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# Best Practices for Corporate Governance and Compliance

*Leading Lawyers on Implementing Compliance  
Programs, Working with In-House Counsel, and  
Responding to Ongoing Concerns*



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# Establishing Corporate Governance in Emerging Growth Companies

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## **Introduction**

I represent a range of entrepreneurial and high-tech companies, ranging from pre-funding start-ups, to venture and private equity-backed companies, to public companies, and generally function as their outside general counsel. I spend a great deal of my time counseling members of management teams—founders and entrepreneurs, CEOs, CFOs, investors, as well as the board itself—in conducting general corporate affairs and compliance programs, whether they be corporate governance compliance or issues related to investors and shareholders.

## **Establishing a Company's First Corporate Governance and Compliance Policies**

I will focus here on corporate governance and compliance best practices specifically for emerging growth companies. These companies are usually relatively small and privately owned, although there are also some smaller public companies I would also include in this category. The issues I typically face first in this arena involve the initial construction of a corporate governance or compliance program. After entrepreneurs develop a technology, process, idea, product, or service, there comes a desire to build a company around this creation, and investors are almost invariably brought on board. However, during the earlier creation or ideation phase, the entrepreneur did not need to think about compliance or corporate governance programs. In order to assist the company in its growth, they will need to construct a workable (and efficient) corporate governance or compliance program. This can be particularly difficult at an early stage in a company's development, as there are generally very limited capital resources available to apply.

Along with constrained capital resources, a nascent company usually will have very limited personnel, almost all focused on developing the company's initial product or service. Thus, my job at this early stage is to first help entrepreneurs and management understand the importance of corporate governance and compliance in their company at the earliest stages of development. Early stage policies are typically less formal, and largely even unwritten—but even a small company that has yet to generate revenues or sell products or services likely will face issues related to

accounts payable, employee hiring, IP management, asset controls, equity and stock administration, and basic financial reporting. Planting the right seeds at an early stage will aid in successful outcomes, as the company expands into later stage developments, and will ultimately help the business to secure financing, be acquired, or prepare to become a public company.

The failure to establish basic governance policies early in a venture can result in serious adverse effects on a company's ability to receive financing, or to secure additional financing, or to become a public company candidate or be acquired, and can in any event substantially diminish the valuation the company can receive in a financing, sale or IPO. In addition, the company's legal administrative costs at each of these steps, and generally, will be substantially higher than they otherwise need be due to increased potential for litigation and the need to fix problems after they have occurred, rather than avoiding them in the first place. Even if the problems ultimately can be fixed, such corrective measures come at a much steeper price the later they are implemented, i.e., a stitch in time.

The bedrock of any corporate governance policy is establishing the "tone at the top," which becomes the management's and the board's expectation for themselves, for the company, and for the company's employees and other stakeholders in terms of their financial accounting, tax, and other regulatory compliance and general ethical grounding. This principle-based (as opposed to rule-based) approach assists, with very little, if any, cost, in guiding the development of behaviors that ultimately result in effective financial controls and accounting policies appropriate for the company and its utilizing limited resources.

### *Early Stage Employment Practices*

Early compliance programs in general should focus on preventing liabilities. Even a relatively small lawsuit involving an employee, or a small lawsuit involving a prior employer's claims against a new company (for example, breaches of non-compete, IP, trade secrets, etc.) can thwart a new venture's growth and development and in some cases could even be fatal to a small company. With a lawsuit, in addition to the substantial cost, a business will face significant challenges in terms of its ability to raise additional financing. Clearly, having to divert precious resources (both money and management

attention) to the defense of a lawsuit, or even the threat of one, instead of to the development of the company product or service, is about the last situation an emerging business needs.

Growing companies by definition need to hire people, and those people will have to come from another company. Thus, it is important to establish practices in even the earliest of companies, but particularly with technology companies, that respect the potential rights of prior employers in the hiring process. Namely, steps should be implemented to ensure that new employees respect their obligations to their prior employers by bringing any information, trade secrets, technology, customer lists, or supplier lists to the new company that would be in violation of any confidentiality, non-solicit or non-compete obligations that they may have with a prior employer.

