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Corporate Governance

How VC-backed Companies Can Get More Out of their Boards

By Joe Mandato

In addition to their oversight role, boards at early-stage companies should be considered strategic assets of the firm. Developing a relation-based model built on a board/CEO partnership can increase start-ups' odds of success.

In an interview in *Fortune* last summer, Intel Corp. chairman Andy Grove explained how he had shifted the primary mission of his company's board of directors "from pure oversight to helping the company ignite growth." Although separation of board and management is essential for oversight and effective governance, Grove was sending the message that he also wanted his board to work with management and contribute to Intel's strategy.

Questionable governance practices and the resulting ruinous scandals have affected a number of well-known US corporations and severely damaged the credibility and standing of management. Many recommendations for change have focused on prescriptive measures—fixes that often relate to board structure, processes and procedures. But more fundamental changes in board behavior and practice might reduce or eliminate the apparent shortfall in effective governance practice. Foremost among them is to ensure that a board works with management and not just on top of it—Grove's message. Moreover, an innovative approach to governance and board involvement may be particularly appropriate for start-ups, given the lack of infrastructure and the many hats frequently worn by senior management. And given the unique challenges of the health care marketplace, that notion has particular resonance for early-stage venture-funded companies in the life sciences.

The Need to Think Differently

VC-backed start-ups may need to think and act differently, perhaps more judiciously, about effective governance than more established firms. The stakes for start-ups are higher and the environment for failure is less forgiving than for established enterprises. The boards of venture-backed companies also often differ from those of larger, well-established firms in ways that may, in fact, increase their risk. And, in the case of these smaller, more vulnerable enterprises, the downside of these risks may not just be a temporary setback but could very well be dissolution of the company for reasons unrelated to normal market risk.

First, venture-backed firms often operate with finite amounts of cash. Mismanaged crises erode that cash position and jeopardize the chances of raising additional funds. Second, many start-ups are led by less experienced management, thereby calling for stronger boards. Third, a start-up board may be dominated by investors who don't possess relevant operating or industry experience and who are often spread thin due to pre-existing board commitments. Board members without relevant operating expertise may overreact in the face of challenges or, conversely, not act fast enough in the face of management challenges that require immediate action.

The need for board-level, industry-specific experience is even more acute in the life sciences. In addition to technol-

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ogy and market risk, young health-care-related firms face industry-specific challenges that require a high degree of management expertise and sophistication: regulatory risk; intellectual property risk; reimbursement risk; and risks related to health-care fraud—always a factor when selling to the Medicare beneficiary population.

Failing to build a board capable of addressing the specific risks of development-stage health care firms, and not using the resources of a good board once it is in place, are potentially critical management errors. Consider **Align Technology Inc.**, a developer of clear orthodontic appliances. It ultimately executed one of the most successful marketing and sales strategies in the history of medical devices. But Align also stumbled in its pre-public days, in part because it did not use its board effectively.

The founding management team, albeit well intentioned, was overeager, both over-committing and under-delivering. For one thing, the company considered a national rollout for its products earlier than it should have. Many key orthodontists had yet to be trained and won over to the technology, and general practitioners had yet to be introduced to Align's product. While executives were confident of the market need for its clear orthodontia, they underestimated the need to lay the requisite groundwork to drive rapid clinical adoption and launch a major consumer-oriented health care product. Align's national campaign was costly, leading to a round of new financing.

Indeed, initiating aggressive product rollouts without first laying the groundwork for physician adoption is a mistake often made by device companies. Heartport Inc. was the darling of investors when it burst on the scene with a new minimally invasive cardiac surgery technology. Reflecting the (anticipated) enormous clinical value of its technology, Heartport's financial value soared—it went public in 1996 and immediately reached a market cap of nearly $500 million. But the company's IPO valuation quickly deflated as cardiac surgeons, proving more cautious than investors, were slow in adopting Heartport's technique. *(See "Re-Starting Heartport,"* IN VIVO*, July 1998.)* Corneal insert maker Keravision Inc. is another example of a company that got ahead of itself during the delicate period of product launch. Like Heartport, it was a member of the medical device IPO class of 1995-96, a group of young companies that saw their stock prices drop when they missed their numbers.

With hindsight, it's easy to conclude that these companies did not take full advantage of the collective expertise and experience resident on their boards. In the case of Align, the board had advised management to take a stepwise approach and begin the product roll-out with a regional launch. (The board similarly questioned management's plan to open an overseas manufacturing facility, but the company went ahead with the outsourcing plan, which has since been rolled back.) It's also possible that they did not fully appreciate their board members' willingness to mentor and counsel management at any time: a seasoned board can also be a steadying influence during the heady days post-IPO, when management, often with more money to spend than ever before, has to face the pressures of public investors for the first time.

