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Best Practices for Building a High Performance Board of Directors

Kauffman Fellows Program

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LVP Background and What's New…

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- Founded LVP in 1996 after 9 years on Wall Street, 4 years as partner with Dick Blum in SF, and 2 years in the wilderness getting LVP's fund started.
- Three VC funds – 1996, 2000, and 2004
- Invested ~$200M, returned over $400M to-date; three active companies will tell the story for LVP III– ShotSpotter, Akros Silicon, Capella Photonics
- Have managed a specialized consulting business for 18 years in parallel with VC activities, resolving complex challenges for institutions and very high net worth families who are active in VC and other illiquid investments.
- Co-founded LittleCast, a direct-to-fan video marketing and commerce platform, with Amra Tareen and Stephen Ackroyd, March 2013, raised $2mm seed financing, will raise Series A Q3 2014
- Forming new early stage VC fund with single LP, to be announced very soon…
- LVP Historic Focus: Software, semiconductor, and communications equipment
- New Fund Focus: Digital Media, Cloud Services, Security, Healthcare Services

There is Plenty of Denial About Board Dysfunction Among VC Company Board Members...

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You take the blue pill and the story ends. You wake in your bed and believe whatever you want to believe. You take the red pill and you stay in Wonderland and I show you how deep the rabbit-hole goes.

- Morpheus from Matrix

If you take the Red Pill, understand that the Board is an essential part of the journey and a critical element of your success or failure

Why Do Boards Matter?

- If you are the CEO, you work for your board.
  - Managed properly, your board will work for you, too.

- If you are a director of any enterprise (public or private, family-controlled or institutional, for-profit or non-profit) you incur specific legal obligations to the different constituencies that you represent and you bear personal liability for the decisions that you make

- If you are a company shareholder, a bad board, or a single bad director, can set in motion a chain of events that can ruin your company

A good board can bring direction, resources, connections and valuable experience that will help the company's chances of being successful

Why Are Many Boards Ineffective?

A wide variance exists in the application of best practices in board governance, particularly in the venture capital industry.

- Some boards are very effective
- Some boards are dysfunctional
- Most boards are not as effective as they could be

What is the most common mistake made by boards of directors?

The presumption of board consensus when it does not, in fact, exist!

The Road to Success Is Almost Never Straight and Challenges Will Occur– These Challenges Often Play Out in the Board Room

