RITES OF PASSAGE

MANAGING CEO TRANSITION IN VENTURE-BACKED TECHNOLOGY COMPANIES

A White Paper by

PASCAL N. LEVENSOHN
Founder and Managing Director

Levensohn Venture Partners
260 Townsend Street, Suite 600
San Francisco, CA 94107
T: 415-217-4710
F: 415-217-4727
www.levp.com

January 2006

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EXECUTIVE SUMMARY

Most venture-backed companies experience at least one chief executive officer (CEO) change as they evolve from a start-up to a fully integrated company. Initiating and managing this transition is the most important decision a venture capitalist (VC) makes as a director. If the process is handled effectively, it can have a major positive impact on the company's future; mismanaging it, however, can lead to operational turmoil and defections from key team members. CEOs and VCs may have different perspectives on CEO transitions; however, this paper makes the case that the key for VCs in successfully managing CEO change in venture companies is to anticipate it; monitor the relationship for familiar, early-warning signs of leadership problems; and initiate a professional and swift transition before CEO shortfalls create serious, even irreparable, harm to the company. This paper represents collaboration between VCs, CEOs, and other technology industry investment professionals who are acknowledged at the paper's end. The objective of this paper is to enhance the body of knowledge for entrepreneurs and VCs alike and to offer prescriptive best practices for the benefit of the venture capital industry.

CASE STUDY: A FAMILIAR TALE OF WOE

This Silicon Valley venture relationship grew, as many do, from a personal relationship: *In 2001, the founder and chief executive officer of a hot young software outfit wanted to raise venture financing. He sought out an old friend, a former colleague, who had become a venture capitalist at a well-regarded firm. The VC considered the entrepreneur a proven winner at selling large software licenses and a highly charismatic and articulate executive with strong industry expertise. The CEO's team, also all handpicked friends, delivered a truly superior software product.*

Over 4 years, the company raised $21 million from two VC firms and started to show some success. After developing the technology, the company secured three large accounts. This impressive sales traction allowed the company to obtain a new round of financing—bringing the total raised to $30 million—and a third VC investor joined the company's board. After the round closed, the new VC noted a behavior pattern in the CEO that caused him some concern. The CEO responded defensively to many normal business questions, reacting as if they were challenges. The CEO subsequently requested additional equity and a substantial retroactive cash bonus for himself. Both requests were significantly above market, and the CEO became outraged when the new VC investor questioned their appropriateness. These were early warning signs in a situation that continued to deteriorate.

The new VC investor reluctantly agreed to a new bonus plan. Shortly thereafter, the company missed the first of many sales forecasts. Prospects for new customers diminished. The vice president of sales quit, and on the way out, he revealed to the board some serious concerns about the product's market strategy and the CEO's leadership skills. The departing executive reported that the CEO was now coming to the office infrequently and rarely held staff meetings. Later pressed about this criticism by the board, the CEO seemed unaware of several serious issues inside the company, and he blamed others for the numbers shortfall, including the former VP of sales.

The company tried some new product efforts, but customer prospects still did not improve. Trying to build board consensus that there was a problem, the new VC investor forced a board confrontation with the CEO, who threatened to resign immediately and to take all of his loyal employees with him. The other investors feared the exodus and said they would only consider a change if the CEO volunteered to step down. The CEO countered with a recommendation to sell the company. The new investor stressed that there would be no exit for the company unless sales increased and the product pipeline improved. While two out of three VC directors agreed that a CEO change was necessary, the lead investor remained loyal to the CEO and refused. Without his vote, the board was stuck. For 10 months, this stalemate sapped the energy of the company and delayed progress on all fronts. Finally, after 1 year without any material new orders, the CEO admitted he needed help and asked to be replaced. While a new CEO was quickly hired, the company's fate remained unclear.

This tale of turmoil is both true and surprisingly common. The early stages of a venture company are not unlike the heady, exciting days of a new romance. The founder of a company, passionate about an idea, consumed with making it happen, meets a VC who is interested in investing. Their discussion focuses on the CEO's strengths, accomplishments, and dreams for the future. The founder envisions a perfect marriage in which his or her sweat equity, technical expertise, and/or market knowledge are valued by the VCs, as evidenced by a large dollar investment and generous compensation. The deal is done, the VCs join the board, and the founder assures the management team that the board is fully aligned with the CEO's vision for the company.

But just as familiar is the unraveling of these once-happy relationships. While such legendary entrepreneurs as Bill Gates and Michael Dell have built enormously successful enterprises from the ground up and run them every step of the way, it is startling to many entrepreneurs to learn that the vast majority—almost two-thirds—of all venture-backed start-up companies replace their founding CEO.[1]

While these transitions are a fact of life in venture backed companies, VC's and entrepreneurs alike must do more to identify the need for change, communicate it openly, and help founders reach a self awareness of their best role in the enterprise. A founder's skills, such as laser-like focus, rapport with key technology people, and even a talent for fund-raising, rarely translate to the more operational and sales-focused tasks that are key to managing growing organizations. A strategy the founder thought was simple must be refashioned or expanded to adapt to market realities. "The 'relentless driver' CEO who brings the product to market is rarely the guy who will thrive on managing the conflict that will emerge at the go-to-market stage," notes management change consultant Dell Larcen.

It falls on the shoulders of the VC investors to first monitor and identify issues and then to initiate and manage the transition from a founder-CEO to a more suitable CEO. Executing that task is arguably the single most important value a VC board will add in the company's lifetime. Yet, because both the VCs and founder-CEOs cling to unrealistic hopes and because venture boards often ignore the early warning signs that the time for a transition has come, replacing a CEO-founder is often a process bedeviled by resentments and discord and one that wastes resources, time, and talent.

