Governance

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§1 Introduction

As with almost every topic in the study of organizations, definitions of corporate governance vary widely and the choice of the definition influences how comparisons among organizations and countries are conducted and how the results and implications of those comparisons are interpreted. A relatively simple definition of corporate governance is that it is “the system by which business entities are monitored, managed and controlled”.¹ This notion of a “system” focuses on the relationship, and allocation of responsibilities, between the owners of the firm, the shareholders, and the managers of the firm who are vested with the duties to oversee day-to-day firm operations. The “management group” consists of two different and important classes, both of which are represented on the firm’s board of directors elected by the shareholders: the “executives”, such as the chief executive officer, who are expected to work full-time on the business of the firm; and the non-executive directors, who are not serving as employees of the firm yet are chosen for the independence and expertise and ability to look out for and protect the interests of the shareholders against attempts by the executives to take advantage of their insider positions. According to Nisa and Warsi, the measure of effectiveness of this system of corporate governance is whether a firm has created an enduring structure “that encourages symbiotic relationship among shareholders, executive directors and the board of directors so that the company is managed efficiently and the rewards are equitably shared among shareholders and stakeholders”.²

While it has long been accepted that the principal participants in the corporate governance framework were the shareholders, management and board of directors, the scope of corporate governance began to change during the 1990s as new and different goals for corporate activities were suggested. Sir Adrian Cadbury, Chair of the UK Commission on Corporate Governance, famously offered the following description of corporate governance and the governance framework in the Commission’s 1992 Report on the Financial Aspects of Corporate Governance: “Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society.”

This formulation of corporate governance brought an array of other participants, referred to as “stakeholders”, into the conversation: employees, suppliers, partners, customers, creditors, auditors, government agencies, the press and the general community. As

² Id. at 129.
described by Goergen and Renneboog: “[a] corporate governance system is the combination of mechanisms which ensure that the management (the agent) runs the firm for the benefit of one or several stakeholders (principals). Such stakeholders may cover shareholders, creditors, suppliers, clients, employees and other parties with whom the firm conducts its business.” The principles of corporate governance of the Organisation for Economic Cooperation and Development clearly state that the corporate governance framework should recognize the rights of stakeholders (i.e., employees, customers, partners and the local community) as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

The focus on interested parties beyond shareholders is the hallmark of a broader view of corporate governance that emphasizes the responsibilities of business organizations to all of the different stakeholders that provide it with the necessary resources for its survival, competitiveness, and success. In this conception, managers remain primarily accountable to the stockholders who have placed their wealth in the hands of those managers; however, managers, particularly the members of the board of directors, are also responsible to groups of stakeholders that have made equally significant contributions to the corporation and these stakeholder responsibilities impose additional constraints on managerial action and the primacy of shareholder rights. Rahim, noting that the roles and responsibilities of directors have been described as the “board as manager”, pointed out that the duties of board members have been vastly extended as CSR has moved from the margins to the center of corporate governance attention.

The stakeholder approach to corporate governance arose out of a growing sense that more consideration had to be given to “the whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated.” The impact and importance of corporate governance was emphasized by Gourevitch and Shinn in the following quotes from their book on the “new global politics of corporate governance”:

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3 M. Goergen and L. Renneboog, “Contractual Corporate Governance”, Journal of Corporate Finance, 14(3) (June 2008), 166.
5 J. Page, Corporate Governance and Value Creation (University of Sherbrooke, Research Foundation of CFA Institute, 2005); and N. Kendall, “Good corporate governance”, Accountants’ Digest, 40 (1999).
“Corporate governance—the authority structure of a firm—lies at the heart of the most important issues of society”… such as “who has claim to the cash flow of the firm, who has a say in its strategy and its allocation of resources.” The corporate governance framework shapes corporate efficiency, employment stability, retirement security, and the endowments of orphanages, hospitals, and universities. “It creates the temptations for cheating and the rewards for honesty, inside the firm and more generally in the body politic.” It “influences social mobility, stability and fluidity… It is no wonder then, that corporate governance provokes conflict. Anything so important will be fought over… like other decisions about authority, corporate governance structures are fundamentally the result of political decisions. Shareholder value is partly about efficiency. But there are serious issues of distribution at stake – job security, income inequality, social welfare.”

Corporate governance begins with the establishment of rules and procedures for allocation of “authority” among groups and persons at various levels within the organizational hierarchy of the company. A person or group vested with authority has the legitimate power to hold the people reporting to him/her or them accountable for their actions and performance and the ability to directly influence, or control, the scope of the duties and responsibilities of such persons and the manner in which they discharge those duties and responsibilities. Authority within a company is typically described through a “chain of command,” which is the system of hierarchical reporting relationships within the company’s organizational structure that also identifies where people (and groups of similarly-situated people, such as shareholders) rank in relation to one another and their formal scope of authority within the company. For example, a large US corporation with multiple business units may have five levels in the organizational hierarchy ranging vertically from top to bottom as follows:

- The shareholders, who are the owners of the corporation;
- The board of directors and the various committees thereof, all of which serve as trustees of the interests of the shareholders in overseeing the activities of the managers of the corporation;
- The senior, or executive, management of the corporation including the chief executive officer (“CEO”), the president or chief operating officer (“COO”), and the various executive and senior vice presidents responsible for oversight of major functional and business units;
- The divisional managers, who perform the day-to-day management functions within each of the business units (i.e., units focusing on products or markets); and
- The functional managers, who perform the day-to-day management functions within each of the functional units (i.e., units focusing on functional activities such as research and development, manufacturing, sales and marketing or finance).

The multi-level hierarchy described above is certainly correct from an ideal perspective as well as a matter of US corporate law; however, it does not represent the typical system
of reporting relationships for an operations viewpoint. For example, while the shareholders are at the top of the pyramid they are not directly involved in issuing orders to, and exercising control and authority over the day-to-day activities of, the employees of the company. Instead, the key reporting decisions that must be made relate to the senior executives and the divisional and functional managers. Similarly, the members of the board of directors do not expect to be able to walk into the company’s facilities and give instructions to the employees. The directors look out for the interests of the shareholders and carry out their duties and responsibilities by selecting the CEO and the other members of the executive team and evaluating their performance. The relevance of this model is limited in the case of large public corporations given the large number of shareholders and the practical limitations that exist on their ability to quickly and directly influence the composition of the board of directors in spite of recent shareholder activism. However, in the case of small, but rapidly growing, emerging companies the outside shareholders—generally venture capitalists and other professional investors—are very involved in the designation of directors and in the selection and evaluation of each of the members of the executive team.

Elements of the discussion of governance in this chapter are based on the assumption that the business is operated through a corporation formed, organized and managed under US corporate governance laws and principles. While many of the issues discussed below are relevant founders of companies operating outside of the US it is important to recognize that “corporate governance systems vary across nations” when comparisons are made using a variety of dimensions including ownership and board structure, managerial incentives, the role of banks and large financial institutions, the size and development of stock markets, company law, securities regulation and government involvement.\(^9\) The most common means for comparison is to focus on the “outsider” model associated with the Anglo-American countries and the “insider” model typically associated with Europe and Japan.\(^{10}\) Simply put, in market-based outsider systems, of which the US and UK are

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primary examples, “... ownership is dispersed and completely separated from control, companies benefit from sophisticated capital markets and thus incur lower debt-to-equity ratios, stakeholders are rarely formally represented and do not participate in company management ... [a] hostile takeover is the severest sanction for management misconduct ... [and] ... outside investors ... are less interested in the strategic long-term goals of the company than in the short-term returns available in the market”. In contrast, the insider systems commonly found in Europe, the Middle East and Asia feature concentrated ownership that is closely associated with managerial control; closer relationships with banks, which means higher debt-to-equity ratios and a higher dependence on bank credit as a source of financing; formal participation by various stakeholders—banks, employees and other business partners—on the board of directors; a dense network of supportive relationships with related businesses; and infrequent use of takeovers to cease control. Founders operating in a country dominated by the insider model would, of course, need to navigate among small, identifiable and cohesive groups of “insiders” who expect to have long-term stable relationships with the company and to be able to communicate with each other easily both in connection with company matters and in other non-company relationships (i.e., banking or supply relationships).