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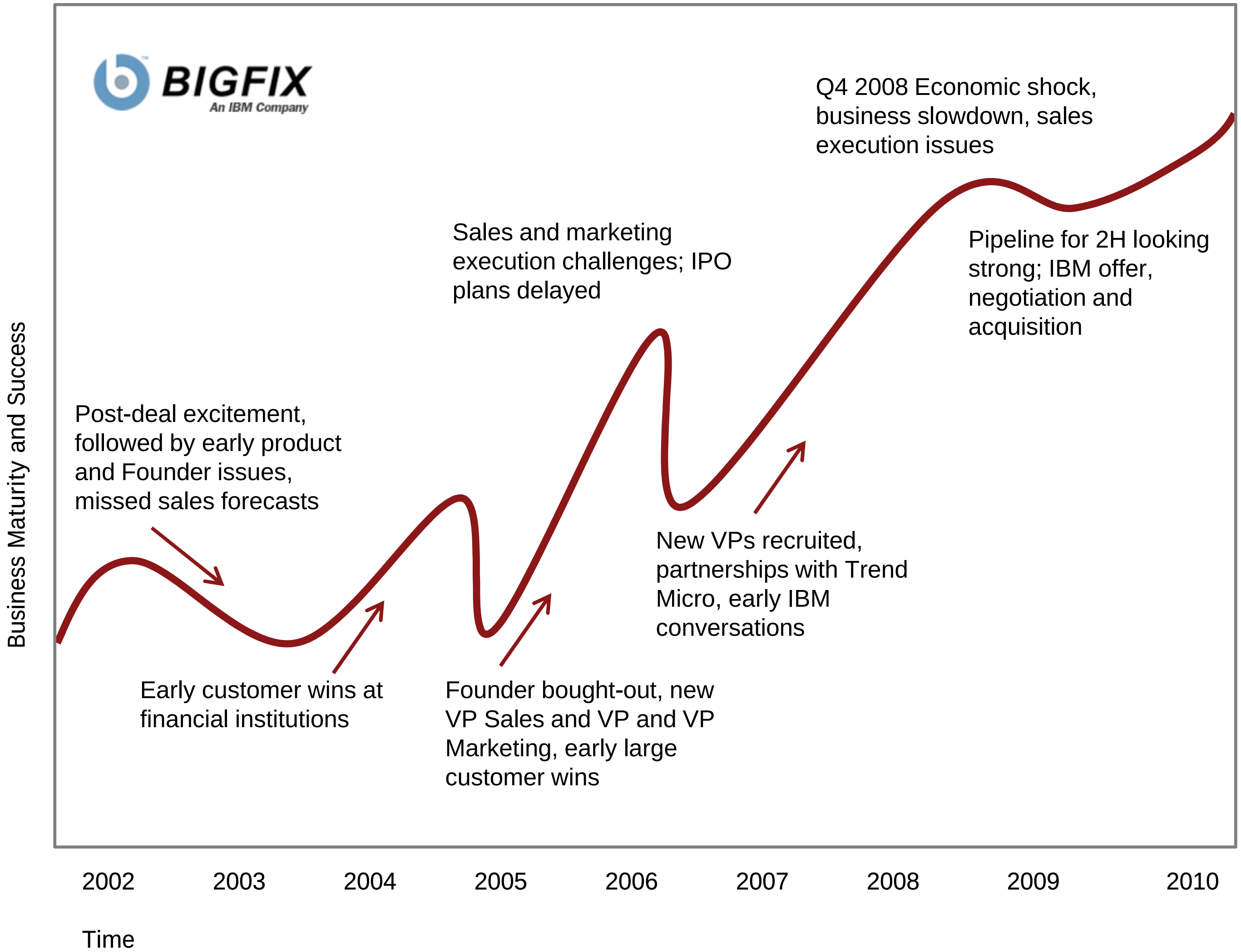
BigFix Case Study On Weathering The Storm – Life Is Never A Linear Path To Success



What is Your Role with the Entrepreneur – Mentor, Advisor, Overseer, or Just a Check Writer?

- Articulate your intended level of involvement with the company
  - Time
  - Capital
  - Rolodex
- Passive or active? Both roles are fine provided you are transparent
  - If passive – be truly passive and request reasonable information flow; don't burden team
  - If active – dedicate your cycles, but realize the management team is running the business, not you. You have invested in "them" to execute on the business

As You Define Your Board Role, Consider Where the Company is Today and How You Want it to Develop

