mark Suster, Will Herman, Brad Feld, James Geshwiler, Peter Rosenblum, Dave Berkus, Dennis Krause and many of our Launchpad colleagues.

Spade Work: How Early Stage Board Directors Add Value

Active board members can be a tremendous resource to a busy CEO and the management team. Understanding the boundaries where board members are able to help vs. harm a company is an important first step in any new board member's education.

Attributes of Great Board Members

- Temperament – calm and experienced, good perspective
- Independent thinker – question and pushback
- Proactive – involved by initiating regular interaction with CEO
- Committed – willing to put in the time - set out expectations up-front
- Networked – ask for help and support to leverage Launchpad and personal network
- Strategic - focuses on strategy, not tactics
- Thoughtful & Observant – first to spot issues or notice what is missing
- Informed - Insists on good practices and knows the rules of the road
- Supportive – provides mentorship, skill development and the opportunity to lead

A good director **does not micro-manage** the business. Remember, it's the CEO's job to run the company.

Attributes of Poor Board Members

- Not committed or overly scheduled – Don't put in the time between meetings – prep or help
- Poor listener – Talk too much at meetings
- Lack of attention to what matters -– Allow the CEO to run the bank account dry
- Temperament -– Get confrontational and destructive with CEO & management team
- Unaware of or ignores best practices – Talk out of school (breach of duty of confidentiality)

There are a number of areas where directors can help their portfolio companies be successful. Legally, directors are required to provide governance and oversight (see "Legal Duties"), however the directors of an early-stage company may choose to be more proactive by adding a great deal of business value and advice. No director is able to provide value in all areas, but great directors often help where they can and make introductions to the right resources when they can't.

Recruiting - This is one of the most important ways in which directors can help. Companies are only as good as the collection of entrepreneurs that populate them. So it really matters who you're able to recruit. In an industry where nothing matters more than the people, helping bring in the very best people should be a top priority for all directors.

Fund Raising – Making sure that a company doesn't run out of funds is a key part of the early stage director's job. Fund raising can occupy a CEO full time to the detriment of her ability to

spend time growing the business. Working with the CEO to hone the investment pitch as well as introducing potential investors are very important director assignments.

Strategic Advice – Active angel investors have access to a wide range of experiences both from the standpoint of being former/current entrepreneurs and being investors. We are deeply involved in the start-up ecosystem and don't spend our days focused on only one company. Many CEOs get lost in the weeds of their company's day-to-day operations. They need someone with a broader world view who can provide both a sounding board and strategic direction. However, a good director does not micro-manage the business. Remember, it's the CEO's job to run the company.

Making Connections & Getting Initial Customers – One advantage to being a member of a large angel group is the strength of your network. Angel group members have access to literally thousands of potential partners, investors, analysts, customers, service providers, and employees through our network. Making connections through this network will prove invaluable to a portfolio company.

Save Time - Directors can help companies avoid spinning their wheels. Startups all have to find an office, setup payroll, manage their finances, etc. As investors, we have connections to the service providers that handle these mundane tasks.

Risk Management – It is the director's responsibility to ensure that controls are in place which are appropriate for each stage of development. Investor Directors should have regular communication with financial/accounting advisors, should have confidence in those advisors, and should review and discuss stage-appropriate controls on a regular basis.

Evaluating the CEO – Directors have a responsibility to ensure that the CEO is up to the task. Where there are concerns, the involved board tries to help develop the CEO – Studies show that founder CEOs generally out-perform external candidates. But when it becomes clear that the current CEO objectively cannot do the job, the directors must initiate the process of replacing him/her. Objectivity is important – a CEO should be judged on whether they are effective, not whether their style is the same as the directors evaluating. When replacing a CEO, key traps to avoid: failing to determine what kind of CEO is needed, rushing the process, mistaking charisma for skill, under-estimating the experience value of past failure, and failure to do deep, blind and thorough reference and background checking.

Ensuring a Successful Exit – Directors have a fiduciary responsibility to maximize value for shareholders. Investors invest in startup companies with the promise of eventual liquidity for their otherwise illiquid stock, and the expectation of many shareholders is that the company will achieve an exit by sale of the company in a reasonable time frame. Directors need to make sure that the management team understands the path to an exit that provides maximum returns to all shareholders. Directors should regularly focus on this issue, making sure the process is understood, the level of preparedness is adequate, and the requisite experience is represented at the board or company level.

Practical Tips

- Make sure you know the company's cash position and timeframe for when cash will run out. This information should be communicated to all investors in a timely fashion.

- Encourage your CEO to keep an updated list of connections that the company needs, and review this list on a regular basis.

- Business as usual is not good enough – companies grow and change quickly – the directors' job is to step back and always consider the bigger picture.

- Our eBook on Exits is a great sourcebook for understanding how to position a company for an exit.

Can You Hear Me Now? Building Great Director-CEO Communication

Establishing a regular, consistent, and open channel of communication is one of the first tasks that a CEO and Director need to tackle. During the honeymoon period, right after a financing round closes, it's much easier to build the rapport you will need when times are tough. And we all know that there will be tough times in the not too distant future!