§2 Board of directors

Assuming the new company has been formed as a corporation the business and affairs of the company will, as a matter of law, be managed by or under the direction of a board of directors. The board of directors is responsible for selecting the officers of the company and overseeing their activities. In addition, the approval of the board of directors is necessary in order for certain actions relating to the company to be taken including amendments to the company’s articles or certificate of incorporation, issuance of shares and options to purchase shares, sales of significant assets, entering into arrangements involving the borrowing of money by the company and mergers. Directors are elected by the shareholders of the corporation and serve for terms specified by law and in the bylaws of the corporation. Directors have duties of care and loyalty that must be observed as they carry out their responsibilities and are generally entitled to indemnification by the company for claims made against them with respect to the discharge of their duties as a
member of the board. Directors of public companies must comply with extensive requirements imposed under federal securities laws and national securities exchanges.\textsuperscript{14}

The minimum and maximum number of members of the board of directors is determined first by the applicable statute and second, more importantly, by the composition of the shareholder group. For example, California law provides that before shares are issued, the minimum number of directors of a corporation is one; after shares are issued, the minimum number of directors is governed by the number of shareholders—if there is only one shareholder, only one director is required; if there are two shareholders, the minimum number of directors required is two; and in all other instances where the number of shareholders of the corporation is three or more than the minimum number of directors is three (except for classified boards). The authorized number of directors within the requirements established by statute will be set out in the corporate bylaws and may be amended from time-to-time by the directors and/or shareholders to reflect changing needs and requirements of investors and regulators. The directors are elected by the shareholders at each annual meeting of shareholders and in the event of a vacancy between annual meetings the remainder directors typically have the right to fill vacancies until the next regularly scheduled election for the seat that has been filled.

Initially the board of directors will be composed of some or all of the members of the founding group. If the corporation is organized under California law and there are only two founders than the number of directors would be just two—both of the founders. However, if there are more than two founders or if the two founders decide to issue shares to key employees and/or outside investor than it will be necessary to expand the size of the board to at least three members and possibly prepare voting agreements to control how the members are selected. Consideration must be given to a variety of issues with respect to putting the board together—how large should the board be (i.e., while three may be the minimum it can be larger); what is the desired background and experience for selecting board members; and what arrangements should be made in advance for changing the composition of the board in the future upon completion of certain milestones (e.g., closing of venture capital financing)?

The usual practice for emerging companies is to start out with a relatively small and manageable board—usually with a range of three to five members. Prior to completion of outside financing the founders will want to be sure that they can retain control of the board while still tapping into experience and expertise that might be available from non-founders that are not involved in the day-to-day operations of the business of the company. Some founders opt for appointing a representative from a critical early business partner, such as a vendor or customer; however, this can be a risky proposition since it is inevitable that the company will want to expand and may then need to revisit its relationship with the business partner or even replace the partner with one of its competitors. If the founders anticipate that the company will be closing a venture capital

\textsuperscript{14} For further discussion of duties and liabilities of directors of public companies, see “Governance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
financing in the near future it may be best to simply leave vacancies on the board until the closing has occurred since it can be anticipated that the investors will want representation on the board and an understanding regarding how directors occupying any seats other than those filled by founders or investor representatives are selected.

**Board of Directors Capacity for Startups: A Lean Approach**

During the startup stage founders are primarily focused on what is immediately in front of them and have little time or patience for considering what might need to be done to build capacity among the members of the board of directors. While this is not surprising, founders should be aware of the following key areas where the board can, and should be expect to, make a valuable contribution to the success of the organization:

**Accounting and Legal.** While founders are often more interested in identifying board members with “industry” experience, it is important not to ignore accounting and legal considerations. One or more of the board members should be assigned audit and legal responsibilities and should be expected to focus on several key areas including accounting policies, internal controls, financial reporting practices, legal and regulatory compliance and the company’s policies and procedures for ethical business conduct. The members should oversee the employment of the company’s independent accountants and the preparation and audit of the company’s financial statements; provide oversight on the external reporting process and the adequacy of the company’s internal controls; and review the scope of the other activities of the independent accountants and the activities of the company’s internal auditors. In discharging their duties, the board members should develop and maintain a regular line of communication with company’s financial management and internal and external auditors. None of the board members involved with audit-related activities or issues should be an officer or employee of the company.

**Compensation and Benefits.** Another important, and often sensitive area, for founders is compensation, their own and the salary and other benefits that will need to be offered to put together the talent necessary for the startup to succeed with its business model. Board members assigned responsibility for compensation matters should focus on establishing executive compensation policies that are consistent with corporate objectives and strategies and recommending to the board compensation for the CEO and other members of the executive team. These members should also work with the executive team regarding recommendations for grants to managers and employees under the company’s stock compensation plans and should also be involved in discussion regarding modifications and additions to the company’s compensation plans taking into account market conditions and actions by competitors. One of the most important, albeit delicate, roles of the board members working on compensation issues is reviewing the performance of the CEO and other executives. None of the board members working on compensation issues should be an officer or employee of the company.

**Management Development.** While there are certainly founders of startups with substantial management experience, management development is an important area in which board members, particularly those who have their own careers as CEOs, can contribute. Board members focusing on management development, who logically may be the same members responsible for compensation matters, should be involved in the design and implementation of organizational management development programs and the review of recommendations for changes in the senior manager positions. In addition, members should work with the CEO on recruiting and organizational culture programs that will bring and maintain appropriate diversity into the company’s mission and workplace.

**Governance.** While the founders will certainly want to retain a voice on the board, if not outright control, inevitably there will be a need for outside directors, either because investors demand it or the skill sets of the founders are simply too limited to fill all of the areas in which directors must be versed in. One or more members should focus on governance, which includes making recommendations regarding nominees for election to the board and various committees of the board based on established guidelines and appropriate and necessary policies and procedures to ensure that the board operates efficiently and effectively. These
board members should also take the lead in educating new board members and ensuring that there is a process in place to measure the performance of board members on a regular basis.

**Sustainability and Social Responsibility.** Every board member should be prioritizing the strategies and activities necessary to create sustainable business; however, given that every corporation, regardless of sustainability, needs to have board members specializing in other areas, it makes sense to have some of the members invest their time on sustainability and social responsibility issues to ensure that the company is developing and implementing appropriate policies and procedures that provide support for the company’s sustainable growth mission. These members should have experience in key areas such as stakeholder engagement and sustainability reporting and bring a network of connections to experts who can guide the corporation in setting up the appropriate governance structure for sustainability.

**Strategy and Technology.** Several members of the board should focus on strategy and technology and should be involved in regular reviews of the company’s strategic direction in its major business segments and the impact that new technologies is likely to have on the company. With regard to technology, board members should have a solid understanding of the company’s technical relationships, including relationships with academic institutions and public sector research facilities, and the adequacy of the company’s technical resources (including its human resources). These activities are key to success and companies are advised to recruit board members with appropriate technical education and experience.

**Finance.** Board members focusing on finance should be involved in regular reviews of the company’s financial posture including utilization of funds, capital structure and outside financing proposals. Finance is always important; however, for a startup it is absolutely mission critical to keep a close watch on cash flow and to make sure that the company becomes and remains well positioned to seek capital from investors and/or commercial lenders. Finance responsibilities may be taken on by the board members handling accounting and legal.

While larger companies often have an executive committee at the board level that is given limited authority to act for the board between meetings on matters already approved in principle by the board, startup boards should not rely too heavily on smaller groups because all of the issues at that stage are important and require input from the entire board. Exceptions may be made for specific matters assigned by the full board from time to time. The immediacy of so many issues for a startup means that board members must be prepared to commit substantial time to their various roles, particularly when there are gaps in experience among the founders and other members of the executive team.

Many startups prefer to operate with small boards, often no more than three members. This is understandable and startups may fill in experience and skills gaps among board members with advisors that can provide talent in some of the areas mentioned above. If an advisor is brought on for a relatively narrow and time-limited project, such as helping the founders nurture specific customer relationships, the activities of that advisor should nonetheless be placed within one of the topical areas mentioned above such as strategy and technology so that there is an orderly understanding of what the company is doing with respect to key strategic issues such as customer development, research and development, production, and sales and marketing. It is important for at least one of the non-employee directors to have an understanding of the roles of the various advisors since advisors are often recruited from the founders’ networks. In turn, if an advisor is recommended by a non-employee director, that director should take responsibility for ensuring that a good working relationship develops between the advisor and the relevant members of the executive team.

