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BOARD MEMBER SELECTION IN NEW TECHNOLOGY BUSINESSES:

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Abstract

Recent events in the US have focused attention on the fiduciary responsibility of independent board members at a public or private company. This paper examines the process of selecting board members at a high tech start-up where issues of investment in innovation, conflict of interest, firm valuation, non-interference in direct management, exit strategy and accounting practices can be difficult for an entrepreneurial team to handle in a timely manner. Start-ups are in a unique position in that they have the opportunity to initiate a board composition that not only can serve them well in the first few years of business but can set the "tone" or "culture" for the expected levels of ethical behavior in the entrepreneurial team. After reviewing the functions of board members, a typology of candidates and general qualifications, suggestions are made to the start-up's entrepreneurial team in the form of a checklist for dealing with several of these issues in board governance.

CHANGING ROLE OF THE BOARD OF DIRECTORS

Recent events in the US have focused attention on the fiduciary responsibility of board members in a company. Questionable tactics in financial reporting at *Enron*, lucrative executive compensation packages at *Tyco* and numerous reports of insider trading and conflict of interest have eroded the confidence in the methodology of board oversight. In the aftermath of recent corporate scandals, the spotlight has shown most brightly on whom shareholders considered the most impartial of board members and who was supposed to best represent their interests – the independent board member. The independence was derived from several attributes: not being part of management or related to any member of management; not having substantial financial investment in the company; not doing business with the company; and not being able to accrue great personal wealth from the company's performance. Nevertheless, despite the disappointment and due to the urging of institutional investors, companies have moved towards having more and more independent directors. (Colman, 1994) However, there are mixed reviews as to the value of the independent directors on the board in relation to firm performance. (Lin, 1996) (Barnhart and Rosenstein, 1998) (Denis, 2001) The role the board plays in corporate governance is certainly becoming more pronounced and the board's relationship with the CEO is also changing. (Pound, 1995)

Start-ups have the unique opportunity to begin corporate governance with principles that have become important to shareholders – transparency, communications, standard and widely accepted accounting rules, and the highest ethical standards. Although start-ups begin their corporate life almost without exception as private companies, many choose to immediately follow SEC and NASDAQ rules about the role independent directors should play in corporate governance. In this way, the corporate governance transition in going from a private company to a public company would be smooth and with no need for major alteration. There are many books and articles outlining the responsibilities of a corporate board member, *The Corporate Director's Guidebook* (1994) being an example. However, few authors have addressed the methodology for the selection of board members, especially in start-ups, let alone high tech start-ups.

Due to the recent adverse stock market conditions and the "witch hunt" now underway in the US to ferret out unethical if not illegal behavior of company management and board members, it is timely for the entrepreneurial team ("ET") to place more importance on board selection than ever before. Further, the selection process may become more laborious than before due to the disinterest being generated in potential board members as they see board membership as more "risky" than in the past. Director and Officer ("D&O") insurance policies, once relatively common in public but rare in private companies, may become a requirement for a prospective board member of any stature, wealth and reputation to join a company board. Few public companies have braved not having D&O insurance in the past and fewer will dare continue not having such protection.

Another reason for developing a corporate governance plan at a start-up centers on its high risk of business failure in the early years. A strong board can assist in detecting and attending to signs of business ailments (Scherrer, 2003). Assembling the right board can also assist the high tech start-up in maintaining its focus on innovation and commercialization processes. (Perel, 2002) High tech start-ups have the added business hurdle to overcome of introducing a new technology to the market and achieving its acceptance within a window of opportunity dictated primarily by the level of investment and low competition.

FUNCTIONS OF A BOARD MEMBER

The Sarbanes-Oxley Act of 2002 imposes requirements on board governance as an attempt to make more uniform board oversight of companies. Basic duties and responsibilities were initially outlined in the Model Business Corporation Act of 1978. (Model Act) However, over time five types of relationships have developed between the board and the company: (a) Legalistic; (b) Agency; (c) Strategy and policy; (d) Advisory; (e) Contributory. Four of these types are described in Ong and Lee (2000) as "theories" that researchers have used linearly and individually to describe the functioning of the board relative to the company. Little research has been done to model board influence on company performance using even two of the relationships at the same time let alone all five.