Attributes of Great Communication

- Timely – bad news should travel as fast as good news
- Transparent – clear and concise info helps in making good decisions
- Relevant – don't overwhelm with minutiae
- Honest & Trustworthy – honest, realistic evaluation of circumstances is at the core of trust building
- Focused on Company Positioning – regular reminders of up-to-date elevator pitch puts everyone on the same page

Attributes of Poor Communication

- Infrequent – turns board meetings into status update only meetings
- Limit Investor Ability to Help – don't put spin on a situation and hide underlying issues
- Insecure or Defensive – you are in the job, so own it
- Focuses on Actions not Results – detailed activity recitations don't matter w/o results
- Not knowing how long the cash will last – fastest way to a company's demise

CEOs who only communicate with directors at board meetings receive no value from one of their most important resources. The advice and value added between board meetings can be as important as the meeting itself. Directors should coach CEOs and help them improve communications to facilitate the decision-making process. CEOs should reach out to all board members and find out what information is of interest to them and what should be communicated on a regular basis. Without consistent communications, board meetings become update meetings for directors rather than a meeting for the company to garner value.

Directors should **coach CEOs** and help them improve communications to **facilitate** the decision-making process.

Timely – When a CEO wants help from a director, information needs to be communicated as soon as possible. For example, if a key employee is going to leave, a director might be able to change her mind if she hasn't already started the new job. If the CEO doesn't communicate early, the director can't help.

Transparent – Making key board decisions requires clear and concise information. Transparency means sharing the raw data as well as the short summary of why something happened positively or negatively. If a product delay is going to result in cash running out 3

months sooner than we discussed, the directors must be alerted.

Relevant – It takes a lot to operate a company. Directors do not need to know every single operational and management detail, because they are not members of the management team. Their role is one of oversight, governance and advice. For example, directors may want to interview senior management and other key hires, but don't need to be involved with hiring a junior engineer.

Honest and Trustworthy – Trust is built with a consistent, steady flow of information. CEOs must be honest and realistic in their assessments. The flow has to go both ways. Just as a director should expect the CEO to give accurate information on the status of a sales pipeline, the CEO should expect the director to be honest about the her ability to deliver on what she has promised.

Focused on Company Positioning – Directors may have an overall understanding of the key company messages but they many not be able to keep up with the constant subtle changes in company positioning which are so common as an early-stage company struggles to find product-market fit. CEOs should always provide directors with a simple, fresh elevator pitch to ensure they position the company correctly. The CEO should also assist the directors in communicating accurately and helpfully with the company's other investors.

Practical Tips

- Big decisions might be finalized at board meetings, but the key issues are often discussed and sometimes resolved, at least in principle, in advance of the formal decision made at the meeting.
- Once every two to four weeks, the CEO should send out an email to all board members. The email should be one page in length using bullet points that outline major achievements, plans for the next several weeks, and items where board assistance is needed.
- It can be very helpful for one non-management board member to schedule a regular weekly call with the CEO to discuss the status update in more detail and act as a sounding board for the CEO. These calls need not be lengthy; 15 to 30 minutes should be enough in most cases.
- Make sure all board members / investors are clear when the company will run out of cash. This is one of the single biggest issues they shouldn't be surprised about.

Stitch in Time Saves Nine: A Guide to Startup Board Prep

It takes real work and advance planning to hold a great board meeting. Too often, board meetings become glorified status updates that deliver almost no value to the company. Great board meetings tackle tough issues and can be stressful. But the end result is usually worth the time and effort spent preparing.

Attributes of Great Board Prep

- Organized – Agenda agreed to in advance by the full board or its lead director and the CEO
- Categorized – for information, for discussion or for approval
- Strategic – focus on one or two important items each meeting
- Prepared – board materials go out several days in advance

Attributes of Inadequate Board Prep

- Poor attendance – get the board calendar finalized a year in advance
- Sloppy Materials – late, messy, incomplete board materials drive poor meetings and can be a source of liability

CEOs/Board Chair should connect with directors in advance of the meeting – This is important for several reasons. First, getting consensus on the key strategic areas of discussion is important for a well-run meeting. Strategic discussions should focus on tough issues that the company faces. Second, while votes are formalized and recorded at the meeting, it is often very important for critical decisions to be discussed and analyzed in advance.

Board materials should be sent out early – You don't want directors reading your handouts at the meeting. Most board materials are focused on company status (e.g. financials, sales pipeline, etc). Good directors will have time to review board materials that are sent out several days advance.

Meetings should be in person whenever possible – For out-of-town or busy board members, it can be difficult to attend meetings in person. It's not unusual to have half of the board dial-in for the meeting. In general, this type of meeting does not work as well. As boards mature and their members know each other better, telephonic connections can work, but there is no substitute to in-person participation.

Schedule meetings well in advance – For early stage companies, board meetings are typically held every 6 to 8 weeks. To ensure attendance at meetings, an annual board schedule should be circulated at the beginning of the year to make sure everyone is available. Also, having board dinners two or three times a year is a productive way to build strong working relationships on the board. When a board has some distant members, a company may schedule board meetings less frequently, perhaps every other month, and schedule monthly 60 minute update calls in the non-meeting months.

The Board Package – Board materials come in many different formats. For consistency sake, it helps to agree on a standard format that will be used in all board meetings. In addition to a brief outline on strategic topics, it is very helpful to report business performance based on Key Performance Indicators (KPIs). A management dashboard that highlights KPIs is an essential tool for evaluating company performance against targets in an objective way. It is very helpful for board packs to include the history of

performance over the past year, a comparison of performance relative to plan and forecasts going forward. Spreadsheets are fine for financial data, but charts are a better visual tool for spotting trends and sparking discussion.