§3 Factors in evaluating and selecting directors

When evaluating candidates to serve as a member of the board of directors, the founders and other parties involved in the selection process should seek persons who exhibit a mastery of certain key competencies for being an effective director. While there is no
universally accepted list of the ideal skills and aptitudes for directors for an emerging company, the following questions should be asked in each instance:

- How strong is the candidate’s knowledge of the industries and markets in which the company operates?
- How strong is the candidate’s knowledge of the activities and performance of the company and skills and responsibilities of the members of the company’s senior management team?
- How strong is the candidate’s knowledge of the operation and role of the company’s board of directors?
- What experience does the candidate have in serving as a member of a board of directors?
- What indications are there that the candidate has a process orientation and understands the steps that will need to be taken in order for the board of directors to effectively exercise its role overseeing the management of the company?
- What experience does the candidate have with regard to understanding and evaluating financial information and monitoring financial performance and other key business indicators?
- What experience does the candidate have with regard to selection and evaluation of persons occupying positions on the senior management team?

In addition to these questions, the evaluation and selection process should focus on determining whether the candidate has certain personality traits that are perceived as being useful to the orderly conduct of business by the directors as a group. For example, it is important to try and determine, through personal interviews with the candidate and by background checks with third parties who know the candidate, the strengths and weaknesses of the candidate with regard to conceptual and independent thinking, judgment and integrity, willingness to learn, effective communication and listening skills, conflict resolution, and understanding and prioritizing the potential risks associated with a proposed plan of action.

Once a candidate has been vetted and is seriously under consideration for an offer to join the board of directors it is important to have a candid conversation with the candidate to ensure that he or she understands the consequences of joining the board and is fully aware of all the risks and burdens associated with serving as a director. It is better not to begin a director relationship than to press forward and then find a short time later that there is not a good fit. Frequent changes in the composition of board, other than those triggered by a specific event such as venture capital financing, will need to be explained to prospective business partners and the process of finding a new director and integrating him or her into the governance process can be a time-consuming distraction to the other directors and the CEO. Ideally, the candidate would be asked to set aside a swath of uninterrupted time, at least half a day, to meet with the CEO, one or more of the outside directors of the company, and perhaps the company’s inside or outside legal counsel, to discuss the following areas:
• Does the candidate know and understand the fiduciary responsibilities that he or she will have under applicable laws in the event that he or she joins the board of directors?
• Does the candidate know and understand the potential liabilities that he or she might have as a result of serving as a director?
• Are there any special characteristics regarding the “culture” of the company or the way the company has operated in the past that the candidate needs to be aware of in order to understand the issues that he or she is likely to be confronted with at the board level?
• Does the candidate know and understand the level of commitment that is expected by the company and other members of the board with respect to discharging his or her duties as a director?

Obviously, the answers to the questions are company-specific and will depend on the particular stage of development of the company and the direction in which the company is heading in the future. For example, while corporate governance issues may be relatively simply during the start-up stage the directors should anticipate the need for the company and the board to formalize compliance processes as the company grows. While the federal Sarbanes Oxley Act, popularly referred to as “SOX,” technically only applies to publicly-listed companies the principles underlying SOX are becoming increasingly relevant to private companies backed by venture capital and other institutional investors. Commitment is a key issue given that board members can now expect to be involved in numerous meetings of the full board and committees and to invest a substantial amount of time in reviewing business and financial information. The candidate should be counseled not to make a final decision at the meeting and should be given a specified period of time to consider all of the information that has been presented before making a final decision about joining the board of directors.15

§4 Executive team

While there are examples of organizations that are led by a single individual exercising what appears to be dictatorial control over day-to-day activities and long-term strategy the realities of an increasingly complex business environment, even for smaller companies, generally dictate the creation of teams of top managers to coordinate the activities of the business units that are part of the organizational structure of the company. These teams are commonly referred to as “executive teams” since they are composed of the CEO officer of the entire company (i.e., the “CEO”) and the CEOs of key functional departments—research and development, manufacturing, sales and marketing, finance and human resources—and any major business units with a non-functional focus such as divisions formed to concentration on specific products or markets. While the formal role of the members of the executive team, as officers of the company, is to act as agents for the directors and shareholders of the company, as a

15 For further discussion of factors to be considered when evaluating prospective candidates for service as a director, see “Governance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
practical matter the executive team exerts substantial authority over the acquisition and use of the company’s resources and the decisions made by the members of the executive team are the determining factors in the success or failure of the strategies pursued to increase shareholder value.

Each business unit, particularly those formed with a product- or market-based focus, has its own senior management team. For example, a division created to market and sell a company’s products in Europe will be led by its own CEO, typically designated as a senior vice president of the company, who will report to the CEO of the company and have various vice presidents and general managers who report to him or her and who oversee operational activities necessary to support the sales efforts in Europe. The focus of this chapter is on the executive team that operates at the top of the pyramid shaped organizational structure and which is led by the CEO. As described below, the size and composition of the executive team evolves with the growth of the company, changes in its key operational activities and decisions about which products and markets should be pursued using the company’s scarce resources. In most cases executive team members wear multiple hats—they are responsible for overseeing the activities of various key business units (i.e., departments or divisions) and looking out for their interests while simultaneously working to create and execute integrating mechanisms and lateral processes to ensure that all of the groups, including their own, collaborate effectively to achieve the overall goals for the entire company. Members of the executive team must have the deep experience and knowledge necessary to lead the company toward development of a core competency in their area of specialization as well as the personal skills to positively interact with other team members and the ability to think strategically on behalf of the company and all of its stakeholders.

§5 --Legal framework

The legal framework relating to the composition of the executive team and the duties of each of the members is laid out in the applicable state corporation law statute as well as in the articles of incorporation and bylaws of the company and in any agreements among the shareholders and/or special resolutions of the board of directors regulating the duties and powers of the officers. Specifically, a corporation will have the officers described in its bylaws or appointed by the board of directors in accordance with the bylaws. Officers will be appointed by resolution, which may also include a description of the duties of the office (e.g., chief executive officer). A duly appointed officer may appoint one or more officers or assistant officers if authorized by the bylaws or the board of directors. In general, officers may take such actions that fall within the scope of their actual or apparent authority. In cases where the actions of an officer have not been authorized by the board or by the bylaws of the corporation, a separate board resolution approving the action should be passed by the board and placed in the minute book. Any officer may be removed by the board of directors, with or without cause, at any time. In addition, an officer may resign at any time by delivering notice to the corporation and the resignation shall be effective upon delivery unless the notice specifies a later effective date. The form of resignation should, of course, specifically identify the office(s) from which the person intends to resign (e.g., president or chief financial officer).
§6 --Evolution of the executive team

Every company, even those that ultimately become global organizations with thousands of employees dispersed around the world, begins as a “start-up” and goes through various evolutionary stages with regard to its organizational structure and the composition of its executive team. At the very beginning there may be no more than a handful of employees including a single founder or several entrepreneurial leaders that compose a small founding group. Formal titles may be loose and scarce and the term “executive” is rarely used in what is generally an informal working atmosphere. Some sort of hierarchy generally emerges when the company begins to interact with its external environment—potential investors, suppliers, customers and key employees. While there is no single model for organizing the management team at the start-up stage, it is common to find that the basic core group consists of a President or CEO, a Vice President for Research and Development (“R&D”) or Product Development and a Vice President for Sales. While this discussion uses the formal title of Vice President, or “VP,” some companies prefer to use other titles for functional leaders, such as “Director” or “General Manager.” The title is relatively unimportant since the crucial action is that the company must identify the person who is to be part of the senior management team and have dedicated responsibility for a particular recognized functional activity.

As the number of employees increases beyond the initial group of founders and other key managers and the business moves out of the garage into more formal surroundings, a senior manager for human resources (“HR”) and administration will be a common new addition to the team, although perhaps not at the VP level. Initial activities in areas such as manufacturing and customer support, which will generally be modest until the volume of sales expands, will be a collaborative effort among the President/CEO, the VP R&D/Product Development and the VP Sales. Members of the founding group that have not assumed any of the three roles referred to above will begin to find their own niches pursuing areas of need that match their interests and educational and professional backgrounds. For example, a founder without substantial managerial experience may gravitate toward exploration of technologies that the company will need to develop or otherwise acquire at some point in the near future. All of the founders may also have the opportunity to interact as board members until it becomes necessary for some of them to step aside to allow participation by any senior managers who are brought in from the outside and representatives of venture capitalists and other professional investors.