In the previous example in this paper, there were several specific problems percolating: lack of CEO leadership, lack of board consensus, and unrealistic personal compensation expectations by the founder. However, there are two vital lessons from this example that have broad applicability in venture companies—lessons that transcend personal relationships and situational details:

The first lesson is that since CEOs who "go all the way" are the exception, not the rule, VCs need to take a proactive approach and manage toward the reasonable expectation of CEO change from day one. That means engaging CEOs in a frank discussion of their strengths and weaknesses, constantly assessing CEO performance, and forging a relationship with the CEO-founder that can transcend a management change, creating a win-win for both parties. The outcome could be a new role for the founder that preserves his or her ability to make a productive contribution to the company.

The second lesson is that most boards ignore clear early-warning signs that the time has come to find a new CEO. Instead, they later find themselves battling the CEO, operational problems, and their own interpersonal dynamics on the board. Seasoned VCs should bring valuable pattern recognition as investors to the boardroom. In this paper, warning signs will be identified as well as the underlying dynamics they represent and suggestions will be offered for best practices to work through these difficult transitions.

[1] Adams, D.D. (2005). Shining a light on the critical role of boards: A survey of boards of private equity-backed companies. (White paper available www.capitalval.com).

VENTURE CEO SUCCESSION IS A NATURAL PART OF CORPORATE EVOLUTION

Founding entrepreneurs must recognize that, if they choose to build their company by accessing the capital and expertise of VCs, it is likely that their role will change over the course of the evolution of the company. This fact has been well documented by a number of researchers, including Dorothy Adams of Capital Value and Thomas Hellmann and Manju Puri of Stanford Business School in a 2001 study entitled *Venture Capital-Backed Firms More Likely to Replace Founder With Outside Chief Executive*. Noam Wasserman of Harvard Business School has dubbed this phenomenon the "paradox of success." He contends, "By trying to raise a large round, founder-CEO's put themselves at the mercy of capital providers, increasing the hazard of succession." Wasserman further notes that once the initial product has been developed, the "mismatch between the skills of the technically adept founder-CEO—whose skills were the key to success until now—and the new needs of the organization"[2] becomes apparent.

In 2003, organizational change expert Dennis Jaffe and Pascal Levensohn identified that the most likely time period for a CEO transition to occur is during the early commercialization period when companies are transformed from research and development projects into commercial enterprises with real customers. This can be difficult for founder CEOs to accept. To wit:

> Many founders find it particularly galling to be passed over or found wanting in their skills at precisely the time when their fledgling companies experience rapid revenue growth and performance above plan. It is an emotionally difficult time for founders because the sweat they have poured into the research and development phase is the foundation for the success the company is currently enjoying. They may view the situation as one of betrayal by the VCs.[3]

That feeling of betrayal is rooted in the poor communication between the VCs and the founders about the natural evolution of venture companies. It is also a byproduct of the understandable but unrealistic emotional attachment the founder-CEO still has to "his" or "her" company, even though the financing process has taken the company out of the founder's control. In the CEO's mind, the VCs were brought in to "help, if I feel I need them," when, in fact, the VCs have purchased the right to control the future of the company.

The key to a smoother transition is to begin the dialogue about how venture companies evolve at the time of the initial engagement. Jaffe advocates for "setting a tone right at the start that being a CEO is difficult, that people never have all the skills they need, that they will be evaluated regularly, and that often a CEO who founds a company can't take it the distance." Jaffe wisely urges VCs to make these themes part of the contracting process so that recommendations for coaching, or ultimately replacement, do not carry the feeling of betrayal. This approach is in sharp contrast to the style of some VCs who try to motivate founder CEOs with a sort of whisper song, intimating, if not outright stating, that a given individual might be that rare example of an executive who can manage through the many different inflection points in a growing company's life. This may be deliberately done to keep the founder-CEO committed and focused during a key development period, but it paves the way for trouble.

[2] Wasserman, N. (2003). Founder-CEO succession and the paradox of entrepreneurial success. Organization Science, pp. 149-172. (Paper available at founderresearch.blogspot.com.)

[3] Jaffe, D.T. and Levensohn, P.N. (2003). After the term sheet: How venture boards influence the success or failure of technology companies. (White paper available at www.levp.com.)

One irony here is that a CEO often is the only employee in a company who is not subject to formal, periodic performance evaluations. More typically, even though the CEO reports to the board, the board is content to sit back and watch, patiently nodding and supporting the CEO as long as various benchmarks are met.

CEOs may prefer this hands-off approach, but it unquestionably sets the stage for a tumultuous replacement of the CEO as a knee-jerk reaction to a singular issue or to a festering performance problem that remains uncoached. It makes much more sense to formalize the process of evaluating CEO performance and integrate this process into the normal course of the board's interactions—for example, having the board discuss the CEO's performance twice a year. That way, the CEO can get feedback on performance issues and even get coaching before the problem escalates to one demanding his or her replacement. When Dell Larcen is brought in to facilitate these CEO transitions, she observes, "I have always been amazed how much of a disconnect there is between perception and reality. Far too many assumptions are made in the absence of candid and open discussion. A good process that becomes a routine practice can avoid many of the pitfalls, and even when an exit is required, can smooth the path." Adds Richard Redelfs, the former CEO of the wireless semiconductor company Atheros and now a venture capitalist: "The reality is that no CEO is all strengths and no weaknesses. The CEO needs strong executives to balance their weaknesses and should be given the support and encouragement by the board to do this from the day of hire, way before the weaknesses cause any issues. This might result in fewer CEO firings!"

THE DIFFICULTY IN REACHING CONSENSUS FOR CHANGE

In a 2002 paper, *Easing Out the Founder*, Scott R. Gordon of executive recruiting firm SpencerStuart makes an observation that may seem, at first glance, quite harsh. "The need for a smooth founder/CEO transition must be recognized and initiated well before it becomes grossly apparent," he writes, adding, "You'll never hear a board member lament that a founder/CEO was replaced too early."[4] In the experience of this writer and that of many VCs, Gordon's words ring sadly true. While some CEOs may feel VCs move too quickly and heartlessly, VCs are typically too slow to acknowledge a CEO's weaknesses and how they are impacting the company.