> Getting **consensus** on the key **strategic areas** of discussion is important for a well-run meeting.

There are several items that most board packs have in common. You should typically expect to find three different sets of documents: 1) Minutes from prior board meetings, 2) Financials and 3) Slide deck with key strategic discussion topics and company status update.

- **Meeting Agenda** – This document should be one page long, should not make any reference to the length of discussions, and should clearly mark every item as being for information, for discussion or for approval.
- **Board Minutes** – This document should be a very short and concise summary of the meeting and contain the list of meeting attendees and any votes acted on by the board. Proper minutes should not use adjectives or flowery language, should not contain humor or irony, should not make note of times or the relative length of discussions, should not contain conclusory descriptions or draw conclusions, should not quote people or attribute things to individuals (except where absolutely necessary or on procedural points), should not highlight dissent, but rather discussion. Proper minutes just record the sequence of events to show that there was a good and thorough process. If improper minutes are presented for approval, Directors should refuse to vote to approve them until they have been prepared properly.
- **Financials** – This set of spreadsheets should include the company's Profit & Loss Statement, Balance Sheet and Cash Flow Statement. It is also useful to have current vs. plan comparisons. It should include a forecast at least for the remainder of the year
- **Key Discussion / Company Status** – In most cases this will be a PowerPoint deck with 15 to 30 slides. The slide deck should include: 1) repeat of meeting agenda, 2) board actions, 3) management dashboard, 4) key strategic issues for discussion, and 5) a status update for each department.

Practical Tips

- Preparing materials and reports for the board is good discipline and provides management with a framework for quantifying and assessing progress on a regular basis.
- Board meetings should not focus on status updates.
- Engage the entire board in establishing what key strategic topics should be discussed in advance of the board meeting.
- A good board holds meetings in person to the extent humanly possible and on a regular basis.

What's Your Point? Or How to Run a Great Board Meeting

If you follow the suggestions discussed in the previous chapter on preparing for a board meeting, you are well on your way to having a productive board meeting. When a board is well informed, meetings can focus on the difficult topics that every early stage company is faced with.

Attributes of a Great Board Meeting

- Focused - Board Chair or lead director should facilitate the meeting and make sure it moves along
- Results Oriented – Extract real value out of each meeting
- Actionable – Make sure each director has a task assigned due before the next meeting
- Punctual – Start precisely on time and end precisely on time (continuance if necessary)

Attributes of a Poor Board Meeting

- Tactical – Stay out of the weeds of company operations
- Tolerant of Distraction – do not tolerate multi-tasking, emailing and texting
- Sloppy – late, disorganized, poorly attended, rudderless

The Board Chair or lead director should consider the following suggestions to ensure the meeting is productive and covers the key areas of board responsibility.

Use a standard format for each of your regular board meetings – Most early stage companies will want to use a variation on the following format for their board meeting structure:

1) **Introduction**: This part of the meeting often takes 30 minutes or less.

- Handle house-keeping issues such as approving minutes, option grants, etc.
- Review company's strategy followed by a review of the management dashboard

2) **Strategic Discussion**: This is the core of the meeting and will take up the majority of the meeting time.

- This is where the board "earns its keep" in terms of adding business value. Helping the company address key strategic issues in areas such as product, market, team, competition and funding are what an early stage board is supposed to do.

3) **Function Review**: This is more of a report and a minority of meeting time will be allocated to it.

- Invite management team to provide update on each department (or bring in one department per meeting for deeper dive)
- Key department discussions include: R&D, S&M and Finance
- Provide board interaction with management team and give management a sense of how the board thinks and how they are held accountable by the board.

4) **Executive Session**: This special session typically occurs after the end of the main meeting, paradoxically, refers to a session where the executives (including the CEO) are out of the room. It is a good practice to hold an Executive Session even if there is nothing special to discuss, because it can be very unsettling to a CEO to have one called when they are not the norm.

- Gives independent board members a chance to discuss the whole management team in confidence
- Board Chair or lead director will typically be instructed to circle back to CEO on executive session, and there should be consensus or even explicit instructions on what to say if the topic is sensitive – many misunderstandings are born from inaccurately summarized executive sessions.

Do not shy from **tough questions** – It's easy for a management team to talk about what's going well and avoid the key challenges they face. And, many times, management doesn't even **realize what they don't know**!

Please note that not every board meeting needs to follow a standard format. There are times when a company needs real strategic guidance and the board meeting can defer the departmental review (though deferring it should be a rare exception, because if you get out of the regular habit, it is a sure sign to the CEO that the board is worried). Pick a format that works for the meeting at hand and then make sure the meeting is well run.

Do not shy from tough questions. It's easy for a management team to talk about what's going well and avoid the key challenges they face. And many times, management doesn't even realize what they don't know! A board member can add tremendous value by making sure that key issues are raised so that management can address the issues before it's too late. The Strategic Discussion section of a board meeting is a good time to ask the tough questions. The "so what?" questions. Remember to get these questions on the board agenda in advance of the meeting. A board meeting has time to cover a few strategic topics. It is difficult to properly discuss all the issues in one meeting. Examples of questions that may be appropriate to ask include:

- **Product & Product Market Fit** – Does the company have a product that is a "Need-to-have" or a "Nice-to-have"? What are the top 2 or 3 problems our customers have and how are we addressing those problems?
- **Market** – Does the company understand its addressable market? Is the company going after a large enough market so that the business can scale? What is the best go-to-market strategy (direct, channels, etc.)? How has the market changed in the last few months?