As the company advances to the next stage of development, presumably after initial product development efforts are well along, the core senior management group will generally be expanded to include a VP position responsible for both marketing and communications. Initially, the VP Marketing will focus on marketing and communication strategies for the company’s initial product, including launch management. However, once the first product is launched, the VP Marketing will be tasked with many other high-level duties and responsibilities, notably the creation of a long-term marketing plan and establishing the infrastructure that can support market research, advertising and promotional strategies and similar activities. At some point, the
VP Marketing will need support from new senior managers with focused responsibilities for product marketing and communications. A senior manager for product marketing becomes important when the company creates and builds its own internal sales team and the holder of the position would be primarily responsible for provide selling tools and related information to the sales force. At that point, the VP Marketing would perform similar functions with respect to the company’s indirect sales channels, including outside sales representatives and distributors. The VP Marketing would also be responsible for communications with trade media and industry analysts; however, another senior manager reporting to the VP Marketing might take on communications with employees, investors, and the business/public media.

At the next stage of growth, which typically is reached when the company is achieving annual sales in excess of $100 million per year or otherwise approaching a potential initial public offering (“IPO”), the most important addition to the senior management team is an experienced chief financial officer (“CFO”), who will generally join at the insistence of outside investors and/or investment bankers interested in assisting the company with the IPO. It is recommended that the CFO join the management team at least 12-24 months prior to any anticipated IPO in order for the holder of the position to implement the necessary periodic reporting systems, evaluate historical performance and results and establish relationships with investors and manage investors issues in collaboration with the senior manager for communications, a role that might eventually be elevated to VP status. In addition, this is generally the point where the CEO/President delegates responsibility for many of the day-to-day operational activities to a chief operating officer (“COO”) thus allowing the CEO to focus on the complex strategic issues described below. In some cases the COO is given the title of President and reports upward to the CEO; however, the more common approach at this point is for the COO to be referred to as the VP Operations. The growth in the number of employees that usually accompanies higher sales volumes means that it is appropriate for the senior manager with responsibility for human resources to be promoted to a VP position and active membership in the deliberations of the senior management group. Finally, one or more of the optional senior management positions described below may be created and filled; however, the timing will vary depending on the specific needs of the company.

While the projected evolution of the executive team for an emerging company is generally acknowledged as reasonable based on anecdotal evidence and observations, there has been surprisingly little empirical investigation. One interesting study was carried out by Baron et al. in the early 2000s when they studied the influence of founders on several facets of “bureaucratization” in a sample of California-based technology start-ups, including the proliferation of specialized managerial and administrative roles and titles. Among other things, they observed that some firms opted for clear jurisdictional

16 J. Baron, M. Burton and M. Hannan, “Engineering Bureaucracy: The Genesis of Formal Policies, Positions and Structures in High-Technology Firms”, The Journal of Law, Economics and Organization, 15 (1999), 1-41, 1. The sample consisted of more than 170 young high-technology firms in California’s Silicon Valley that were part of the Stanford Project on Emerging Companies (“SPEC”). Id. at 4 (including a description of the characteristics of the study group and references to detailed discussions of sampling and data collection methods). For further discussion of the SPEC and the research carried out on the
distinctions among the management team from the very beginning of operations, including a formal organizational structure and specialized managerial roles and titles that evidenced expertise and authority in areas such as finance and operations; however, other firms operated with minimal structural and functional differentiation at the top, excepted as mandated by law and external stakeholders such as venture capitalists, and rarely created vertical distinctions among managers through the use of “senior” and “executive” titles among the ranks of their vice presidents. 17

Obviously, the development and growth of the management team creates significant challenges for the entire company, particularly the person at the top—the CEO. Among other things, the company must establish guidelines for hiring senior team members (e.g., job descriptions, experience requirements, resource requirements for each office and criteria for measuring and rewarding performance). In addition, the company must create and follow rules with respect to interactions between the various functions covered by the management group. For example, the VP Sales and VP Marketing must have a clear understanding of the roles of their groups with respect to each product line and develop methods for regularly communicating with one another and making sure that information is also disseminated to other management team members. Another issue to consider is the need to seamlessly transfer duties and responsibilities among members of the management team as the company grows and the new members are added to manage specialized functions. In fact, it is important to actually plan for these transitions at the earliest possible stage since the information should be used to develop job descriptions and recruiting strategies.

Diversity among the members of senior management teams has become a prominent point of discussion with respect to firms in Silicon Valley. Data from the above-referenced study by Baron et al. indicated that the average percentage of women included in the senior management teams of the surveyed firms was 14% and that senior women were typically toiling in human resources and administration and much less likely to be found overseeing engineering or research and development activities. 18 When the spotlight was placed on the top of the organizational hierarchy the researchers found that only about 10% of the studied companies had a woman occupying the role of CEO, president or founder. Gender diversity at the top of the organizational hierarchy did have an impact on hiring policies for other roles within the company as the researchers found that when there was a woman at the top of the pyramid the company, or leading the engineering or research and development functions, it was much more likely that the company would have more women in scientific and technical positions.

§7 --The chief executive officer

17 Id. at 23-24.
It takes a fair amount of time before the duties and responsibilities of the company’s senior leader expand to the scope described above and the focus of the leader changes dramatically as the company evolves and grows. At the time a company is launched, a President will typically emerge from among the members of the founding group. He or she may not assume the CEO title at that point, particularly if it is anticipated that an executive from outside the founding group will be brought in at some point in the near future. In any case, this initial President will almost always take on some or all of the responsibilities that will ultimately be divested to other members of the core management team, notably R&D, sales, HR and administration. Unless the company is launched with a finished product and an initial order, most of the time will be spent on the road talking to key players in the market to obtain input and feedback on the company’s initial plans. Numerous meetings will, and should, be held with prospective customers, investors and other business potential business partners. A President with an aptitude for public relations may also begin working with media sources to generate interest in the fledgling business and its proposed products and services. Based on all the information collected from these activities, the President should be the person who takes initial responsibility for determining the best way to focus the firm’s technology and R&D efforts on creation of marketable products and services. At the same time, the President must begin building the company’s employee base; however, caution must be used not to fill too many positions that ultimately will be supervised by new members of the senior management group since they may prefer to build their own teams once they come on board.

No person, regardless of talent and energy level, can continue to juggle all of these activities without assistance for a sustained period of time. Accordingly, the President should have a plan in place from the beginning for bring in new members of the core management team and outsourcing other functions until the company has reached the point where internal growth is necessary and cost-effective. The hiring sequence typically follows the functional development of the product. Accordingly, a VP R&D and/or Product Development is a top priority followed by a VP Sales to assist the President in identifying and development a customer base upon which initial revenues can be projected. With those functions covered, the President can invest more time and effort in marketing and cultivating relationships with prospective investors and business partners for other functional areas, such as manufacturing and distribution. External resources can be used to handle other key functions until senior managers are needed and identified. For example, outside accounting firms can generally assist not only with accounting and audit services, but also offer help with business and tax advisory services, selection and implementation of financial systems and internal controls and consulting services in diverse areas such as compensation, security and information technology.

As the core management team expands and external resources are deployed for interim financial and administrative functions and activities, the President can turn his or her attention toward the roles that will occupy more and more time in the future as the company expands. Among other things, the President, or CEO if someone else assumes that office, should be prepared to take primary responsibility for those activities which are essential for the company to acquire the additional resources necessary for the company to grow including development and management of the image and reputation of
the firm; public and media relations; development and launch of initial marketing plan; definition and development of the initial product line; financial and legal matters, including development of relationships with commercial banks, venture capitalists, investment bankers and professional service providers; and exploration of potential strategic partnerships. Note, of course, that several of these functions will ultimately be passed on to other members of an expanded core management group. For example, financial and legal matters usually fall within the scope of responsibilities for the CFO once that position is filled and the VP Marketing will ultimately oversee marketing and public relations activities.

Regardless of the stage of evolution of a company the senior leader, whether he or she is referred to as the President or the CEO, has a broad, if not overwhelming, set of duties and responsibilities. Some of these duties are formal and prescribed by law and the governing documents of the company (e.g., the articles of incorporation and bylaws of a corporation); however, most of the expectations imposed on the CEO are often vague and are left to the CEO to define and execute. A CEO is confronted with challenges in a number of different areas and from various stakeholders and he or she must be able to balance and prioritize the demands on his or her time and intellectual resources. For example, at any point in time the CEO may be focusing on the timetable for launching a new product or service and establishing and testing specifications for the product or service; evaluating and responding to unforeseen actions by competitors; responding to the concerns of key customers; reviewing the suggestions of the marketing team regarding shifts in brand strategy and image of the company; and preparing for the next board meeting and a presentation to prospective new investors.