This is not to suggest that CEO transition be approached lightly. VCs value the contributions and emotional commitment of founder-CEOs, and they recognize that CEO change always carries the potential for disruption. It should never be a "one strike and you're out" decision. For example, when an otherwise excellent CEO has a very specific deficiency, say in sales, it is sometimes possible to compensate by hiring strong sales executives to balance out the management team. If the CEO lacks an appropriate communication style, either internally or externally, management coaches can be engaged to help correct that.

Such efforts only work with a clear-eyed executive who is fully aware of his or her own strengths and weaknesses, however. More commonly, the period preceding a CEO transition resembles what Heidi Roizen, a managing director at Mobius Ventures, describes as an accumulation of actions and troubling behaviors as the CEO becomes increasingly overwhelmed. "As I think about the 'sure signs,' what I

[4] Gordon, S.R. (2002). Easing out the founder. (White paper available upon request from SpencerStuart at www.spencerstuart.com)

realize is that they tend to feel like waves washing on the shore," Roizen observes. "Most of these are not single events but rather subtle behavior patterns you 'feel' over and over."

The importance of this gut feeling that things aren't right cannot be overstated—it is a critical part of the successful VC's ability to recognize patterns in a timely manner and address them proactively. However, there is a reason why many VCs sit with an uneasy feeling for a relatively long period of time. Replacing a CEO requires engagement, confrontation, follow-up, resolution, and a better alternative. This type of confrontation is unpleasant as it strains the personal relationships between individual board members, between the board as a whole and the extended senior management team, and, of course, between the director leading the call for change and the exiting CEO. A VC's greatest potential corporate contribution, or greatest opportunity to fail, occurs during the period of board assessment leading to a CEO transition. This process is necessarily subjective and summons up all of the VC's abilities to make an accurate judgment about the implications of the CEO's departure or continued tenure at the company. As Roizen notes, "You have to articulate what you are looking for. You have to figure out how to keep the company operational in the interim. You have to agree on a recruiter, spend time bringing that person up to speed, then go through interviews, then reach consensus, then land someone, deal with not only their compensation but the repercussions on all the compensation and equity holdings among management, etc. It's the hardest work we do, so people don't jump at the opportunity to do it."

IDENTIFYING WARNING SIGNS AS THEY OCCUR

VCs should pay close attention to their intuition if they feel increasingly concerned about a CEO's leadership. However, they do not have to rely on gut feel alone. In discussions with VCs, CEOs, and management experts, we identify six common early warning signs of trouble in the corner office. In the face of increasingly complex tasks and challenges, many CEOs in over their heads will exhibit behaviors that should trigger immediate discussion and sometimes action by board members. If left unchecked, they can seriously undermine the company.

1. **Staying the wrong course: Resistance to or rejection of board input.** It is not uncommon for a first-time CEO or a founding CEO to begin his or her relationship with the board as if it were a strictly advisory group, forgetting that CEOs are employed by and report to the board. When the CEO is executing on plan, this friendly, supportive atmosphere may continue for some time. As the company matures and the CEO's responsibilities become more complex, members of the board commonly share suggestions and best practices from other companies with the CEO. A CEO who does not react constructively to board member suggestions, who is inflexible in considering strategic changes, or who stubbornly clings to a plan that is not working, is exhibiting a warning sign. The outward symptoms can range from a CEO who seems affable and receptive in meetings but then does not act on board suggestions to a CEO who is overtly dismissive of input.

2. **Offsite and out of touch: Disengagement and avoidance.** A CEO who perceives problems but does not know how to fix them will sometimes indulge in the ancient practice of denial. Odd as it sounds, it is not uncommon for a CEO who feels overwhelmed with challenges within his or her own company to aggressively seek seats on outside boards, schedule vacations, and become involved

in political, community, or charitable endeavors. A CEO who is often missing in action because of these activities is likely to either be seeking outward, reassuring signs of approval and status or has lost the requisite “fire in the belly” that a venture company CEO needs. Board members rightly worry when they have trouble reaching a CEO or learn from employees that he or she is often unavailable or absent from important meetings due to outside commitments or interests.

3. **Indignation: Emotional, combative behavior.** A healthy ego is a prerequisite for a successful CEO. But defensive, emotional responses to legitimate questions from a board member are a reason for concern, whether they occur in private or in formal meetings. Good judgment, reasoned responses, and calmness under pressure are critical qualities for a CEO. A CEO who deserves increased compensation, for example, can clearly, calmly, and logically make that case to the board. Trying to browbeat or extort a raise is a warning sign.

4. **The silent treatment: Cutting off information flow to the board.** When was the last time the CEO initiated a call to you, as a director? If that is a difficult question to answer, consider it a warning sign that the CEO is scrambling to stay in control. Investors have stakeholders, too, and CEOs must consider it a high priority to manage investor expectations. Typically, every director should hear from a CEO in advance of board meetings, as well as least once or twice a month to celebrate good news, discuss a setback, or just discuss an issue on which the CEO could use a sounding board. If a director consistently hears bad news from other directors or employees at the company instead of the CEO, it implies there is more bad news you just don’t know about yet.

5. **Buck-passing and finger-pointing: Ignorance of key operational details.** If the CEO consistently pleads ignorance of a problem, complains that he or she was not informed, blames other executives without presenting a clear case and a plan to remedy the situation, or tries to throw problems back on the board’s lap, there is a problem. Redelfs pays particularly close attention when it becomes obvious that a CEO is not on top of details unless they involve his or her own strengths. Indeed, the CEO leadership needed to take a company to the next level involves a keen ability to balance attention to all parts of the business and make sure there are strong executives leading elements in which the CEO is not as strong. “At the end of the day,” notes Redelfs, “it is the CEO who must recognize his or her weaknesses and build the team to compensate.”

