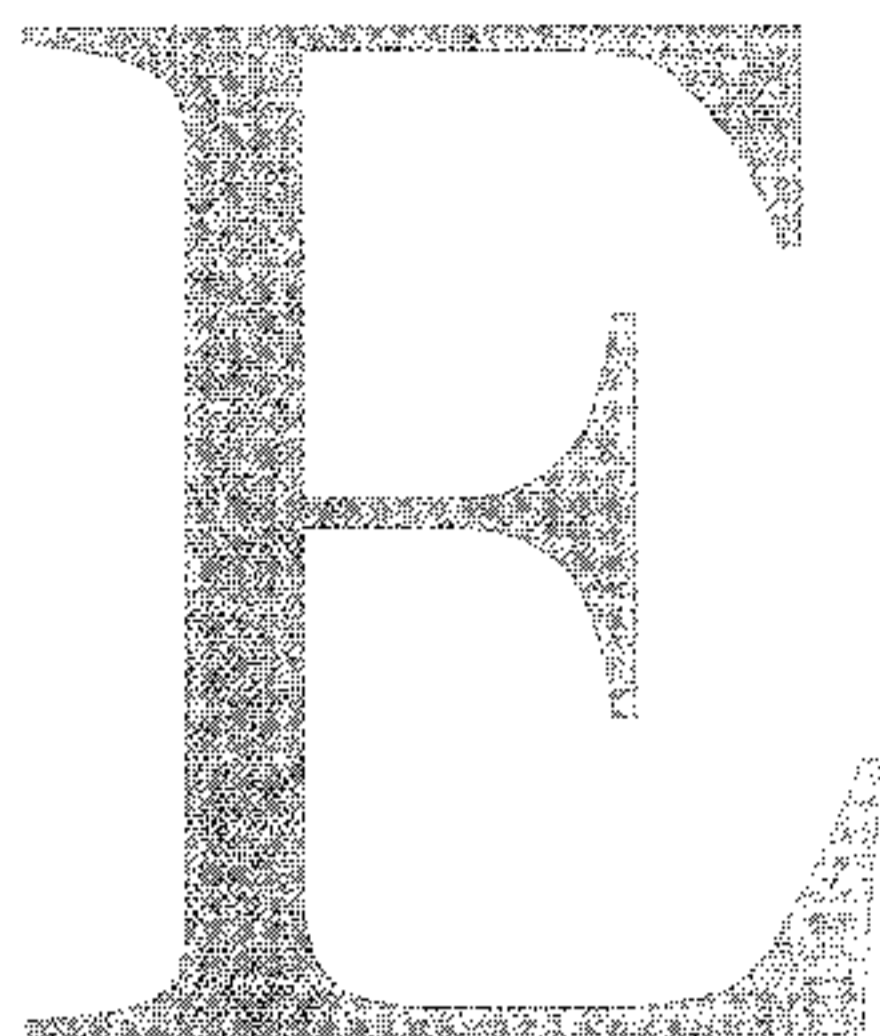


Most entrepreneurs want to make a lot of money and to run the show. New research shows that it's tough to do both.

If you don't figure out which matters more to you, you could end up being *neither rich nor king*.

# The *f*ounder's DILEMMA

BY NOAM WASSERMAN



**VERY WOULD-BE ENTREPRENEUR** wants to be a Bill Gates, a Phil Knight, or an Anita Roddick, each of whom founded a large company and led it for many years. However, successful CEO-cum-founders are a very rare breed. When I analyzed 212 American start-ups that sprang up in the late 1990s and early 2000s, I discovered that most founders surrendered

management control long before their companies went public. By the time the ventures were three years old, 50% of founders were no longer the CEO; in year four, only 40% were still in the corner office; and fewer than 25% led their companies' initial public offerings. Other researchers have subsequently found similar trends in various industries and in other time periods.

We remember the handful of founder-CEOs in corporate America, but they're the exceptions to the rule.

Founders don't let go easily, though. Four out of five entrepreneurs, my research shows, are forced to step down from the CEO's post. Most are shocked when investors insist that they relinquish control, and they're pushed out of office in ways they don't like and well before they want to abdicate. The change in leadership can be particularly damaging when employees loyal to the founder oppose it. In fact, the manner in which founders tackle their first leadership transition often makes or breaks young enterprises.