- **Team** – What roles do we need to fill so the business can succeed? Will the people we have today help us succeed both now and in the future? Do we have a first class person in every key slot? If not, do we understand what we need and can we work around their limitations?

- **Competition** – What's happening within the competitive landscape? Why are we winning/ losing sales to our competition? More than whose position is improving, whose position is changing fastest, and why?

- **Finance** – What is the company's long term financing strategy? What are the company's plans to help drive shareholder value?

Practical Tips

- Set one or two strategic topics per meeting and discuss them towards the beginning of the meeting

- Facilitate the meeting by keeping it focused and getting everyone's opinion on key strategic topics

- Ask board members for help and follow-up after meetings with assigned action items

- After the meeting, review the board meeting with the Chair or lead and provide feedback on the strengths and weaknesses of the meeting

- Watch out for sloppiness – it can be an early warning sign of CEO incompetence or board apathy and should not be tolerated

Chemistry Experiment: Recruiting A New Director

To build a board that has real impact on the success of a company, you need to understand what constitutes a great board. Every board needs a variety of skills to help the CEO with a multitude of challenges. Skills such as relevant industry experience, prior CEO experience, fund raising and exit planning are all critical roles on a board. Start by identifying what you need to add to your board, and then you are ready to start recruiting.

Attributes of a Great Recruiting Process

- Additive – A new director should add key skills to the board
- Timely – Don't let the process drag out, treat it like you would a key hire
- Objective – Just because someone is a good friend doesn't mean they are a good addition to your board

Attributes of a Poor Recruiting Process

- Divisive – Poor selection process can lead to negative feelings and be disruptive to the operation of the board
- Surprising – Concealing from board candidates company issues and expectations on time commitment for the position
- Conflicted – Candidates for an independent seat should be truly independent of financial ties to the existing board or company and be evaluated objectively

Most early stage companies have 3 or 5 person boards. Founders have 1 or 2 seats, investors have 1 or 2 seats, and there is one seat slotted for an independent or industry director. Over time, boards can grow, and companies can out-grow their existing boards. So understanding the process of recruiting a new director is important. There are many similarities in this recruitment process to hiring a senior member of the management team, so you should be familiar with the following steps.

Assign one board member to run the recruitment process: Although this is a team effort usually run by the CEO and one designated director, someone has to be in charge, and someone has to be the point person for all communications with candidates.

Assess your needs in advance: Knowing your current board's strengths and weaknesses will help you identify the characteristics for your ideal candidate. Make sure you prioritize your selection criteria so you can properly rank prospective board members.

Use your board to increase the pool of candidates: Whether they know someone directly or through one of their business connections, board members are great source of talent.

Over time, boards can grow, and **companies can out-grow their existing boards**, so understanding the process of recruiting a new director is important.

Run a parallel, open process: When you hire a new vice president you interview multiple candidates at a time. This speeds up the process and allows you to evaluate several individuals. Recruiting a new board member is no different. Be open and honest with candidates about your process. They should know what you are looking for and how you will reach a decision.

Share relevant company information with your top candidates: Although you must be careful as to what you disclose, it is important to be open and honest about the company. Nobody likes surprises when they take on a new position. Also, make sure you set expectations correctly for what the duties and time commitment will be for the director role. Before company information is shared, an NDA should be in place.

Rank all candidates and work towards a consensus opinion: To form a cohesive board, new directors need more than one strong supporter on the board. Make sure that candidates are interviewed by most, if not all directors wherever possible. From the feedback they provide you can determine your top candidate and get an indication of how the board will assimilate the new director.

Onboarding a new director: Once you have your candidate and she indicates a desire to join the board, it is very important to talk to her about board norms, how board meetings are run, and expectations of board members. The board should vote to make the offer official. After joining, the director should be furnished with copies of the last few board packages, a calendar of upcoming meetings, and an oral summary of board norms and expectations.

Board Evaluations

Boards should consider regularly conducting an evaluation of their effectiveness. Any such evaluation should be run by one person, and steps should be taken to ensure confidentiality of input so that participants can be candid with their thoughts. It may be appropriate to ask for the assistance of company counsel to avail of attorney-client privilege protection for sensitive issues. The evaluation should include a peer review of directors, as well as input from the CEO on director and board effectiveness. The formality of the process should be adjusted to reflect the stage of the company. Even done informally, it is a valuable tool for driving board awareness and effectiveness. Topics to address may include: board processes and supporting materials, board composition, committee organization and processes, role of the board and board leaders, board's relationship with CEO, board culture and dynamics, potential board development needs, overall board effectiveness, individual director effectiveness (self and peer).

Practical Tips

- New directors must be carefully chosen for their objective value-add and their independence.
- The process used for recruiting directors speaks volumes to the candidates about the quality of the board they are being asked to join.
- Assessing the current board’s strengths and weaknesses on an annual basis is a useful exercise to undertake, even if you aren’t looking for new board members.

Chapter 6

Hazard Pay: Fundamentals of Director Compensation

There is a subset of a company board that should receive compensation for their duties. Any management team member or Venture Capitalist who is compensated by a venture fund should not expect to receive compensation for their board service. But an independent director or an angel investor who is not receiving any outside compensation should receive payment for their board service. So what is the appropriate level of compensation? And in what form should that compensation be?