6. **“Pulling up the drawbridge”: Directing management team to stonewall board inquiries.** Faced with performance insecurities, a CEO often will turn inquiries from board members to other executives into a loyalty test, putting out the word that no executive is to communicate with a board member without informing the CEO and getting approval. If calls to senior executives result in returned calls from the CEO, or executives provide what sounds like scripted, vague answers, it is a warning sign. Similarly troubling is a CEO’s effort to deal with a major setback in a series of individual calls or meetings with board members rather than a conference call or full meeting. The concern is that the CEO is spinning the situation in a fashion that may conform to what he or she thinks each director wants to hear.

Each of these signs above is in the early warning category. They may begin to appear before there is any measurable or obvious problem. The team may well seem intact and motivated, development may seem on plan, and no obvious setbacks may be obvious. However, left unchallenged and unaddressed, it is likely the board will soon see the following two, far more serious signs that the need for change has arrived:

- **Inaccurate forecasts.** If a CEO is unable to accurately forecast more than one or two key drivers of the company's success, it is serious reason for concern. Chronic quarterly revenue shortfalls, unreliable time estimates for acquiring customers or closing contracts, and chronic delays in development schedules suggest the CEO is simply not being effective in managing to plan. For example, consider the situation where the CEO controls all the key relationships with a critical channel partner, and somehow that large purchase order that the board has been hearing about from the CEO for months continues to be delayed, indefinitely. Efforts to independently verify the reasons for the delay meet stiff resistance from the CEO, and somehow the board just can't get a straight answer about the root cause of the problem. It is time for a change.

- **Top performers leave and mediocre employees hang on.** This is a critical sign of trouble and one that defensive, insecure CEOs will attempt to "spin" in a number of ways. If employee departures at the vice president level increase and the CEO experiences difficulty in filling them, there is a leadership problem. Be particularly concerned when exiting employees cite "personal reasons" or lifestyle changes as the reasons for their departure, which typically suggests that they are not comfortable with the direction and prospects for the company. Also be concerned if the CEO characterizes the departures of formerly prized executives with the suggestion that the company "is better off without him," or, "She really wasn't that good." If the board first hears of poor performance by an executive only after his or her departure, odds are the CEO has either lost touch or is scrambling to try to make a negative development seem like a positive one. A related warning sign is when a CEO aggressively protects executives who appear to be struggling. It may be that the CEO is protecting a loyal friend or confidante at the expense of the company. Executives do grow into their positions and improve as they become more familiar with a given domain, but a venture company is not a management training program.

Clearly, these early warning signs and red flags involve behaviors and attitudes that are subject to interpretation and nuance. One outburst, one instance of not being able to reach a CEO, or one executive leaving is not grounds to initiate a transition. However, each provides some impetus for board members to pay closer attention to what the CEO is saying and what is actually happening. A challenge facing venture boards is that some of the early warning signs are actions that deliberately disguise problems. Management change expert Larcen has found that, "even when the CEO's inability to manage is creating unbearable tension internally, his managers will not cross the line that has been drawn—and will not reveal the real conflicts being played out.… It is amazing how far these situations can go before the board has enough data to act."

THE VIEW FROM THE OTHER SIDE OF THE TABLE

In discussions with a number of veteran CEOs, the question was raised: "What do you consider as the signs that it may be time for you to move on?" Almost all of their answers involved a sense that the passion they once had for the job felt like it is ebbing away: "The thrill is gone from dealing with the challenges of the business." "I've run out of ideas for how to address critical issues facing the company." "I just realize that I would rather be somewhere else." "I've stopped believing in the pitch to customers and investors." Or, "I give up trying to reconcile the differences in expectations among board members or between the board and me."

The passion and drive required to launch a business are so significant that it is not surprising that these executives cast the situation in terms of whether they still "have it" or "feel it" or not. This evaporation of passion, energy, and ideas has a specific source—a loss of confidence, the natural consequence of feeling overwhelmed and not possessing a sufficiently broad enough array of skills to manage the complex challenges of a growing venture company. Feeling that confidence ebb away is discomforting and anxiety producing, so it is no wonder many executives become defensive or emotional as they perceive that the company's needs are outpacing their own abilities. Moreover, if the executive has been hearing that unrealistic whisper song of encouragement from VCs that was mentioned previously, the sense of failure also eats at the individual and increases the anxiety. The lament that the CEO has become frustrated and feels unable to resolve differences among board members is often a legitimate complaint, one for which boards must take responsibility. In *After the Term Sheet*, Jaffe and Levensohn examined board misalignment in some detail, concluding that the inability or unwillingness of boards to take responsibility for aligning their goals and priorities was a major source of frustration, and ultimately, failure, for many venture companies: "It is a fact of life that not all investors are created equally, and the investors that do the most work, have the most money at risk, and have the best track records will continue to drive the venture company's agenda.… Another common source of misaligned boards comes from different levels of risk tolerance and patience."[5]

Let's examine misalignment in the context of CEO change. Why, if everyone, including the CEO, usually knows that the CEO is either underperforming or is not well suited to delivering on the current plan of record, does a small group of smart people have so much trouble discussing this matter openly? As previously stated, it is a difficult and delicate interpersonal matter to confront a hard-working CEO who has set the stage for the company's future success. However, it is also a case of misaligned interests. Often, the seed round VC who recruits or makes a bet on the initial management team will have a vested interest in maintaining those relationships that are different in nature from independent directors as well as different from VCs who join the board in later rounds. A relationship that is forged in friendship and loyalty does not easily transition into a director-CEO relationship characterized by objective oversight.