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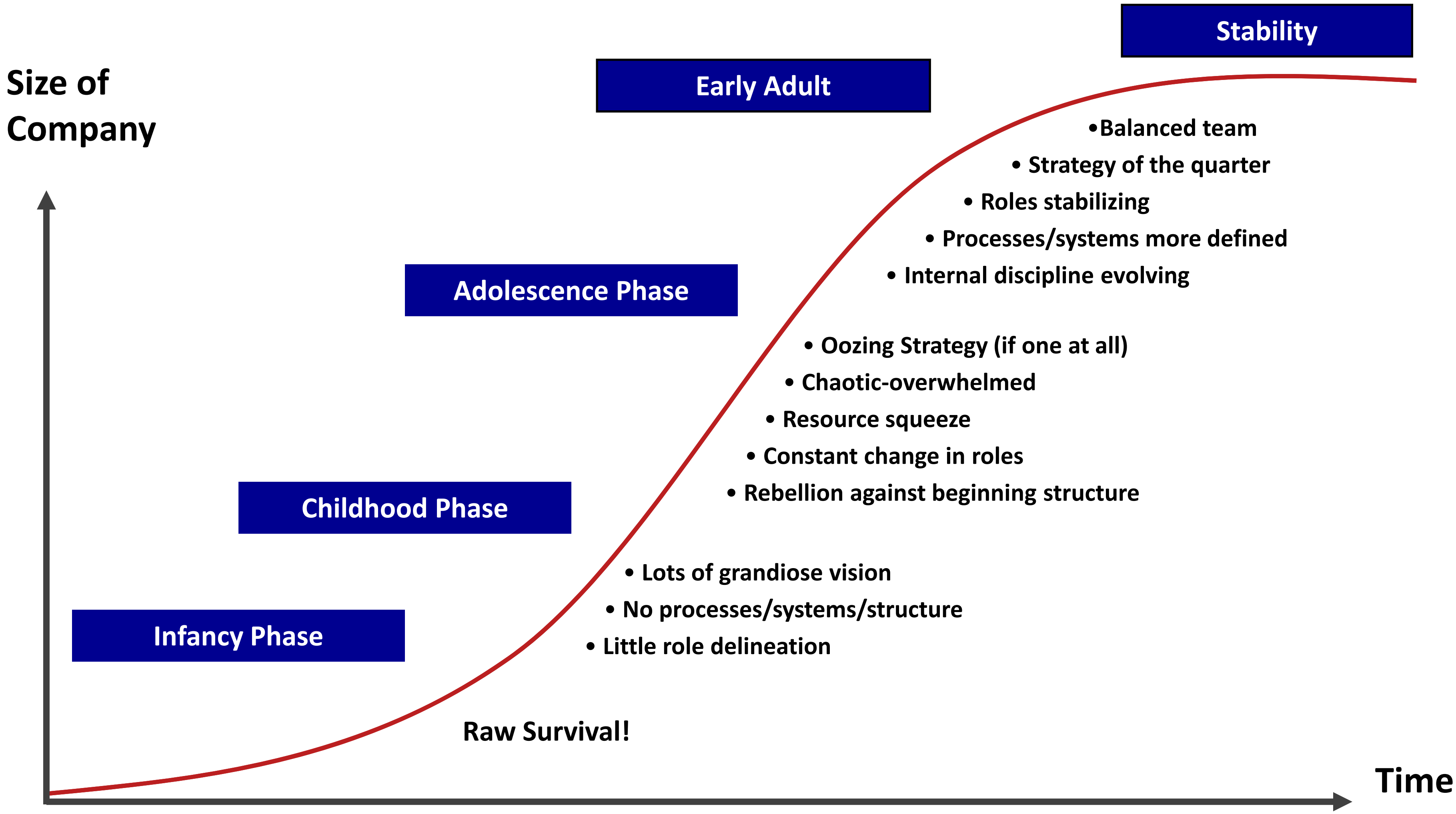