Attributes of a Great Compensation Policy

- Linked to Evaluation – changes in director comp can coincide with evaluation
- Equity-Based – Conserves valuable cash and aligns long term interests
- Reasonable – Over-paying directors can be a source of liability
- Well-Documented – Spell out key issues like contingent vesting to avoid confusion

Attributes of a Poor Compensation Policy

- Excessive – Cannot be supported by objective benchmarks
- Informal – Not well documented, or based on promises of future actions
- Cash-Based – Growth company investors will generally not tolerate use of cash beyond repayment of reasonable expenses

Most directors of early stage companies are highly professional and accomplished people with a great deal of valuable expertise. Some will not make the significant commitment of time necessary to serve on a board without being compensated for that time (a contrasting and minority view holds that because the board seat was negotiated for, it is unfair to ask for compensation as well).

> Compensation for board service should be based on the **reasonable use of company equity** to align the board's interests with those of the shareholders

A value-added director is generally well-worth the equity spent on them. However, in either case, board service to early-stage companies is generally not a salaried position. Compensation for board service should be based on the reasonable use of company equity to align the board's interests with those of the shareholders. Board observers are generally not compensated unless their role is such that they are actively engaged in helping the company on a regular basis, and even then payment may or may not be offered.

Compensation decisions can be improved by being accompanied by evaluation: Boards must be able to defend the reasonableness and appropriateness of their compensation decisions and should not be in a position of paying directors who are not effective contributors. Before an annual grant occurs is a good time to look at any changes to board composition.

Based on Common Stock and Long Term Vesting: Directors should be paid in the form of stock options to purchase stock (typically common, or similar derivatives such as restricted common stock shares) which vest over a period of time (typically two to four years).

Reasonable in Amount: Early-stage directors are often paid in common stock (typically via options or restricted stock grants) in an amount equal to somewhere between 0.25% and 1.0% of total shares outstanding on a fully diluted basis. Board chairs or extremely active directors with specific industry contacts and introductions may be at the higher end of the prevailing range. Executive directors and special advisors are special cases and may fall outside of the range, though it is the responsibility of the board to ensure the appropriateness of all compensation paid by the company.

Well-Documented: The policy on director compensation should be written down and should specify what happens to the vesting of stock options upon resignation, should specify single-trigger acceleration upon change of control (to ensure that the directors will not vote against an acquisition in the best interests of the shareholders), and should set out guidelines for incurring and reimbursement of reasonable, actual expenses in connection with board service. It can also be desirable to record that directors shall have the right to purchase stock on the terms of the company's most recent financing if room remains, or a right to participate in future financings.

Practical Tips

- Director compensation can benefit from being accompanied by evaluation.
- The compensation policy should be well documented.
- Director comp must be reasonable, benchmarked and defensible.

Chapter 7

Ignorance is Not a Defense: Legal Duties for Directors

While being a great director is often about adding strategic business value, and it is safe to say that thriving companies give rise to less risk than failing ones, there are some legal requirements which come with the job. Most of them are rooted in common-sense, but it is important to understand that you are a legal fiduciary to the shareholders, and to understand what that means. These duties cannot be shirked, delegated or ignored, and rest upon you until your resignation is formally accepted.

Attributes of a Great Fiduciary

- Careful and Prudent – Duty of care requires you to exercise good business judgment and use ordinary care and prudence in guidance of business
- Loyal – Duty of loyalty requires you to put the company's interests ahead of your own (conflicts of interest and breaches of confidentiality violate this duty of loyalty, even where accidental)
- Faithful – Duty of good faith requires you to act with honesty and genuinely good intentions

Attributes of an Inadequate Fiduciary

- Reckless or Careless – poorly conceived or documented decision-making process
- Self-Dealing – involvement in board matters in which you have a direct OR indirect personal interest (other than as a shareholder)
- Loose-Lipped – failure to keep company confidences is a serious issue
- Dishonest or Opaque – failing to be honest and transparent about your motives or the reasons for your views can lead to serious issues

Core Fiduciary Duties

Board members owe a fiduciary duty to the corporation (and secondarily to the company shareholders and creditors). Fiduciary duty is the highest standard of care under both legal and ethical domains – it is a legal relationship of trust relative to your principal (i.e. company, shareholders and creditors). A fiduciary may obtain assistance, but must select help with care. Regardless of assistance, a fiduciary cannot delegate their duties – the duty is permanently attached until an effective resignation (and expiration of statute of limitations).

Duty of Care: A board member must exercise good business judgment and use ordinary care and prudence in their guidance of the business.

Duty of Loyalty: Directors must put the companies' interests ahead of their own and should keep in mind that any breach of confidentiality or conflict of interest violates this duty of loyalty.

Duty of Good Faith: Directors must act with candor and genuinely beneficent motives, and are judged on this quite harshly after the fact. Jurisdictions vary on whether this is an official duty, but it is almost always applied after the fact, so directors who are very wise behave as though it is an official duty.