If a director—any director—can make a logical case for CEO change that is supported by facts, the rest of the board must listen long and hard before rejecting the case, or, much worse, turning a blind eye to a troubling pattern. In fact, if a director of the company is willing to go on the record demanding that the board vote to remove the CEO, the board can no longer function under the status quo because the

[5] Jaffe, D.T. and Levensohn, P.N.(2003). After the term sheet: How venture boards influence the success or failure of technology companies. (White paper available at www.levp.com.)

CEO knows the board is divided. Consequently, the CEO's future behavior will change—not necessarily in ways that are in the best interests of the company. That is why it is so critical for directors to seek and achieve alignment.

CRITICAL POINTS IN THE CHANGE PROCESS

Even when general consensus for change has been reached, individual VCs may be bogged down with concerns that delay action, such as "wishing the executive could have more time; concerns about the echo of the move across the organization; worry about the process and who will keep the boat afloat after the change; and worry about finding someone better," notes VC Kevin Compton of Kleiner Perkins. As a result, most VCs put a high priority on trying to make sure the management team supports a CEO transition. This can be a time of paralysis and dysfunction in the company. The CEO may be trying to quietly rehabilitate him/herself in front of the board, or lobby for more time, while executives who are unsure about the future may begin to make their own contingency plans and stop working full-out on the company's immediate challenges.

If the board decides to make the change immediately, then it must acquire the talent or reallocate existing people to cover the critical functions of the CEO and risk wider defections. Rather than risk significant dysfunction within the organization, it is best to take action sooner rather than later. Promod Haque, managing partner of Norwest Venture Partners, observes that:

> A common mistake I have seen boards make over my 16 years in the VC business is not taking timely action to change a non performing CEO for fear that it will rock the boat. Other management team members will usually rise to the occasion to make things work even if they disagree with the Board decision. In many cases, the management team will come up with suggestions to manage the interim situation while a search is being conducted for a new permanent CEO.

Either the board must acquiesce to the existing CEO, or it must risk immediate disruption of the business and defections of key executives. Neither of these outcomes is desirable. If the board acquiesces, then it must develop a longer-term transition plan for the founding CEO that keeps him/her engaged during the near term but sets in motion actions that will reduce the Company's dependence on this person as soon as possible. If the board decides to make the change immediately, then it must quickly acquire the talent or reallocate existing people to cover the critical functions of the CEO or hire an interim CEO.

Rather than risk ongoing dysfunction within the organization, it is best to take action sooner rather than later and an interim CEO is often the best course. Boards should avoid the temptation to seek a new CEO in relative secret while the founder-CEO remains on the job. Scott Gordon of SpencerStuart notes that "loyalists could turn against the new CEO, reducing the likelihood that a transition will succeed. In the worst case, the founder leaves with a significant chunk of the company's talent."[6] An interim CEO, on the other hand, can enable a Board to move forward during the recruitment of a new CEO, involving other members of the management team in the process. John Peters, an experienced Silicon Valley

[6] Gordon, S.R. (2002). Easing out the founder. (White paper available upon request from SpencerStuart at www.spencerstuart.com)

interim CEO, believes the optimal tenure for an interim CEO is 4 to 6 months. "If a company is in a troubled state, the interim CEO can work to clean things up and stabilize the business, thus allowing the board to attract a more qualified permanent CEO than might otherwise be possible."

The lag between the time that a consensus has been reached for the need for a CEO change and its actual implementation is always longer than it should be. As they come to embrace the need for a change, directors nonetheless often do not communicate promptly enough about such basic things as who will take responsibility for managing the process, what individual directors are signing on to do, who will communicate with the CEO as the official spokesperson for the other directors, and what is the message that everyone has agreed to deliver.

Many boards have outside directors who will often have different perspectives or vested interests than VC board members. Using these outside directors effectively in such situations can be very helpful in building consensus on the board and providing balance. They also can work as a buffer between the CEO and the VC shareholders. Independent directors are generally viewed by management as being less conflicted and better able to act as fiduciaries in the best interests of all of the company's stakeholders because they do not have a heavy wallet thrown in the center of the board table. Ideally, a strong independent director has proven industry and/or management expertise, may also be a CEO, and can mentor the CEO and serve as a model for the management team to respect. Edward Kozel, a former director and chief technology officer of Cisco Systems, now serves as an independent director on both public and private technology company boards. He observes that the role of the independent director can be pivotal in facilitating transition negotiations with departing CEOs: "A neutral party can assist or occasionally intercede and dispassionately work with the CEO to deal with pending change and any subsequent negotiations, hopefully mitigating emotions and focusing energy on the issues relevant to both the CEO and company's success."

BEST PRACTICES FOR MANAGING A CEO TRANSITION

Even in difficult situations where the CEO is not happy about a transition, it is important for the board to work toward reaching an amicable agreement and involve the founding CEO in the business of the company going forward. This is particularly important when the founder is a significant shareholder with rights to a board seat.

Another recent example of a company facing CEO transition is instructive: *This young software company had been built by a technically savvy founder and staffed with members of his family. They had an excellent product, and the CEO had done an admirable job keeping costs under control. Once venture investment was brought in, however, the founder continued to manage the company like a family business, trusting few outside his immediate circle and generally resisting investment in an expansion strategy, which was a necessary step if the new investors were to realize an appropriate return.*

It was clear to the new lead VC investor that the founder's support was critical to the company's next stage; it also was clear that the founding CEO was not the man to achieve the growth the company needed. However, instead of waiting for the relationship to devolve, the new VC investor made sales performance goals a component of the new term sheet with the condition that, if sales were not met, the CEO would be replaced.