Wisely chosen directors are a strategic asset of the enterprise and should act in concert with management—Andy Grove's self-imposed mandate. However, that message is often lost amid the drumbeat for change in corporate oversight: both board roles are critical.

The Appropriate Board Role with Management

By definition, a board must be an overseer, to ensure that management is acting on behalf of shareholders. It therefore must be independent of management influence: hence Grove's resolution in 2000, on the advice of a board member, that to be an effective chair for Intel required him to give up his CEO position. (Contrast his decision with that of Disney CEO Michael Eisner. Only after enormous shareholder pressure did Eisner agree to relinquish his role as chair to dispel any notion of conflict of interest.)

Ensuring a clear separation of the board from the interests of management has been an obvious trigger point for change in governance practice. One response has been the arguably burdensome Sarbanes-Oxley legislation. Inspired by the sense of outrage at corporate excess and poor governance, Sarbanes-Oxley has provided an aggressive response to that crisis by specifically targeting the egregious behavior relating to excess executive compensation and questionable professional standards. The law provides a framework to institute checks, balances, and controls to ensure that a higher degree of corporate responsibility and accountability exists within the enterprise. Importantly for VC-backed enterprises, while the legislation is mainly targeted to public companies, there has been talk of extending it across a broader landscape including early-stage ventures.

For less mature companies, Sarbanes-Oxley points to a legitimate need to alter board and committee make-up to better delineate the responsibilities for internal controls and complete integrity of financial reporting. In an early-stage company, outside counsel can and should advise management as to the timing of these checks, balances, and controls, when appropriate, and as the company matures. Another way to assist management is to make sure the board includes a current or former CFO—one with rapid-growth start-up experience, who can organize and chair the audit committee and advise management on infrastructure development.

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The Prescriptives

While Sarbanes-Oxley has been the most apparent change to the governance landscape, there are also prescriptive measures, which are mostly a series of structural and process changes. *(See Exhibit 1.)*

Some prescriptives may seem obvious, but nonetheless are not always implemented. One that is often proposed is the separation of key roles, as noted earlier. A CEO, for example, should not concurrently serve as the board chair—especially if the CEO is also the company founder. The separation minimizes the potential for conflicts of interest and is more likely to provide the CEO with a chair that can serve as an important board resource. The chair is also a built-in check and balance on behalf of the board on the actions taken by the CEO. Moreover, the founder should not automatically be elevated to the role of chair: it may create a conflict of interest—founders often seek a quick exit—and in many cases an entrepreneurial mindset, while critical to driving the development of a technology, can be at odds with the need to monitor management's actions and initiate discipline into a company's operations.

As a practical matter, that means the CEO and the chair must share values, and each must be prepared to place confidence in the other to act in the best interest of all stakeholders. Such is the case at **Novasys Medical Inc.**, a VC-funded enterprise developing a novel therapy to treat female incontinence. Novasys is chaired by Ray Larkin, the former CEO of Mallinckrodt Inc.'s Nellcor Puritan Bennett subsidiary. Larkin had previously worked with Novasys' CEO

Post-Enron Governance Practice

EXHIBIT 1

Approaches to Change	Impact on Firm	Recommendations for Early-stage Companies
Sarbanes-Oxley		
Establishes an Oversight Board to set standards for financial reporting of public companies	Increased financial and compensation compliance requirements	Appoint an experienced CFO as company matures
Prescriptive Measures		
Separate key roles	Separation of CEO and Chair reduces potential for conflict of interest	Carefully evaluate qualifications of founder as Chair
Strictly define board/ management roles	Improves transparency and clearly defines oversight role; form smaller working groups and committees for efficiency	To offset silo effect, increase communication between CEO and board; clearly define expectations of board members; company challenges and issues should define board and management roles
Skill-based board tailored to stage of company	Allows management to tap members' expertise and experience	VCs to assign partner with relevant experience to board; rotate partners as company needs change; smaller boards to facilitate communication
Conduct closed board sessions	Allows board to consider critical issues outside of management's presence	Essential agenda item at every meeting
Increase attendance to improve oversight	Pay board members	Even applies to cash-conservative start-ups to attract high-caliber members
"New Board" Approaches		
Make the board a strategic asset	Must create a board/management partnership; close relationship between CEO and Chair with shared values; appropriate board members based on company stage and strategies	Experienced Chair to mentor CEO; CEO and Chair co-develop meeting agenda (more working sessions, less story-telling); engage board with management and company issues; significant between-meeting contact for Chair and CEO; rotate VC partners as company needs change

Source: De Novo Ventures

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Debra Reisenthel, and the two had developed a relationship grounded in mutual trust and confidence. "Ray has done what I hope to do—grow a successful company," notes Reisenthel. "But not only is he a mentor to me, he also has credibility with the board. For example, he can give them a more substantive analysis of how I am doing than most other board members. He can also help champion the company's decisions and educate the board, saving management time and effort." Such a bond may not always exist between executive and board, especially if board members are selected, as can be often the case, based on name recognition or their investment interest alone.

