BUILDING THE VENTURE-BACKED BOARD

POST SARBANES-OXLEY

Populated by investor owners, the boards of venture-backed companies are a different breed than their corporate counterparts. Venture capitalists often become very involved in the tactical operations of the business and maintain significant influence in strategic decisions until the company establishes traction in the market. Further, the relationship between venture capitalists on the board and company management can be inherently tense as management — usually the company founders — often want venture investors to maintain a more distant, advisory role.

Nevertheless, it is during the early stages of a venture-backed company that the foundation for a successful board is built. The board composition and practices established during this period not only influence the effectiveness of the company's governance as it becomes a larger, public company, but also the likelihood of its success over the long run.

In order to understand the dynamics associated with building a successful board of a venture- backed company, we analyzed the board composition and practices of all high tech and biotech venture backed organizations — more than 80 in all — that went public in 1996. Because they went public just prior to the dot-com explosion and subsequent implosion, the 82 companies in our sample represented more "traditional" high tech and biotech company boards. We examined changes to board composition each year over a five-year period, analyzing a number of variables, including the size of the board, the functional backgrounds of outgoing and incoming board members, the movement of VCs on and off the board, and whether the board members had previous operating company experience.

From there, we identified the best-performing of those companies, analyzing their board practices and comparing them with those of the worst-performingcompanies. We confirmed that the better-performing companies — those with higher revenue and market capitalizations — tended to display certain characteristics and follow distinct practices. Occasionally, the data seemed contradictory. For example, we learned that early investors tended to leave the board sooner on better-performing companies, but, yet, in some very successful companies, VCs stayed on the board long after the company reached relative maturity. Despite these exceptions, a number of consistent themes emerged.

As part of our analysis, we also conducted interviews with 25 CEOs, VCs and board chairs in Silicon Valley to better understand the rationale behind the data. The interviews and data revealed seven key characteristics of successful venture-backed boards:

1. Planning the board started as soon as the company was launched.
2. The size of the board was kept small.
3. Venture capitalists left early.
4. The board planned for succession.
5. New directors had operating experience.
6. The number of insiders was limited.
7. A lead director or mentor was identified.

Much has changed in the years since we first began tracking this group of venture-backed companies, of course. The technology and biotech sectors are recovering from the post-bubble implosion that drove down valuations, slowed new company formations and stifled initial public offerings. The landscape for public companies also has changed dramatically in the aftermath of several highly publicized corporate scandals, which swept in new governance regulations and requirements, including the Sarbanes-Oxley Act of 2002.

So, we wondered, are the best practices of the Class of '96 still relevant today? And what impact, if any, are Sarbanes-Oxley and the new listing requirements having on the development and operation of venture-backed company boards? To find out, we recently talked with 12 board chairs of leading high tech and biotech companies to get their views on whether these best practices continue to apply today or whether the current corporate governance environment calls for new approaches.

What did we learn? In short, the response to Sarbanes-Oxley, although significant in other ways, had only a nominal impact on these "best practices" for building boards. There were two changes noted; one was to slightly increase the average board size. This primarily was due to the requirement that board committees comprise independent directors, as well as the increased time commitment for directors, which discourages "double-duty" on committees. The second change we noted was the increased role of financial experts on the audit committee. New regulatory requirements have placed many new responsibilities on the audit committee and boards have responded by seeking out financial experts who not only possess accounting expertise, but also have the executive experience to be able to contribute to a broad range of strategic discussions. No other significant changes were cited during this affirmation of "best practices." What follows, then, are guidelines for building effective boards for venture-backed companies.

START PLANNING THE BOARD WHEN YOU LAUNCH THE COMPANY

It is never too early to start thinking about your board. Building an effective board is absolutely critical for a venture-backed, emerging company and is just as important as assembling a top-notch executive team. Why? Because an outstanding board will help the company build an executive team, gain credibility and obtain early customers, as well as tackle the many other critical challenges facing an early-stage company.

Board chairs from the top-performing companies in our survey were able to give numerous examples of the tremendous thought and effort expended to attract excellent board members. They first focused on attracting top VCs, and later, strong independent board members to replace the VCs who inevitably rotated off. The quality of the board was a key part of the company's success throughout its growth. As Karen Richardson, CEO of E.piphany stated, "We started building the board from the first day of the company. Getting the top venture capitalists will, in turn, help to attract the top executive team, as well as outstanding outside board members. We never compromised the quality of new members throughout our growth.

If we could not attract a top director to fit a specification, we took a different approach."

