COVER STORY

Startups' boards of directors: Are they up to the job?

Public turbulence at some highly hyped 'unicorns' has raised concerns among investors about whether young companies are getting what they really need from board members

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Tech unicorns, until recently the darlings of the VC world, are suddenly facing tumultuous times. So are their boards.

In the wake of several high-profile startup stumbles, greater attention is being focused on startups' directors. In theory, board members are overseers who are supposed to offer guidance, experience and differing perspectives to challenge those of company executives. But at young companies, the board is frequently limited to the founders and close associates. It may not include any other voices until the company begins to receive significant outside investment. There are increasing worries among investors that haphazardly created boards can be too small, too insular or too disengaged to provide what's expected of them: what many are calling "adult supervision."

James Bergeron, a longtime venture capital and private equity executive who mentors Silicon Valley CEOs and their boards, noted that many startups are headed by a "20-something or 30-something who's never run a company in their life," and needs grounding in aspects of business they haven't experienced.

Bergeron, who sits on two boards now and has served on about 10 all told, says it's "worthy of self reflection" by startup investors and boards to make sure these would-be disrupters also embody ethical behavior and good judgement, and "have folks at the table who are independent."

"It's reasonable to say we need to take corporate governance more seriously," agreed Eric Wiesen, managing partner at Menlo Park's Bullpen Capital, and a veteran of 16 boards. "A lot of boards of directors in later stage companies are absolutely having the conversation."

In the wake of the epic compliance and supervisory failures at human resources startup Zenefits, he said, board members at young companies are starting to ask questions such as: "We don't have a compliance committee. Can we get one?"

That's easier said than done, he said: "It often takes a couple of years to constitute and staff them."

In today's rapidly evolving environment, however, that may not be fast enough.

> *'We need to take corporate governance more seriously.'*
>
> **ERIC WIESEN,** Bullpen Capital

Changing narratives

Lax oversight by boards was less of an issue during the boom times when funding was flowing freely and valuations seemed to go ever upward. Six or eight months ago, many of these companies were flying high. Then a flurry of changes – everything from slowing growth in China to valuation markdowns by big investors like Fidelity and Morgan Stanley – cooled the atmosphere dramatically.

For none did the climate shift so rapidly as Zenefits.

In less than three years, Zenefits exploded from three employees to 1,600. By mid-2015 it boasted a $4.5 billion valuation, with the swagger to match. Since then, however, the company has lurched from one misstep to another. It missed revenue targets and drew criticism over its own employee record-keeping. More seriously, it now faces a series of allegations that its brokers did business in many states without legally required licenses. Further damaging revelations have followed, including that Zenefits had a free-wheeling ethos so engrained that employees had to be admonished not to have sex in the stairwells.

Amid the roiling series of disclosures, CEO Parker Conrad's abrupt ouster in early February highlighted the fact that until then, the board consisted of just four people: Conrad, co-founder and chief technology officer Laks Srini, then-COO and now CEO David Sacks and Lars Dalgaard, general partner at Zenefits' lead investor, Andreessen Horowitz.

The same day that Sacks announced Conrad's exit, he said Zenefits was adding three additional investors to its board: Peter Thiel, co-founder of PayPal and Founders Fund; Antonio Gracias, Valor Equity Partners' founder and managing partner, and Bill McGlashan, TPG Growth's founder and managing partner. His announcement acknowledged a lack of proper supervision: "Our culture and tone have been inappropriate for a highly regulated company."

The board move added heft – and considerable outside experience – to the panel, but it's too soon to say if the change will help.

"The years of experience (being added) to the board will be a resource to the company," said Zen-

On board: "Companies don't typically discuss this stuff publicly," Wiesen says.

TODD JOHNSON

efits' spokesman, Kenneth Baer.

"Companies don't typically discuss this stuff publicly," Wiesen said, "and rarely proactively change their board composition the way Zenefits did."

Bad blood

At Theranos, the problem wasn't a lack of board members. As the secretive blood-testing firm rocketed to a valuation of $9 billion, enigmatic CEO Elizabeth Holmes assembled a star-studded panel of heavyweights.

It included superlawyer David Boies, former secretaries of state Henry Kissinger and George Schultz, ex-U.S. Senate Majority Leader Bill Frist, plus a selection of retired top military brass.

But when the Palo Alto company came under fire from regulators over the reliability of its tests and the supposedly groundbreaking technology behind them, observers pointed out that only one board member – former Wells Fargo CEO Richard Kovacevich – had extensive business experience. Observers wondered how much focus and expertise the board's other luminaries were able to bring to bear at the company, particularly as several were in their late 80s or older.

In response to the criticisms, the company has since shuffled its board. It brought on Boies and constituted a "governance board" of five members, with the larger group as an "advisory board." Theranos' web site lists 12 people, including Holmes, as part of its "boards of directors and counselors."

Why the change? "It made business sense at the time," said a Theranos spokeswoman.

When it, too, ran into trouble, Practice Fusion's board acted more decisively, booting founder and longtime CEO Ryan Howard upstairs to chairman last August, and appointing Tom Langan first as interim chief executive and a few months later as permanent CEO of the electronic medical records company. Less than three months later, the 10-year-old medical technology company laid off a quarter of its 300-person staff, in what Langan called a necessary step "to accelerate our path to profitability and positive cash flow."

Neither entrepreneurs nor VCs see one standard-issue solution to startup governance issues.

In some cases, bringing in board members from outside a highly complex industry may create complications.

Tom Lee, founder and CEO of San Francisco's One Medical Group, a tech-savvy medical group seen as a potential unicorn, warns that Silicon Valley's attempts to disrupt highly regulated arenas like health care and insurance can result in companies "overstepping their bounds."

"Folks coming from outside try to innovate, but may not be aware of the regulatory environment," he said, suggesting that having industry-specific experts on board is critical.

CEO Josh Reeves, whose Gusto, a Zenefits rival, has raised $136 million and had a $1 billion valuation as of December, said boards must ensure "that the CEO is performing and the executive team is the right executive team."

That suggests that a private board that isn't asking lots of questions, and demanding answers, isn't doing management or investors any favors. The quality of a Gusto board meeting, Reeves said, is determined "by how many debates we have."

7 common mistakes of startup boards

TOO FEW IN THE ROOM

Early on, boards tend to be founders, top executives and close associates. They can't be relied upon to take a challenging attitude toward existing management — after all, they are existing management for the most part.

TOO MANY IN THE ROOM

As companies grow, boards tend to expand as each major investor who comes on board wants to come onto the board as well. But the bigger the group, the less ownership each member feels, and the harder it is to reach a consensus on important decisions.

COMMITMENT ISSUES

Sure, getting a "star" CEO or celebrity on the board attracts attention — but does he or she really have the time, energy and interest to nurture the business, or is it just a nice paycheck on the side?

IT'S WHAT YOU KNOW

Often what young companies need most, and seek least, is counsel from those who have long experience in the very industry they are trying to "disrupt."

SWEATING THE SMALL STUFF

Get a group of hands-on CEOs on the board — and the danger is that they'll be hand-on as directors as well, to manage (or micro-manage) the business when they should be more broadly focused on strategic thinking and oversight.

DIVERSITY, PLEASE

Companies are frequently formed by like-minded, similar people. But a good board typically needs a broad range of viewpoints, born of varied expertise, experiences, genders, ethnicities and backgrounds.

MISALIGNMENT MATTERS

The board's role is not to be a cheerleader for management, but if a board and management are fundamentally out of alignment on strategy and execution, it's a recipe for trouble.