

Why CEOs of Early Stage Companies Fail

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Introduction

Most CEOs of early stage companies fail. This paper discusses the principal reasons for those failures. It is directed primarily to CEOs of early stage companies. The objective of this paper is to raise the awareness of CEOs as to the principal behaviors that result in failure and offer CEOs a forewarning to avoid failure.

This paper is also directed to board members and investors as a compilation of what most already know and a confirmation of like-minded observations and opinions among their peers.

The content includes material taken from interviews with experienced venture capitals, angel investors, and others close to the business of building early stage companies.

First, *failure* needs to be defined.

In some instances, the nature of CEO failures can cross the boundaries of companies in all stages of development. However, this white paper is limited to addressing failure of CEOs of early stage companies.

In the context of this white paper, failure of a company executive in his or her role as CEO is distinguished from failure of the company. In many instances, a CEO may fail but a company will succeed. On the other hand, failure of a CEO may result in failure of a company. Often times it is difficult to separate CEO failure from failure of a company. And not infrequently, a CEO and the board of directors both fail, one compounding or exacerbating the failure of the other.

A CEO and a board can both fail.

Failure of a CEO as used in this white paper means failure to produce the results required for a company at a particular stage of development. Certainly, failure exists if a CEO is not meeting the expectations of a company's board of directors. Failure can also exist even if a board of directors does not recognize the shortcomings of the CEO.

Failure should be measured against objective standards.

Failure is presumed to be measured against objective standards. That may well be the case when reviewing a situation unemotionally or without conflicting relationships with the CEO or the company. That also may be the case when the results of a CEO's failure so clearly impact the negative performance of a company that even one with a subjective point of view cannot avoid the obvious. However, in most instances, the determination of a CEO's failure is made by a board of directors and/or investors who cannot maintain total objectivity, but who for the most part attempt to apply objective standards fairly.

Failure can be by omission or commission. It can be direct or indirect. Failure can be recognized before the anticipated result of such failure manifests itself. In many instances, the consequences of a CEO's failure produce clearly identifiable negative results. In other cases, early signs of failure are complex and less obvious.

Understand the context when dealing with failure.

Failure is contextual. Behavior or skill sets valued when a company is in one stage of development or particular mode can prove to be valuable or even essential. Yet, those same behaviors or skill sets can prove disastrous in a different context.

Perhaps the most complex situations involving CEO failure exist when the board of directors is complicit. This can result from boards that are meddlesome and minutia focused, wasteful of the CEO's and management's time, act with agendas that are personal to one or more board members, fail to provide needed support to the CEO, fail to understand a business and take the time to be effective board members, provide conflicting or mixed messages to the CEO, among others. Occasionally, a board is so dysfunctional that it fails singularly, causing the failure of the CEO and the company in the process.

This paper does not address the broad topic of the failure of boards of directors other than to recognize the interrelationship between such failures and those of a CEO. When addressing the performance of a CEO, one should take care not to use the excuse of board failure as a red herring to justify the failure of a CEO.

The Problem

The problem of CEO failure is multi-faceted. First, a CEO's failure must be recognized. Second, the nature of that failure must be characterized. Third, a determination must be made as to whether the failure is correctable. And fourth, action must be taken.

Uncorrected failure is never eliminated too soon.

Recognizing failure of a CEO can at times be surprisingly elusive. This usually stems from the fact that most boards are late to face reality and admit that perhaps their CEO is not doing the job required. Virtually every venture capital or angel investor queried on this subject stated that they have never seen an instance when a CEO was replaced too early.

Characterizing the nature of a CEO's failure often occurs simultaneously with recognition that the CEO is failing to do his or her job properly. The substance of this white paper addresses the character or nature of CEO failures. By addressing the types of failures, it is hoped that boards of directors, and perhaps CEOs themselves, will more quickly recognize when failure exits, assess it, and take action.

In rare instances, failure is correctable.