KEEP IT SMALL

Unlike the boards of large, publicly held companies, boards of venture-backed companies are invariably hands-on and become significantly involved with operations. In the words of Ed Zander, now CEO of Motorola, "Large company boards are there to protect the interest of the shareholders. That's not enough for an early-stage company. Board members have to actually work and help the company with day-to-day survival."

To take on this responsibility, a board must be agile. Limiting the board to a maximum of seven to eight members makes agility possible and facilitates coordination of meetings and overall communication.

Although the Sarbanes-Oxley legislation requires that the audit, compensation and governance committees comprise independent directors — sometimes requiring boards to add outside directors to serve on these committees — the consensus among the leaders we interviewed remains that the best-performing boards are smaller.

Given that the average board size among S&P 500 companies is 11, it might seem that adding another member or two should not make much difference. Yet it does. Each additional member adds geometric complexity to decision-making and communication.

"You always have 'type A' people on boards. With an excessive number of board members, you simply cannot maintain a dialogue," observed Skip Battle, former CEO of Ask Jeeves and a board member of PeopleSoft. "In addition, the impact of each person is more significant on a smaller board, so each member comes to the meetings well-prepared."

VCS DEPART SOONER

Most VCs readily will confess that their interest and expertise resides in building a company from the startup or "mezzanine" stages through $100 million in revenue. Once the company obtains traction in the market, VCs tend to leave the board to focus on other companies. Our study confirms this behavior.

A chairman of a biotech company candidly noted that some VCs "become much better board members after they are fully distributed." But this perception was not universally held; we also found examples in which the VC continued to serve on an emerging company board at the request of the CEO well after the investment was liquidated.

Our research shows that, for venture-backed companies, a key turning point comes within three years of an initial public offering. Typically, the VCs will be fully distributed by this point, have moved on to new ventures and rotated off the board. Some VC firms have strict policies requiring that partners leave portfolio boards within 12 months of distribution, but most do not have such requirements.

THE BOARD PLANS FOR SUCCESSION

The board of an emerging company is a dynamic body, growing and evolving as the company itself changes. Successful boards plan for membership succession to accommodate the evolving needs of the company and communicate this understanding early so that expectations become institutionalized.

Former Packeteer CEO Craig Elliot likened the ongoing management of a board to a relay race in which the baton of governance gets passed several times in the early stages of a company. During the earliest stages, angel or seed fund investors can provide exactly the amount of handholding, reality-testing and financial oversight a startup requires. Yet these board members may not be sufficient once the organization moves beyond the startup stage.

At the next milestone of the company's development, VCs who focus on later stage financing will invest and these larger investors typically gain at least one board seat. As the company grows and a liquidity event such as an IPO becomes imminent, a chief financial officer typically will transition onto the board as the "financial expert." Prior to the IPO, additional non-executive board members are recruited. This is an excellent time to recruit a strong board member since candidates may be attracted to the stock opportunity.

Once revenues exceed $100 million, companies often begin to set up the infrastructure for sustained growth. A company at this stage usually is beyond the expertise and interest of most VCs. Most needed on a board at this stage are directors with operational experience in developing new markets and customer bases. VCs rotate off and recruiting new board members with experience running a larger, more complex organization becomes critical. As Andy Rachleff of Benchmark Capital stated, "We (venture capitalists) are experts at zero to $100 million. Beyond that, it makes more sense for the board of the company to be composed of operating executives."

Determining who should stay on the board and who should go can be awkward. One way to handle these situations is to conduct an annual self-assessment of the board, initiated by the board chair. Board assessments, which have become a standard of good corporate governance, should include frank discussions about individual directors' contributions and expectations of continued board tenure. All members must buy into a common vision of the board's roles and responsibilities so that when it is necessary to make a change, it is clear that the change is part of a long-term, well-conceived strategic plan of governance.

SEEK OPERATING EXPERIENCE

Our research confirmed that board chairs and CEOs invariably prized directors with relevant, hands-on operating experience. That experience counts for far more than marquee names without such experience. Many directors commented that "marquee" candidates can end up being disappointing choices, sometimes leaving boards in tough times and not contributing in good times. Certainly, new directors must possess top credentials, but they also must be willing to roll up their sleeves and work. For this reason, many emerging companies prefer to recruit executives who have run companies themselves because they understand how to contribute in both good and tough times.

