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Start-Up Corner

The Evolution of the Board of Directors in Start-Ups and Emerging Companies

Jim Ryan and Lovina Consunji*

In this column, the authors explore the basics of how the makeup of a board of directors is determined and how it evolves over the life of a typical start-up or emerging company.

As entrepreneurs and investors think about the companies they are involved in, one of the most important topics they consider is governance. There are many ways to influence the path of a company, but the most fundamental aspect from a governance perspective is the board of directors.

The board of directors is a group of individuals, elected by the shareholders, who are empowered by law and a company's charter documents to manage its business and affairs. Among other things, they can aid in creating a successful business and go-to-market strategy, putting together the right management team, structuring strategic transactions, building good financial habits, and avoiding legal and compliance issues. In making these decisions, the board owes fiduciary duties of care and loyalty to the company and its shareholders.

The size and composition of a board of directors typically evolve over time to meet the changing needs and strategic direction of the company. Initially, boards may be smaller and composed primarily of the company's founders and early investors. As the company grows, the board often expands to include independent directors who bring diverse skills and perspectives, such as financial expertise, industry-specific knowledge, and operational experience. This column explores the basics of how the makeup of the board is determined and how it evolves over the life of a typical start-up or emerging company.

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Electing the Board

The board of directors is elected by the shareholders of the company. The methods for electing boards of directors can vary significantly depending on the company's state of incorporation and governing documents. The default starting point is that the holders of a majority of the outstanding voting shares have the right to elect all of the directors. Eventually, most venture-backed start-ups evolve from the default state and negotiate bespoke arrangements in connection with raising equity financings as discussed further below. Typically, the publicly filed certificate of incorporation sets out the by share class and series composition of the board and a non-public voting agreement will be entered into among the shareholders to lay out exactly who gets to decide who fills the different seats.

Size and Composition

For start-up companies, a board's size and composition will depend largely on its stage, industry, and financing history. Determining the optimal size of a board is crucial. Boards that are too small may lack diverse outlooks or objectives and risk becoming stagnant.

Conversely, boards that are too large can become unwieldy, complicating governance and operational efficiency.

At a high level, the board composition of the average venture-backed start-up largely tracks the balance of its shareholder base with proportionally more directors being appointed by the investors as the company takes on more dilution by selling shares to investors. Although all directors owe fiduciary duties to all shareholders, this rebalancing is generally seen as a proxy for keeping the viewpoints of the board aligned with the characteristics of the shareholder base. Of course, this is a general rule and there are common stock–controlled boards in companies with high proportions of investors on the capitalization table and vice versa.

Among its many duties, the board determines who the officers of the company are and so the balance of power on the board is important in determining who is running the company. As the board composition changes, entrepreneurs and investors should think carefully about how the balance of the board composition

relates to the founders' say in the company and long-term role and make sure the agreed upon structure is properly reflected and protected in the relevant documents.

At Incorporation

Under Delaware law, where an overwhelming number of start-up companies incorporate, there can be as few as one director. When a start-up company first incorporates, the board will typically consist of the main two or three founders. It is not uncommon for an early stage company to have a board of directors, all of whom are shareholders and all of whom are also officers or employees of the company. This arrangement allows the founders to maintain control and make decisions quickly.

Pre-Seed to Seed Funding

As emerging companies grow, they often need to take on funding from external sources. Many initially rely on convertible instruments, such as convertible notes and SAFEs, which do not carry votes at issuance. Investors in convertible instruments do not typically have any entitlement to vote for or sit as the directors on the board. With that caveat in mind, a larger seed investor may request a board seat or observer rights to influence the company's direction and protect their interests.

Priced Equity Rounds: Series A and Beyond

The board typically evolves as the company matures. For most venture-backed start-ups, changes in a board's size and composition are negotiated during funding rounds and can be made a closing condition of a financing (i.e., certain resignations and appointments need to occur to receive new capital). In most cases, voting agreements are entered into to ensure the desired outcome and specific series of shares or specific persons/investors are given the right to designate representatives who the other shareholders are in turn required to elect.

In a traditional Series A financing, where the start-up company sells equity in the form of preferred shares at a fixed price, the

board is expanded to provide a seat for the lead investor with the remaining seats left for the common shareholders. As more venture capital rounds are completed, additional board seats are commonly added for the lead investors in those new rounds. In connection with these future rounds, further variations, such as removing an earlier investor's board seat to add the new lead's designee or freezing the size of the board without a representative for the new lead, become more common.

At some point, investors and/or management may look to round out the expertise around the board table and have one or more independent directors (i.e., those without an affiliation with the company or any of the investors) join the board. This often comes up when there might otherwise be an equal number of common and preferred director seats, as a sort of tiebreaker. The designation of an independent director usually requires some cooperation between the holders of common shares and the investors or their director-appointees.

As the company matures, it is not unusual for the number of board positions allocated to the common shareholders (and therefore the founders) to be more restricted. Often, for example, there is a seat reserved for the current CEO of the company, regardless of whether that person is a founder or controls the common share vote. To the extent there are more founders or significant common shareholders than there are allocated board seats, sensitive conversations are necessary in order to determine who will be on the board.

Further Considerations and Concluding Thoughts

At different stages in a company's life cycle, its board's size and composition will change to reflect its changing shareholder base and needs. As the ultimate decision-making body for a company, the board's composition is one of the most important keys to success. Parties should take into consideration the background and skills of potential board members, as well as the personality and culture fit of those individuals, to build a governing body that maximizes the company's chances of success.

While there are market norms (which are always evolving), there are few hard and fast rules about what a private company

board needs to look like at any particular stage. It is important to work with experienced legal counsel and other advisors to determine what is appropriate and best fits the needs of the parties in the specific circumstances.

Note

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