Core Legal Duties - Governance

In addition to its over-arching fiduciary obligations, the law in all jurisdictions imposes basic responsibility for the governance of the company on its board. Most of these concepts can be inferred from other sections of this guide, but it is worth repeating here. Regardless of the state of incorporation or stage of the company, all boards are typically responsible for the basic governance of their company through:

- Policy setting and enforcement
- Evaluation (and replacement) of the CEO
- Determining the adequacy of financial resources
- Approving annual budgets
- Making account to stakeholders for company performance

Board members owe a **fiduciary duty to the corporation** (and secondarily to the company shareholders and creditors).

Test of Adequacy – Availability of the Business Judgment Rule

The sole test of the adequacy of the governance provided by a board is whether the board can avail itself of the protections of the business judgment rule. This is a basic rule giving very fundamental protection to directors who do their best. Under the business judgment rule, directors do not have to be correct, they just have to use proper care. The business judgment rule states that a director's business judgment will not be questioned or give rise to liability unless it can be shown that the director acted:

- In haste without proper diligence or process (preparation, materials, undue reliance on experts)
- In abuse of appropriate discretion, or
- In breach of a fiduciary duty

Special Duties During Financial Crisis or at Insolvency

Financial crisis brings new duties to the fore. Once a company becomes insolvent, its directors owe fiduciary duties to the company for the benefit of its creditors, while at the same time attempting to maximize the economic value of the firm for any potential residual benefit to the shareholders. In other words, creditors become a source of liability in addition to shareholders when a company becomes insolvent. When a company is in the "zone of insolvency" the directors' duties are unchanged. Directors must continue to discharge their fiduciary duties to the company and its shareholders by exercising their business judgment in the best interests of the company for the benefit of its shareholders. However, the risks are higher and the potential

for creditor liability looms. Directors may want to proceed carefully and thoughtfully especially with respect to expenditures, and observe good board process meticulously. They may choose to retain separate counsel to advise the board if a serious conflict between duties to the company and to potential creditors arises.

Practical Tips

- Directors have legal duties which cannot be ignored.
- Good decision-making process is the key to discharging these duties.
- Effective directors will strike a healthy balance between oversight duties and adding business value.
- Certain matters, such as properly paying wages and withholding taxes, give rise to personal liability for directors and should be overseen rigorously.

Chapter 8

Guarding the Till: Basic Financial Controls

One of the key areas in which directors help to protect shareholders is by adequately overseeing the company's financial affairs. This can be detail-oriented work, but the oversight is critical.

Attributes of a Great Financial Controls

- Appropriate for the Stage – good controls are ratcheted up over time
- Process-Based – proper controls baked into the systems and processes of the company
- Transparent – regular reporting through management dashboard
- Proper Oversight – Audit committee responsible for ensuring adequate skills and resources

Attributes of a Poor Financial Controls

- Excessive – burdensome and unhelpful for the stage of growth
- Informal – Not well documented, or based on established routine
- Poor Oversight – Under-staffed, under-skilled, or not adequately reviewed

The key to ensuring adequate oversight (and managing risk) is ensuring that the company has an adequate set of financial controls at each stage of its development. One very important step is to ensure that the company keeps current in its payroll and taxes (all forms of tax, including payroll tax) or the liability for unpaid amounts can come back to directors. (In a business failure situation, these taxes must be paid before the company's funds are fully depleted.) An audit committee consisting of one or more members with accounting and finance knowledge and a good working relationship with the company's accounting/financial advisors is very important for well-run companies. Ideally it will be established at the first board meeting. Here is an overview of controls which might be appropriate at different stages of company development.

The key to ensuring adequate oversight (and **managing risk**) is ensuring that the company has an **adequate** set of **financial controls** at each stage of its development.

Basic Controls for Seed R&D Stage: Controls and approval thresholds around contracting, purchasing and disbursements, payroll, treasury management, any fixed assets, and stock administration. An awareness of fraud risks (smaller companies typically have fewer people making segregation of key financial duties more challenging to achieve) and an understanding of the company's key financial processes, monitored appropriately, layered on top of the Board's review of financial metrics, should normally cover the typical risks.

Controls for Early Commercializing Stage through Growth Stage: Previous controls, plus, establishment of an Audit Committee (may consist of one member at first), critical accounting policies, including a policy on

revenue recognition, regular review of accounting staffing for adequacy and competence, a collections policy and write-off thresholds, fraud controls, and understood methods for forecasting and factoring of the sales pipeline. Establishment of key financial metrics is helpful at this stage if not already in place.

Controls for Pre-Exit Companies: Previous controls, plus a significant effort toward better documentation of internal controls, organization of information for presentation (possibly in a data room if a deal is possible within months), and the beginnings of a lightweight set of Sarbanes Oxley type controls and disclosure controls. (While this level of control may not be essential, fluency with the concepts will be critical in getting through a successful due diligence process with a large buyer at anything other than a fire-sale valuation.)

Special Controls for Struggling Companies: If a Company is approaching financial crisis, special spending controls and additional board process may be appropriate. In insolvency situations, directors owe duties to creditors and should proceed with caution – see Legal Duties for more detail.

Keeping it all in Perspective and Bringing it Back to Value-Add: While it is important to understand your legal and fiduciary duties and the importance of basic controls, it is not in the shareholders' interest to allow them to overtake the entire board process and drive the board into habits of fiddling with policies, focusing on compliance activities, or focusing on past operational or financial performance. Although these are important tasks, they can easily grow to dominate all of the board's time and leave little room for adding real business value to the company as set out in this guidebook. Remember, thriving companies are much less likely to give rise to liability than failing ones, so try to keep the board's focus balanced on both controls/governance and driving the business to succeed. Form committees to dig into policies and compliance and report back to the board on a regular basis, but don't allow the routine and tactical to overtake the important and strategic.