The CEO of a larger company may be able to delegate certain matters to other members of the executive team; however, person at the top of the hierarchy of an emerging company generally does not have that luxury. An emerging company CEO has several broad areas where he or she must take the lead—setting and executing company strategy; establishing and reinforcing the desired organizational culture; recruiting the other members of the core management team and making sure that they learn how to work together with a focus on the desired strategy; allocating the cash and other resources of the company among the current operational activities; and communicating with key external stakeholders including vendors, customers and investors. In general, the CEO has the primary responsibility for managing the company towards profitability and navigating through the challenges of growth, expansion and change. When the company is in its early stages, often without resources and confronted with what appear to be overwhelming challenges, the CEO has a special role in motivating other managers and employees and in selling prospective members of the executive team on the potential of the company and its business model.

**Must-Have Skills for a Startup CEO**

Writing for *Forbes* in 2014, Deeb argued that being a “startup CEO” was one of the hardest jobs in the business world given the wide range of skills that were needed in order to be successful and the enormous odds against the new company surviving, and the lack of resources relative to a CEO at a Fortune 500 company.
company. He noted that there is no universal profile for “the best startup CEO” and that people differ in terms of skills, style and personality and companies face different challenges with respect to market conditions; however, in his view there were a handful of “must-have” skills for increasing the chances of being a successful startup CEO that included the following:

- “A clear vision of where the ship is sailing”, which means the ability to articulate and execute a plan for creating a unique and competitive solution to a real world problem for potential customers
- “A finger on the pulse of the industry and competitive trends”, which involves staying on top of trends and collecting information that can be used to steer the company in the direction it needs to stay afloat once the journey has been launched
- “Solid team management skills to keep all employees sailing in the same direction”, which includes articulating the vision to employees, building a consensus for the vision among employees and listening to and implementing ideas from employees about how to improve and achieve the vision
- “Impeccable sales and motivational skills, while maintaining credibility with clients, investors and employees”, which means acting as the “Chief Evangelist” for the new business and generating excitement for the vision while simultaneously demonstrating business judgment, intelligence and credibility
- “Keep the business on plan and budget”, which involves setting and pursuing “achievable proof-of-concept points”, creating strategies for the key drivers of success and putting the right people in place to manage them and relentless tracking progress to spot and address problems quickly
- “Keep the company liquid”, which starts with setting the right proof-of-concept points and then establishing a reasonable timetable to achieve those points and making sure that the company has enough capital, including a cushion, to achieve those goals

Deeb’s suggestions obviously overlap and the startup CEO has to keep each of them in mind as he or she runs the business and interacts with employees, customers and investors. For example, as a practical matter the most important concern of the CEO at the beginning is to “keep the company liquid and in business” and the best way to do this is to be sure that the launch phase business plan is focused on attainment of proof-of-concept points that prospective investors have accepted as reasonable triggers for providing additional funding. At the same time, when budgeting for the pursuit of the initial goals the CEO must be realistic and anticipate the problems will inevitably arise as they usually do for startups. This means that the CEO must have a “Plan B” in mind and must be prepared to make difficult decisions, including salary reductions and even layoffs, in order to keep the company going long enough to find smoother waters.

**Source:** G. Deeb, “The 6 Must-Have Skills For A Startup CEO”, Forbes (February 12, 2014), http://www.forbes.com/sites/georgedeeb/2014/02/12/the-must-have-skills-for-a-startup-ceo/ [accessed June 24, 2015]

One of the most studied and debated issues relating to governance of emerging companies during their early stages is the roles and actions of founders that assume the duties of the CEO. Several researchers have argued that founder CEOs may be more prone to non-value maximizing decisions because they are less objective about the prospects of the firm and more reluctant to approve and implement decisions and strategies that might reduce their ability to retain control over the resources of the firm and corporate affairs. In order to address this concern, outside investors, such as venture capitalists, may insist that they have effective control over the board of directors so that they are in a position to monitor and control the activities of management and, if

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necessary, replace a founder CEO prior to the IPO if there are genuine concerns regarding the objectivity, motivations and skills of the founder CEO and his or her ability to effectively manage the difficult transition from private to public company. However, while independent directors may be better able to implement regulation and control processes they may not be able to provide the CEO with the guidance regarding strategic direction that is necessary in fast growing industries. In fact, researchers have observed that “inside” board members may be better equipped than outsiders to assist the CEO in developing an appropriate innovative firm strategy due to their direct knowledge of the firm’s operational activities and their day-to-day exposure to the competitive and technological environment in which the firm operates.\(^{20}\) Other researchers have argued that the presence of a large number of insiders on the board can actually temper any undue optimism of the CEO and support objective decisions based on the ready availability and analysis of high quality firm-specific information continuously provided by the insiders.\(^{21}\)

§8 Board of advisors

As discussed above, if the new business is organized as a corporation, the law requires that the corporation must be managed by a board of directors. However, the board of directors may be supplemented by an additional group of independent advisors who can provide the founders with the benefits of their expertise regarding the operation of the business without the formalities normally associated with a board of directors. An independent board of advisors can similarly be used with businesses organized as one of the non-corporate forms, such as an LLC.

There are a number of potential benefits to forming and using a board of advisors. First and foremost, advisors can provide perspective and experience that the founders themselves might lack. This is particularly the case when the advisors have formed their own businesses in the past, since they should be able to help the founders avoid common mistakes. Second, a solid board of advisors can give credibility to a new business when it is going out to raise funds from outside investors. Third, experienced businesspersons can provide the company with valuable business connections that can help the company find, and establish relationships with, new business partners. Fourth, advisors can counsel the founders on identifying individuals to add to the management team. Finally, in family-owned businesses, advisors can often ease the tensions that may arise in dividing responsibilities among family members in different generations.


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In addition, consideration should be given to the age, gender and cultural background of the advisors. For example, it makes a good deal of sense to match an advisor’s gender and cultural background to the company’s employee and/or customer base. By so doing, the founders have access to someone who may understand the problems and concerns of the employees or customers and can provide specific advice from a perspective otherwise unavailable to the founders. Advisors should also be able to get along with others in the advisory group. While the founders may not conduct many formal advisors’ meetings, it is important for the advisors to feel comfortable giving their frank opinions. Finally, like board members of a corporation, advisors must be able to balance their theoretical or technical knowledge against the practical requirements of business strategy and planning.

Ideally the advisors will include persons with experience in achieving the next set of strategic goals and objectives that the founders have laid out for the company. In other words, people who have confronted the same challenges and addressed and solved the same problems that are likely to come up for the founders. For example, if the company is trying to grow from 30 to 150 employees, the advisors should have experience in dealing with that crucial stage of expansion. Advisors whose experience is limited to the early stages of growth simply replicate what the founders have already achieved and advisors who have led much larger enterprises generally cannot provide the practical advice for a company of that size, even though their participation may impress potential investors. It is best to have at least three advisors in order to encourage active dissent—two advisors often try to find mutual agreement—but more than five advisors will likely make the project too difficult to manage and adversely impact productivity.

Founders should not form a board of advisors as “window dressing” and should be prepared to take advisor input seriously. Advisors do not have the same legal standing with respect to the company as the members of the board of directors and owe no fiduciary duty to the shareholders of the company. As such, the founders are free to ignore advice received from the advisors. However, founders who continuously fail to pay attention to their advisors show a real disrespect to the time invested by the advisors and the experience they are willing to offer and will soon find that advisors leave the position and take with them a bad memory of their interactions with the founders and the company. Some founders put together a “rock star advisory board” that includes celebrities from the industry in an effort to impress investors and customers; however, these schemes generally are not effective unless there is clear evidence that the advisor are indeed actively engaged in providing support and guidance to the founders.