Another prescriptive for better governance calls for a clear and complete definition of the respective roles of both board and management. Yet while this may be useful in a large company where the board's principal role is oversight, the same may not be true for a start-up. *(See "Good Boards, Bad Boards and Why They Matter,"* START-UP, *Sept. 2003.)*

Strict rules, as they relate to roles and working relationships, often create a degree of formality that may be counterproductive in an early-stage company, where the nature of the problems to be solved and the skills required to solve them may be more useful indicators of who does what than the more traditional approach. Instead of waiting for regularly scheduled board meetings, for example, the CEO should engage individual board members, based on their respective skills, including having them interact with staff and management to help resolve specific challenges that might require that respective skill to resolve them. In addition, to be an effective overseer of management, a board should always schedule private time without management (typically at the end of every formal board meeting), so that they may openly discuss critical issues independently and later communicate with management with one voice.

Appropriate board composition is also an important, if a seemingly obvious, prescriptive and perhaps the most important for a life-science start-up. Smaller boards can more easily coalesce with management and be less bureaucratic, in keeping with the entrepreneurial nature of start-ups. Also, the level and quality of members' contributions are more obvious and addressable.

Several factors can unduly influence board make-up, including management's pre-existing relationships with prospective members (members should be free of any contractual relationships with management of the enterprise or other board members) and the desire of VCs to protect their investments. On the positive side, start-ups should consider a skills-based board, to ensure that the enterprise has access to the appropriate range of know-how necessary to achieve the goals it has set for itself. These skills can include functional expertise as well as industry expertise, tailored to the needs of the company based on its stage of growth. Matching board skills against organizational needs is critical at most any time in the enterprise life cycle. An early-stage firm preparing for a product launch has differing needs relative to board skills than does a later-stage company, for example. A start-up may also consider imposing term limits for outside directors, which gives management the built-in flexibility to add directors with skills appropriate to the company's stage of growth.

Entrepreneurs in the venture community are questioning the number of VCs serving on their respective boards, asking how an individual VC's experience matches up with the needs of the company. While venture firms can add value, the entrepreneur should consider their ability to do so relative to the company's specific needs. One entrepreneur participating in a recent *START-UP* study cited a number of VCs who are confident in their ability to be effective managers, without ever having had adequate experience in doing so. *(See "What Entrepreneurs Want, Get, and Don't Get from VCs,"* START-UP, *June 2004.)* A smart VC will assign the partner with the most relevant skills and experience to a board position once a deal is completed, and not necessarily the partner who developed the investment opportunity. As the needs of the company evolve, the venture firm might also consider rotating their own board seat to the partner with the most relevant skills for that particular stage of the company. Similarly, a venture partner in a non-lead position should consider stepping down from a board after a finite amount of time post-funding, allowing the seat to be filled with an outside director with valuable operating or strategic skills that can better protect the investors' interests.

The entrepreneur also needs to consider prospective members' capacity relative to other board commitments. Directors serving on more than six or seven boards may not have the time required to meet the CEO's needs for adding value. They—and management—need to recognize that and be willing to step aside, when appropriate, in the best interest of the company.

Companies are also well advised to compel board meeting and committee attendance. Poor attendance should cause a member to step down. Breaking down into smaller board-level working groups and committees can minimize inconvenience to board members. Thus, new committees should be considered and formed, especially a governance committee, an audit committee, and a compensation committee. Effective committee management by qualified directors increases efficiency and attention and helps ensure director commitment. Finally, in light of increased demands on a director's time, even cash-conservative early-stage companies should consider cash compensation for outside directors. It not only helps attract high-caliber board members, but also demonstrates that their time is valued: because the majority of start-ups fail, it's becoming increasingly difficult to woo a quality director for options alone.

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The New Board

While these prescriptives are largely intuitive and rooted in common sense, less obvious non-traditional approaches to achieving board effectiveness can also help early-stage life science companies. In addition to providing appropriate oversight, an effective board must also engage management to improve problem-solving and to promote the effective use of resources, including continually challenging the business model, strategy, and tactics.

