Corporate governance in fast-growing technology companies
Introduction

While corporate governance has become a popular subject in management literature, academic research, and business news, most attention is focused on large companies and the often dramatic scandals that the failure of their boards has caused. Inspired by the emergence of a wider discussion about the corporate governance practices of the technology industry, “Corporate Governance in Fast-Growing Technology Companies,” the latest study published by the Korn Ferry Institute, will look at the special aspects of boardroom work in smaller companies in the technology sector.

Based upon review of academic research publications on corporate governance written by leading subject matter experts and management scientists from around the globe, we discussed the major findings and theories in interviews with 40 individuals who are serving on boards of public and private companies in the technology sector and have incorporated their experience from the business world.

In particular, we looked at the following issues:

- What are the specialties of fast-growing companies in the technology industry and how do these affect requirements for efficient corporate governance? How does the life cycle of a company play a role?
- What is the role of the board of directors in smaller technology companies and how does it differ from boards in more traditional environments?
- What qualifications and behavioral characteristics are required for executives to become effective non-executive directors in this sector? What can executives do to develop themselves into high-caliber non-executive director candidates?
What is special about technology?

**Rapid pace, disruptiveness, and vulnerability.** The technology sector and its many start-up companies often present challenges that are quite different from other industries. First of all, the pace and impact of technological innovation is enormous. So far, the developments described by “Moore’s Law”—the number of transistors on an integrated circuit doubles approximately every two years, and so will overall computer performance—and “Bezos’s Law”—the permanent decrease of computing power price, coined by Greg O’Connor, founder of App2Zero—remain unchallenged. Disruptive innovation destroys proven and tested business models—data centers are being replaced by cloud services, physical entertainment storage by streaming technologies, traditional payment modes questioned by virtual currency. If there is a new, groundbreaking way to “re-connect the dots”—combining existing technologies to create a new product, like the iPhone, which was mainly based on readily available components—it is only a matter of time until it will be done.

Growth is often unimaginably fast—as an example, even way back in 1997, eBay hosted 2,000,000 auctions in a single month, compared with only 250,000 during the whole of 1996—and yet it is not a guarantee for long-term success. Eric Kutcher, global leader of McKinsey’s High Tech Enterprise Practice: “If a health-care company grew at 20% annually, its managers and investors would be happy. If a software company grows at that rate, it has a 92% chance of ceasing to exist within a few years. Even if a software company is growing at 60% annually, its chances of becoming a multibillion-dollar giant are no better than a coin flip.”

And this growth has a massive impact on the structure as well as the culture. Kim Cameron and Robert Quinn of Ross School of Business describe how companies race at a rapid pace through the four stages of their life cycle—after a brief “entrepreneurial stage” focusing on niche formation and creativity, they quickly evolve into their “collectivity stage,” defined by high-cohesion commitment of the founding team; they then become more stable and institutionalized in their “formalization stage;” and finally they become settled and spread out in their “structure elaboration and adaptation stage.”

While start-ups are often seen as agile and innovative, their smallness and newness are often rather “liabilities,” as management scientists like Andrew Henderson, associate professor at the McCombs School of Business at The University of Texas at Austin, puts it. “Start-ups face the challenges of the high cost of capital, scarcity of managerial skills, and intense competition,” writes Coral Ingley, associate professor for management at AUT University, New Zealand.
“Ironically, large companies may be more agile and able to change direction whereas start-ups may be locked into a single investor’s direction.”

**The founder as a limitation.** In many cases, the “genius entrepreneur” is much less helpful when it comes to taking the company to the next level. Says a non-executive director who sits on several boards of privately owned technology companies: “There is the emotional attachment of the founder, who is often less willing to share or delegate responsibility. Founders often tend to overestimate their own capabilities.” A director of a solar equipment company whose founder has by now stepped down and was replaced by a CEO from outside says: “As the company grew, it took a while until the founder realized that his own capabilities as chief executive did not match the new requirements of the company after it has grown to twice its size within twelve months.” Coral Ingley explains the consequences of concentrated ownership and power: “This situation can lead to the ‘Icarus Paradox,’ where the founder-CEO is overconfident of his or her abilities, leading to a sense of invincibility, which may foster reckless actions. For such CEOs, their early success can breed complacency, inertia, and risk-aversion.”
There is life after an IPO.