Advisors generally serve as such for the intangible benefits associated with helping a new venture grow and prosper. In addition, advisors can learn a good deal about the industry and observe various strategies and techniques that they might be able to apply in other situations. However, founders should not ignore the need to offer tangible benefits, in the form of cash and equity, to advisors to compensate them for the time spent reviewing the company’s affairs with the founders. For example, advisors may be offered an honoraria, payable annually or quarterly, in exchange for a commitment of a certain period of time to review information provided by the founders and participate in advisors’ meetings. In addition, advisors may receive options to purchase equity interests in the company.
Advisors should be solicited and vetted with the same care as prospective members of the board of directors and with the same level of transparency and disclosure that is offered to board of directors candidates. The founders should take the time to develop a short written overview of the business and their expectations for advisors. During the interviews with advisor candidates the founders should carefully evaluate whether the advisor can really fill a significant need for the company and can be counted on to share their experiences in a productive way as opposed to simply dictating how things must be done. If a particular advisor will be mentoring other members of the management team, the advisor should meet with those people to ensure that all parties understand the advisor’s role and that the managers understand what the advisor is expected to bring to the table.

Since advisors are not serving in positions recognized by statute or common law, such as director or officers, all of the duties and obligations of the company and the advisor are a matter of contract between the parties and it is important to have a carefully drafted advisor agreement in place before an advisor begins his or her service to the company. Such an agreement creates binding legal obligations on the advisor with regard to protecting the interests of the company, which is important since advisors do not have the fiduciary duties to the company and its shareholders that directors and officers do. Advisory agreements may sometimes be supplemented by written charters and procedures, similar to bylaws, which apply to a “board of advisors” that the company might create that includes all of the advisors that have been engaged. When negotiating and drafting an advisory agreement the following issues should be considered:

• **Duties.** The agreement should clearly describe the duties to be carried out by the advisor and this generally means setting out expectations regarding the number of meetings or other events the advisor will be expected to attend, either live or via teleconference; the type and amount of preparation that expected of the advisor to carry out his or her duties including reviewing of reports, business plans and/or budgets; and any other duties that fall within the specific competencies and experience of the advisor such as identifying business opportunities or working with executives and managers in a particular functional area. The description of duties should cover reporting and communications paths, such as whether the advisor will be reporting to the board of directors or to the members of the management team. The agreement should make it clear that the advisor is an independent contractor and how no power or authority to act for, or purport to bind, the company in interactions with third parties (and the should specific prohibit the advisor from making any representations that he or she has authority to bind the company). Duties may be described in the main advisory agreement or may be outlined in a separate consulting contract. Founders should make it clear that they intend to convene board of advisors meetings on a regular basis, perhaps three to six times a year, and should make sure that each meeting is structured and focused include an overview of company performance since the last meeting and detailed and lively discussion of two or three strategic topics that are most important to the company at that time.
Term and Termination. It is customary for the parties to agree on a specific term for
the advisory relationship in order to clarify the expectations of both side regarding the
duration of the advisor’s availability and the level of commitment expected of the
advisor and facilitate planning for how the advisor’s time will be used and allocated.
However, while the agreement may specify a term it should also be clear that the
advisor’s service is “at will” and the company, as well as the advisor, has the right to
terminate the relationship at any time with or without cause. At the end of the term
the company can simply let the agreement lapse if the advisory arrangement has fell
short of expectations or there is no longer a need for the advisor’s particular services
and experience. If the company believes that it is still important to have the advisor
on board at the end of the term the parties can extend the agreement. Founders
generally hope that an advisory arrangement will extend for three or four years;
however, the more realistic approach is to provide for consecutive one year terms that
need to be renewed by both parties.

Compensation. As mentioned above, founders should consider compensating
advisors for the time they spend providing support for the company and there are a
variety of methods that companies use for compensating their advisors. If cash
compensation is offered the agreement should specify the amount and timing of
payments and any conditions that will need to be satisfied in order for a payment to
be earned and payable. If equity compensation is offered the agreement should
address issues such as the number and type of securities, pricing (i.e., the exercise
price if the advisor is to receive options) and vesting restrictions (i.e., the shares will
vest over an extended period of time, usually three to four years, and no shares will
vest until the advisor has served for a specified minimum period such as six months
or a year to ensure that the advisor is committed). Another issue to consider is
reimbursement of expenses that the advisor may incur in carrying out his or her duties
and it is common for the parties to include simple procedures for reporting expenses
and pre-approval of expenses over a certain amount by an executive of the company.

Information Rights and Protection of Confidential Information. Unlike directors,
advisors do not have any statutory or common law rights to receive information from
the company or inspect the company’s books and records and it is therefore necessary
to provide for information rights by contract in the advisory agreement. The
company should be willing to provide the advisor with access to all of the information
relevant to the advisor’s duties including copies of reports, meeting notices, minutes
and other materials. Delivery of these items should be timely and is often tied to
delivery of the same items to directors of the company. However, the company
should reserve the right to withhold information from the advisor at its discretion and
the agreement should include detailed duties and obligations on the advisor with
respect to protecting “confidential information” of the company that he or she may
receive or observe during the course of acting as an advisor.

Participation in Board Meetings. Some companies ask or expect their advisors to
participate in meetings of the board of directors, particularly in those situations where
an advisor is brought on board specifically to provide advice to the directors as a
group as opposed to management of the company. In that situation it is important for
advisors to be given sufficient information in advance of board meetings to allow
them to make a meaningful contribution when asked; however, it should be clear to everyone that participation in board meeting and access to information provided to directors does not give any advisor a right to vote on matters that come before the board. The company and the board of directors should have the absolute right to ask an advisor to leave a board meeting at any time and, in fact, advisors should probably be asked to leave a meeting whenever the boards will be receiving advice from counsel on privileged matters since case law indicates that the attorney-client privilege does not extend to advisors. Another issue that needs to be considered if advisors are providing guidance directly to the directors at board meetings is providing advisors with indemnification in the event they are named as defendants in shareholders’ litigation or other lawsuits that may be brought against the company. If indemnification is offered the agreement should make it clear that the rights of the advisor are being granted to him or her as a “third party” and not as a director or officer of the company.

- **Ownership of Intellectual Property Created by Advisor.** Since it is not always clear whether intellectual property created by advisors during the advisory relationship would be considered to be “work-for-hire”, and thus owned by the company, the agreement should include an express assignment by the advisor to the company of any developments or works that the advisor might create while carrying out his duties and responsibilities to the company under the agreement. These types of provisions are particularly important when the advisor is also interacting on a day-to-day basis with company personnel to assist them in designing and executing projects that are expected to result in technologies and other byproducts that would be eligible for intellectual property protection.

- **Conflicts of Interest.** Advisors are generally recruited and engaged on the basis of their broader experience and contacts within a particular industry or market sector and, as such, the agreement should address the possibility of conflicts of interest between the advisor’s relationship with the company and his or her other business interests and activities including advisory or consulting relationships with an actual or potential competitor of the company. At a minimum the advisor should be required to disclose any relationships with third parties that might create a conflict of interest. If desired, the company could insist that the advisor’s relationship be “exclusive” and prohibit the advisor from doing business with any actual or potential competitor of the company without first obtaining the company’s consent, which could be withheld for any reason or no reason by the company. Obvious concerns for the company with regard to these types of relationships with actual or potential competitors include the leakage of the company’s confidential information, disputes regarding ownership of the intellectual property created by the advisor and dilution of the advisor’s attention to, and interest in, the company and its business.

While an advisory board can be a valuable resource for the founders, there are situations where the founders conclude that they simply don’t have the time and resources to do all of the things recommended to make the board operate effectively. In those cases, the
founders may consider several alternatives. For example, they can convene periodic meetings of their key professional advisors (i.e., lawyer, accountant, banker, management consultant etc.) to tap into the experience they have gained in counseling a wide range of businesses. These people are often able to ask the tough questions that are appropriate at the company’s particular stage of development. Founders may also create a network of ad hoc advisors or mentors with whom they meet occasionally on an informal basis. Some founders put together a small group of advisors to provide support on a specific short-term project. Finally, an advisor relationship may be based on the advisor’s ability to fill in any gaps on the company’s board of directors and management team (e.g., an advisor might be engaged for six to twelve months to provide input on finance, operations, procurement or regulatory matters until the company has grown to the point where it can bring on a full-time in-house specialist).

§9 Reporting and recordkeeping systems

The founders, working with the company’s attorney and accountants, need to set up a business recordkeeping system that will allow the founders and other managers of the company to track the performance of the business and comply with all legal and tax reporting requirements. Counsel should also work with the founders to develop a system for documenting and tracking the various contractual relationships of the business. In many cases, recordkeeping requirements will actually be mandated by one or more laws or regulations, such as federal and state tax laws. In other situations, the founders will need assistance from counsel in identifying those records that should be collected and organized in order to allow the company to easily respond to external reporting requirements and use the information for other purposes. For example, as noted above, employment records should be maintained to comply with employment-related laws and regulations, including wage and hour laws, and to provide a basis for evaluating the workers for compensation and job position review purposes.