Directors are Often Unrealistic in Making This Assessment

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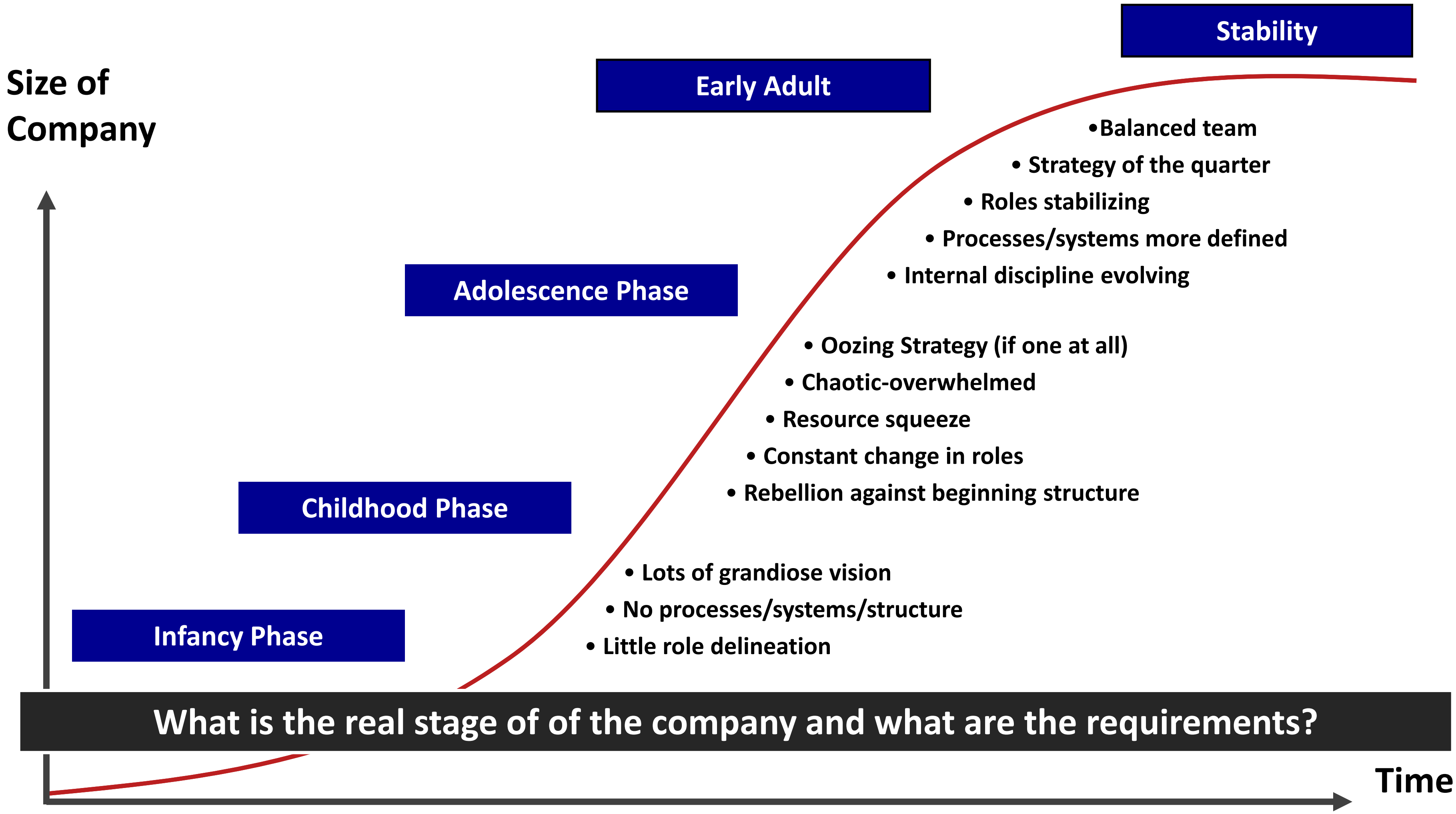
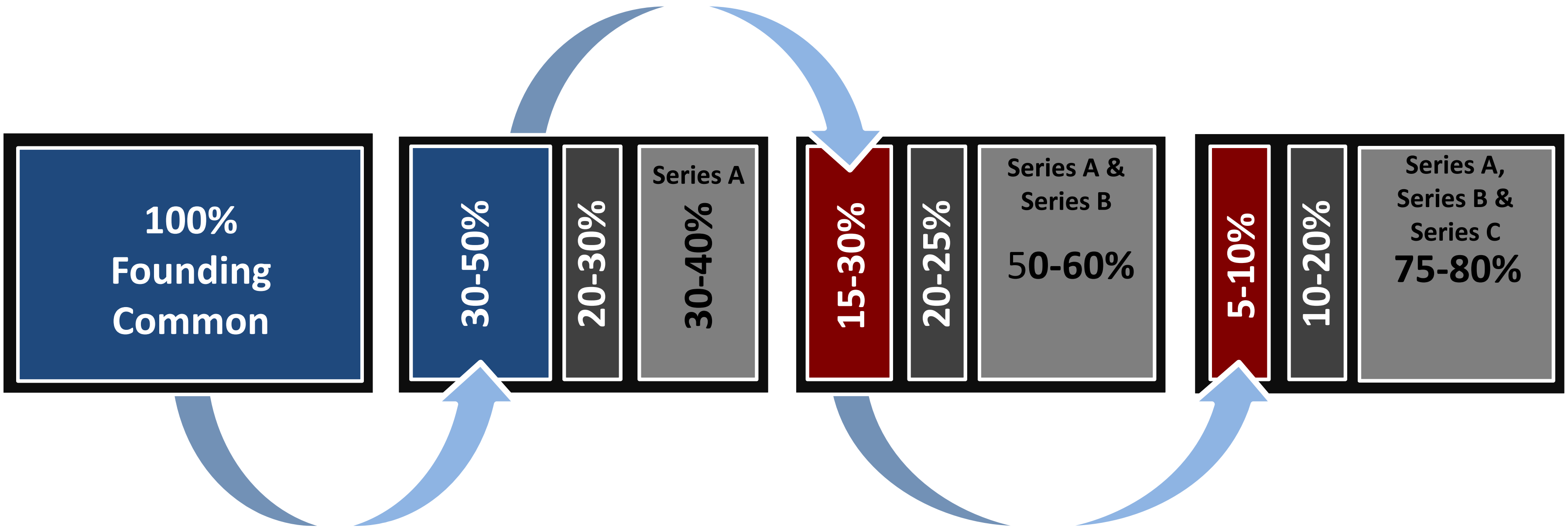


Deal with Dilution When Meeting with Founders



- Many founders don't understand dilution math or expect to get full options refreshes at every financing round, even when they don't deliver….
- Having this discussion and setting realistic expectations, especially if the company doesn't perform according to plan, should occur BEFORE the check is written.