In particular, an IPO can be the tipping point. McKinsey’s Eric Kutcher: “Both in their culture and in their incentive structure (for example, change of control agreements), many start-ups give little thought to life beyond the IPO.” A partner of a private equity firm specializing in growth investments in the technology space confirms this: “The founding team of entrepreneurs quickly reaches its limits. Financial success, after an IPO, is often the final nail in the coffin.” Igor Filatotchev, professor of corporate governance at Cass Business School, City University London: “In the context of IPOs, most founders who take their firms public represent ‘untested management’ and lack vital experience, and this increases a probability of strategic errors and efficiency losses.”

“Especially in technology start-ups, the founders underestimate the importance of a strategic go-to-market approach based on ‘tried and tested’ methodologies,” comments Werner Penk, president of technology markets at Korn Ferry, who held various executive positions in large, established technology companies as well as in start-ups. “They are often overly confident in the leading edge their products and technological innovation provide, but do not see how important established relationships between market participants and overall trust and reputation of an organization as well the people who represent it are.”
The human factor.

These factors lead to a very different approach when it comes to corporate governance: “For established companies, recent changes in the structuring of boards have largely been driven by regulatory reviews,” says Coral Ingley of AUT University, New Zealand. “Over time, good-governance advocates have developed no shortage of remedies for failures of governance. Most of these remedies are structural: They’re concerned with rules, procedures, composition of committees,” writes Jeffrey Sonnenfeld, Lester Crown professor in the practice of management for the Yale School of Management. But: “The key isn’t structural, it’s social.”

This is even more the case for the technology industry, says the operating partner of a private equity firm: “It is a very unique field. Financial institutions often do not understand the special implications of the technology sector—for example, disruptive innovation—and due to the size of a typical start-up company, they often fly under the radar of the established players in the market.”

A director who serves on the board of a private software company says: “When I was asked to join the board, the company was small and most of the management team as well as the employees had a background in software development and computer sciences. No one looked at the people side of the business, and almost nobody had a clue—or an interest—in the financial aspect of running a company.” A non-executive director who sits on the board of a medium-sized and privately owned technology company says: “In smaller companies, in their early stage of life, decision-making processes are often much quicker—but also often much less scrutinized in terms of their overall strategic impact.”

For private companies, this requires the founder to understand what benefits a (voluntarily created) supervisory board can bring. “Often founders fail to understand that this is not about control—but about much more,” comments a professional board director with experience in family-owned companies.
THE ROLE OF THE BOARD

“Established companies reportedly focus more on compliance, CEO leadership, routine board matters, and risk management. Start-ups, however, focus more on future development, competitive positioning, and operational issues,” says Coral Ingley of AUT University, New Zealand. Given these circumstances, there is a great opportunity for non-executive directors to add value. But how? “For established companies, the board’s role and influence are clearly defined in the corporate governance literature and there is delineation between directors’ and management’s responsibilities,” Ingley comments. “For start-ups, these roles are not always so clearly defined.”

Friendly boards. “In order to prevent managerial errors and compensate for the relative lack of experience, the board should be involved in the critical functions of active monitoring and evaluation of decisions made by the CEO and other top management team members,” suggests Igor Filatotchev of City University London. When boards focus less on supervision and take over an active part, Renee Adams, professor of finance, Commonwealth Bank chair in Finance Australian School of Business, University of New South Wales calls this “friendly boards.” This approach can often be found in real life. A former partner of a “Big 4” accounting firm who is a member of the supervisory board of several technology companies says: “I am an advisor to the management, who have strong roots in tech but lack some of the more formalized financial management and governance capabilities.” “The board members should provide guidance to the management team, ideally by asking questions—the simpler, the better,” says a non-executive director. “The role of the board as trusted advisor, even as a coach to the founding team or CEO, is a mission-critical success factor for smaller companies,” says Werner Penk, president of technology markets at Korn Ferry.

