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RECRUITING THE 1ST INDEPENDENT BOARD DIRECTOR

A guide by lifecycle stage from start-up through IPO

A Caldwell Whitepaper

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Entrepreneurial CEOs believe what they do and the products they create will change the world. By nature, they are agile, creative and comfortable dealing with uncertainty. Their laser-like focus on how to fix a specific problem allows them to clearly see the solution. Charles Handy wrote in his book *The New Alchemists*, that entrepreneurs also share two key traits - dedication and doggedness. Combined, these qualities allow entrepreneurs to build businesses with huge potential.

However, these visionary traits normally aren't enough to establish a commercially viable and sustainable business. Steadfast belief in their vision to transform the world often detracts the entrepreneur from the fundamentals required to create and govern a profitable company. Passion can cloud their judgment when it comes to the essential details and processes needed to grow an idea into a business.

Assembling a strong board is a critical stage in the development of a company. A diverse board with a broad mix of skills and experiences will provide a much needed balance to an entrepreneurial CEO. By integrating the vision of the CEO with the broad view of the board, early stage companies create an ecosystem that primes the venture for growth. In short, successful companies take the necessary actions to design a board that adds value at every stage of its lifecycle.

Recruiting the first independent board member is crucial to the future success of the enterprise. Companies can choose to recruit the first independent director at any time, and the earlier it happens, the more likely they are to have board members in place who possess the right skill sets and experiences to foster growth. Many, however, wait until angels have invested. Once a company has received funding from venture capitalists, adding an outside director becomes an absolute requirement.

Waiting until it is mandated often results in investor-appointed board members whose priorities may differ from the company's needs. Optically speaking, companies that appoint independent board directors who are clearly aligned with an investor (i.e. entrepreneur in residence, operating partner) are often perceived by future investors as having a board that is stacked – a nuance that is often overlooked and underestimated.

Best practices dictate that the size and composition of early stage boards evolve in concert with each stage of the company's life cycle: from start-up to IPO and beyond.

LIFECYCLE STAGE MATRIX

	BOARD SIZE	RATIO OF INTERNAL VS. EXTERNAL
Stage I The seed/start-up	3-4	Management: 1-2 Investors: 1-2 Independent: 0-1
Stage II Early commercialization/external funding	4-5	Management: 1-2 Investors: 2-3 Independent: 1-2
Stage III Expansion	5-7	Management: 1-2 Investors: 2-3 Independent: 2-3
Stage IV Pre-IPO or other liquidity event	5-7	Management: 1-2 Investors: 2-3 Independent: 2-3
Stage V After the IPO	7+	Management: 1-2 Investors: 2-3 Independent: 2-3

STAGE I: The seed/start-up

During the seed/start up stage, companies do not have any revenue; their energy and resources are focused on R&D and building organizational infrastructure. Start-up boards usually consist of founders. With the key role of a board being to protect shareholder interests, who are primarily the founders in this phase, this composition makes sense. Startup boards usually have three members, but the size varies depending on the number of founders.

Common Pitfalls Resulting From Building a Board of Investor-Appointed "Independents"

- Insular thinking
- Duplication of skills
- First-time board members
- Conflicting loyalties
- Issues resulting from perceived conflicts of interest
- Hidden agendas
- Complacency
- Lack of knowledge of the regulatory environment
- Indecisiveness due to fear of liability issues
- Disconnection of interests between board, management and investors
- Overemphasizing harmony and underestimating the value of healthy debate in the boardroom
- Discounting fellow board directors
- Crossing the lines from oversight to management
- Absence of leadership

STAGE II: Early commercialization/external funding

Early funding can encompass friends/family or angel investors. While friends/family tend to be passive investors, angel investors are usually – though not always – more active, bringing valuable experience leading or running technology ventures. Investors will privately and/or publicly advocate for their appointees. Regardless, by accepting external financing, the company now has a fiduciary responsibility to all of its shareholders (not just the largest ones). At this stage, investors expect the board composition to reflect independent and objective oversight. Typically the size of the boards receiving early funding ranges from three to five directors.

STAGE III: Expansion

As revenues start to come in, the company shifts to expansion mode. Cash flow enables it to mobilize resources to increase its production capacity and continue to develop/refine product offerings. At this stage, companies often expand geographic coverage, increase customers and broaden their channels of distribution. Although not required, this is the stage where proactive companies add one or two independent directors.

