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BoD Potential Friction

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Quick Summary: The CEO and the Board Members should be aware of some common potential areas of conflict.

Abstract:

For the most part, CEOs and the company's Board of Directors share the same goal: The company's success. However, there are some areas of potential conflict that can arise. Interestingly, many of those conflicts occur when the company is doing well and not when they are struggling. Being aware of these potential conflicts and addressing them as soon as they appear on the horizon is in everyone's best interest.

As previously discussed, the Board of Director's fundamental goal is to provide overall direction and management of the company that is in the best long-term interest of the shareholders. Their method of accomplishing this goal is to work with the company's CEO and not by directly interacting with the company's employees. Private company boards are typically dominated by Inside Directors who are in some way affiliated with the company – most often as founders or outside shareholders. One or two Outside Directors with domain experts or management coaches may be asked to join the Board to provide more insight and objectivity.

With one notable exception, Board Members, the CEO, company employees, business partners, and customers have the same common goal: The company's long-term success. In fact, *Principle 3* of this collection, "*Provide an Acceptable Return to All Investors,*" consists of twenty-one articles on this subject. The one exception to the common goal assumption is the fundamental motivation of the financial investors represented by some of the Board Members, and it stems from the definition of "long-term success." As discussed in article 3.020301, "*Company Success Versus Investor Returns*," financial investors' first and foremost responsibility is providing an acceptable return to their investors. If the company is successful in the long-term, it is "nice," but it is not the financial investor's primary concern. This is not an insensitive approach; it is a fact of business life. Limited partners, such as Institutions and Pension Funds, give (venture) investors money to make money, not to make great companies. To be fair, great companies usually provide excellent returns to their investors. However, those returns may not materialize with the timeframe required. This divergence of interests can manifest itself in board discussions about future company investments.

For example, financially motivated Board Members may be interested in short-term profitability to become more attractive to a potential acquirer. The company and other Board Members may be interested in making longer-term investments in next-generation products that will benefit the company much later. The short-term focus of financially driven Board Members may balk at those investments pushing for less investment to increase short-term profitability to make the company more attractive to a potential acquirer or delay the need to raise more capital, which would dilute their ownership share. It is easy to criticize this apparent short-term thinking and behaviors and other similar financially driven Board Members actions, but one must realize they have different fundamental motivations. Their job is to invest in companies the funds that were entrusted in them by their investors (ex. Institutions and Pension funds). Their job is not to build great companies but to maximize their investors' returns.

Another factor that should be considered when interacting with financially driven Board Members is that they clearly understand that most startup companies fail – 50% in the first five years and 80% by year ten. Extinction, not survival, is the norm. Venture firms' track records of only one in ten of their investments return significant returns, in spite of their careful due diligence and experience, validate the high failure rate. The most probable causes of those failures are, first, the lack of laser-beam market focus and, second, the lack of proper execution. Although other Board Members may embrace the CEO's long-term vision, financial investors will probably be more focused on short-term customer validation with a corresponding interest in customer acquisition tactics and not long-term company strategy.

All-in-all, financial investors, with their wide-ranging experience with other similar companies, can provide a continued dose of reality to board discussions. Understanding their primary motivation (to make money) helps to respond to them accordingly.

Financial investors have far more control over a company than what may be stated in terms of their voting rights or other terms in the company's Articles of Incorporation or Operating Agreement. They can exercise this power subtly or forcefully. Their power is based on their actions (or threats) to limit their participation in future funding rounds. Smaller or high-growth companies typically go through several funding rounds (ex. Series A, Series B, … Series "x") to raise capital to accommodate their growth. Potential investors often expect current financial investors to participate in future rounds on a pro-rata basis. If the current investors do not make that commitment, future investors may think that if the current investors, with their intimate knowledge of the company, are not investing, there must be some non-obvious reasons. Future potential investors, with many different investment opportunities, may simply decide to invest elsewhere. By threatening not to participate in future rounds, a current investor Board Member can leverage that position in other areas.

There can be legitimate reasons that current investors do not participate in future rounds. If so, those reasons will, most likely, be publicly disclosed. A good example of this situation involves Angel investors who may invest their personal funds and decide to limit their investment exposure in any company.

During future round negotiations, current investors can also exert influence by suggesting some draconian terms for the next round to increase their power. They may suggest certain new voting rights or new items that require Board approval.

Another area where major disagreements between the company and the financial investors may arise is during exit discussions, either an acquisition of the company or an IPO. The investors will naturally think of these events as terminating events in which their relationship with the company will end (after some holding period). For the company, both of these transitions will result in a marked change in how they do business and, in most cases, the expectations that their new owners will have. Company personnel will not realize any accessible monetary rewards immediately preceding this event. In most cases, the acquirer, whether another company or the public markets, will expect the company to continue performing at or above the same levels as in the past. To do this, the existing team must remain intact. During the acquisition discussions, the investors, who have been through the process many times before, will lead the effort. Although the CEO will be involved, they must remember that the primary motivation of the investors is to maximize their return, not to ensure the company's long-term well-being. Financial board members typically focus on early exits, even understanding that significantly higher returns may be possible if they stay the course for a longer period. Most venture firms raise new funds every four years. They start the fundraising process in the third year. By being able to highlight successful exits when they are raising money (during the third year) can make them more attractive to new potential fund investors. Chapter 7.03, "*Mergers and Acquisitions*," is dedicated to this subject – and the reality of missed M/A expectations.

One thought to always keep in mind when dealing with investor board members is the "Golden Rule": "*He who has the gold makes the rules*!"

Conflicts that are not as severe or threatening as those described above may also occur with other Board Members that center on tactics or strategy. A common source of disagreement can occur between the company, struggling to manage cash, and a Board Member, who "sees" the bigger opportunity and wants the company to reach out more aggressively. Board Members' opinions of individual staff members and their capabilities of fulfilling their assigned roles now or in the future is another potential area of conflict. CEOs may have blinded loyalty to some of their employees who have been with them from the beginning and not willing to make tough decisions.

Without a doubt, the largest conflict can involve the apparent need to replace the CEO! The fact is that the skill set to envision a company and have the entrepreneurial mindset and ability to start a company is not necessarily applicable to an ongoing business. Some Board Members (probably experienced financial investment Board Members) may reach this conclusion quicker than other Board Members, who are loyal to the CEO.

None of the potential conflicts listed above are like fine wine that gets better with age. As painful as it will be, a speedy resolution is in everyone's best interest.