The board as resource provider. For start-ups that are resource-poor, boards also operate as resource providers. “Given that high-tech start-ups are commonly resource-poor, these external stakeholders may play an important role in accessing critical external resources,” says Bart Clarysse, chair in entrepreneurship at Imperial College London Business School. Coral Ingley: “For start-ups, the board is seen as a resource pool and a think-tank with specialist skills that are directly applied to the business issues at hand.” These resources are often intangible, such as networks. Werner Penk, president of technology markets at Korn Ferry says: “Entrepreneurship and a healthy appetite for risk isn’t everything. Often founders do not have access to the relevant commercial channels, which board members with a relevant background can provide.”
Ljiljana Erakovic, senior lecturer in the department of Management and International Business, The University of Auckland Business School, confirms that board directors often play “an essential part in attracting clients, finding new partners, enabling international contacts with technology providers, and attracting new investors.”

One board director wasn’t prepared for this: “I thought I was recruited because of my wisdom and experience. I was surprised to learn that the management board expected me to open doors for them and introduce them to potential customers whom I knew from my previous career.”
How to make boards perform.

Board effectiveness and the inherent team dynamics have been the subject of research for a long time—but not in this specific sector. “Little attention has been focused on board composition in start-ups, and more specifically high-tech start-ups,” Bart Clarysse of London Business School notes.

**Board to complement the management team.** Various factors influence the composition of the board. First, it should complement the key strengths and resources of the management board and the company’s key stakeholders. “Board composition should fill the gaps that the management team has,” comments a professional board director with experience in family-owned companies. “Where outside board members have human capital that is complementary to the founding team, the value added in terms of network, experience, and access to external resources may be substantial,” notes Bart Clarysse. Korn Ferry’s Werner Penk says: “A board, which is composed of people with a diverse background, and interpersonal competencies, which are complementary to the management board, can add a lot of value to start-up companies. Seasoned executives can provide long-term vision, emotional stability, and experience from previous executive positions.”

**The prestigious board director.** But there is a danger lurking. “Founder often tend to ask other successful entrepreneurs to sit on their supervisory boards,” comments a professional board director with experience in family-owned companies. And it might be tempting for founders or external investors to appoint a well-known industry veteran to the board. “Especially in pre-IPO situations, a well-known name will surely help,” says an operating partner of a private equity firm.

But this is not always a suitable approach. “Prestigious directors are more likely to be active board members who exert their power when interacting with executives and other board members, particularly at newly public firms, where circumstances are evolving and where active directors are likely to have the greatest direct influence. This level and intensity of involvement may seem intrusive to incumbent executives and directors, who have their own perspectives and who have established work routines and an internal status structure among board members,” says Abhijith Acharya, assistant professor of strategic management at Lee Kong Chian School of Business, Singapore Management University. “Prestigious directors provide signaling value, expertise, and valuable network connection, but they can also generate costs in the form of challenges to the power of the CEO and current directors, and disruptions to the internal status structure and operations of the board.”
A seasoned investment banker who sits on the board of a number of private and public supervisory boards comments: “This is not a situation where you seek the limelight. While you need to have a strong personality, you also need to know your place—and don’t run the CEO's show.”

**Chemistry and culture.** Once the board has been assembled, it is now important to make it work. “Chemistry and collaboration are two of the most important drivers of a high-performing board,” says Korn Ferry’s Dennis Carey. Board members should get used to an environment that may differ from that of more established companies. Especially in companies still influenced by the founders, “professional managers will become ‘quasi-family’ and ‘family’ members,” says Meng Yun Wu, School of Finance and Economics, Jiangsu University, China. To create a “management-friendly board,” directors must have a proactive approach in acquiring information characterized by actively “accumulating, investigating, and exchanging information from internal and external sources,” notes Ljiljana Erakovic of the University of Auckland Business School.

Jeffrey Sonnenfeld says: “Team members develop mutual respect; because they respect one another, they develop trust; because they trust one another, they share difficult information; because they all have the same, reasonably complete information, they can challenge one another’s conclusions coherently; because a spirited give-and-take becomes the norm, they learn to adjust their own interpretations in response to intelligent questions.”

So the individual board director must have some discerning qualities to perform well in a tech company board. What does an individual have to bring to the game?

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**“Boards are expected to perform qualitatively different roles at various points in the life cycle of a company.”**

- Shaker Zahra
  University of Minnesota
The ideal tech NED.

We asked our interview partners to distill a set of competencies that make an ideal board director for smaller technology companies.