Failure is sometimes correctable. A CEO can be coached to make behavioral changes. Occasionally, or more likely rarely, a highly disciplined CEO will take it upon herself or himself to perform in a manner alien to her or his instincts so as to remedy omissions or commissions that otherwise would result in failure. In most cases, however, it is simply too late to do anything other than replace the CEO, or even worse, watch as a CEO and company fail together.

Lack of Intellectual Honesty

As stated above, most CEOs of early stage companies fail. A large number of those failures stem from some manifestation of the lack of intellectual honesty by the CEO.

The term intellectual honesty refers to the ability to make assessments objectively and without undue influence from one's own limited point of view. Intellectual honesty is the ability to see things as they are, not as one wishes them to be. It is the ability to avoid viewing one's business world through rose-colored glasses, or unduly pessimistically.

Intellectual honesty calls for lots of objectivity, wherever it may be found.

It is virtually impossible for anyone to be purely intellectually honest. On the other hand, when it comes to a CEO evaluating himself or herself, one can recognize the limitations of one's personal experience and skill sets and seek advice and perspective from others. And as to members of a board of directors, intellectual honesty requires each board member to

avoid wishful thinking in the hope that somehow a poor performing or mismatched CEO will miraculously be transformed into something different.

Attaining and maintaining intellectual honesty requires a great deal of effort. It is why successful CEOs and investors of venture-backed companies should strive to build sound and diverse boards. It is why a CEO should build a team of the best people available, comprised of those who will challenge a CEO and conventional wisdom. It is why a CEO seeks perspective from a variety of sources and disciplines. It is why a board should hold executive sessions without the presence of a CEO. It is why boards of early stage companies should avoid intertwining themselves in the business of day-to-day operation of a company.

Know what you don't know.

The biggest single risk resulting from lack of intellectual honesty is finding oneself in the condition of not knowing what one does not know. Identifying what one does not know can prove very disruptive to underlying assumptions that form the framework for a business and plans for growth. So it is understandable, but not acceptable, for a CEO to avoid seeking information and advice that will identify and clarify limitations as to one's point of view or knowledge base. However, all too often it is something that is totally off a CEO's radar screen that creates havoc for a business or the ability of a CEO to do his or her job effectively.

CEOs are not alone in exhibiting a lack of intellectual honesty. Their boards can easily be, and not infrequently are, complicit in this type failure that ultimately falls on the shoulders of the CEO. A board of directors must examine the underlying assumptions that form the basis of the plans and reports presented to it by the CEO and other members of management. Too often the failure of a CEO is closely tied to the failure of the board of directors.

The lack of intellectual honesty can result in the failure to recognize that a disruptive change has occurred in the marketplace or within the technology used by a company. Even if one recognizes that a significant change has occurred, the lack of intellectual honesty can prevent a correct assessment of that change and impose a sense of euphoria and false expectation that things are not all that bad and surely will get better.

Being intellectually honest is hard work.

Maintaining intellectual honesty requires discipline and hard work. It requires a CEO to do necessary fact finding and analysis. It requires an ability to identify key issues and priorities and to act on those priorities. It requires the ability to focus one's attention while simultaneously managing a business without wearing blinders. Above all, it requires a CEO to know his or her strengths and weaknesses and have the strength of

character to supplement those weaknesses with outstanding people. And it may require a CEO to recognize a dysfunctional, meddlesome, or ineffective board and the need to reconstitute that board or resign as CEO. That is a tall order and why most CEOs fail.

Failure to Listen to Gain Perspective and Make Changes

Let's examine a subpart of intellectual honesty: namely, the failure to listen to gain perspective and change. There is no substitute for perspective. Depending on the circumstance, perspective can be both a wide-angle lens and a microscope. Certainly through one's own experience one gains perspective. Rarely in the dynamic of early stage companies is that enough. CEOs must seek advice and listen.

Failure to listen is a common reason why CEOs and companies fail.

Failure to listen is a common reason given by venture capitalists as to why CEOs of early stage companies fail. A CEO must not only listen to board members, but must engage and at times collaborate with them. Effectively using the resources available within a board of directors is a learned skill; it is an art form.