Practical Tips

- A good and appropriate set of controls will drive proper financial oversight
- Well-designed management dashboard makes regular review easy
- Controls should be reviewed and adjusted for adequacy regularly

The Importance of Alignment Between Board Members and Management

There are many issues investors and management teams face when it comes to the topic of alignment. In the case of a startup company, alignment means that investors and management agree on key corporate development issues such as strategy, team, financing and exit planning.

You shouldn't expect smooth sailing all the time with a startup company, but alignment issues can be especially stormy, which is very dangerous. Building a successful company is hard enough without having investors and management pulling in opposite directions on fundamental topics. Since investors typically hold board seats in startup companies, you better have core alignment if you want the company to move forward and succeed. With this chapter, we will focus on two key company issues: financing and exit planning.

I think we all can agree that management and investors are both looking to build a company that delivers significant shareholder value. Unfortunately, how the CEO defines (or comes to define) success can be quite different from how the average investor defines success. I can provide you with dozens of scenarios where misalignment occurs. For the sake of brevity, I will provide you with three examples:

1. A first-time management team raises $5M from a big name VC and gives up 50% of the company to the VC. Less than 12 months later, an unsolicited offer comes in to buy the company for $25M. Since the management team owns about 50% of the company, they are looking at a $12M exit. Not bad for a few years of work for a couple of 20 something year old guys. However, the VC isn't interested in turning $5M into $12M in a year's time. That kind of exit doesn't allow them to achieve the returns they need for their fund. So, the VC blocks the deal and the management team has to keep working.

2. A startup CEO raises $1M from a small group of angel investors. As part of taking the money, the CEO promises that she will try to limit any future equity financings. This will allow the company to be well positioned for a smaller earlier exit in the $20M - $40M range. Both the angels and the founders will have a nice return and the risks associated with inexperienced founders growing a large company are capped. Fast forward 18 months and the CEO receives a term sheet from a VC for $15M on a $30M valuation. Everyone should be happy, right? Well, not necessarily! In this example, the new VC investor isn't interested in buying out the early angel investors. And, the VC puts a provision in the deal terms that allows them to block any exit that's less than $100M. The angels are trapped in this investment for at least another 5 to 7 years, because it will probably take that long before the company exceeds a $100M valuation. And, there is risk it will never happen.

3. After raising $1M from angel investors, the company raises an additional $25M from VCs. Even after the VC investment, the angels own 10% of the business. But, the VCs preferred shares come with a 1X liquidation preference and an 8% dividend. After 5 years, the value of the liquidation preference and the dividend has grown to $45M. When the company exits for $75M, the VCs take $45M off the top leaving $30M to be split between all shareholders, including the VCs. That 10% equity stake owned by the angel investors is worth $3M. So the angels get a 3X return... It's better than a sharp stick in the eye, but, wow, can future round deal terms result in a suboptimal IRR!

Variations on these three examples happen quite frequently with early stage investments. They incorporate the three most common areas where management and investor misalignment occur:

1. Acceptable size for an exit
2. Acceptable timing and plan in place for an exit
3. Size and deal terms around future rounds of financing

You want to make sure **management** and the rest of the **board** are in sync with a long term financial plan. And, make sure you **revisit the plan** on at least an annual basis.

As very early investors in a startup company's history, angel investors will participate in one way or another in most of a company's equity financing rounds. Whether you are a board member or key investor, it's important that you discuss with management the implications of taking investment from new investors. Most first time entrepreneurs, and even some experienced CEOs don't fully understand the financial implications of raising additional rounds of financing.

One of the most important discussions at board meetings relates to the company finances. But don't limit the conversation to simply discussing whether there's enough money in the bank to make payroll this month. You want to make sure management and the rest of the board are in sync with a long term financial plan. And, make sure you revisit the plan on at least an annual basis.

For example, is the board's objective to build a substantial company and take it public? If the answer is yes, you will need a financing plan that will allow the company to achieve over $100M in annual revenue and maintain a 40%+ annual growth rate. In most cases, such a company will raise $20M+ in multiple rounds of financing. But let's say the board's objective is to get a product to market, attract a small set of early adopter customers, and then sell the company for $30M. If that's the case, then you probably can't raise much more than $2M to achieve a 10x return for the investors.

Another way to avoid future misalignment on financial and exit issues is to discuss the financial plan with new investors before they invest. You must understand how they see the company's path to success, and evaluate whether their plan is achievable and lines up with your expectations.

Angels should be proactive and have the discussions with management early on when their relative influence is greatest (i.e. during the period when angels are still the dominant investors). That is the period for angels to add value, build trust and form lasting relationships. Worst case, even if major new investors come in, those relationships will allow you to maintain at least some moral influence down the road.

Lack of regular communication is the main culprit for the creeping advancement of misalignment. In the answer to a previous question, I recommend that the board have at least an annual discussion on the company's long term financial plan. This plan needs to address key issues such as the financing and exit strategy. In companies where there are a number of angel and VC investors, things can move quickly and a lot of different threads can develop in parallel, so you may need to discuss these plans more frequently than once a year.