By Definition, Management Teams and Investors View The World Differently

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Startups are Rife With Conflict - Consider Some of the Most Common Conflicts Between Board and CEO

	Investors	CEOs
Personality	27%	0%
Burn Rate	0%	22%
Exit Strategy	22%	18%
Management Changes	21%	16%
Valuations	18%	24%
Sales & Market Strategy	12%	20%

Source: NVCA 2006

Defining the Board's Essential Role

- Maximize shareholder value for all of the company's shareholders
- Attract, recruit, and retain talented management team and board members
- Mentor, task, and measure the executive team
- Provide a level of insight, business perspective, and expertise that is otherwise unavailable to the company's management team
- Oversee and promote fiscal, legal, and ethical governance standards

Duties and Responsibilities of Directors Include …

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- Serving as fiduciaries for all shareholders
- Hiring and firing the CEO, ratifying officer selection and seeking continuity and strengthening the Board
- Reviewing and confirming basic company objectives and business strategy
- Overseeing company performance and inquiring into performance deficiencies
- Identifying barriers to company progress and proactively sensing timing for change

Best Practices for a Constructive Relationship Between Board & CEO

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Set explicit expectations with periodic review

- Identify a fair and aggressive corrective plan
- Implement metrics for director accountability
- Honestly ask & answer the difficult questions
  - How is the company operating?
  - Is it truly on a success path?
  - Are the CEO's skills contributing to the company's success?
  - Is the CEO largely operating from strength or weakness?

- <u>Must have</u> an annual CEO Review and Evaluation

Four Common Types of Misalignment Create Direct and Indirect Tension at the Board Level and Beyond

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Economic

- Common vs. preferred shareholders
- The Trados decision highlights process failure among misaligned VC's and common shareholders…

Fiduciary

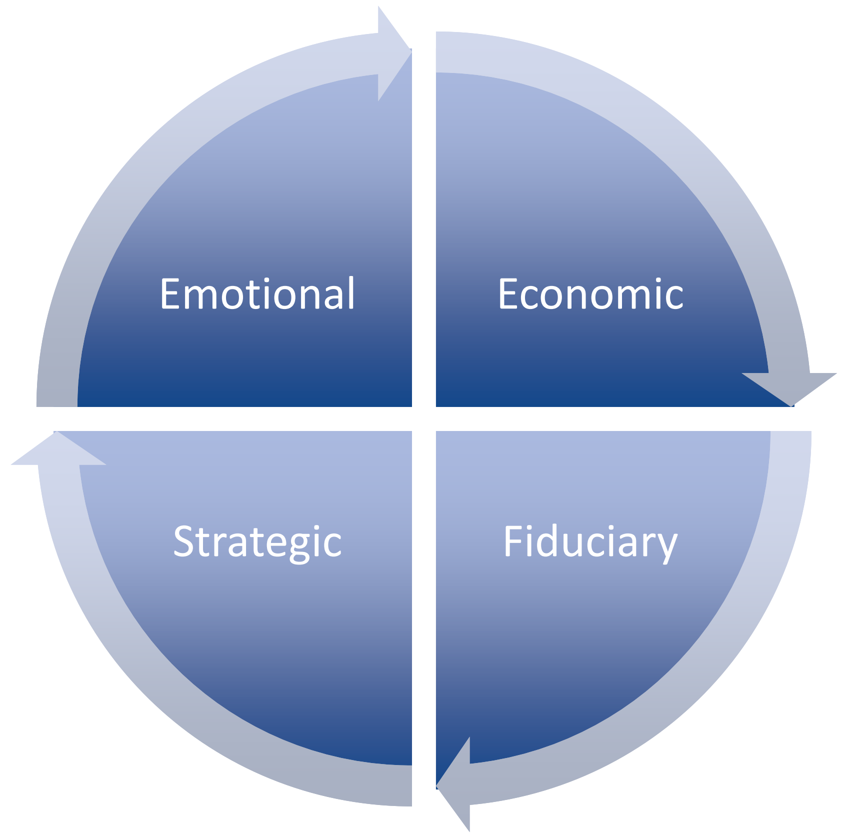
- Violations of fiduciary duty
- Are all Directors paying attention?

