TOPE ADEBAYO LP

A GUIDE TO ADOPTING CORPORATE GOVERNANCE FOR STARTUPS

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Introduction

Corporate governance is a system that an organization puts in place to ensure its efficiency and sustainability. This system includes the rules, principles, ethics, and measures required to ensure compliance with regulatory and standard practice. Most jurisdictions have established standard corporate governance practices for public companies, emanating from an understanding of the need for a public organization to meet its responsibilities to the government, investors, employees, and the general public. However, corporate governance takes a backseat for startups, as, as they prioritize needs such as securing funding, product development, achieving market fit and attaining profitability. While startups may operate without significant regulatory scrutiny, the importance of corporate governance cannot be over-emphasized. This article examines the reasons for the slow adoption of corporate governance by startups, underscores its importance, and makes recommendation for corporate governance implementation at different startups stage.

Adoption of Corporate Governance in Startups

Unlike public companies, startups are not obligated to adopt corporate governance standards. While this gives startups the liberty to develop and adopt corporate governance systems that best suit their size and operations, corporate governance often does not make it to the priority list of startups. There are also concerns that implementing corporate governance practices may slow down decision-making processes, hamper innovation and growth, diminish founders' autonomy, increase overhead costs, and introduce administrative and operational complexities.

The impact of poor corporate governance has far-reaching consequences for startups and their stakeholders. It may result in a loss of shareholder's value, criminal liability of the company, downsizing, loss of market share or bankruptcy. For instance, the FTX group's bankruptcy filing exposed a lack of proper corporate governance, as questionable related party transactions were discovered in their audited accounts[1] that would have been queried, interrogated and possibly avoided if good corporate governance practices had been in place.[2] Likewise, Theranos, a once-promising startup valued at over $9 billion was shut down and the founder/CEO, Elizabeth Holmes found guilty of defrauding investors. Investigations revealed several misrepresentations and the lack of transparency to Theranos' board and investors.[3] The sudden failure of several promising startups and budding unicorns underscores the need for good corporate governance in ensuring corporate sustainability and stability.

Corporate Governance focus for Startups

To maximize the benefits and mitigate the challenges of corporate governance, startups need to adopt governance measures, processes, and principles relevant to their specific stage of development. A startup's corporate governance needs at later fundraising rounds or upscaling stage will be broader and more complex than its corporate governance needs in its early years,[4] as expounded below. It should be noted that the stages are not linear, and the timeline and characteristics may vary.

[1] Francine McKenna, A Complete Failure of Corporate Controls': What Investors and Accountants Missed in FTX's Audits, at https://www.coindesk.com/layer2/2022/11/18/a-complete-failure-of-corporate-controls-what-investors-and-accountants-missed-in-ftxs-audits/ accessed 13 July 2023.
[2] George Calhoun, FTX And ESG: A Panorama Of Failed Governance (Pt 1 – The Internal Failures) at https://www.forbes.com/sites/georgecalhoun/2022/11/21/ftx-and-esg-a-panorama-of-failed-governance-pt-1--the-internal-failures/?sh=26ef23b42d9d accessed 30th November 2022.
[3] Connie Roff, Everything you need to know about the Theranos scandal, https://www.panmacmillan.com/blogs/literary/theranos-elizabeth-holmes-john-carreyrou accessed 30th November 2022.
[4] Corporate Governance for Startups & Scale-Ups, IBC Segmentos (2020), https://idbinvest.org/sites/default/files/2021-04/IBGC%20Segmentos%20-%20Corporate%20Governance%20for%20Startups%20%26%20Scale-Ups.pdf accessed 30th November 2022.

Ideation Stage

At the conception stage of a startup when partnerships are formed, ideas are conceived, market analysis is done, and the product map is developed, the corporate governance focus should be on:

a. defining founders' expectations, roles, responsibilities, and contributions (monetary or intellectual);
b. determining equity interests and vesting schedule for founders' shares;
c. establishing the rules for joining and exiting the company;
d. clarifying ownership of intellectual property; and
e. management and Board composition.

Seed and Early Stages

As a startup evolves, its priority shifts to product development and building a minimum viable product (MVP). Fundraising efforts are intensified due to the high cost of development and the need to scale operations and gain market traction. The corporate governance focus should be on;

a. Ensuring corporate legal good standing (i.e., tax remittance and obtaining requisite permits, licenses and regulatory approval if needed).[5]
b. Optimising relationships with employees (i.e., developing an employee handbook, definition of key roles and performance metrics, and introducing employee reward and benefit schemes to improve employee retention).
c. Managing relationship with customers (i.e., drawing up standard service agreements to define the company's obligations, responsibilities, and liabilities to the customers).
d. Managing relationship with investors (this includes investment documentation such as confidentiality and non-disclosure agreement, subscription

[5] The often boosts investors' confidence.

agreements, simple agreements for future equity, options, loan agreements, debenture, etc, depending on the nature of investment).[6]

e. Defining board composition, powers, and responsibilities based on the company's contractual obligations to investors and articles of association.

f. Financial audit and controls to ensure accountability to investors.

Growth and Expansion Stages

At this stage, startups expand into new markets or product lines and may undergo significant organizational changes such as hiring key personnel, expanding their infrastructure, and implementing advanced marketing strategies. The company is concerned with optimizing operations, sustaining revenue streams, enhancing profitability, and potential exit strategies like mergers & acquisition, or going public. The corporate governance focus should be on,

a. Ensuring the efficiency of the board by developing a board charter and ensuring the right mix of executive and non-executive directors with requisite qualification, expertise, experience, and network to provide leadership and guidance, and navigate the company into achieving its goals.[7]

b. Developing policies & manuals to ensure efficiency as operations is scaled up.

c. Mapping out the relationship between the company's holding company and subsidiaries (if any).

d. Advancing the relationship between management and the shareholders/investor.[8]

e. Improving internal control measures (i.e., defining the company's risk appetite and ensuring proper risk management and the preparation of audit plan).

f. Developing succession planning to ensure continuity and longevity of the company.

Conclusion

Corporate governance is key to the sustainability of any organisation including startups. It can be wielded as a tool by a startup to protect the interests of its stakeholders. A startup in its early years need not adopt the standards of corporate governance expected from public companies rather, its corporate governance system should evolve throughout its lifespan. The

[6]It is important that the investors' expectations, rights and privileges are clearly spelt out in the investment documentation. At this stage, startups much avoid contractual obligations that will stifle the company's growth and expansion plans or discourage future raising round.
[7]There may be need to set up board committees which can interrogate specific issues and make recommendation to the board.
[8]At this stage, formalizing and optimizing the relationship and communications with shareholders and investors is of priority. Such communication is to reflect accountability, transparency, and inclusivity.

basic and simple corporate governance measures and systems adopted in a startup's early years can be developed into a more sophisticated and advanced system of corporate governance as the company grows and expands.

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