The sales goals were not met. Because that condition of employment was part of the original contract, it removed some of the emotion and hard feelings from the relationship. Moreover, the VC insisted that the founding CEO remain chairman, and he worked out a role for him as a salesman—two functions that the founder embraced and which added great value to the company. Over time, the founder made important contributions, although his aversion to risk was still holding the company back. The VC investor proactively took the lead again in negotiating a phase-out of the founder's services through a multi-year buy-out that retained the founder's loyalty and support but created a new board that was better aligned and poised for growth.

In discussions with venture board members and other involved professionals, a set of best practices has emerged that can facilitate these delicate transitions in a fashion that sets the company up for success, not failure, and creates good ongoing relationships. Even if a company is facing a transition as a result of not adhering to some of these suggestions in the past, the transition stage is a good time to implement processes that will lessen future problems. It is significant that Adams's survey of close to 200 venture and private company boards in the U.S. and Europe found that not only had 64% of companies replaced the founding CEO, but the majority of boards had replaced the second CEO as well.[7] It is never too late, in other words, for a venture board to enact these best practices and smooth the process of CEO transition by adhering to the following measures:

1. **Explicit expectations and periodic review.** Given that the CEO reports to the board, the board must establish objectives and expectations for the CEO from the beginning and periodically review progress with the CEO. The board and CEO should discuss and agree on performance expectations at time of hire and periodically on an ongoing basis. At least annually, the board should conduct a 360-degree review of the CEO's performance, encompassing management team feedback, board member feedback, and feedback from other key stakeholders, as appropriate.

   Paying particular attention to the warning signs discussed here, the board should provide candid feedback to the CEO on areas requiring improvement, and a developmental plan should be put into place on these areas. An outside organizational development consultant may be brought in to conduct the 360s and to provide recommendations to the board based on this feedback. The consultant might also be used to provide coaching to the CEO, as necessary, to help address the developmental areas requiring improvement. Clear expectations set an objective standard against which the board (perhaps through a one-on-one with the lead director) can confront the CEO as soon as an early warning sign or red flag is detected. The ensuing discussion should consist of a nonjudgmental description by the board of the issue(s). The CEO should present his/her side of the issue(s), and then the parties should engage in a constructive dialog to reconcile any differences of opinions and to agree on a corrective action plan.

2. **Identify a fair and aggressive corrective plan.** Engaging in a constructive process with the CEO starts with the basics. First, leave emotions behind so that objective good judgment can dominate the dialog of change. In some cases, an outside consultant should be retained to defuse an otherwise emotionally deadlocked situation. In all cases, a designated representative of the board must engage

[7] Adams, D.D. (2005). Shining a light on the critical role of boards: A survey of boards of private equity-backed companies. (White paper available www.capitalval.com).

with the CEO and build an alliance of trust. As that relationship evolves, the CEO must come to appreciate the need to ask and answer some penetrating questions:

- Is this company on the path to success?
- If not, why?
- How do my weaknesses in particular skill sets contribute to the lack of success?
- Is it in my best interest to continue to drive for success, or am I fundamentally going to be required to operate, not from strengths, but from weaknesses, and ultimately cause the company to fail?

Based on her direct experience as a consultant in this type of situation, Larcen asserts that "when the assessment of the CEO's potential for success is driven by the CEO with a consultant who is then contracted to come back to the board with the CEO and report out, most executives will take responsibility for making the right decision." The critical success factor in the process outlined above is that the CEO and the board are not locked in battle over the decision. Instead, the board has laid out a constructive process to evaluate what the company needs at this particular stage of development and whether this CEO can lead the company to the next stage.

3. **Communicate a clear message when the board has decided on a transition plan.** When the decision has been made to replace the existing CEO, the board and the CEO should agree on a clear message that will be communicated to employees, customers, investors and other stakeholders explaining the reason for the change. It is essential that all parties adhere to this message. If the message doesn't resonate as truthful, it will be rejected. A convincing message acknowledges the good work done by the existing CEO and outlines the skills and experience the company will be looking for in the new CEO. Be specific about the new role for the existing CEO and the timing of the transition. Done correctly, this message can leave the existing CEO's ego intact while setting a positive tone for the future of the company. Involving the existing CEO in the decision process is often a good idea. For example, the board's CEO search committee might establish basic benchmarks that define the minimum acceptable qualifications for a candidate. Then, the founder could be asked to choose the finalists from a pool of qualified candidates. Gestures like this send a message to the management team that embracing the company's next phase does not mean betraying the founder.

4. **Post-transition, the company must not blame past management.** Whether or not the existing CEO remains with the company in another capacity, the incoming CEO must not publicly blame the prior administration for any ills of the company. The incoming CEO must focus on the future and communicate the vision, values, objectives, strategies, and plans for the company going forward. The new CEO should emphasize what is going to be different under his/her administration without denigrating the prior CEO for decisions and actions in the past.

CONCLUSION

Successful VCs come in many flavors of temperament and technical skill, but, if they are to be successful over the long term, they must share one common characteristic—good judgment. Personal conviction in one's choices and a strong ego may conflict with the unfettered exercise of this good judgment. Ultimately, board misalignment and ignoring warning signs of the need for leadership change can have its roots in the unwillingness of board members to admit a mistake or to accept that a new phase of a company's life demands new leadership.

Effective leadership as a board fiduciary requires putting aside your own personal agenda, checking your ego at the door, and doing what is in the best interests of the company. It is critical to share realistic performance expectations with the management team, keep an eye out for early warning signs, and act to determine whether leadership gaps can be strengthened with other executives. Testing the waters with fellow directors early can help to build consensus for proactive and constructive CEO succession from a position of strength rather than scrambling to shore up a disintegrating management team.

