

Assembling a venture-backed company board

VC-backed companies need a board optimally composed, structured and incented for each stage of a fast-moving development cycle. There are unique challenges that have to be met.

BY MARK H. LIVINGSTON AND REBECCA FOREMAN JANJIC

ESTABLISHING AND MAINTAINING an effective board requires skill and tact under even the most favorable circumstances. From exercising oversight, to balancing the competing interests of stakeholders, to addressing the many other issues that, broadly speaking, fall under governance, the challenges can be daunting. In the fast-forward world of venture capital, those familiar issues are greatly magnified by rapidly changing competitive markets for portfolio companies, explosive growth rates, succeeding rounds of investment, and potentially conflicting exit timing and strategy among the investor base.

Based on our experience helping VC

firms build and maintain boards for their portfolio companies — and on a series of conversations we recently conducted with leading venture capitalists — the most intimidating of those challenges not only differ in degree from those faced by public companies, and even other private companies, but often differ in kind. While no perfect responses to these issues exists, understanding their dynamics and addressing them can help ensure that the board of a venture capital-backed company (VCBC) does what any effective board should: advance the interests of the enterprise with appropriate corporate governance, which, in the long run, advances the interests of the VC firm.

Board composition

The venture capitalists we spoke with agree that board composition bears careful thought at every stage of funding. At the Series A level, the VC will potentially find in place a very small board that might include a founder/CEO, an angel investor, and perhaps an independent director, all of whom could possibly be first-time directors. Filling out the board, ideally to a maximum of five members at this stage and no more than seven over all the rounds of financing, calls for a balance of expertise among members: operational, strategic, financial, and industry-specific.

However, Series A investors and later investors that come in on subsequent rounds want to have their interests vigorously represented, which could possibly conflict with the aim of having the right mix of expertise on the board and a board that is aligned strategically. That basic tension — between the ability to raise capital and the desirability of having a fully functional board with the right mix of skills, which actively supports the successful development of the company — can be especially strong during the early stages of funding and the company's development. Further,

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there can be difficult sensitivities to manage with a founder who has chosen unqualified yet personally close directors to serve on the start-up board. The VC must balance the desire to upgrade the board with the potential for conflict in forcing the issue prior to or just after investing.

At every stage of development, there remains the allure of filling a board seat with a ‘door opener’ — someone presumed to have connections at companies with which the VCBC would like to do business. However, because executives who hold current operating positions are unlikely to be able to take on the intensive demands of VCBC board service, the ‘door opener’ is likely to be a retired executive. Unfortunately, the useful life of those connections diminishes far more rapidly than is presumed, as their networks begin to stale within their first year of retirement (with the exception, perhaps, of those executives still active through industry associations and related boards). Since quickly removing the director is extremely difficult, the VCBC board must live for far too long a time with someone whose value rapidly wanes and who may lack relevant competencies. As one prominent venture capitalist advises, the wiser course is to put presumed ‘door openers’ on an advisory board or sign them to consulting contracts

Rapid board evolution

As the VCBC evolves through the four typical stages of its lifecycle — seed funding, early commercialization, late stage expansion, and liquidity — the board must evolve with it, maintaining the right mix of expertise for each stage and being prepared to change directors when circumstances warrant. Maintaining and refining that mix of directors is even more difficult with VCBC boards because of the rapid pace at which VCBCs develop and change. They may double in size yearly and suddenly find themselves in unfamiliar territory when, for example, rapid expansion thrusts them into challenging supply chain issues or other strategic manufacturing decisions.

Not only do VCBCs scale rapidly but they often pivot strategically in the course of their development. Their technology may take off in a new, unforeseen direction. They may find different markets that are more accessible and accepting than the markets they had initially addressed. Or the business model could change dramatically, from, for example, an asset-intensive strategy to a licensing model. Such changes can render the skills of current board members obsolete almost overnight, requiring the difficult and delicate task of easing them off the board in favor of people with more relevant skills and experience.

Board members must not only apply differing business, strategic, and operational knowledge at each stage of the VCBC’s development, they must also be able to apply different governance skills as the company grows and changes. In the early stage, the entire board usually implements and oversees governance duties as a body. During early commercialization, the board may designate a lead audit member or form an audit committee to review critical financial information and assess the finance team. In late-stage expansion, the board should create compensation and nominating/governance committees. The role of chairman also varies over time, and the delicate question of who should fulfill those duties (the CEO, an independent director, or a VC) is a particularly challenging decision. In many cases, VCBC boards have to discharge a critical governance responsibility that every board faces eventually: choosing a new CEO. Although notable exceptions occur, few Series A CEOs have the skills required to lead a company through late-stage development and rapid scale-up.