Strategic

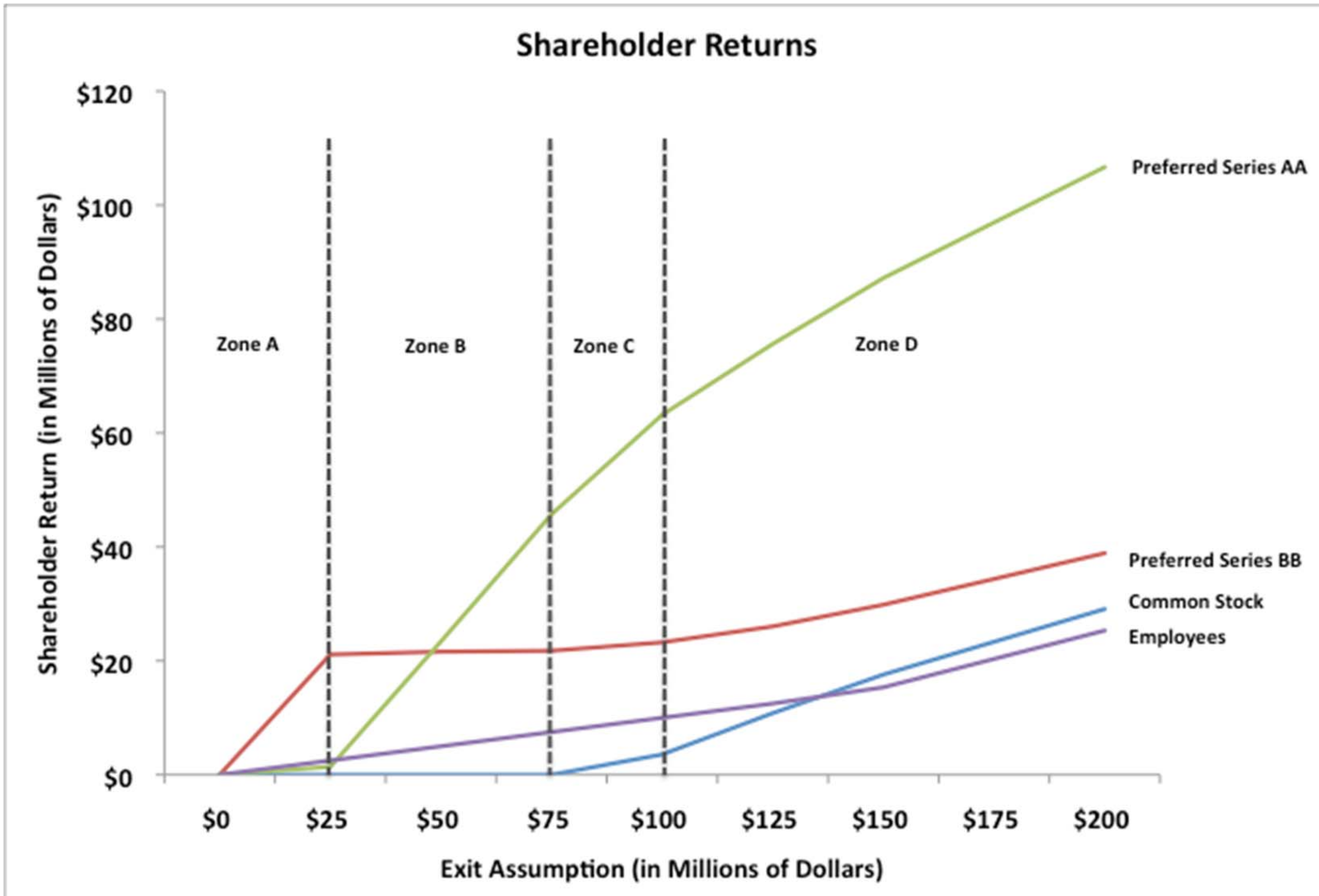
- How do you spell independent?

