Diligent

# THE GOVERNANCE GAP

Why governance is critical to
investor-backed companies

# The Governance Gap

For many startups, governance can be a dirty word. It conjures images of gray-haired old men at the head table unfurling red tape at every turn. Of rules, regulations and roadblocks. Of nefarious outside influences. To many company founders, governance is something you worry about later, when the initial public offering (IPO) happens. However, these are all misconceptions that can have profound consequences on the future of an early-stage business.

## WHAT IS GOVERNANCE, AND WHY DOES IS MATTER?

Before we delve into why governance matters, let's take a step back and define what the term actually means and how it applies to companies early in their life cycle – from launch, through growth and scaling, to becoming IPO ready. In layman's terms, governance refers to the rules, structures and procedures by which a company operates. For start-ups specifically, governance is the infrastructure – the technology and practices – that enable a business to grow and scale.

You don't have to cast your net particularly far or wide to find examples of bad governance severely hindering the progress of a potential unicorn as it reaches a certain stage of its growth. Uber, Theranos, WeWork and SoFi all should serve as cautionary tales to today's founders and early-stage investors. It doesn't matter how fast or effectively you grow and scale if the bad, unethical or just plainly illegal behavior of those involved from the beginning compromises the culture, brand, ethics or compliance of the company further down the line.

Laying good governance foundations early in the business life cycle ensures readiness for future growth and the challenges that come with it. As we've seen time and again – with Zynga, for example, or Arrivo – growth can happen very quickly. Accordingly, it is incumbent on the founders to ensure that proper governance checks and balances are in place before it occurs.

## BENEFITS OF AN EARLY FOCUS ON GOVERNANCE

1. **Governance provides founders with a strategic, operational and ethical framework for growth**

   In the wild west of early-stage growth and VC funding, good governance can be a North Star. Identifying the right people, processes and growth strategies early prevents reactionary or knee-jerk decisions which might not serve the best interests of the company or those involved with it. It doesn't matter how big

### WHEN GOOD GOVERNANCE GOES BAD (PART 1)

**RIDE SHARE PLATFORM**

The problems stemmed from a CEO who displayed a blatant disregard for workplace conventions and transportation laws. A series of privacy scandals and complaints of discrimination and sexual harassment unbalanced the company. The CEO resigned in 2017 and left the board in 2019.

**BIOTECH FIRM**

It was initially the stuff Silicon Valley dreams are made of - a young biotech CEO pledging not only disruption and innovation but also promising to improve the entire healthcare system. However, it all quickly came tumbling down when the company's blood-testing technology and methods were widely discredited.

your business is now; if you've got problems beneath the surface, they are guaranteed to arise sooner or later. Even the Titanic didn't see the iceberg until it was too late.

2. **Governance prepares companies for IPO**

   Fostering good governance helps companies plan for the future, and serves as an essential step when considering an IPO, a merger or an acquisition. For those with the dream of going public one day, establishing proper governance will eventually be required. Regulations, disclosures, diversity quotas, shareholder engagement – the throes of public company operations don't have to come as a shock if your company considers them early on the growth journey to IPO.

   The same applies if your company decides to follow an M&A strategy instead. Instances of bad governance can knock even the best laid plans off track. Recruiting the right board members will be particularly critical to ensuring preparedness.

3. **Governance positions companies favorably for fundraising and transactions**

   Even for the companies that are planning on staying private for an extended period of time, good governance signals to investors maturity and potential. With the rising prominence of private market financing and private secondary transactions — not to mention the favorable investment terms for public investors in private companies — many companies are incentivized to stay private longer.

   To put it in simpler terms, governance is an asset for fundraising. It offers security. It shows a clarity of thought and vision for the future. It provides an insight into longer-term plans, lending credence to the idea that your company will one day evolve into a viable, truly successful business.

   Ultimately, good governance and diversity of thought in group decision making leads to better business outcomes. As Sean O'Dowd, the Managing Director of Silvercrest Asset Management notes in this Q&A for Yale Insights, good governance "is crucial for the long-term sustainable success of the business."