We found that companies frequently sought an executive with a specific area of expertise in an upcoming company initiative such as entering a new market, a commercial launch or international expansion. Given that emerging company directors are expected to participate in a more tactical way than their counterparts on larger company boards, the addition of such an executive can be invaluable. According to Bill Ringo, CEO of Abgenix, "Board members with operating experience are particularly important as companies reach later stage development."

LIMIT THE NUMBER OF INSIDERS

Minimizing the number of inside directors on a board was viewed as a key criterion to an excellent emerging company board well before Sarbanes-Oxley. Our research reveals that outstanding boards limit insiders to one or two.

Although technical or scientific founders or co-founders may covet the perceived esteem of serving on the board, their access to the CEO and other board members already is strong. Technical or scientific founders' greatest contribution comes not from serving on the board but by advancing the technology or science and getting the products to market. In the words of Jeff Miller, formerly CEO of Documentum and now a venture partner with Redpoint Ventures, "You must avoid the trap of putting the technical co-founder on the board. They have all the access to the board they need through the CEO and it's simply not a good use of their capabilities nor is it good governance. There is really no reason to have more than one insider, the CEO, on a board."

Another experienced board member, Bill Krause, former CEO of 3Com and Caspian Networks, was even more outspoken on this subject. "Whether the CEO keeps the former CEO or co-founder on the board is an intelligence test for that CEO. There is no reason from a governance perspective and there are a number of potential negative consequences for keeping them on the board."

Understandably, this can be a difficult decision because the scientific or engineering community typically holds the technical leader in very high regard. But we learned that the top companies simply take the time to educate technical and scientific employees on the rationale and long-term board strategy.

LEAD DIRECTOR OR MENTOR

We found that the best boards had one director who acted as the confidante or "mentor" for the CEO. Some observers may view this practice as inappropriate given the emphasis on board independence. In an early-stage company, however, the board's willingness to work closely with the CEO can be very beneficial to the interests of the shareholders.

The role of the lead director or mentor can be tricky, however, as one of the key responsibilities of any board is to replace the CEO when necessary. Nevertheless, mature directors with operating experience typically know how to serve as a confidante to the CEO, while remaining objective on performance assessments.

The first non-VC director to join a board also can have a challenging role. The VCs typically are focused on near-term financial results so that their investments may achieve maximum returns when they sell their stake in the company. The outside director is less influenced by any particular timeframe for liquidity.

In fact, one CEO who wanted to remain anonymous stated that a VC evolved to become one of his best directors, but only after he fully distributed the investment in his company.

CONCLUSION

Through its financial control and reporting requirements, the Sarbanes-Oxley Act has had a dramatic effect on the corporate governance of public companies and exerted significant influence over the governance of all companies. By moving responsibility for recruiting directors squarely into the purview of board nominating committees, it also has changed the way many public companies build and evolve their boards.

Our research and discussions with directors, however, reveal that the best practices for building the boards of venture-backed companies have only nominally changed because of Sarbanes-Oxley. The highest-performing companies begin planning the board early, limit board size and the number of insiders, rotate VCs off the board early, plan for succession, recruit directors with operating experience and identify a lead director or mentor for the CEO. Additionally, emerging company boards should maintain high standards when adding new board members. Many talented executives prefer serving on smaller company boards to larger company boards; after all, it is easier to see the impact.

Amid all the demands of a startup company, it is easy to put building the board on the backburner. Yet making the board a top priority will facilitate all of the company's strategic and operational initiatives and ensure that it is primed for success.

About Spencer Stuart

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About the author

PHIL JOHNSTON is the manager of Spencer Stuart's San Francisco office. He is a member of the firm's Board Services, Life Sciences and Technology, Communications & Media practices. Since joining the firm in 1998, Phil has held a number of management and practice leadership positions and currently co-leads the firm's Strategic Leadership Services for North America. He routinely places candidates in board and senior level positions across multiple functions. Phil has completed more than 250 searches in his career, including numerous board-related searches. His assignments for HP, Cisco, Equinix, Pinnacle Systems, Align Technologies, Yahoo! and Packeteer include multiple placements in board and leadership roles.

Prior to joining Spencer Stuart, Phil worked for another international search firm. Previously, he served as the top human resources executive for two companies that were acquired by Lucent, and served on the boards of portfolio companies, including TSS (now TIBCO), Teknekron Infoswitch, Software Alliance, IEX and Tenera. Phil also is a former board member of Discovery Toys.

After graduating with a bachelor's degree in psychology (magna cum laude) and a master's degree in industrial relations from the University of Minnesota, Phil began his career in human resources as the personnel manager for American Hospital Supply Corporation (now Baxter).

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