The transitions take place relatively smoothly if, at the outset, founders are honest about their motives for getting into business. Isn't that obvious, you may ask. Don't people start a business to make pots of money? They do. However, a 2000 paper in the *Journal of Political Economy* and another two years later in the *American Economic Review* showed that entrepreneurs as a class make only as much money as they could have if they had been employees. In fact, entre-

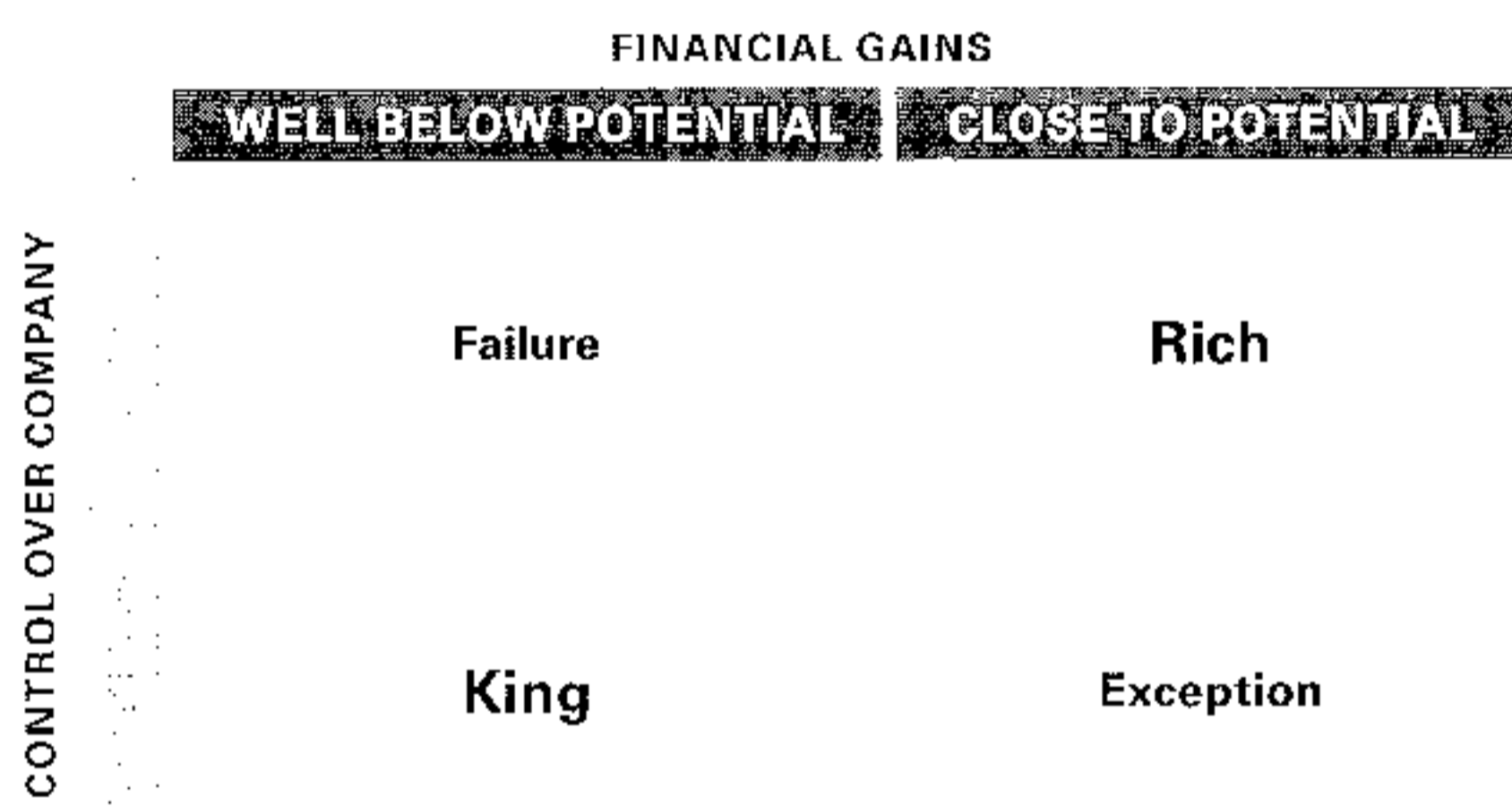
preneurs make less, if you account for the higher risk. What's more, in my experience, founders often make decisions that conflict with the wealth-maximization principle. As I studied the choices before entrepreneurs, I noticed that some options had the potential for generating higher financial gains but others, which founders often chose, conflicted with the

desire for money.

The reason isn't hard to fathom: There is, of course, another factor motivating entrepreneurs along with the desire to become wealthy: the drive to create and lead an organization. The surprising thing is that trying to maximize one imperils achievement of the other. Entrepreneurs face a choice, at every step, between making money and managing their ventures. Those who don't figure out which is more important to them often end up neither wealthy nor powerful.