The capacity to listen includes hearing what is said, pursuing an important line of thought, striving to understand the nuances and subtleties of what is being said, weighing conflicting points of view, and allowing oneself to be coached to make behavioral changes.

The capacity to listen extends beyond listening to one's board of directors. It requires a CEO to engage with his or her team members, foster discussion, encourage challenging debate, and carefully listen to the messages being sent, some of which may be very subtle. It requires a CEO at times to seek advice of those independent of the company, those who can be effective sounding boards.

There are many listening posts.

A CEO must also listen to the marketplace. Few original plans of early stage companies stand unchallenged once the marketplace is engaged. The sooner a CEO begins listening to what the marketplace is saying the sooner she or he can take action and adapt to reality. Not everything relates to matters of strategy and the marketplace. There are matters of finance, personnel, allocation of time, and everything in between. All are important. All require the capacity to listen.

A CEO is the chief strategist for a company. He or she may not be the company's visionary but certainly is the chief strategist. The CEO must set a strategic course for a company and become an advocate for that strategic direction. And when information, opinion, and advice challenge that strategic direction, a CEO is thrown into a conflicted position. Fairly and

objectively weighing and acting upon such challenges is very difficult. It is an ability held by few CEOs and a reason why few CEOs of early stage companies survive.

Rarely is a rotten listener a long-term success.

The process of seeking opinion and advice may force one to weigh differing opinions. At best this is difficult and requires an extraordinary amount of objectivity. However, reaching the correct conclusion is not enough. The willingness to change and ability to make changes in a timely manner are essential if a CEO is going to avoid failure. Certainly there are many instances when a CEO listens to her or his own counsel to the exclusion of all others. Some will attain short-term victories. However, as David Titus of Windward Ventures stated, "Rarely is a rotten listener a long-term success."

The first part of the capacity to listen is to hear what is being said; the second part is to act upon what is heard. A CEO should anticipate that change, and occasionally dramatic change, will be required. The difference between long-term success and failure may turn on whether a CEO had the foresight to have in the wings an alternative plan, one dictated by early and perhaps muted voices in the marketplace that challenged a company's original plan.

After listening, take action.

A CEO should not become paralyzed in the pursuit of information, opinions, and advice. The point of diminishing returns can be reached. Joe Sullivan, a long-time angel investor, relates the story of a CEO who endlessly examined and re-examined the marketplace and analyzed data in pursuit of an ideally defined product. The company ran out of money before it ever tested its basic assumptions in the market. Sometimes it is better to listen, take action, and listen again.

Lack of Communication

Closely related to the ability to listen is the ability and willingness to communicate.

A CEO must have a clear vision for the company and must articulate that vision to the board of directors and members of his or her team. However, effective communication goes beyond articulating a clear vision. Good communication requires good reporting. It requires a CEO and the team to develop the right metrics for a company. It requires transparency.

Good communication requires transparency.

Good communications with one's board is a study in relationship management. A CEO should always maintain a friendly and respectful demeanor toward her or his board of directors, but at the same time recognize that board members are not necessarily friends of a CEO. They are his or her boss.

The relationship with a board of directors should be one of engagement and not conflict. A CEO should carefully manage expectations. Enthusiasm should not cloud communications. And the best way to do this is to temper one's optimism with a hard dose of intellectual honesty and avoid surprises. And the best way to avoid surprises is through complete and timely reporting of all material and substantive aspects of the business.

Too many first-time CEOs of early stage companies are naive about the realities of communicating and developing a productive relationship with their boards. They may find that the consequence of that naiveté is failure of the CEO in the eyes of board members.

Board diversity is important.

The above discussion assumes that the board is diverse and its members seek to perform their function objectively. A founding CEO who creates a board in his or her own image with no intention of seeking effective communication with that board may feel secure in holding his or her CEO position. However, that is a false sense of security, as the benefits of board diversity and objectivity are lost to the company.