§10 --Annual or periodic reports

Outside investors will typically insist upon the right to receive periodic reports from the company regarding its financial performance, including copies of financial statements that have been reviewed or audited by the company’s accountants. In addition, state corporation laws may require that shareholders receive an annual report that includes a balance sheet, an income statement, and a statement of changes in financial position. In some cases, states may adopt additional disclosure requirements, such as a description of certain transactions involving affiliates and indemnification or advances given to officers or directors. These annual reports must be sent to shareholders within a certain period of time following the end of the company’s fiscal year. Some states may require quarterly

reports. Shareholders generally have statutory inspection rights to review and copy the records of the company.

§11 --Contracts

The company will begin developing a network of contractual relationships as it begins to raise capital from others, rent real property and tangible assets for use in the business, and enter into contracts for supplies and the sale of its goods and services. Among the transactions that will need to be documented are sales agreements with customers and vendors; agreements with sale representatives; distribution agreements; repair and maintenance agreements; leases of real property; and computer and software-related agreements. The company should develop a contract management system that includes the following elements:

- A filing system should be established that includes all written memoranda concerning any transaction the business has, regardless of whether it is a simple purchase order, acknowledgment, sales order or written contract.
- If it is anticipated that the company will enter one or more types of contracts on a frequent basis, it may be economical to seek the assistance of counsel in order to draft various "model" forms. The most common examples are purchase orders, employment agreements, invoices and warranty forms.
- A system for tracking important dates in the company's contracts should be established. For example, whenever a contract is executed, it should be reviewed in order to determine all deadlines (e.g., renewal options on leases, expiration of warranty periods) and such deadlines should be placed on a master list with a short explanation.
- Oral contracts and agreements should always be confirmed in writing in order to ensure that there are no ambiguities with regard to anticipated performance. This is very important for agreements with independent contractors.
- Key agreements should be reviewed on a periodic basis to ensure that the business is in compliance with all of the terms thereof. For example, shareholder agreements should be reviewed by counsel, as should loan agreements and supplier and distribution contracts.
- When the company conducts a good deal of business through its agents, it is important to establish a system that places restrictions on the authority of its agents to bind the company for obligations to third parties. Whenever it is desired to limit the authority of an employee to purchase, sell or otherwise act on behalf of the business, notice of such limitations should be sent to third parties that deal with the employee on a regular basis. Third parties also should be given notice when an employee leaves the company.

§12 --Accounting and financial records

Most founders have a flair for the environment in which their fledging company will be operating. They may be a great salesperson, an outstanding scientist, a visionary
technologist or a brilliant marketing guru. Unfortunately most people do not like to keep the books; however, the founders must remember that the company's books and financial statements represent a score sheet which tells how the business is progressing, as well as an early warning system which lets the owners know when and why the business may be going amiss. Financial statements and the underlying records will also provide the basis for many decisions made by outsiders such as banks, landlords, potential investors, and trade creditors as well as taxing authorities and other governing bodies. The necessity for good, well organized financial records cannot be over-emphasized. One of the greatest mistakes made by owners of small businesses is not keeping good financial records and making poor business decisions based on inadequate information.

Quality financial information does not necessarily translate into complicated bookkeeping or accounting systems. Far too often small business owners become overwhelmed by their accounting system to the point where it is of no use to them. An accounting or bookkeeping system is like any tool used in a business; it needs to be sophisticated enough to provide the information needed to run the business and simple enough to implement. Questions that need to be asked in developing an accounting and financial reporting system are who will be the users of the financial information; what questions do need to be answered to manage the business; and what questions should be answered for government or regulatory taxing authorities? As the business grows, the founders and other managers should work closely with the company’s accountants to ensure that the accounting system is providing the appropriate information.

The basic road map into any accounting system is the chart of accounts. It is this chart which helps establish the information which will be captured by the accounting system and what information will subsequently be readily retrievable by the system. This tool, like the rest of the accounting system, needs to be dynamic and should grow as the size and needs of business changes. To help establish a good working chart of accounts, the founders need to answer some questions, in conjunction with their accountants, as to how the business will operate, and what information is important to those persons who will be managing the activities of the company. Some of these questions include:

- Will the business have inventory to account for? If so, will it be purchased in final form or will there be production costs?
- Are fixed assets a significant portion of the business?
- Will the company sell only one product or service or will there be several types of business?
- Will the company have accounts receivable from customers that the company will need to track?
- Is the company going to sell in only one location or will it do business in several locations?
- Are the products to be sold subject to sales tax?
- Does management need to track costs by department?
- What type of government controls or regulatory reporting is the company subject to?
Each one of these questions can have several answers and will probably generate more questions. Each answer will have an impact on how the chart of accounts is structured. It may seem that developing a chart of accounts is not particularly high on the list of things to do when starting a new business; the amount of time and money which a well-organized accounting system may save can be significant as the need to generate information for various purposes increases.

§13 ----Method of accounting

One of the decisions that should be made by any new business is whether to keep the records on a cash or accrual basis of accounting. The cash basis of accounting has the advantage of simplicity and almost everyone understands it. Under the cash basis of accounting, sales are recorded when money is received and expenses are accounted for when bills are paid. The increase in the money in “the cigar box” at the end of the month is how much money the business made. Unfortunately, as everyone knows, the business world is not always so easy. Sales are made to customers and companies sometimes must extend credit. The business will also incur liabilities which are due even though the company has not have received the invoice or has the cash available to pay them. Most users of financial statements such as bankers and investors are accustomed to accrual basis statements and expect to see them. Once management becomes familiar with them, they provide a much better measuring device for business operations than cash basis statements. Whether management uses the cash or accrual basis, it is possible to keep books for income tax purposes on a different basis than for financial statements. It may be more advantageous (less tax) for the company to do so. A new business selects its accounting method on its first federal income tax return and its first state tax return.

§14 ----Designation of bookkeeping responsibility

The founders must determine who will keep the financial books of the company. Very often the founders designate one of their own to keep the books and that person underestimates the commitment they have made to other phases of the operation and the time required to maintain a good set of financial records and books of account. As a consequence the recordkeeping is often low priority and must be caught up later. This approach, though rarely planned, can require a substantial expenditure of time and money. While it is important for the founders to maintain control and stay involved in the financial operations of the enterprise, this can be achieved by maintaining close control over the check signing function and scrutinizing certain records. The company’s accountant can help develop a good program of record-keeping duties for founders, employees and any outside bookkeepers.

§15 Internal controls

Internal control procedures are a system of checks and balances within a business enterprise which help to ensure that the company’s assets are properly safeguarded and that the financial information produced by the company is accurate and reliable. When the company is operating as a one-person shop or at least handling all of the company's
financial transactions, maintaining good internal accounting control is relatively straightforward. However, when a company grows enough so that the founders must delegate some of the bookkeeping functions, it becomes more difficult to ensure that all the transactions are being accounted for properly. No matter the size of the business, the answer to the following questions should always be “yes”: When the company provides goods or services to its customers, is it sure that the sale is recorded and the revenue is recorded in accounts receivable or the cash is collected? When cash is expended by the company, is the company sure that it received the goods or services? The methods used to ensure that these two questions can be answered affirmatively will vary widely. The solution in a particular instance may be as simple as numbering the sales tickets and being sure all tickets are accounted for or reviewing all invoices and timecards before signing company checks. These are fundamentals in a well-run business. As the company grows, consideration should be given to concepts such as segregation of authority as well as employee fidelity bonds or controlled access storerooms. These are essential stepping stones to maintaining good control over the business. Outside investors will generally impose even more formalized rules relating to internal controls and the company will need input from outside accountants at that point to be sure that the controls are consistent with industry standards and the size of the company’s operations.