Emotional

- Too often emotion clouds decision making
- Ego versus well-founded conviction



Do the Math: Valuation and Structure Often Create Hidden Misalignments Between Shareholders



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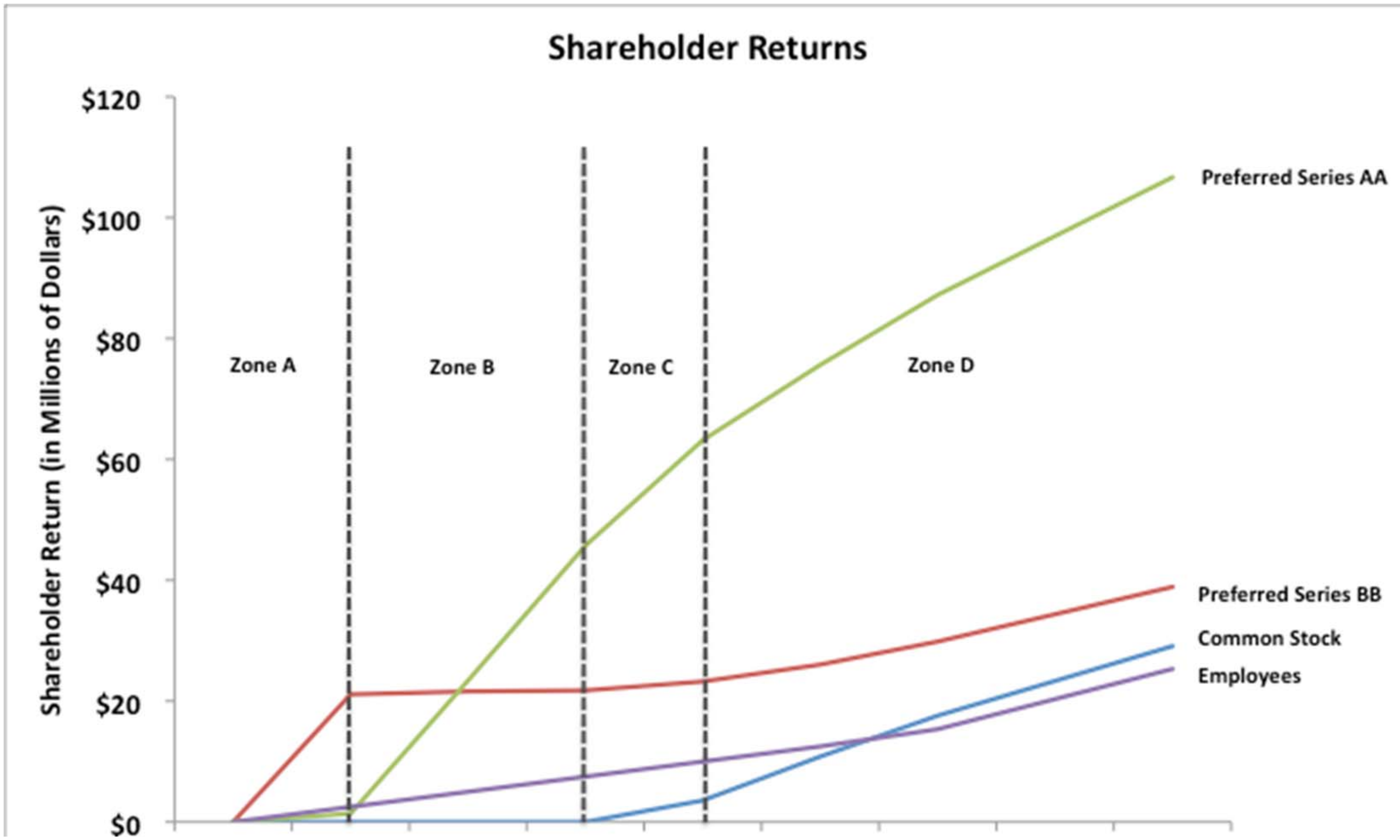

Understanding each shareholder's relative economics across a range of outcomes can often help drive a "win-win" solution for a financing or at time of exit

Early Warning Signs in the Board - CEO Relationship

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1. Staying the wrong course: Rejection of board input
2. Offsite and out of touch: Disengaging from daily operations
3. Indignation: Emotional and combative behavior
4. The silent treatment: Cutting off information flow to the board
5. Buck-passing: Ignorance of key details and blaming other executives for unexpected shortfalls
6. Pulling up the drawbridge: Directing his or her management team to deflect board inquiries