### The Trade-Off Entrepreneurs Make

Founders' choices are straightforward: Do they want to be rich or king? Few have been both.



### Inside the Founder's Mind

Founders are usually convinced that only they can lead their start-ups to success. "I'm the one with the vision and the desire to build a great company. I have to be the one running it," several entrepreneurs have told me. There's a great deal of truth to that view. At the start, the enterprise is only an idea in the mind of its founder, who possesses all the insights about the opportunity; about the innovative product, service, or business model that will capitalize on that opportunity; and about who the potential customers are. The founder hires people to build the business according to that vision and develops close relationships with those first employees. The founder creates the organizational culture, which is an extension of his or her style, personality, and preferences.

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From the get-go, employees, customers, and business partners identify start-ups with their founders, who take great pride in their founder-cum-CEO status.

New ventures are usually labors of love for entrepreneurs, and they become emotionally attached to them, referring to the business as “my baby” and using similar parenting language without even noticing. Their attachment is evident in the relatively low salaries they pay themselves. My study of compensation in 528 new ventures set up between 1996 and 2002 showed that 51% of entrepreneurs made the same money as – or made less than – at least one person who reported to them. Even though they had comparable backgrounds, they received 20% less in cash compensation than nonfounders who performed similar roles. That was so even after taking into account the value of the equity each person held.

Many entrepreneurs are overconfident about their prospects and naive about the problems they will face. For instance, in 1988, Purdue University strategy scholar Arnold Cooper and two colleagues asked 3,000 entrepreneurs two simple questions: “What are the odds of your business succeeding?” and “What are the odds of any business like yours succeeding?” Founders claimed that there was an 81% chance, on average, that they would succeed but only a 59% probability of success for other ventures like their own. In fact, 80% of the respondents pegged their chances of success at at least 70% – and one in three claimed their likelihood of success was 100%. Founders’ attachment, overconfidence, and naïveté may be necessary to get new ventures up and running, but these emotions later create problems.

### Growing Pains

Founders eventually realize that their financial resources, ability to inspire people, and passion aren’t enough to enable their ventures to capitalize fully on the opportunities before them. They invite fam-

ily members and friends, angel investors, or venture capital firms to invest in their companies. In doing so, they pay a heavy price: They often have to give up total control over the enterprise. Angel investors may allow entrepreneurs to retain control to a greater degree than venture capital firms do, but in both cases, outside directors will join the company’s board.

Once the founder is no longer in control of the board, his or her job as CEO is at risk. The board’s task is straightforward if the founder underperforms as CEO, although even when founders are floundering, boards can have a hard time persuading them to put their “babies” up for adoption. But, paradoxically, the need for a change at the top becomes even greater when a founder has delivered results. Let me explain why.



## CHOOSING money

A founder who gives up more equity to attract investors builds a more valuable company than one who parts with less – and ends up with a more valuable slice, too.

The first major task in any new venture is the development of its product or service. Many founders believe that if they've successfully led the development of the organization's first new offering, that's ample proof of their management prowess. They think investors should have no cause for complaint and should continue to back their leadership. "Since I've gotten us to the stage where the product is ready, that should tell them that I can lead this company" is a common refrain.

Their success makes it harder for founders to realize that when they celebrate the shipping of the first products, they're marking the end of an era. At that point, leaders face a different set of business challenges. The founder has to build a company capable of marketing and selling large volumes of the product and of providing customers with after-sales service. The venture's finances become more complex, and the CEO needs to depend on finance executives and accountants. The organization has to become more structured, and the CEO has to create formal processes, develop specialized roles, and, yes, institute a managerial hierarchy. The dramatic broadening of the skills that the CEO needs at this stage stretches most founders' abilities beyond their limits.

A technology-oriented founder-CEO, for instance, may be the best person to lead a start-up during its early days, but as the company grows, it will need someone with different skills. Indeed, in analyzing the boards of 450 privately held ventures, I found that outside investors control the board more often where the CEO is a founder, where the CEO has a background in science or technology rather than in marketing or sales, and where the CEO has on average 13 years of experience.

Thus, the faster that founder-CEOs lead their companies to the point where they need outside funds and new management skills, the quicker they will lose management control. Success makes founders less qualified to lead the company and changes the power structure so they are more vulnerable. "Congrats, you're a success! Sorry, you're fired," is the implicit message that many investors have to send founder-CEOs.

Investors wield the most influence over entrepreneurs just before they invest in their companies, often using that moment to force founders to step down. A recent report in *Private Equity Week* pithily captures this dynamic: "Seven Networks Inc., a Redwood City, Calif.-based mobile email



company, has raised \$42 million in new venture capital funding....In other Seven news, the company named former Onebox.com CEO Russ Bott as its new CEO."