## WHEN GOOD GOVERNANCE GOES BAD (PART 2)

### SHARED WORKSPACE FIRM

This firm's failed IPO was brought about by a combination of factors. It was losing huge amounts of money, its projections for the size of its target market were wildly optimistic and the founder had a complex web of personal connections with the company that could have posed numerous conflicts of interest. They stepped down in 2019.

### ONLINE PERSONAL FINANCE COMPANY

The company's CEO was toppled by an unseemly sex scandal with an executive assistant, coupled with accusations from investors of misstatements made to them relating to certain products. That behavior continued unabated among other senior employees, leading to comparisons between the company and a "frat house." The CEO stepped down in 2017.

> "[Good governance] is crucial for the long-term sustainable success of the business."

**Sean O'Dowd,**
**Managing Director,**
**Silvercrest Asset Management**

# THE COMPONENTS OF EARLY-STAGE GOVERNANCE

For an early-stage company, the obligation of governance is to ensure that the company has the right ingredients for growth. Broadly speaking, we can boil the focus down to three general areas:

1. **Equity governance**
2. **Board governance**
3. **Operational efficiency**

Let's take a look at each of them in turn.

## 1. Equity Governance

For early-stage companies, early-stage governance revolves around equity. Having a plan for managing your equity ledger will help you to ensure that you're planning around the growth of your company. Not doing so could have a significant impact on your ability to raise capital and to hire talent.

Not having a structured equity plan — or leaving one as an afterthought — can have disastrous consequences, ranging from a lack of knowledge around true ownership (which will invariably hurt an exit when the time comes), to ownership disputes, to potentially unexpected dilution upon exit. Alongside that, poor equity planning will inevitably hinder the hiring of new talent at a time when it's needed most.

Make sure that you're able to view your cap table in real time, and that you're working off the same information as your investors and lawyers. It's important that you source and adopt the right software early on in your journey. Ensuring that you do so will mean that you're not piecing together disparate bits of information at the same time you're trying to operate and grow a business. Using Microsoft Excel, for example, might seem like an easy, sensible option at first but it can quickly become unmanageable — and will more than likely require expensive assistance from a law firm in order to untangle any issues later on. A few specific recommendations:

- [x] Keep up with your stock options, warrants and convertible notes in one centralized platform.
- [x] Select a technology that enables waterfall analyses and scenario modeling for multiple liquidity events.
- [x] Invest in a good modeling tool that will allow you to understand how new deal terms are likely to affect your outcomes.
- [x] Assemble pre-built workflows for important but time-consuming tasks like collecting and tracking e-signatures.
- [x] Ensure your cap table platform provides a view of individual equity-stakes and personalized equity portals for investors and employees.

For more information on cap table technology, see page 6.

## 2. Board Governance

A well-constructed board can be an invaluable asset to scaling companies. A board with the right level of experience, connections and business know-how will be able to help an early-stage company scale their business while putting malleable governance structures in place that can evolve as a company matures. As founders strive to get their arms around governance, it's important that they have access to board members who have been down this road once or twice. For early-stage companies, board governance will tend to center around the crucial issue of board composition. Diversity is key. Having a diverse mix of skill sets, backgrounds and geographic representation — along with gender and ethnic diversity — are critical to building an effective board. Ultimately, the skill sets of your board should mirror the company's goals for one, three and five years down the road. Whether that entails expanding into global markets or new segments, ensure you have the board expertise to match. A strong board enhances the long-term sustainability of your company by acting as a sounding board for the founders or making the right introductions at the right time. As the company grows, board performance should be assessed on an ongoing basis, and board expertise rotated out or in as needed.

It's also beneficial to visualize how your board might evolve over time as your company continues its growth. Early-stage boards, for example, are generally composed of founders and investors, while large public company boards are mostly independent in structure. As the company grows, boards should become less operational and relational — and more focused on strategy, risk and compliance. You should plan to travel this spectrum as the company matures.

