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Founding Entrepreneurs and their Replacements

Objective
After many years of experience as an executive search firm working with hundreds of company founders, venture investors and board members, we became concerned with the level of dysfunction in the process of managing and/or replacing founders. As a result, we decided to investigate by doing research to determine if we could improve the process and reduce the risk and pain for all parties.

What We've Done
We focused our research by interviewing approximately 30 executives representing founders, "second generation" CEO's and investors. Most individuals were from the Mid-Atlantic region, although we did have contact with a Silicon Valley investor and with entrepreneurs in New England and Canada.

What We've Learned
There were wide variations in the stories we heard, highlighting the fact that each company has unique characteristics based on the blend of founder(s), investors, product/market focus, industry, stage of growth, etc. But through the diversity, several common themes and observations emerged.

From the Founders' Perspective
Our primary conclusion about entrepreneurial founders is that those who proactively consider the way they will handle change of control and ownership, and potential personal exit strategies from their company are better prepared and amicable when a change happens. Those who don't plan, or who avoid considering what loss of control will be like, can end up surprised, angered and in some cases become destructive.

As reported in our interviews, founders who were **not prepared**, **or who were edged out (representing about 80% of the examples)**, experienced events such as they:

- Weren't willing to give up increasing levels of control and dilution of ownership.
- Reached a point where the entrepreneurial skills that enabled them to start a company became the very skills that stalled its growth at a critical juncture, especially in the area of control and delegation.
- Failed to hit performance goals and the Board of Directors lost faith in their ability to lead.
- Proved incapable of raising next rounds of VC funding.

The founders who **were prepared** and considered their exits in advance (representing less than 20% our sample) had some of the following characteristics:

- Possessed enough self-awareness to realize they were not enjoying the demands of a growing company.
- Recognized they were not prepared to take the company to the next level of growth.
- Were eager to launch another start-up.
- Attracted high-level talent to whom they could pass the baton.
- Defined a new, meaningful role for themselves within the company.

These founders were able to initiate a departure or role change with their Board in a positive, constructive manner (and technologists seem to have an easier time with this). A critical element of transitioning into a new role is reaching agreement on the responsibilities and performance measures in the position. Founders retain "informal power" in their companies and they can influence an organization in positive ways (supporting the new leader's vision and strategy) or negatively (acting as a "loose cannon" pursing personal interests over corporate goals). The degree to which the founder can set limits and accept boundaries determines how successful he/she will be in a position supporting the new leader.

Inevitably the less prepared group found their transition out of the company or into a new role marked by varying degrees of stress, conflict and negative impact on the organization. With founder teams, the situation in which one of the leaders departed was even more complex, especially when considering equity interests, and required far more finesse in working through the transition.

From the Investors' Perspective

Investors indicated that more due diligence on the management team's motivations could be useful, including a more direct discussion of the founder's options for potential exit or internal transition strategies. Additionally, investors said they could be more direct about the level of control and involvement they plan to have in the company. Each investor we spoke with had a unique predisposition around either keeping founders in place or in a useful company role as long as possible, or moving them out at the first signs of problems (and everything in between). One investor indicated he wanted the founder close at hand in the event the "professional" team encountered dramatic technology or market changes, in which case the founder could quickly "take over the reins."

Some of the specific triggers from the investors' perspective that a founder may need to exit the company include:

- Consistently not hitting sales goals over a 6 to 12 month period, including unreliable and inconsistent sales forecasts and pipelines.
- Poor financial management, especially in financial reporting.
- Repeatedly missing key product development milestones.
- Trying to "snow" the board, especially an issue when the board has limited access to the senior team.
- Lack of strategic planning and long-term priority setting, evidenced by "fire fighting" and heroic acts of a reactive, short-term nature.
- Failure to recruit and build a strong management team.

Investors indicated that gaining a better understanding of the founder's underlying motivations (financial, personal, career, etc.) and growth capacity before investing would be valuable. Additionally, getting to know and staying close to the founder's spouse/partner (if they have one) is a good way to pick up cues related to changes in commitment, energy, etc.

For portfolio companies already showing signs of distress, investors need to assess quickly the founder's ability to step up to the plate, step aside or step down.

From the Second Generation CEO's Perspective

Once the decision is made to replace the founder or for the founder to step aside, second generation CEO's are, in most cases, carefully selected. The founder(s), if they remain, ideally must be aligned around the change or the transition will be sub-optimized. Our findings on typical challenges included:

- Replacement CEO's who arrived with the founder still in the company, but forced to take a new role and only superficially supportive of the change, was "the kiss of death". These second generation CEO's vowed never to repeat this situation due to the stress and negative impact on themselves and the companies they joined.
- Other replacement CEO's have worked successfully with the founder when the founder's new role is clearly defined and desirable to him/her (e.g. CTO, Head of Business Development or R&D, etc.). This option is especially attractive in companies where technology and product leadership are key competitive factors.
- A majority of these leaders said it is often easiest when the founder is completely out of the picture, letting the new CEO focus on running the company (although the founder's ongoing equity position remains a complicating factor).

The bottom line on this issue is the quality of communication and understanding between the founder (if he/she stays inside the company) and the Board. The Board has to trust the founder to support his/her successor, or ask the founder to leave at the first signs of "sabotage." This requires members of the Board to actively monitor how the founder is doing in his/her new role and how well the second generation CEO perceives the relationship is working.