Yale University's Jeff Sonnenfeld, associate dean in the School of Management, argues that the most effective boards "are robust, effective social systems." Such a governance model emphasizes partnering and advising relationships between board and management. How people work together and partner to resolve critical issues confronting the enterprise is every bit as important, if not more so, than the usual recommended structural changes. This "new work" of the board—a phrase introduced eight years ago by the academician and board member Barbara Taylor and colleagues in the *Harvard Business Review*, describes how the role of a board should have evolved. Well before malfeasance at companies like Enron and Tyco International Ltd. brought other shortcomings of the board/management relationship to light, Taylor had called for the board to act as an adviser/partner to the CEO, thus enabling greater utilization of members' skills.

If boards are staffed with the quality and experience that both entrepreneurs and investors seek, why not put that expertise to good use? Members are not only willing, but also look forward to sharing their expertise and skills with management. The question is how to accomplish this while preserving the oversight role. One way is for board members to stay in close contact with the CEO, even on a weekly basis, rather than adopting a reactionary stance with respect to day-to-day operations as well as strategic matters. At **iScience Surgical Inc.**, for example, a start-up developing a novel surgical approach to treat glaucoma, CEO Mike Nash invites board members to attend staff meetings, speak with physician investigators, and discuss company issues with any member of the management team. The process allows the board to "kick the tires," thereby building better relationships with management and also better informing the board about certain specifics of company operations that may be useful in its oversight or strategic role. Nash also thought strategically about board make-up from the outset. He sought initial investors with experience in ophthalmics, then recruited Tom Bender, CEO of CooperVision Inc., as an outside director. The moves paved the way for effective board development and provided iScience with another level of know-how and perspective.

The new board also encourages open, flexible practices. Board meetings become an exchange of meaningful information with time for debate and critical decision-making, as opposed to listening to a series of well-scrubbed reports from management. Developing the meeting agenda should be a joint effort between the CEO and the board chair.

At the heart of the new board is a belief that a member cannot contribute to effective governance unless he or she understands the dynamic of managing the enterprise and also gets to see it first hand. By inviting board members to sit in on staff meetings periodically, iScience's Nash shows self-confidence and a trust of his directors. Spending time with executives and walking the floor also keeps directors engaged. It works both ways, too: a corporate employee quoted in the *Wall Street Journal* claims this practice demonstrates that "there are people higher up than us that actually care about what is going on." Russell Hirsch, a partner at Prospect Ventures, makes it a point to engage managers at the lowest levels of any organization on whose board he sits, thus demonstrating his obvious support and interest in the enterprise. Setting expectations with a prospective board member is another essential task of both CEO and board chair. Working together, they should spell out what is expected of a board member, including the amount of time he or she is expected to contribute to the enterprise.

An effective board must also engage management to improve problem-solving and to promote the effective use of resources, including continually challenging the business model, strategy, and tactics.

The new board believes that its members should have a level of accountability and responsibility for specific tasks, while also being careful not to impinge upon or be seen as undercutting management of the organization's day-to-day activities. For example, a board member experienced in sales should be called upon to vet the structure of a sales management team and potential hires; he or she may even have worked with some of the job

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candidates. That input is valuable, but only so long as it remains separate from the actual recruiting and hiring, which should be left to management.

Taking Time, Building Trust

The CEO must recognize that board-building is a dedicated task like any other, and not just patronage to be doled out. To be avoided is a situation such as *Business Week* described at the Coca Cola Co.: a board "top-heavy with diplomats and financiers, but short on the kind of marketing expertise that Coke could use." (Despite the company's spotty performance and loss of market share in the past few years, interestingly, Coke's board has remained largely intact.) With the support of the chair, the CEO needs to drive the effort to recruit members with whom the team is comfortable, who might add value through particular skills, expertise, or experience and who has the time and motivation to be involved in leading the company to success in an especially challenging time.

Unfortunately, however, board and management responses to the increasing demands placed on them by Sarbanes-Oxley and the buzz of scandal have been slow. Advances in board governance and organizational effectiveness must go beyond current practice and an emphasis on structural reform. Prescriptive measures are important and useful, but incidences of faulty oversight continue despite the outside pressures of media scrutiny, stakeholder litigation, and attempts at legislative fixes. While it may be obvious that governance must be more effective, no one has yet identified the right fix.

In the meantime, early-stage companies in particular should recognize that in an entrepreneurial organization, relation-based management built on a board/CEO partnership makes greater and more effective use of board skills and may have a significant positive impact on organizational results and effective governance practices. ●

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