STAGE IV: Pre-IPO or other liquidity event

Once a company achieves significant revenues, the board shifts focus in anticipation of a liquidity event. This exit of initial investors directly impacts board composition. The type of transaction dictates the expertise needed on the board. Companies preparing to go public need to consider the specific requirements of the listing exchange. These requirements include electing an independent, qualified financial expert and the number of independent directors on the board/serving on the audit and compensation committees. Generally speaking, though the SEC, NASDAQ and NYSE have similar expectations about board structure and composition, compliance requires understanding the key differences in timing (i.e. registration vs. listing) and the number and roles held by independent board directors. While there are no set rules regarding when to initiate a board succession plan, most experts agree it is best to start 12-24 months before an event.

STAGE V: After the IPO

Following an IPO, a company might still need to recruit additional independent directors, as both exchanges require a majority of independent directors within one year of listing. Venture capital and private equity firms often continue to hold their seats on the board following an IPO. Over time, the initial investors vacate seats creating openings on the board. Also, independent directors retire or choose not to stand for re-election. Board structure and composition is a dynamic and evolving process. Successful companies understand and plan for these changes by instituting an ongoing board succession plan.

Assembling a strong board is a critical stage in the development of a company. A diverse board with a broad mix of skills and experiences will provide a much needed balance to an entrepreneurial CEO.

MARKET INSIGHT – why it is critical to plan ahead, allowing 12 to 24 months to identify and recruit the first independent board director.

In our experience, companies begin to recruit independent directors only after they have committed to a liquidity event. All major stock exchanges require companies to have a majority of independent board directors. Waiting until the last minute puts unnecessary strain on internal resources and has the potential to force the choice of an available candidate instead of the best candidate. With increased external scrutiny, employer policies limiting board service and the continued demand for diverse board candidates, it has become a seller's market with high profile candidates often pursued by multiple companies. Underestimating the time required to recruit independent directors forces the company into a corner. With looming deadlines, they can risk losing the opportunity to engage the best candidates, who often want time to conduct their own due diligence, as they will have personal liability for information contained in the registration statement.

Consideration needs to be given to the following factors:

- Greater shareholder pressure - demanding greater rights and influence
- Complex regulatory environments abound
- Navigating risk mitigation factors - businesses and markets continue to intersect with overlapping supply chains, emerging technologies, and strategic growth opportunities.
- Expectation of clear and transparent communication – must articulate long-term approach to core strategy and performance issues
- Recruiting board directors is taking longer –fueled in part by narrow profiles and unrealistic expectations of management and board as competition for directors increases.
- Companies need to employ a strategic approach to board composition and succession planning both of which need to be linked to the long term goals of the business.
- Candidate pool is becoming more selective – there is increased competition for board directors, and candidates understand that there are significant reputational and financial risks associated with serving on an outside board.
- Many large companies have instituted policies that prohibit and/or limit outside board service.
- Heightened awareness of the value added through diversity - firms such as ISS (Institutional Shareholder Services), NACD, HACER and WomenCorporateDirectors track governance practices and board composition and link their findings to performance and governance risk.

Factors to consider during the transition from private to public

Pre-IPO companies share a common dilemma - building a board in a compressed time-frame. Quite simply, they lack the luxury of time, often having to recruit several board directors with a broad range of knowledge and experiences in months vs. years.

Regardless of whether an investor plans to exit completely or retain a role in the future company governance and ownership, prospective shareholders look for a public company board with high-stature board directors who will ask and act on tough questions. The primary focus of a public company board is protecting shareholder interests and ensuring SEC requirements are met.

Caldwell has observed several trends influencing the board recruitment landscape:

- Need for new board directors to possess several new competencies – simultaneously.
- Appreciation that renewing a board in preparation for an IPO is a competitive advantage.
- Accessing public markets brings a new level of scrutiny to a company.
- Bias for previous public company experience and premium placed on board directors who are known or connected to the current board.
- Awareness that the post-IPO board should not have the same experiences as the pre-IPO board.
- Regulatory requirements mandate a majority of independent non-executive directors.
- Building/strengthening committees to comply with regulatory standards. For example, after a public offering, the audit committee must comprise at least three independent members, one of whom must be an SEC-defined "financial expert"
- Shifting role of the board to include oversight of risk management and compliance requirements.
- Approaching board composition strategically - filling seats with expertise the company needs for the future.
- Enhancing board room dynamics by building consensus.