The five relationships or functions ascribed to board behavior in this paper are listed below in similar form to that of Table 1 in Ong and Lee (2000). We will briefly discuss the attributes of each relationship and the impact they may have in assembling a board for a high tech start-up.

Legal. The company board has powers and responsibilities endowed by its articles of incorporation, corporate bylaws, federal and state statutes, or regulations passed down from the SEC or stock exchanges.

Agency. The role of agency dates back to the expectation that owners and managers can have a divergence of interests. (Berle and Means, 1932) In this light the primary job of the board directors is to provide impartial and diligent oversight of a company's operation and management *in the interest of all shareholders*.

Strategy and Policy. As a result of performing its legal and oversight duties, the board exercises judgment in evaluating business plans, investment opportunities and organizational priorities. The process of evaluating and approving such major strategic options of the company empowers the board in establishing strategy for the company. (Zahra, 1990) Research has shown a positive correlation between board involvement in corporate strategy and firm performance. (Pearce and Zahra, 1991)

Advisory. Board members are expected to perform in an advisory role to company management. Large investors in a technology company, such as venture capitalists ("VC's"), at times insist on playing a major advisory role as board members, especially with youthful and inexperienced management teams. VC's can overplay this role to their detriment if they fail to gain the trust of the entrepreneurial team early in their association. (Besenitz, Moesel, Fiet and Barney, 1997)

Contributory. Board members do volunteer their services operationally in many ways with or without additional compensation under the conditions that the time to complete the service is not burdensome and that the service does not compromise their career or current position. This relationship is attributed to a "stewardship" function of a board member. (Davis, Schoorman and Donaldson, 1996)

TYPOLOGY OF BOARD MEMBERS

Investor. Anyone who has made a significant investment in the start-up frequently asks for a board seat principally for the sake of "protecting" their investment. Venture capitalists commonly ask for a restructuring of the board as they make an investment, assuring themselves of enough board seats to reflect the size of investment being made in the company. Depending on the limited partnership agreement governing the venture capital firm, it is often the case that the VC partner him/herself has to sit on the board associated with his/her "deal."

Employee/Manager. It is common for managers or other employees, especially founders, to request a board seat, frequently using the argument that they own considerable stock and they have a significant stake in board decisions. Entrepreneurs can find that the CEO's membership is adequate for representing the interests of the managers and other employees. Employees are obvious "insiders" who are biased in that they tend to protect their jobs with the company.

Relevant Stakeholder. Other stakeholders found on boards include customers, suppliers, legal counsel, spouses of the CEO or other board members and family members. Entrepreneurs are advised to avoid encouraging such candidates to join the board, principally for avoiding conflict of interest.

The Independent Board Member. Extensive research has been conducted analyzing company performance relative to board structure parameters such as number of insiders, number of independent members, board compensation, etc. The motivation for such research is obvious. It attempts to answer the question: "What kind of board is associated with acceptable company performance? The consensus from this research, despite a weak association, is to advocate for more independent board members (Barnhart and Rosenstein, 1998) (Denis, 2001).

GENERAL QUALIFICATIONS FOR INDEPENDENT BOARD MEMBERS

More variables that are ascribed to a board member on an individual basis that certainly can influence company performance include (a) communications; (b) motivation; (c) operations experience; (d) teamwork; (e) time. These attributes are especially important for an entrepreneur to assess in a candidate for a board position.

Communications. One attribute that may portray the prospective board member's true temperament is that board member's ability to communicate. Witnessing the would-be board member's oral presentations, especially in group meetings, and a review of some his/her writings on business subjects can give insight into the individual's mode of thinking, reasoning and judgment.

Motivation for Being an Independent Board Member. What motivates a person to join a board as an independent director? Compensation in the form of bonuses and stock options can be a significant incentive. (Gutierrez, 2003) One model of human behavior poses three classes of variables in determining human behavior (Jain and Triandis, 1990). Social factors such as roles, norms, self concept and interpersonal agreements form one class of variables. Act satisfaction associated with pleasurable activities is another class. Finally, perceived consequences of performing the act is the third class.