**Perspective and strategic capabilities.** A skilled board director is able to think globally and to discuss multiple aspects and impacts of issues and project them into the future. “Start-ups have a higher future orientation than established companies in relation to the development of the organization, and have a greater focus on competitive positioning. They place more importance on the task of monitoring the strategic health of the organization than established companies, and when selecting a new board member, start-ups assign greater importance to candidates’ recognized strategic capabilities,” says Coral Ingley. “The ability to ask the right questions and to anticipate trends before they had an impact on the company were mission-critical elements for my role. My background as a strategy consultant made a difference when I was selected to join the board of a software company,” says a former partner of a global management consulting firm. “The board was composed of senior executives with operational background and substantial financial management know-how. I was the only one who knew how to extrapolate trends and their commercial impact.” People whose interests are too narrow or who focus solely on the “here and now” will struggle. The ideal candidate will be widely read and easily project future scenarios.

**Managerial courage.** “I have to deal with two founders in their late 20s who have become very wealthy after the IPO. To be effective in my role, I have to stand my ground and be independent, in thinking and acting,” says a high-profile academic who serves on the board of a technology start-up. Herbert Unterköfler, senior client partner of Korn Ferry and lecturer on corporate governance at WU University in Vienna, adds: “A good non-executive director is fearless when it comes to being autonomous. Independence is the most valuable asset,” and that includes mental independence as well as financial independence. “In our board meetings, I am really a pain in the neck, as I am putting my finger where it hurts,” says a former partner of a global management consulting firm who sits on the board of a software company. “I am always willing and ready to escalate when I see something that does not look right,” says a non-executive director of a larger technology services provider with a background in both blue-chip and fast-growing companies. “The supervisory board member—and even more so, the chairman—can say things that the executive board members are often afraid to say,” says a chairman of the supervisory board of a public software company. People who do not hold back anything that needs to be said and are...
not afraid to take negative action when necessary are well prepared for being a board director in a tech environment, as long as they can provide “actionable,” positive, and corrective feedback to others. The ability to stand alone, staking out tough and lonely positions, speaking out as a lone voice while still being a good team player—these are critical competencies for board directors.

**Decision quality.** A good board director makes good decisions based upon a mixture of analysis, wisdom, experience, and judgement. “The ideal tech board director is open-minded, intellectually curious, and first of all a very good listener,” comments a full-time board director with experience in founder-led private tech companies. “He can deal with complexity, and is modest enough to assume he does not know everything and to ask questions.” This often means, “Hold your horses,” until a thorough analysis has occurred. Patience is required—one who is action-oriented and resists process and problem complexity may find succeeding as board director difficult. The key is to try to understand the people and data before making judgements and acting upon them—even if the situation is ambiguous.

**The right motivation.** To vet the potential board member for a new role, look at his motivation and see whether it is in line with the demands of the job. “I was looking for something else in my life,” says a seasoned investment banker who sits on a number of supervisory boards of private and public technology companies. “My previous career was dominated by deal-making.” “I wanted to broaden my horizon in a drastic way,” says a high-profile academic who serves on the board of a technology start-up. “This was an entirely new situation for me, but that was what I was looking for. I was intrigued by the intellectual challenge, operating outside my comfort zone of the academic world.” This is even more the case when having more than one non-executive director position. A seasoned non-executive director says: “Before I became a full-time director, my career as an executive was very much characterized by rotation. I was actively seeking unusual and new situations. Today, my directorship portfolio provides me with the same variety and complexity.” Another director comments: “I was actively looking for a director role in a smaller, fast-growing company in a pre-IPO situation. When I was a non-executive director at a larger public corporation, most of the supervisory board meetings were simply rituals, without any way for me to influence the development of the company.” “Ideally, the NED is passionate about the business of the company,” says a board member of an emergent solar equipment company.
What to watch out for.

**No on-boarding.** Given the smaller size of the organizations of start-up companies, many comfortable administrative perks often found at larger companies are missing. This often means the lack of a formal and proven induction process for the new board member: “There was no on-boarding. I had to gather all the information myself; so I connected with the other members of the supervisory board and made sure I understood both the business matters and the intra-board dynamics,” says a board director. “Luckily, the chairman was instrumental in helping me to settle in,” said a former partner of a global management consulting firm who sits on the board of a software company. “For me it was difficult—although I knew how to work in committees and task forces, I had difficulties understanding the particular culture of a technology start-up,” says a high-profile academic who is on the board of a technology start-up.

