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"Start-Up" Series
Getting Control of Risk Early & Quickly

A. Some Things Never Change... or Do They?

Zeno of Elea, the 5th Century B.C. Greek mathematician and disciple of the renowned Greek philosopher Parmenides, once posited the paradox of "Achilles and the tortoise" to validate his master's theory that the world of motion and change was all appearance. To Parmenides, true Being (reality) was absolutely static and unchangeable: *"That which is*, *is*." The Heraclitian notion of reality as continuous change and motion, to Parmenides, was mere illusion.

To illustrate the point Zeno told the story of how the tortoise challenged the great Achilles to a race. The tortoise wanted a head start. Fair enough. The hero felt magnanimous and agreed. The race under way, by the time Achilles reached the tortoise's starting point, the tortoise had left the gate. By the time Achilles reached the point where the tortoise had moved to, the tortoise had traveled a little further from there. And by the time the great Achilles reached that point, the methodical tortoise had moved a little further still. Every time Achilles reached the tortoise's last starting point, the tortoise had moved on ever so little more. By this analysis, Zeno reasoned, Achilles could never catch the tortoise!

B. Corporate Governance

To many entrepreneurs and senior executives, business is like that. While subscribing to Heraclitus' common sense notion that the only constant in the world is change, they act as if the race belongs unabashedly to the swift and that the fundamentals of risk management and good governance are luxuries they can ill afford. Nothing could be further from the truth. Risk *is* the "Achilles Heel" of start-ups; sound corporate governance is the answer.

In our InfoSheet on ***"Corporate Governance: Small-Medium Enterprises"*** in the **Grey Book Corporate Compliance Series**, we described the role of governance for privately-held SMEs in the 21st Century environment of increased corporate regulation and liability. In this **Grey Book** we want to zero in on how start-up companies can break the stranglehold of **"risk"** and get it under control early and quickly by examining sound governance structures; director and executive qualifications; the often tense relationships between management and the board, and between the board and its shareholders; as well as the often competing priorities of investors and founders.

C. Structuring the Board

Fundamentally, controlling risk is about two things: putting the right pieces in place at the beginning of the race *and* managing change throughout the race. That's it. Those organizations that get this early will beat the proud Achilles every time. Putting those pieces in place and managing change is the *stuff* of good corporate governance.

In most closely-held companies the shareholders are the founders and principal investors. This means that in most of these companies the shareholders elect *themselves* to the board of directors (BOD) and continue to identify themselves personally and inextricably with the company as it moves forward. It seems "the natural thing to do". But more often than not this can be a latent source of future tension, disruption and risk for the company, particularly as the business begins to grow and requires second or third round financing. Who, then, should sit on the board?

To begin, it is important to separate *ownership* from *management*. Entrepreneurs and founders often fail to grasp the significance of this distinction. There is no rule that says that each founding shareholder should have a seat on the board. Nomination or election to the board, even in the start-up phase, should be based on what the company needs to succeed. This will actually require the founders to think it through a little more deeply than is typically the case. For example, has the company a clear vision of its business and strategy? If so, what skill sets does the board need to fulfill the company's mission? What skill sets do the founders have? Is there a match? Is anything missing? Questions such as these are a good place to start.

Director Qualifications

To ensure effective board oversight and risk management, the qualifications of individual directors is critical.

- ***Business Experience:*** Does the director have experience in the industry or sector in which the company operates? If so, how much? What kind? Operating a retail franchise or government department, for example, is very different from operating an emerging software company or IT consulting firm;
- ***Management Experience:*** The board may require directors with experience in financial reporting or strategic planning, experience establishing corporate strategy (as opposed to operational tactics and details), defining the mandate and qualifications of the CEO, or assessing management performance;
- ***Integrity and Ethics:*** As "soft" (or tortoise-like) as this may sound, ethics and integrity, no less than reputation and results, play an increasingly vital role in attracting investment, enhancing confidence, and increasing shareholder value. In their book *The Integrity Advantage*, Gostick and Telford argue how integrity creates competitive advantage in the new economy.