Of course, with many, and perhaps most, early stage companies, a CEO cannot choose the board members and diversity appears to be merely an objective not a reality. But, even within boards overly populated with venture capital and other investors, one finds a diversity of backgrounds. It is incumbent upon the CEO to dig below the surface and mine that diversity.

Failure to Recruit Superior People

Developing a productive working relationship with one's board is not easy for a CEO, nor is developing a good team. High on the list of reasons given for CEO failure is the inability or unwillingness to build a team of outstanding people. These should be people competent enough to challenge the CEO and diverse enough in their respective skill sets to supplement what a CEO brings to the table.

Building a good team requires personal confidence.

Building a good team requires objectivity, enough confidence to be willing to hire people better than oneself, and discipline and patience to avoid making convenient hires. A CEO must have enough introspection to know which talents and skills are needed to supplement a CEO's own shortcomings. Part of building a good team requires not only hiring skills but also performance evaluation skills and toughness to make changes without delay when the need arises. This seems obvious. Yet,

violations of these simple rules are frequent enough to warrant special mention among venture capital and angel investors as a reason for CEO failure.

Mismatch with Company Needs

There is an often stated reason for a CEO's failure that may not in fact be a failure. This is what is referred to as a mismatch between a CEO's skill sets and the needs of the company as it progresses through its stages of development.

As succinctly stated by Frank Singer, a long-time angel investor, the skill to take a company from zero to one is quite different from that required to go from one to ten.

A mismatch is not always a sign of failure.

This is a reality of corporate life more than it is an example of CEO failures. So rare are examples of CEOs who can take a company from inception to maturity that most business people can name the few examples of those who have accomplished this. It may be asking too much of human nature to expect a CEO to objectively evaluate his or her skill sets with the needs of a company. However, it is not too much to ask that of the board of directors. This situation only becomes a failure of a CEO if when faced with an objective assessment of personal skills and corporate needs a CEO resists stepping down.

Closely related to the situation of a mismatch is that of a CEO staying in her or his comfort zone. A common example of this occurs when a startup CEO who is a technologist or an engineer refuses to step out of that early stage role as the guiding technologist or engineering manager and into needed engagement with the marketplace. Such CEOs are characterized as simply not business people. They lack the discipline and multi-faceted perspective to understand and act upon the needs of a business. They lack a sense of priority. These situations are considered particularly troublesome when such CEOs are viewed as holding the technology "keys to the kingdom" and refuse to relinquish trappings of the CEO position. Failure of this sort by a CEO can and frequently does lead to failure of the company.

Failure of Fiduciary Responsibility

The final category of CEO failure is that of lack of fiduciary responsibility. It is separate from the broadly encompassing lack of intellectually honesty but is equally broad in what it covers. Whereas lack of intellectual honesty is a creation of the absence of objectivity and awareness, lack of fiduciary responsibility is a creation of lack of integrity.

Under the umbrella of fiduciary responsibility lies a commonly noted reason for CEO failure: namely, lack of commitment. For a company, this is an insidious form of CEO failure. In this

Never lose sight of one's fiduciary responsibility.

situation, a CEO goes through the motions of the job, but knowingly fails to make the time and mental commitment to do what is necessary to make an enterprise a success. Another example of failure of fiduciary responsibility is when a CEO tries to manage information flow to the board of directors or knowingly fails to provide a complete picture of the realities of business conditions. CEOs who manage information flow or restrict access to members of the management team do so for reasons of lack of confidence or lack of integrity. In either case, it is a failure of fiduciary responsibility. Needless to say, CEOs who overreach with salary and stock options fail in their fiduciary responsibility.

Summary

The principal reasons for failure are few.

The principal reasons why CEOs fail are surprisingly few: Lack of intellectual honesty; failure to listen; lack of communication; failure to hire superior people; mismatch of skill sets and company needs; and failure of fiduciary responsibility. Yet, the matter of CEO failures can only be characterized as filled with nuance and complexity. CEOs must be ever aware of what might befall them. Boards of directors must be ever vigilant in the review of CEO performance and willing to make changes when required, and just as important, must be aware of their own performance and avoid complicity in failure.

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