SELECTING THE FIRST INDEPENDENT BOARD MEMBER

Recruiting a company's first independent director can occur at any stage in a company's life cycle leading up to an IPO. Proactive companies seek independent directors earlier in their development because they appreciate the competitive advantage of an engaged board. Investors (whether angel/venture capital/private equity) will likely demand an independent director.

Once a company decides to go public, adding an independent director is no longer optional – it becomes a requirement. The earlier in its life cycle that a company takes this step, the more likely it will be in a position to select the skill sets and experiences that will benefit the enterprise, rather than being subject to investor appointees or regulatory requirements.

Board size influences the number of independent directors that can be added. The range of skills and experiences to consider when choosing a company's first independent director can be grouped into the following categories:

PERSONAL CHARACTERISTICS AND QUALIFICATIONS OF INDEPENDENT DIRECTORS

PERSONAL CHARACTERISTICS	QUALIFICATIONS
• Exemplify personal integrity, fairness and honesty. • Intellectually and emotionally resilient and able to offer a well-founded and potentially critical review of business matters, yet modest and mature enough to recognize his/her appropriate role as a director. • Inquisitive, analytical and fact-based. Able to evaluate strategy, acquisitions, business plans, financial issues, and people in a constructive manner. • Forward-thinking and strategic, yet pragmatic and operationally strong • Committed to building long-term shareholder value.	• Demonstrate professional excellence. • Embody characteristics and behavior that constitute professional excellence, like respect for others, fair evaluation and positive regard, as a model for others to follow. • Be willing to act on and be accountable for Board decisions. • Have the ability to provide wise, thoughtful counsel on a range of issues. • Have a history of achievements relevant to the company's current challenges, and the ability to leverage that experience to help shape and advance the company's strategic goals. • Be loyal and committed to driving company success, functioning as a positive ambassador and company advocate in the communities it serves. • Be able to take tough positions while being a collegial team player, fostering candor and constructive collaboration. • Be willing to devote sufficient time to carrying out board duties and responsibilities, and be committed to serve on the Board for an extended period of time. • Support and establish the company's commitments in hiring and other personnel practices. • Meet the SEC and NYSE or NASDAQ standards for independence in relationships with suppliers and service (such as audit) firms.

REQUIRED BOARD COMPOSITION OF PUBLIC COMPANIES

At the most basic level, a company needs directors who understand the business and the industry so they can help management think strategically. For companies electing their first independent director, a few key profiles emerge as the most sought after:

CEO mentor/coach

A co-pilot who offers meaningful advice and counsel to the CEO – brings the perspective of having "been there, done that." Brings a history of achievements relevant to challenges currently faced by the company and the ability to leverage those experiences to help shape and advance the company's strategic goals. Mentoring is part of his/her DNA.

Marquee/brand name director

Presence provides instant "street cred." Brings relevant industry experience and is well known in the community. Reputation provides board validation and, in turn, validates the company. Instrumental in opening doors to sources of funding, customers and ecosystem partners. Sets the bar for future independent directors.

Ambassador

Experienced in the art of government or versed in how government operates. Brings wisdom and ability to navigate public policy issues.

Domain expert

Subject matter expert. Is an authority in a particular aspect of the business (whether it is the actual industry or technology), helps guide the business, acting as a steward for growth. Well-grounded in the realities of the business drivers, potential risks and opportunities.

Ecosystem partner

Understands that business success depends in large part on how the various entities within that ecosystem are able to work together, co-develop, co-deliver or collaborate. Adds value through intimate knowledge of customers, suppliers, distributors, OEMs, systems integrators, and/or solution providers.

Utility player

Plays several positions competently, a jack of all trades. Tends to fly under the radar, yet their value is high because they give companies so many different options. By playing several roles well, a utility player is a treasured commodity. Oftentimes, the utility player is called upon to fill significant holes not covered by the management team or other directors.

Financial expert

A hallmark of SOX legislation, the presence of a qualified financial expert is required for a company that is planning an IPO. Every public company needs an independent financial expert on its audit committee. Beyond compliance, brings knowledge of GAAP and financial statements. Experience includes preparing or auditing financial statements, accounting for estimates, accruals and reserves and internal controls. The right Financial Expert can help set the tone that says, "We do things right. We say what we do and we do what we say."

To unlock the value of a strong board, the best defense is a good offense. Successful companies employ preemptive strategies for board recruitment and composition. Monitoring and adjusting board structure and composition at each stage in its lifecycle is the first step in building a board that can provide sage counsel during the growing pains. Everyone (management, employees, shareholders, customers) benefits from the diversity of thought and experiences offered by independent directors.