Another major culprit creating misalignment is different **deal structures** between the rounds of financing. Examples of these deal terms include liquidation preferences and dividends.

Another major culprit creating misalignment is different deal structures between the rounds of financing. Examples of these deal terms include liquidation preferences and dividends. Later stage investors can still achieve a good IRR even if earlier investors don't. So make sure you carefully review the deal terms that most closely impact your returns with each new round of financing. And, if possible, work with the board to negotiate out the most egregious deal terms so you can avoid future misalignment issues.

Chapter 10

CYA: Liability Insurance for Directors

While the risk for most directors of early-stage companies is reasonably low, there is risk, and it should be insured. D&O insurance is a key part of recruiting world-class directors, and such world-class directors will pay for the expense of insurance very quickly in terms of value-add.

Attributes of a Great D&O Program

- Backed by Company Charter – Company charter is first line of defense and should indemnify directors
- Adequate In Scope and Amount – The policy should be appropriate for the company stage
- Competitively Priced – A good D&O broker should be used to get competitive bids and explain key policy differences
- Advancement of Expenses – The policy must forward the costs of defenses to the director in real-time rather than waiting until the director is absolved
- Tail Coverage – Must automatically convert to tail or run-off coverage at a minimum of 2 years

Attributes of an Inadequate D&O Program

- Out of Date – Policy not in step with current pricing or coverage norms
- Overpriced – Sourced through someone's friend who is a broker
- Full of Loopholes – Policy terms and exclusions matter – get help from broker

Prices vary year to year but $1-2M in coverage should be obtainable for less than $10K per year in premiums, and it may be possible to do much better than that. Directors should not only insist on coverage, but should make sure they dig under the surface and have the terms of the policy explained to them.

Backed by Company Charter: All companies should have an indemnification clause in their certificate of incorporation which is the first line of defense.

Not all Policies are Equal: The terms and exclusions of these policies vary greatly and two similar price quotes may offer very different coverage. A good broker made to work hard is essential in this process. Look for coverage on the A side, B side and C side, and watch the exclusions.

Reasonable in Scope and Amount: Work with a reputable broker to find a policy that is competitively priced and appropriate for a company's stage and then review it annually.

Advancement of Expenses: If a director must pay his or her own defense costs up front out of pocket, an insurance policy is of little value. Make sure the policy includes the advancement of defense expenses.

Tail or Run-Off Coverage: If a company stops paying its D&O premiums, the policy lapses, even for claims accruing during the coverage period. This can be a major issue in the context of an exit by acquisition – these transactions are often the source of lawsuits and this is the worst time to let the policy lapse. It is crucial to ensure that the policy either automatically adds "tail" or "run-off" coverage for any director who leaves and also for situations where the company is acquired. If the insurer will not give automatic coverage, insist on getting an agreed-upon price for such coverage, and make sure that price is paid BEFORE the company runs out of money or closes an acquisition.

Practical Tips

- D&O policies are tricky, but a good broker can help.
- Ignoring details can be as bad as not having any coverage at all.
- Not something that can operate on a "set and forget" basis – put an annual review of D&O on the board calendar.

Appendices

First Board Meeting Agenda

For many startup companies, you will join a board that has limited structure to both the meetings and other key governance issues. To make sure that best practices for boards are put in place early on, we recommend that the initial board meeting use the following for an agenda.

- Appoint Secretary (usually counsel), Assistant Secretary (someone to sign documents) and Secretary pro tem (writes minutes)
- Discuss appointing a Chair (best practice) or lead director or none
- Discuss use of counsel
- Adopt stock option plan and new bylaws
- Appoint audit and comp committees (all independent and often one or three)
- Establish calendar
- Establish agenda for first few meetings
- Authorize D&O Insurance
- Approve budget for first tranche and/or year

Quarterly Update for Investors

Many CEOs don't have experience writing a short update for investors. A two to three page quarterly report is essential to keep investors in the loop and limit surprises. The following list is a useful outline for this quarterly report.

- Brief discussion describing progress made since the last update
- Include info on Product, Team, Competition, Partnerships
- Financial performance highlighting recent sales and operational expenses
- Update on cash position and plans for future fund raising
- Where appropriate, make sure to ask the investors for help in areas where their network can be of service to the company
- Include recent P&L, Balance Sheet and Cash Flow reports
- Depending on the number of investors it might make sense to send a forecast

Overview of a Board Reporting Pack

There are several items that most board packs have in common. You should typically expect to find four different sets of documents:
1) Meeting Agenda, 2) Minutes from prior board meetings, 3) Financials and 4) Slide deck with key strategic discussion topics and company status update.

Directors should read these materials in advance of the board meeting and come prepared with any clarifying questions and comments.

- **Meeting Agenda** – This document should be one page long, and should not make any reference to the length of discussions.

- **Board Minutes** – This document should be a very short and concise summary of the last board meeting and contain the list of meeting attendees and any votes acted on by the board.

- **Financials** – This set of spreadsheets should include the company's Profit & Loss Statement, Balance Sheet and Cash Flow Statement. It is also useful to have current vs. plan comparisons. It should include a forecast at least for the remainder of the year

- **Key Discussion / Company Status** – In most cases this will be a PowerPoint deck with 15 to 30 slides. The slide deck should include: 1) repeat of meeting agenda, 2) board actions, 3) management dashboard (see next section for an example), 4) key strategic issues for discussion, and 5) a status update for each department.

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