**Time consumption.** “Time considerations have long been identified as the number one reason directors decline new board appointments and resign from current appointments,” says Steven Boivie, associate professor in the Mays School of Business at Texas A&M University. A professional non-executive board director: “Being on the supervisory board of a technology start-up feels very much like an executive management position. You are ‘always on’—this is not a situation where you meet four times a year and otherwise switch off and forget about it.” A seasoned investment banker: “One mandate for a gaming start-up kept me busy for about two days a week—that was much more than I originally expected. There were a lot of ad-hoc meetings due to outside events.” A non-executive director with experience in both blue-chip and start-up companies: “Demands of fast-growing companies are often much higher than in traditional environments, due to the special nature of the board and the hands-on role that the directors play. Especially the chairman will need to invest much more time than the other board members.” A professional non-executive director confirms this: “At one time, I was personally involved in a major M&A transaction—the management board was dependent on both my experience in this from my previous career as on my connections to banks and advisors, and they literally called on me day and night.”

**Lack of infrastructure.** And there is another issue: “Start-ups often cannot provide the infrastructure for a director who is used to having that kind of support from his previous engagements. Ideally, an individual has an ‘anchor directorship’ at a large company where an office, a personal assistant, and other facilities are provided. Most of the smaller tech companies are not prepared for this,” comments a seasoned director. A full-time non-executive director says: “Keeping
in touch with the underlying technology trends of the market is much more difficult in nascent markets than in mature industries where the cake has already been divided.” There are software providers who offer solutions for the distribution of board meeting documents, but this opens up another can of worms—information security.

**Compensation.** Compensation for non-executive directors in smaller emerging companies often does not reflect the demands of the role as described before. “NED compensation tends to be between €20,000 and €30,000 for smaller, fast-growing firms, if at all,” says a director of several privately held technology companies. “The reason for this relatively low compensation is that the companies are often strapped for cash during their ramp-up phase—although that is when they would benefit most from senior-caliber non-executive directors, which they cannot attract.” Another director with a background as a private equity investment manager says: “Given the amount of time I need to invest, the director’s compensation is not much more than a nice add-on. If I weren’t so keen on the other benefits from being a board director, I would not do it.” A seasoned investment banker adds: “Privately owned firms often do not pay enough for board mandates. Especially the chairman’s role is usually underpaid, given the overall investment of time and resources that is expected.” Also, “often owners of privately-owned firms with founders acting as CEOs do not see the value of a supervisory board beyond its traditional control function and are hesitant to compensate it appropriately,” remarks a board member of several private technology companies.

Herbert Unterköfler of Korn Ferry confirms this: “Especially smaller companies do not pay their supervisory boards in line [with] what their contribution is. They don’t reward the knowledge that a supervisory board provides.”

There are alternative compensation models that take into account the dynamics of a fast-growing company. A chairman of the supervisory board of a public software company says: “I believe supervisory board members’ compensation should be linked to their own performance and also the overall development of the company.” Igor Filatotchev describes an alternative: “Young, fast-growing firms are typically cash-poor and not able to provide NEDs with high salaries; they may use equity instead.” This has also another effect, especially for tech companies in a pre-IPO situation: “Non-executive director equity may be a proxy for firm quality when direct financial valuations are difficult because of the high level of risk and relatively short performance history of the firm. Using this signaling framework, they suggest that equity incentives attract high-caliber directors who are able to mitigate both adverse selection and moral
hazard problems in the IPO firm. Therefore, NED equity can be used by external investors as a potent signal of the unknown ex-ante quality of the firm.” This signaling effect was confirmed by a great number of directors. “I have a board mandate which I am doing for free, just because of the intellectual challenge I get from being in this particular part of the high-tech sector;” says the operating partner of a private equity firm who is on the board of a small and fast-growing nanotechnology start-up.
Conclusion

The tech industry has its own rules and mechanisms—it operates at a different pace compared to other industries, with many small players and often unforeseeable technological developments causing disruption, which can affect both large and small companies. Especially for smaller, emergent companies, the overall role of the board is substantially different, and the requirements for individuals to become board directors are very specific—a proactive and consultative mindset combined with the right motivation and a generally “hands-on” attitude makes the ideal board director look quite different from his peers in the more stable environments of other industries. A competent board director can be instrumental for the success of a fast-growing technology company, and the rewards for the individual can be equally great.
References


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