Ineffective Boards…

- Fail to communicate– both in and out of the boardroom
- Suffer from Denial Syndrome—they fail to act and make decisions.
- Fail to reconcile diverging viewpoints.
- Avoid conflict
- Regularly hold excessively long board meetings (over three hours without a strategic planning or other extraordinary agenda)
- Allow the use of smartphones and computers for non-board related business during the board meeting

Effective Boards…

- Establish a clear and mutual understanding of expectations between the Directors and the CEO
- Conduct a formal annual performance evaluation of the CEO
- Have routine executive sessions among non-executive board members only
- Have directors who work as a team and want to get together
- Encourage open/honest communications
- Resolve differences of opinion constructively and quickly
- Have directors who are accountable to each other

Ineffective Directors…

- Feel compelled to say something and to be heard, disregarding relevancy or effectiveness of comments.
- Become disengaged because they no longer feel that their opinion matters—this could be over a strategic disagreement.
- Fail to resolve disagreements quickly and constructively
- Do not maintain regular board meeting attendance.
- Deliver inconsistent messages between the actual meeting and their post-meeting behavior— Passive-Aggressive syndrome.
- Succumb to lead investors who discourage constructive discussion from the rest of the board
  - In VC, smaller firms in particular are afraid to break ranks with the lead investor for fear of not getting into future deals.

Effective Directors…

- Know and understand their responsibilities as directors
- Are informed when they arrive at the board meeting, know the industry, and know the company’s context in it
- Do not attack the CEO or other board members when he/she answers their questions.
- Participate in free and easy communication outside of the boardroom
- Are willing to give an outlier perspective as an individual member of the group

Some Recommendations

- Process, process, process…
- Ask, and answer, the hard questions early
- Be realistic about your operating forecasts and be prepared to revise them – up or down
- Keep the recent Trados decision in mind when considering conflicts of interest and misalignment between shareholder classes: *"Trados's primary lesson is the importance of directors having an unrelenting focus on the interests of common stockholders and the very limited extent to which directors should consider the non-contractual interests of preferred stockholders in structuring transactions."*
  Sullivan & Cromwell analysis
- Be open to working with outside consultants to address team and other management issues
- Be creative when considering solutions

What Does it Mean to be A Fiduciary?

Legal Requirements

- Duty of Care
- Duty of Loyalty
- Duty of Good Faith
- Duty of Confidentiality
- Duty of Disclosure
- Enforcing the business judgment rule

Duty Of Care

- Requires a director to act with the care that an ordinarily prudent person in a like position would exercise under similar circumstances

- Requires directors to
  - Make informed decisions
  - Obtain information they believe is reasonably necessary to make a decision
  - Make due inquiry.

Duty of Loyalty

- Requires a director to act in the best interests of the corporation and not in the interest of the director or a related party
- Issues often arise where the director has a conflict of interest
  - Where the director or a related party has a personal financial interest in a transaction with the company
  - Where the director usurps a “corporate opportunity” that properly belongs to the company
- Generally, corporate laws have procedures for handling interested transactions and corporate opportunities, such as by requiring full disclosure and disinterested director approval.

Duty of Good Faith

- A separate duty of good faith has emerged in some jurisdictions such as Delaware where a director has engaged in such egregious behavior as to not have acted in good faith.

- Examples of not acting in good faith
  - Consciously or recklessly not devoting sufficient time to required duties
  - Disregarding known risks
  - Failing to exercise oversight on a sustained basis.

- Failure to meet the duty of good faith can have serious adverse consequences to a director, such as being exposed to personal liability for breaches of the duty of care or losing coverage under indemnification or insurance policies.

Confidentiality and Disclosure

- *Duty of Confidentiality*. A subset of the duty of loyalty. Requires a director to maintain the confidentiality of non-public information about the company.

- *Duty of Disclosure*. Requires a director pursuant to the duties of care and loyalty to take reasonable steps to ensure that a company provides its stockholders with all material information relating to a matter for which stockholder action is sought.

Business Judgment Rule

- Creates a presumption that in making a business decision, the directors of a company acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.

- The business judgment rule helps protect a director from personal liability for breaches of fiduciary duties by essentially shifting the burden of proof to a plaintiff alleging that the director did not satisfy his/her fiduciary duties.