To establish effective employment practices, one also must ensure compliance with (and a culture that respects) federal, state, and local anti-discrimination laws and policies. Growing entrepreneurial companies are characterized by a freewheeling, intense, often very fun, and, particularly in engineering-oriented companies, male-dominated culture. It is important to ensure that—without stifling the innovation and entrepreneurial process or the free flow of communications and the open sharing of ideas—this positive entrepreneurial culture does not morph into an environment of perceived harassment or hostility, where there is a great deal of risk with potential litigation.

### *Assessing the Risk Profile*

When I begin working with a company, I need to understand certain information to help assess the company's "risk profile" and its need for remedial corporate governance measures. For example, what roles do the management members occupy and how do they relate to each other, who the board members are and their various roles (e.g., investor, founder, independent, management), as well as how they interact with management. With management, I like to know their prior experiences in companies large and small, whether or not they have been involved in litigation (and what scars they carry as a result), and their prior management experience, particularly in building efficient but effective corporate controls and governance systems. This helps to know what motivates them, what worries

the CEO and CFO from a legal or risk management perspective, and what keeps them up at night. I also immediately ask to see a copy of the “capitalization table” to understand any stock issues they have, and ask if all employees have signed appropriate proprietary information agreements.

If I am helping a later stage company, then I want to know the nature of their stockholder base. Who are their investors? How has the company been financed? Has there ever been a “down round” financing, or any adverse dilution for shareholders, or is it a company that has the potential for a number of contentious shareholders (e.g., former founders)? If the company has suffered a difficult or down round of financing, I want to know if some of their prior investors that were adversely affected by that financing remain upset with the company. If they were, then that increases the company’s risk profile, as those disappointed investors are more likely to be looking for an opportunity to re-advantage themselves at some point in the future, whether at the time of an acquisition or an IPO, to gain back some of that dilution. In such situations, the company will need to be even more studious in its ongoing communication and relations with its shareholders.

Capitalization, stock option issues, and compliance with Internal Revenue Code Section 409A can all become potential roadblocks for an emerging company. Section 409A, for example, imposes an additional 20 percent tax on anyone receiving “deferred compensation.” The IRS has expansively construed “deferred compensation” to include any stock option with an exercise price below the “fair market value,” which is for early stage companies a very difficult value to ascertain and highly speculative at best. The IRS has provided several different methods to establish a presumptive fair market valuation, but many companies, particularly before they begin receiving counseling regarding this counterintuitive and non-obvious tax legislation, will create an arbitrary value for the stock options without any IRS-approved basis, or will engage in financing transactions that “taint” the stock option price—e.g., by selling common shares to investors for \$1 per share, while simultaneously setting an option exercise price at \$0.10 per share. While this additional tax is theoretically assessed against the recipient (i.e., the employee), the company itself could have liability for failure to ensure proper withholding, as well as potential claims by the aggrieved

employee who suddenly is hit with the 20 percent penalty. In any event, the company now must address a very unhappy employee.

Companies in more highly regulated industries have a much heavier compliance duty. Companies in the health care, medical device or biotechnology sectors, for example, are subject to substantial additional regulations from the FDA, or via Medicare or Stark “anti-kickback” laws among others. If these companies do not have written and very explicit compliance policies regarding the conduct of their business and its compliance with the regulatory framework around their industry, both the company and its officers and directors can be subject to a much higher degree of legal and regulatory scrutiny and potential liability than, for instance, a company that develops and sells computer software. Such companies need, at a very early stage, to have persons experienced in regulatory and quality oversight and compliance, which of course increases the start-up cost.

### **Problem Areas for Early Stage Companies**

As a company expands, it brings in investors, and with those investors additional board members are added. The board at that stage would typically be comprised of one or two management and/or common stockholder representatives, as well as some investor representatives, and typically one or two outside directors. At this stage it becomes very important, as part of the corporate governance and compliance process, that management led by the CEO, with a great deal of assistance from the CFO or director of finance, develops with the board an effective communication policy and an effective policy for implementing corporate governance.