§16 Legal and regulatory compliance programs

Any business, regardless of its size, will find itself subject to a variety of legal and regulatory schemes, and the founders must seek advice from counsel on implementing legal compliance programs that track and evaluates the procedures that the company uses to comply with applicable federal and state statutes. The nature and complexity of the company’s compliance activities will vary depending on the size of the company, the type of business activities and the geographic areas in which the company is operating. For example, technology-based companies should move quickly to create and protect their intellectual property rights portfolio and this requires implementation of appropriate compliance programs including procedures for safeguarding valuable trade secrets. The founders must also ensure that procedures are put in place for complying with federal and state employment laws above. Other compliance areas commonly applicable to emerging companies in the US and elsewhere include tax planning and reporting; securities laws; international business laws; and sales and consumer protection laws.23

As part of the process of establishing effective legal compliance programs an analysis should be conducted of the impact that compliance with applicable federal, state and local laws and regulation will have on the company’s business and competitive position and the specific regulatory hurdles that must be overcome in order for the company’s products and services to be distributed and promoted in various markets should be identified. For example, if the company is involved in the development of new pharmaceutical products, the compliance plan must address the applicable regulatory procedures with respect to testing of the products to confirm their efficacy and safety and

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23 For further discussion of compliance activities, see “Compliance: A Library of Resources for Sustainable Entrepreneurs” prepared and distributed by the Sustainable Entrepreneurship Project (www.seproject.org).
the founders should carefully consider the amount of time required to obtain the necessary approvals and the costs associated with completing the review process. Legal and regulatory compliance typically requires advice from attorneys and other consultants with relevant experience and skills who can assist the founders with satisfying the specific criteria imposed by each of the regulatory agencies for review and approval of the company products and services, including any required disclosures, applications, testing and certifications. In some cases the company may choose to form a relationship with a strategic partner which might facilitate completion of the regulatory process. For example, small companies involved in the life sciences area often develop marketing and distribution relationships with larger companies that include an undertaking by the larger company to move the products through the regulatory process. Such companies typically have a good deal of experience in minimizing the time required for obtaining approvals.

While many founders believe that compliance programs are just for public companies, there is growing recognition that private companies should implement policies and procedures to create a compliance environment and encourage managers and employees to take steps to ensure that the company meets its obligations under applicable laws and regulations. For example, while the federal Sarbanes-Oxley Act of 2002 ("SOXA") applies only to US public companies, many private companies have taken various steps to adhere to the spirit of the legislation and prepare for the day when either they will become a public companies or the regulations will be expanded to apply to them:

- Establishment of an independent audit committee and an internal audit function;
- Adoption of a formal code of ethics and formal internal controls and procedures;
- Recruitment and election of one or more independent members for the board of directors, including persons qualified as “financial experts,” and implementation of formal training programs on compliance issues for directors;
- Prohibitions on procurement of non-accounting services from the company’s independent auditors and requirement of formal board approval of all non-audit services;
- Adoption of formal policies relating to conflicts of interest;
- Regular review of benefit plans and management and director loan policies;
- Reviewing and changing current accounting practices;
- Preparation of a “Management’s Discussion and Analysis” section in the company’s financial statements;
- Adoption of formal “whistleblower” procedures and reporting systems; and
- Certification of financial statements by chief executive and financial officers.

Even the implementation of these procedures creates substantial costs for private companies. Among the expenses and other resource issues that might arise while attempting to implement corporate reforms are higher costs of directors’ and officers’ liability insurance; higher fees payable to independent auditors; increased costs relating to expansion of company’s internal audit function; substantial increase in the amount of time that management is diverted from business to tend to compliance issues; and
increased turnover among senior managers, particularly in the finance area, due to added stress of dealing with compliance problems.

Private company adoption of elements of SOXA is by no means a universal phenomenon; however, various surveys of private companies indicate that a majority of mid- to large-sized private corporations have implemented SOXA-based or other corporate governance reforms. The scope of the changes by any single company depends on various factors, including budgetary constraints, requirements of outside auditors and insurance carriers and the likelihood that compliance procedures will be mandated in the future under federal or state laws. Many companies view compliance programs as an essential part of a larger strategy of identifying and managing business and financial risks. In addition, many private companies are required by their business partners to adopt certain compliance procedures as a condition for conducting business with those partners. Finally, as private companies increase the amount of business they do in foreign countries they have little choice but to establish compliance programs that reduce the risk of liability under import/export laws and other laws and regulations relating to relationships with foreign businesses and governmental officials.

§17 Risk management

Good governance includes risk management and the founders, working with any non-founders who join the board of directors of the new company, should carefully consider steps that can be taken to protect the company from liabilities and losses that threaten the ability of the company to achieve its business and financial objectives. One important risk management tool is business insurance. While business owners typically do not like to pay for insurance the founders need to understand that sufficient insurance can be as critical to the success of a business as a good product or service. Without proper insurance the founders could lose all of the money, time and effort they put into the company.

Insurance is like any other product or service that the company may purchase. Before purchasing it the founders should consult with more than one broker as to the company's specific needs for protection. It is also useful to discuss insurance needs with acquaintances in the same or related business. Before buying coverage, an effort should be made to check out the reputation of the company that is underwriting the policy. Insurance companies are regulated by state insurance commissioners and generally must be licensed by the state in order to do business with consumers and companies therein. Companies are rated by various rating organizations, such as the A.M. Best Company, and such ratings are available through insurance brokers.

The key task for the founders with respect to insurance is being able to understand the terms of each policy that might be available to the company and determining the type and amount of coverage that might be appropriate in light of the company's operations and financial condition. A number of factors should be considered in analyzing the protection offered by specified insurance policies. For example, consideration should be given to the scope of losses covered by the policy; the periods covered (i.e., timing of events or actions covered by the policy); the property covered, in the cases of policies for damages...
to company property and/or properties of others; the persons covered; the deductible amounts and maximum dollar amount of coverage; the term of coverage; and exclusions.

The types and amounts of coverage must be evaluated on a cost-benefit basis like any other commodity purchased by the company. Usually, the company will want to insure against risks that could have significant detrimental impact on the business, which normally include damage to company property (e.g., fire, earthquake, storms, and other natural disasters), as well as indirect or consequential losses from such damage; theft and other crimes; damages and losses associated with transport of goods and other property; liabilities to third parties based on damages or losses suffered by such parties as a result of actions of the company or its agents; and worker's compensation and employer's liability. In addition, special types of coverage may be necessary and appropriate depending on the activities of the particular business. For example, insurance coverage is an important consideration for companies interested in establishing electronic commerce. The founders must also be aware that the terms of the company's building, office lease or mortgage may require that the company carry certain kinds of insurance coverage in specified minimum amounts. If the company has leased equipment or has borrowed money from a bank or other lenders, there will usually be insurance requirements in the contractual documents relating to these transactions. Finally, health, disability, and life insurance coverage can be an important form of employee benefit, as well as a valuable tool for handling sudden changes in the ownership group.

Depending on the nature and size of the business it is often a good idea to self-insure for all or a portion of certain losses. Self-insurance can be accomplished by not buying coverage for incidental risks or increasing the deductions on policies that are purchased. Often raising the deductible can have a very favorable impact on policy premiums. The administrative cost to the insurance company to process small claims is quite high and consequently the rates typically go down substantially if they are relieved of this expense by insuring only for losses in excess of a sizable deductible amount. An insurance broker can provide comparative costs for coverage with varying degrees of deductible amounts.

While insurance coverage is very helpful as a means of reducing business risk, an attempt should also be made to further reduce the potential risks to the company and its owners from the business activities by including certain provisions in various contracts. For example, many businesses attempt to limit their liability to customers and others through contractual exculpatory clauses, limitations on liability, limitations on the available remedies, or disclaimers. However, in many cases, it is unclear whether these limitations will be enforceable as a matter of law. Also, many transactions include indemnity contracts pursuant to which one party undertakes to compensate the other party for certain losses or damages it might suffer as a result of entering into the transaction.
About the Author

This chapter was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, *Business Transactions Solution*, is an online-only product available and featured on Thomson Reuters’ Westlaw, the world’s largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 80 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquartered in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph.D. from the University of Cambridge. For more information about Alan and his activities, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his website at alangutterman.com.

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) was launched by Alan Gutterman to teach and support individuals and companies, both startups and mature firms, seeking to create and build sustainable businesses based on purpose, innovation, shared value and respect for people and planet. The Project is a California nonprofit public benefit corporation with tax exempt status under section 501(c)(3) of the Internal Revenue Code dedicated to furthering and promoting sustainable entrepreneurship through education and awareness and supporting entrepreneurs in their efforts to launch and scale innovative sustainable enterprises that will have a material positive environmental or social impact on society as a whole.

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