A little care by the *founders* up front in structuring the board, by the *board* in appointing its CEO (e.g., one who knows the industry or has commercialized a new product before), and by the *CEO* in selecting his or her management team, will go a long way in preempting many of the latent **risks** that lie dormant in the formative stages of the “start-up”; risks that can later hinder or even derail the most dedicated founders and entrepreneurs when the financial and market realities of growing the business start to expose the Achilles’ heel of the enterprise.

D. Relationship of The Board to Management & Investors

In those closely-held private corporations where the founding shareholders are virtually indistinguishable from the directors and officers, the risk of tension, distrust or misalignment between the board, management and shareholders is obviously reduced. This virtual indistinguishability, however, carries legal and business risks of its own such as competing priorities, conflicts of interest, and agency risks. These risks, however, begin to manifest themselves more acutely as the company begins to add new employees and turns its attention to raising outside capital to finance its expansion or operations. Typically, this capital will take the form of *debt* and/or *equity*.

Where raising of capital takes the form of *debt* (whether a note, debenture or other debt facility, secured or unsecured), these tensions will often surface when the “shareholders” are asked to *guarantee* the debt and require the consent of spouses. Where raising capital takes the form of *equity*, different issues will arise depending on the identity of the investors (angels, venture capital, etc.), the maturity and experience of the board and management team, and the market potential of the business.

Debt or Equity?

Which form of capital structure is best for the early-stage “start-up”? That is a little like asking whether Achilles will ever catch the tortoise? Or how long a piece of string is? The short answer: *both* are, and *neither* is (Parmenides would be proud). In most cases, the early-stage company will eventually require both forms of capital to finance its expansion and operations. Initially, *equity* may appear to be the preferred instrument for early-stage companies, particularly where the “start-up” is cash-strapped and cannot rely on cash flow to service a debt facility. If, however, the company has a product or service that is generating cash or has other leverageable assets that can be secured, the right debt instrument might be attractive. Alternatively, there is *convertible debt* (a hybrid of both). Each of these instruments and facilities carries its peculiar risks and benefits.

Debt, for the most part, carries greater short-medium term risk for the company. It carries with it a continuing obligation to repay with interest (regardless of the fortunes of the company); and, unlike equity, more of it can’t be issued at will to shore up flagging revenues. On the other hand, the founders and existing shareholders retain ownership and control of the company and continue to participate in its growth, without dilution - an important consideration for many founders as they plan their exit strategy. *Equity*, on the other hand, may or may not carry less risk for the founders and existing shareholders, depending on the source of capital, the terms and conditions of the investment, and the exit strategy. For the investor, on the other hand, *debt* is typically less risky than equity, particularly where the obligation to repay is secured by immediately realizable assets (cash, accounts receivable, equipment, etc.). Debt holders, both secured and unsecured, for the most part, will rank ahead of equity holders in the event of bankruptcy. But unlike equity holders, debt holders (except for convertible debentures) will not participate in the upside of the company’s growth. Moreover, in the case of *equity*, unless the board has taken positive steps to “founder proof” the company, certain investors (notably venture capitalists) will often insist on control of the board. Here, perhaps more plainly than anywhere else, is where attention to good governance in the founding stages of the company’s formation will mitigate the foreseeable risk.

E. Managing Change & Controlling Risk

To paraphrase Heraclitus again, *“the only constant in the world is change”*. While no scientific enterprise could be reliably undertaken without the acknowledgment of fixed laws that do not change, in the business world Heraclitus’ admonition prevails. Change is virtually unrelenting and comes in many forms, including changes in market conditions, resource availability, business regulation, global competition, and the like, requiring quick adaptability, experience and continuous re-alignment, both by the board and by executive management. Companies that take the time to put the right pieces in place in the “start-up” phase of the enterprise and that continue to pay attention to sound governance and management throughout the early stages of the business, will find themselves far better positioned to adapt to change, to manage the risks, and to finish the race.

The above outline of controlling risk in “start-up” organizations is intended as a basic introduction for entrepreneurs, business executives, officers and directors. It is not intended as legal advice. Consult your solicitors if you have any specific questions.

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