ABOUT THE AUTHOR

PASCAL N. LEVENSOHN, *Founder and Managing Director, Levensohn Venture Partners*
Pascal Levensohn founded Levensohn Venture Partners in 1996. He invests in the enterprise software, semiconductor, and communications sectors and helps companies with strategic issues such as creating new commercial partnerships and team building associated with board/management transitions. A professional equity investor since 1983, he has worked actively with portfolio company management teams since 1990.

Prior to *Rites of Passage,* Pascal published numerous articles on trends in venture capital with a particular emphasis on best governance practices in the boardroom. Directors and Boards magazine has published three of his articles: *The Problem of Emotion in the Boardroom* (1999), *Tyco's Betrayal of Corporate Governance* (2002), and *The Ten Pitfalls of Venture Boards* (2004). In November 2003, Pascal co-authored a white paper on corporate governance entitled *After the Term Sheet: How Venture Boards Influence the Success or Failure of Technology Companies.* In addition to receiving national attention from the *Wall Street Journal* and other business and venture industry publications, the white paper has become part of the governance curriculum at the Harvard Business School. Pascal maintains an active blog focused on issues of religious tolerance, pluralism, and interfaith dialogue between Jews, Christians, and Muslims at www.pascalsview.com.

Pascal received a BA in Government from Harvard University and is a graduate of the Lawrenceville School. He currently serves as a member of the Steering Committee of the Socrates Society, a leadership development program of the Aspen Institute with which he has been involved since 1997. Pascal is a member of the Council on Foreign Relations and the Pacific Council on International Policy.

CONTRIBUTORS

DOROTHY ADAMS, *Founder, Capital Value*
Dorothy Adams is a professional board director, investor and advisor to companies. She has extensively researched the governance best practices for companies backed by private equity and venture capital, making her alert to the potential pitfalls of private company boards. Her advisory work includes board evaluation, facilitation of strategic planning, as well as conflict resolution for boards, management and investors. Over the last 15 years, she has served on or chaired seven private company boards, most in the telecommunications and technology sector in Europe.
http://www.capitalval.com/

KEITH BENJAMIN, *Managing Director, Levensohn Venture Partners*
Keith Benjamin specializes in enterprise software investments with an emphasis on companies developing technologies that offer improved solutions for long-standing business problems. Prior to becoming a venture capitalist in 1999, Keith had been an investment research analyst for 16 years, emphasizing companies exploiting new technologies, including education and entertainment software, Internet and e-commerce, and enterprise software. Keith was ranked as an Institutional Investor All-Star Research Analyst in 1998 and 1999.
http://www.levp.com/team/kb.html

JAMES J. BUCKLEY, *Consultant, SpencerStuart*
Jim Buckley is the global leader of Spencer Stuart's technology, communications, and media practice. He brings an extensive background in the computer hardware, software, eLearning, and networking arenas.
http://www.spencerstuart.com/consultants/1332

KEVIN COMPTON, *Partner, Kleiner Perkins Caulfield & Byers*
Kevin Compton joined Kleiner Perkins Caulfield & Byers in 1990. Kevin has focused his investment activities in the enterprise software and the telecommunications industry. Kevin serves on several private company boards and has been rated as one of the Top 20 Venture Capitalists in the World for over a decade. Prior to joining KPCB, Kevin was vice president and general manager of the Network Systems Team at Businessland (now Siemens). While in this role the company's sales increased from under $70 million to over $1.4 billion.
http://www.kpcb.com/team/bio_detail.php?frm_id=13

RANDY HAYKIN, *Managing Director, Outlook Ventures*
Randy Haykin is a managing director and co-founder of Outlook Ventures. Prior to Outlook, Randy held various senior sales and marketing positions in the high technology arena over the past 19 years with high-profile companies such as Yahoo!, Viacom, Paramount, BBN, IBM, and Apple Computer.
http://www.outlookventures.com/team_bios.html

PROMOD HAQUE, *Managing Partner, Norwest Venture Partners*
Promod Haque joined Norwest in 1990. He has been ranked as a Top 10 Dealmaker on the Annual Forbes Midas List for the past three years. In 2004, Forbes named him as the #1 venture capitalist based on performance over the last decade. Promod focuses on investments in semiconductor and components, systems, software, and services. Prior to Norwest Venture Partners, Promod spent 18 years in various operational roles ranging from product development, marketing, chief operating officer, and chief executive officer at various public and private companies, including Siemens International, Thorn EMI, Emergent Technologies, and Dimensional Medicine, Inc.
http://www.nvp.com/team/teamBio.aspx?StaffID=21

MATTHEW HOWARD, *Partner, Norwest Venture Partners*
Matt Howard brings over 20 years of experience in marketing, product management, engineering, business development, and sales in a wide range of technologies to Norwest Venture Partners. Matt focuses his efforts on communication and storage systems, embedded systems, semiconductors, and security. Prior to joining the firm in 2000, Matt held a number of senior positions with Cisco's IOS organization and the Internet Business Unit.
http://www.nvp.com/team/teamBio.aspx?StaffID=48

DR. DENNIS JAFFE, *Professor, Saybrook Graduate School*
Dennis Jaffe is a world-recognized leader in management and organizational change. As professor at Saybrook Graduate School in San Francisco, he created their doctoral program in Organizational Systems. He received his BA in Philosophy, MA in Management, and PhD in Sociology, all from Yale University. He also serves as a board member and fellow of the Family Firm Institute and World Business Academy and is a professional member of the NTL Institute and the Academy of Management.
http://www.aspenfamilybusiness.com/jaffe.asp

EDWARD KOZEL, *Managing Director, Integrated Finance Limited*
Ed Kozel is a managing director of Integrated Finance, Ltd., a private advisory services firm. He joined Yahoo!'s board in October 2000 and is chairman of the Audit Committee. Until 2002, he was a member of the board of directors of Cisco Systems, Inc., where he worked for 11 years in a variety of roles, including chief technology officer and senior vice president of business development. In addition to Yahoo!, he serves on the boards of Reuters PLC and Symbol Technologies.
http://www.ifltd.com/sanfrancisco/index.html#kozel