This process includes many of the same concerns that the early stage or seed stage company faces, such as how policies will be implemented, and how the company will continue to sow seeds and cultivate those corporate governance and compliance standards that have begun to sprout, and reinforce the “tone at the top” that has hopefully been established, all without undue economic burdens that might detract from the company’s goal of commercializing and selling a product and becoming a profitable enterprise. While non-public companies are not subject to the compliance

requirements of the infamous Sarbanes-Oxley Act (SOX) and the related SEC regulations, they must begin to prepare as if they were to go public. In such a case, there would also be a review of their controls by underwriters, the underwriters' counsel, public investors, and others. Inadequate compliance or too much additional remediation at this stage, at a minimum, will substantially increase IPO costs, and could delay or even jeopardize the IPO itself. Even if, as is more likely, the liquidity event will occur by a sale to a public company, then the acquiror will insist on a level of compliance and controls sufficient to ensure that the acquired company can be integrated with its SOX-compliant corporate governance and internal controls.

Thus, as the venture transitions into this early commercialization stage, many of the corporate governance and compliance programs will focus on further development of the finance and accounting area, including development of critical accounting policies, expansion of in-house expertise, development of revenue recognition policies, monitoring of those policies, and establishing effective spending controls. It is incumbent upon a board at this stage to instruct management to develop (and then for the board to oversee) a spending authorization policy that states what the management's spending authorization policies are, what dollar amounts or thresholds or certain subjective types of agreements, regardless of their dollar thresholds, that may require different approval levels. They also need to develop general guidelines for management, and then develop more granular details as to this policy with the principal financial officer. Issues here would include what checks a CEO can sign with or without co-signature, what levels and to what types of entities, what authority is granted to the various officers. It is also necessary to begin developing a more rigorous approach to areas of potential fraud. This policy needs to include controls regarding travel and entertainment (T&E), as well as the engagement of outside vendors and centralizing payment through an accounting department with checks and balances.

Additionally, it is important at this stage to establish formal board committees, particularly an audit and a compensation committee. These committees do not assume the same level of formality that, for example, comparable public company board committees would. At this level, it is mainly developing both accounting and other corporate controls and

practices on a transitional basis from the early stage company through to the later stage or liquidity stage.

The audit committee oversees the company's financial and accounting functions, and selects and interacts with the company's independent auditors. The audit committee should meet directly with the company's auditors periodically (perhaps once a quarter) in the absence of any management presence in order to independently assess the company's finance and accounting controls. This allows the auditors to express any problems they may be having with management, as well as concerns that they may be having with regards to the company's controls or policies.

The compensation committee oversees management compensation to ensure compensation is being adequately and equitably paid across the company, and to identify any issues that could be arising (e.g., compliance with the IRC Section 409A and option pricing).

An excellent resource for boards of emerging growth companies is "A Simple Guide to the Basic Responsibilities of VC-Backed Company Directors," a white paper written by The Working Group on Director Accountability and Board Effectiveness, a member association of venture capitalists, CEOs, and industry thought leaders. "A Simple Guide..." and two other white papers are freely available at [www.levp.com/news/whitepapers.shtml](http://www.levp.com/news/whitepapers.shtml).

## **Issues When Considering an IPO**

In the later stage, as a company begins to anticipate a liquidity event in the form of an acquisition or IPO, the board must take a much more active role in overseeing the company's corporate governance practices and assessing internal controls. During this period it is incumbent on the board to begin, for example, holding executive sessions in which management is excluded, perhaps solely with the outside members of the board together with the company counsel. Here the board could begin discussing and airing any concerns it may have regarding the company. Whether it be from a business level, corporate governance, or compliance level, it is necessary for the board then to set the tone from the top, and for the CEO or CFO to communicate that tone from the top to the company.

Board members also should insist the company begin implementing confidential and anonymous internal reporting processes so that employees in these companies, to the extent that they believe there are problems, have an ability to express those concerns in a confidential fashion. This can be accomplished through readily available service providers who establish toll-free numbers or Web-based reporting systems. Typically an audit committee member should be the independent director and, hopefully independent of any of the principal investors of the company, can receive these reports and review them with company counsel.