Operations Experience. Just as it has been reported in the literature (Farris, 1982) that basic knowledge of the underlying technology area has been found to be useful in the success of a manager of knowledge workers in a technology area (resulting in more innovation), so it is likely that a board member can exercise his/her fiduciary responsibility in an improved manner if he/she is knowledgeable in the technology area of the start-up. There is certainly merit to having independent board members who have different backgrounds, such as legal, financial, technical, managerial and ethnicity.

Teamwork. It is imperative that the prospective board member demonstrate the ability to handle group dynamics in a professional manner. A tendency to dominate meetings, be vociferous or cantankerous can torpedo a board meeting.

Time Requirements. Serving on a board can consume considerable time so entrepreneurs should be aware of the contribution of possibly the most important asset a professional has – his/her time. Frequently, independent directors have a full time job at another company or organization and simply cannot afford more than that amount of time per month.

BEST PRACTICES IN BOARD GOVERNANCE

Several best practices that are pertinent to high tech start-ups are the following. Several of these practices are listed in Sherwin (2003):

1. Majority of directors are independent.
2. The Chair and CEO are separated.
3. Audit committee is composed entirely of independent directors, whose backgrounds indicate a high degree of financial competence.
4. Board conducts annual performance review of management team.
5. Board has a CEO succession plan in place.
6. All committees chaired by independent directors.
7. Board membership exhibits diversity in experience, skills, backgrounds, gender and ethnicity.
8. Trust, communications and teamwork are nurtured in board activities.
9. Review of strategic plan and annual financial plan happens at every board meeting.
10. Board meetings are planned with published agenda one week in advance with targeted start and end times.

CHECKLIST FOR BOARD SELECTION AND CONCLUSIONS

As a result of the prior discussion the following ten assessment steps in Table 1 form a guide for entrepreneurial teams in dealing with board member selection. The first seven steps assess the board member candidate's suitability for general board membership while Steps 8-10 specifically deal with the issue of the start-up's technology focus. There is much activity, perhaps even turmoil, in the initial period of starting up a company. Entrepreneurial teams are often eager to start the product or service development process once funding is secured. It is easy to put off board member selection or relegate it to the lead investor in the company. However, the ET may never be in such an advantageous position again to help select the best available group of people who will perform oversight of the company's management and make other valuable contributions.

Table 1

Usage of Table 1 by an ET in assessing a board member candidate can also be modified by assigning a "weight" to each attribute. For example, the absence of a board member on the current board that exhibits strength in Step 4 may lead the ET to assign a higher weight to Step 4 than to others. However, it is important that ET's understand that no attribute can be ignored. Indeed, board candidates who rate poorly in Steps 3, 5 and 7 can cause trouble far in excess of their potential positive contributions.

In summary, the selection of board members for new technology businesses is an important step in laying the groundwork for a company's success. The process of selection should be seen by ET's as a rare opportunity to strengthen the people assets of the company. Choosing board members can very well rival the importance of choosing key operational team members.

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Table 1
Assessment Steps for Selecting an Independent Board Member in a High Tech Start-up

Step No.	Attribute	Areas	Comment
1	Business Experience	Marketing, Sales, Strategy	These areas are probably most useful to a start-up
2	Communication Skills	Active Listening and Succinct Verbalization	Individual must be able to "listen" to the E-team's issues and not "overtalk."
3	Ethics & Background	Impeccable ethical background	Avoid selection of anyone with questionable reputation.
4	Ability to "Open Doors"	Relationship with Potential customers, suppliers, potential investors	This is valuable initial "capital" for the start-up.
5	No Conflict of Interest	No significant interest in ownership or financial association	Too much potential conflict will necessitate excusing the board member from deliberations
6	Time Availability	No more than 2 other board memberships	Regardless of other virtues, absences from deliberations does disservice to company
7	Chemistry with Founders	More so than age difference, interpersonal skill is important	Difficulty in relating to founding team is a "no-no."
8	Gen. Knowledge of Technology	Career in technology	A degree in technology helps
9	Specific Knowledge of Company's Technology	User, Developer, Researcher	User is most needed for a start-

			up
10	Operational Knowledge of Technology Companies	Executive of functional area	Sales and Marketing of Technology products or services most helpful