When choosing a new CEO or new directors, VCs and VCBC boards may feel impelled by the accelerated development cycle to take a shortcut: appoint people who don’t need to be assessed for the job. Simply recruit people who have an impeccable resume or bear a well-known name that is likely to excite stakeholders or potential investors.



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— Mark Livingston

Such compromising on the assessment of candidates is risky. No matter how good candidates look on paper or in the press, they should be thoroughly vetted through referencing, proven assessment tools, and structured interviews — tools that can enable decision makers to measure candidates against required skill sets, create the right mix of skills for the board overall, compare candidates, and ensure the right dynamics for the board.

Board recruitment

Board service makes great demands on any director’s time, in public or private companies. The demands on VCBC directors can be greater. Compare the intensity and velocity of overseeing an established company, growing at a rate of 10 percent annually and facing no crises, with that of a company growing at ten times that rate. “Directors of VC-backed companies find themselves faced with a lot more 10 p.m. phone calls than other directors do,” says a veteran venture capitalist. Further, while the boards



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of public companies typically meet four to six times a year, which is certainly demanding enough in terms of preparation, travel, and participation, a board of a fast-growing VCBC may meet as often as monthly. Finding a board candidate with the right qualifications who is willing to make that kind of time commitment can be difficult.

The willingness of well-qualified candidates to serve will also be affected by the unique circumstances of a particular board. For example, some experienced public company directors, accustomed to having enforceable oversight power, might decline to serve on a VCBC board that is advisory only versus those VCBC boards where all directors — independent or a VC — have equal voting rights. Other experienced public company directors might welcome an opportunity to experience the VC world and be part of industry-changing technologies away from the scrutiny of proxy advisory firms or activist funds, as well as avoid the frustrations of the

heavy compliance load for today's public company directors.

Similarly, a first-time director might prefer the decreased liability and lower pressure of a purely advisory board or a governing board where the decisions being made are far more focused on company strategy and overall growth than high-profile compliance or compensation issues subject to public filings. Many candidates, regardless of the board's status, will be attracted by the chance to interact with today's generation of entrepreneurs, taking equity in these exciting enterprises and perhaps directly invest their own money to boot.

In recruiting directors for VCBC boards, we take care to convey to potential candidates the unique circumstances of the company and its board. As one senior venture capitalist says, "Each director slot we seek to fill is a bespoke description of role, contribution potential and desired characteristics driven by the nature of the company." Whereas in large public companies the processes, committee structure, and governance regulations would be instantly recognizable to an experienced director, VCBC boards run the gamut from boards that resemble public company boards to small boards dominated by a single investor or a powerful personality. Securing a candidate who is the right fit for any board, public or private, involves a careful, deliberative process but, as with so many aspects of high-velocity VCBCs, the process must often be tightly compressed, with no sacrifice of candidate quality, integrity and culture fit.

Board compensation

Perhaps few things have changed as dramatically with VCBC boards in the past decade as the issue of director compensation. Though the bulk of director compensation still comes in the form of equity, candidates now expect at least some modest cash compensation for their service — and they are increasingly willing to request it. Says a leading venture capitalist, "Twenty years ago, in the then unlikely event that a board candidate asked for cash, I think most VC people would have found it offen-

sive." No more. VCBCs increasingly offer some cash compensation and, say a number of venture capitalists, the VC firms who resist the practice are swimming upstream.

Board diversity

Board diversity may be seen not merely as an issue of board composition but as an issue of board competencies. Today, many of the world's leading global companies define diversity not in terms of race and gender only but also as differences in nationality, cultural experience, career experience, and skill sets such as operating, marketing, technology, and product development. Although not subject to the same scrutiny around diversity as a public company, VCBCs are serving end markets, which may place significant value on how a company's board reflects the world around them and their own customer base. Health care appears to be an industry vertical with less of a challenge in delivering gender diversity than the technology or industrial sectors. A key consideration may also be the future desirability of a European listing of shares, taking into account the increasingly tight regulatory frameworks around board diversity in the EU.

VCs expend an enormous amount of time, energy, and intellectual firepower finding entrepreneurs and businesses that offer an extremely rare combination of innovation, a compelling business model, an impressive management team, and great potential for rapid growth. To this winning formula the VC firm brings needed capital and often expertise in its chosen technological field. But to ensure that the formula produces maximum yield, the best VCs add one further ingredient: a board optimally composed, structured and incented for each stage of a fast-moving development cycle to ensure ongoing, meaningful, and desired support for their portfolio companies. ■

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