REQUIRED BOARD COMPOSITION OF PUBLIC COMPANIES

	NYSE	NASDAQ
Majority of independent directors	• Within 1 year of listing date	• Within 1 year of listing
Independent audit committee	• At least 1 independent member by listing date • Majority of independent members with 90 days of effective date of registration statement • Fully independent committee within 1 year of effective date of registration statement • No non-independent members permitted during phase-in if company required to file periodic reports with SEC before listing	• At least 1 independent member by effective date of registration • Majority of independent members within 90 days of effective date of registration statement • Fully independent committee within 1 year of effective date of registration statement • No non-independent members permitted during phase-in if company required to file periodic reports with SEC before listing
Number of audit committee members	• 1 member by listing date • 2 members within 90 days • 3 members within 1 year of listing date	Not specified
Independent compensation & nominating committees	• At least 1 independent member on each committee by earlier of date IPO or 5 business days from listing date • Majority of independent members on each committee within 90 days of listing date • Fully independent committees within 1 year of listing date	• At least 1 independent member on each committee by time of listing • Majority of independent members on each committee within 90 days of listing • Fully independent committees within 1 year of listing

Companies that constantly assess their board's strengths and weaknesses against their current lifecycle stage and long term objectives have a better chance of thriving.

Once a target date has been set for a liquidity event, board structure and composition takes on a whole new level of importance. If the plan is to go public, the timeline as it relates to independent directors on the board is fixed. While it is easy to identify the characteristics of the ideal board director, there are no shortcuts when it comes to the time required to recruit independent directors. Preparing to go public is intense, but the process is eased when boards already have independent directors in place. A clear understanding of the governance rules can help achieve the best possible outcome.

A board that quickly identifies potential gaps in experience is better positioned to course correct by supplementing the missing knowledge. Without question, the company and its leadership will face challenges at each lifecycle stage, and responsibility for anticipating and resolving these challenges rests on the board. Having a board with the right mix of skills provides a competitive advantage when challenges erupt (and they will).

CONCLUSION

Regardless of their lifecycle stage, a company that invests the time to build a diverse board that is rich with independent directors will reap many rewards. From intellectual capital to social capital to interpersonal capital – independent directors bring wisdom and experience to a growing company, and offer unbiased perspective to the management team. Too often the boards of early stage and venture/PE backed companies limit the universe of prospective board directors to their personal network. Companies that make it a priority to add independent directors before it is mandated are considered truly competitive and transparent.

In today's business environment, investors, customers, regulators, employees and the broader community demand greater oversight from boards. The presence of independent board directors in the early stages of growth gives shareholders and future investors confidence that someone will be watching over the interests of all investors.

The first step to strategic and economic alignment of the company's long term objectives with shareholder needs comes in the form of a truly independent board director. Who, when and how a company recruits them is unique to the venture. However, it is clear that at some point every company planning to go public will need to add its first independent director. Thinking ahead and giving the company ample time to recruit the best independent director increases the venture's future success. Our advice, start early and choose wisely relative to the specific needs of the company and its lifecycle stage; don't rush.

ABOUT THE AUTHOR

Bethany George is a consultant in Caldwell's Board & CEO and Private Equity/Venture Capital practices. With more than 25 years of search experience, Bethany has focused solely on recruiting board directors for the past 14 years. She has placed over 125 board directors for clients in a variety of industries, geographies and ownership structures. Bethany also brings extensive experience recruiting ethnic and gender diverse board directors for her clients.

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WE BELIEVE TALENT TRANSFORMS™

At Caldwell we believe Talent Transforms. As a leading provider of executive talent, we enable our clients to thrive and succeed by helping them identify, recruit and retain their best people. Our reputation–nearly 50 years in the making–has been built on transformative searches across functions and geographies at the very highest levels of management and operations. With offices and partners across North America, Europe and Asia Pacific, we take pride in delivering an unmatched level of service and expertise to our clients.

Understanding that transformative talent is not limited to executive levels, our Caldwell Advance solution focuses on emerging leaders and advancing professionals who can also have a profound impact on a company's ability to turn potential into success. We also leverage our skills and networks to provide agile talent solutions in the form of flexible and on-demand advisory solutions for companies looking for support in strategy and operations. Also, we are a leading licensed certified partner of The Predictive Index (PI), an award-winning talent optimization platform with a suite of talent strategy and assessment tools that – when integrated with our search process – helps clients hire the right people, then manage and inspire them to achieve maximum business results as fast as possible.

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