It is important in such cases that employees do not fear retaliation for legitimate concerns or grievances they may express. The board should begin directing management to develop effective risk assessment policies, and also begin reviewing more carefully the internal controls regarding finance, accounting, and hiring, and begin solidifying the processes around those controls. They should ensure that there is an effective human resources function, and further expand on the company's accounting systems. This would include a much more complete review of revenue recognition-related issues as well as educational programs that would maintain or enhance competence levels. In addition, critical accounting and other software processes should be reviewed and/or implemented or updated.

Depending on the circumstances, a company may consider engaging outside parties or contractors to review all of these internal controls, albeit on a relatively limited and economically efficient fashion. At this point compliance policies would tend to be reduced to a much more specific written format. Within the accounting group, a code of business ethics or conduct should become more specific as the issues that the company faces also becomes much more specific in later stages. As the company begins to expand internationally, it also is critical to monitor the company's compliance from an international perspective, whether with the tasks of tax and employment compliance in whichever jurisdictions the company may have in place, or service providers.

### **Company Communication and Efficiency**

Throughout each of these stages, company counsel must be communicating with management and with the board. I therefore recommend that

management, the board, and company counsel interact on a monthly or bi-monthly basis, and that company counsel attend all board meetings and reviews. This gives everyone an opportunity to discuss the issues, and for company counsel, who are experienced in these matters, to be able to identify weaknesses. The most pressing weaknesses an experienced attorney may spot are those that no one has yet begun to consider. They might locate these by observing the company's growth at a particular stage, at which point counsel can communicate with their point of contact, which is the CFO or CEO at the company, or the full board in general. Typically, counsel will interact with many different companies at any given time and will be much more attuned to the specifics of governance practices and compliance practices.

There is no universal compliance policy, as each company is driven by its industry, stage of development, and company personality. Each company exhibits a certain culture which the various executives and the board take on. What works for one company—for example, a tighter or looser approach—may not work for another company, and it may be different as a result of industry or geographic location of the company and its personnel.

### *Counseling Challenges*

The most difficult aspect of counseling in the emerging growth company sector, from a corporate governance and compliance standpoint, is impressing on individuals the importance of taking rational steps and diverting both limited time and limited resources to developing a solid compliance framework. All emerging companies tend to try to function as efficiently as possible in order to minimize their “cash burn.” The tendency of people is to focus on immediate needs. My challenge is to help them understand that the growth and ultimate success of their company depends to a great degree on their compliance. I tell skeptics that a good framework can help them ultimately to reduce overall expenses, and can help them avoid issues that may diminish value or hamper the ability to reach a liquidity event.

In the process of working with company management to employ and support the development and implementation of appropriate corporate governance and internal control measures, one must speak to a

businessperson like a businessperson, and to aid them in understanding that with only a few, relatively simple steps, judiciously and rationally employed at the right time, they actually can enhance their value (or at the very least reduce their future cost burden and reduce litigation risk). Thus, compliance becomes an investment, and not an administrative expense. A mature businessperson will understand economic realities as well as the payoff for themselves in terms of a future sale, along with the benefit of alleviating potential stress or distractions. If you align your goals with the company's business goals, and you earn the trust of the management and board through your interactions, then the advice you give from a compliance perspective will be viewed as helpful, and will further the company's long-term goals. What counsel does not want to present in these scenarios is a furtherance of administrative or purely legal objectives which may seem only annoying or trivial.

## **Conclusion**

My advice to clients across all levels of the emerging growth area is that you cannot avoid having to operate without an effective corporate governance and compliance framework. However, it is important to keep that framework simple, cost-effective, and appropriate for the stage of the venture. It also is crucial to establish operable processes and procedures—establishing anything too complex will result in non-compliance. Ultimately, these policies are only as effective as the people implementing them, so establishing a strong tone at the top is key. More principled foundations, as opposed to rules-based approaches, will reach a more effective long-term result. By keeping it simple, principled, and gradual in the approach, compliance, and the ultimate success of the venture, can be greatly enhanced.

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