## TYPES OF BOARD DIVERSITY TO CONSIDER:

### PROFESSIONAL BACKGROUND AND EXPERTISE:

Look for board members who have experience scaling similar business models or subject-matter expertise. It's a plus if board members have strong reputations and reputable contacts in the industry you serve.

### BOARD MEMBER INDEPENDENCE:

Begin incorporating independent board members as early as possible to provide outside perspectives, avoid conflict-of-interest situations and ensure that personal interests don't dominate at a formative stage in the company's life cycle.

### REGULATORY EXPERTISE:

If you have an IPO in mind, then find a board member with regulatory expertise who can help navigate the more demanding and onerous regulatory hurdles before it's too late.

### GEOGRAPHIC REPRESENTATION:

If your company has plans to expand to new markets or jurisdictions, then you'll need to make sure you have the operational expertise to match.

### DEMOGRAPHIC DIVERSITY:

The composition of your board should generally mirror the composition of your consumer base (whether in terms of race, age, gender or other characteristics); failure to do so not only risks insensitivity but also risks missing critical customer nuances and market influences.

### 3. Operational Efficiency

Despite often being founded on new technologies and disruption, many early-stage companies fail to apply those same forward-thinking principles to their own operations. It's a strange imbalance, but one that can hobble growth just as everything begins to take off.

The role of a company founder is at its most critical in this early-stage period. The processes and procedures that are put in place at the beginning will define the trajectory of a company as it grows. It's essential that founders make sure they are streamlining manual and administrative processes — from bookkeeping to cap table management to customer relationship management — wherever possible so that they can focus their time on the strategic activities that will enhance company growth.

Finding a solution that allows you to streamline these processes early on is something you will thank yourself for much further down the line.

As a company grows from early-stage to late-stage, there will be an ever-greater number of these processes that ultimately contribute to effective governance. It's likely that you will need processes in place for entity management, efficient data access, secure messaging and news analytics, as well as ensuring you have proper board management software in place to allow critical business decisions to take place as smoothly as possible.

> The boards of 60% of the most heavily funded venture-backed startups don't include a single woman despite the fact that companies with one or more women on their board have 26% better share performance than companies with all-male boards.
>
> TECHCRUNCH

# CHOOSING THE RIGHT GOVERNANCE SOLUTION FOR YOUR COMPANY

Good governance starts at an early stage. As your company grows, your governance requirements will evolve too. Improving governance as you scale or plan an exit scenario is an essential part of successful growth. Whether you have 10 employees or 10,000, Diligent serves as a one-stop shop for your governance needs.

Our governance solutions are built for companies to grow from seed stage through a capital markets event and beyond. Diligent's intuitive platform includes everything you need to accurately manage your capitalization and apply governance best practices from day one. And it won't break the bank: Choose the solution that best suits your business size and budget.

**Launch**

Ideal for seed stage companies, the Launch package contains everything you need for your first round of funding. It will help you to:

- Model term sheets in your fundraising
- Understand dilution
- Manage cap tables

**Growth**

This package is aimed at early-stage companies in expansion mode, and will provide all the tools you need to scale headcount. In addition to the features offered in our Launch package, it will help you to:

- Create and model your option plan as you scale employee hiring
- Manage options, grants and board approvals

**Scale**

Aimed at more mature growth companies, the Scale package fosters good governance, solidifies best governance practices and helps you to prepare for the future. In addition to the features in our Launch and Growth packages, it will help you to:

- Enable employees to access their options
- Manage board meetings
- Access a diverse pool of top leadership and board talent
- Securely share sensitive documents with potential investors

**IPO Ready**

This package helps companies prepare for an IPO by prioritizing good governance and ensuring compliance for a successful exit strategy. In addition to the features in the Launch, Growth and Scale packages, it will help you to:

- Manage entity data for M&A or conflicts of interest
- Enable D&O questionnaires
- Manage executive compensation
- Simplify SOX compliance
- Access market intelligence and benchmark your company against peers