DELL LARCEN, *CEO, Larcen Consulting Group*
Dell Larcen brings more than 20 years executive-level management experience as well as 10 years corporate-level management consulting to the role of president and chief operating officer of Larcen Consulting. Dell has consulted with a broad range of clients, including Fortune 100 companies, corporations facing rapid change, and early stage start-ups in high tech, finance, publishing, and healthcare. Dell's practice has included several venture groups dealing with internal team dynamics. She also has worked with a variety of high-tech startups.
http://www.larcen.com/about/dlarcen.html

JAY W. LORSCH, *Louis E. Kirstein Professor of Human Relations, Harvard Business School*
Jay Lorsch is the Louis Kirstein professor of Human Relations at the Harvard Business School. He is the author of over a dozen books, the most recent of which are *Back to the Drawing Board: Designing Boards for a Complex World* (with Colin B. Carter, 2003), *Aligning the Stars: How to Succeed When Professionals Drive Results* (with Thomas J. Tierney, 2002), and *Pawns or Potentates: The Reality of America's Corporate Boards* (1989). *Organization and Environment* (with Paul R. Lawrence, 1969) won the Academy of Management's Best Management Book of the Year Award and the James A. Hamilton Book Award of the College of Hospital Administrators.

DEBRA MEYERSON, *Associate Professor, Stanford Graduate School of Education*
Debra Meyerson's research focuses on the following areas: organizations, gender and race relations within work organizations, grass roots change processes and distributed leadership, organizational learning, and inter-group relations.
http://ed.stanford.edu/suse/faculty/displayRecord.php?suid=debram

JOHN K. PETERS, *CEO, Reconnex*
John has built a distinguished executive management career in Silicon Valley. John has been CEO or interim CEO of several venture capital-backed companies including Reconnex, a provider of enterprise risk management solutions; PocketThis, an application software provider to mobile carriers; Yipes Enterprise Services, an enterprise-focused provider of Ethernet network services within and between cities; Netli, a software-intensive network service business; and Sigma Networks, a provider of broadband metropolitan area services. Prior to Sigma Networks, John Peters was executive vice president for Concentric Network Corporation where he held various senior management roles leading the operations, engineering, product development, product management, Web-hosting services, and corporate development organizations.
http://www.reconnex.net/about/management.asp

MATT MILLER, *Managing Director, WaldenVC*
Matt Miller has 19 years of management experience, including 14 years at Silicon Valley software companies. He has over 8 years of experience serving as an officer of a public company or CEO of a private company.
http://www.waldenvc.com/

RICHARD REDELFS, *Venture Partner, Foundation Capital, former CEO, Atheros*
Rich Redelfs joined Foundation Capital after 20+ years in networking and communications, a combination of start-up entrepreneurial as well as large company intrapreneurial experience. Most recently, he was president and CEO of Atheros Communications (NASDAQ: ATHR), which he joined as a start-up with 21 engineers and an office manager.
http://www.foundationcapital.com/team/redelfs.html

MICHAEL ROLNICK, *Partner, ComVentures*
Michael Rolnick focuses his investments on networked infrastructure, including communications, computing, storage, security, and wireless. Prior to joining ComVentures, Michael served as vice president for New Ventures at E*TRADE Group, Inc.
http://www.comventures.com/team/michaelRolnick.htm

HEIDI ROIZEN, *Managing Partner, Mobius Venture Capital*
Heidi Roizen is a managing director of Mobius Venture Capital, focused on early stage technology companies. She serves on the board of directors of the National Venture Capital Association, where she serves on the Executive Committee. Heidi has also served as vice president of Worldwide Developer Relations for Apple Computer and was the founder and CEO of T/Maker Company, a successful software developer and publisher, where she worked for 13 years.
http://www.heidi.roizen.com/

KIP SHEELINE, *Managing Director, Levensohn Venture Partners*
Kip Sheeline focuses on the software and communications sectors. Prior to becoming a venture capitalist in 1999, Kip spent 11 years at Hambrecht & Quist, specializing in communications, software and Internet infrastructure. As managing director of the communications industry practice at H&Q, Kip was responsible for all of its investment banking activities related to communications, including software, systems, components, and services.
http://www.levp.com/team/ks.html

NOAM WASSERMAN, *Assistant Professor, Harvard Business School*
Noam Wasserman teaches the required first-year MBA course on Entrepreneurial Management at Harvard Business School, and he has also taught in Harvard's Executive Education program. Noam received his PhD in Organizational Behavior (with concentrations in Sociology and Microeconomics) from Harvard University in 2002 and received an MBA (with High Distinction) from Harvard Business School in 1999, graduating as a Baker Scholar.

Noam's research focuses on Founder Frustrations, with particular emphasis on roles played by the founders, top executives, outside investors, and board members of high-potential entrepreneurial ventures. His paper entitled "Founder-CEO Succession and the Paradox of Entrepreneurial Success" was published in Organization Science in March-April 2003 and won Harvard's 2003 Aage Sorensen Memorial Award for sociological research.
http://dor.hbs.edu/fi_redirect.jhtml?facInfo=bio&facEmId=nwasserman

JOY WEISS, *President and CEO, Dust Networks*
In the past 20 years, Joy Weiss has provided leadership for a broad range of technology companies. Joy was steeped in networking technologies early in her career in a variety of R&D, sales, and general management roles at Nortel Networks, including her role as President and GM of Nortel's Network Management division where she presided over record-breaking growth. As President and CEO of Esker, Joy led the enterprise software company through its IPO and subsequent merger with Teubner, Inc. Most recently, Joy served as president and CEO of Inviso, an award-winning microdisplay company.
http://www.dustnetworks.com/company/team.html