The founder's moment of truth sometimes comes quickly. One Silicon Valley-based venture capital firm, for instance, insists on owning at least 50% of any start-up after the first round of financing. Other investors, to reduce their risk, dole money out in stages, and each round alters the board's composition, gradually threatening the entrepreneur's control over the company. Then it usually takes two or three rounds of financing before outsiders acquire more than 50% of a venture's equity. In such cases, investors allow founder-CEOs to lead their enterprises longer, since the founder will have to come back for more capital, but at some point outsiders will gain control of the board.

Whether gradual or sudden, the transition is often stormy. In 2001, for instance, when a California-based internet telephony company finished developing the first generation of its system, an outside investor pushed for the appointment of a new CEO. He felt the company needed an executive experienced at managing the other executives who oversaw the firm's existing functions, had deeper knowledge of the

# CHOOSING power

Founders motivated by control will make decisions that enable them to lead the business at the expense of increasing its value.

functions the venture would have to create, and had experience in instituting new processes to knit together the company's activities. The founder refused to accept the need for a change, and it took five pressure-filled months of persuasion before he would step down.

He's not the only one to have fought the inevitable; four out of five founder-CEOs I studied resisted the idea, too. If the need for change is clear to the board, why isn't it clear to the founder? Because the founder's emotional strengths become liabilities at this stage. Used to being the heart and soul of their ventures, founders find it hard to accept lesser roles, and their resistance triggers traumatic leadership transitions within young companies.

## Time to Choose

As start-ups grow, entrepreneurs face a dilemma – one that many aren't aware of, initially. On the one hand, they have to raise resources in order to capitalize on the opportunities before them. If they choose the right investors, their financial gains will soar. My research shows that a founder who gives up more equity to attract cofounders, nonfounding hires, and investors builds a more valuable company than one who parts with less equity. The founder ends up with a more valuable slice, too. On the other hand, in order to attract investors and executives, entrepreneurs have to give up control over most decision making.

This fundamental tension yields “rich” versus “king” trade-offs. The “rich” options enable the company to become more valuable but sideline the founder by taking away the CEO position and control over major decisions. The “king” choices allow the founder to retain control of decision making by staying CEO and maintaining control over the board – but often only by building a less valuable company. For founders, a “rich” choice isn't necessarily better than a “king” choice, or vice versa; what matters is how well each decision fits with their reason for starting the company.

Consider, for example, Ockham Technologies' cofounder and CEO Jim Triandiflou, who realized in 2000 that he would have to attract investors to stay in business. Soon, he had several suitors wooing him, including an inexperienced angel investor and a well-known venture capital firm. The

angel investor's offer would have left Triandiflou in control of the board: Joining him on it would be only his cofounder and the angel investor himself. If he accepted the other offer, though, he would control just two of five seats on the board. Triandiflou felt that Ockham would grow bigger if he roped in the venture capital firm rather than the angel investor. After much soul-searching, he decided to take a risk, and he sold an equity stake to the venture firm. He gave up board control, but in return he gained resources and expertise that helped increase Ockham's value manifold.

Similarly, at Wily Technology, a Silicon Valley enterprise software company, founder Lew Cirne gave up control of the board and the company in exchange for financial backing from Greylock Partners and other venture capital firms. As a result, CA bought Wily two years later for far more money than it would have if Cirne had tried to go it alone.

On the other side of the coin are founders who bootstrap their ventures in order to remain in control. For instance, John Gabbert, the founder of Room & Board, is a successful Minneapolis-based furniture retailer. Having set up nine stores, he has repeatedly rejected offers of funding that would enable the company to grow faster, fearing that would lead him to lose control. As he told *BusinessWeek* in October 2007, “The trade-offs are just too great.” Gabbert is clearly willing to live with the choices he has made as long as he can run the company himself.

Most founder-CEOs start out by wanting both wealth and power. However, once they grasp that they'll probably have to maximize one or the other, they will be in a position to figure out which is more important to them. Their past decisions regarding cofounders, hires, and investors will usually tell them which they truly favor. Once they know, they will find it easier to tackle transitions.

Founders who understand that they are motivated more by wealth than by control will themselves bring in new CEOs. For example, at one health care-focused internet venture based in California, the founder-CEO held a series of discussions with potential investors, which helped him uncover his own motivations. He eventually told the investors that he wanted to “do as well as I can from an equity perspective...[and do] what will be required for the company to be

successful in the long run." Once he had articulated that goal, he started playing an active role in the search for a new CEO. Such founders are also likely to work with their boards to develop post-succession roles for themselves.

By contrast, founders who understand that they are motivated by control are more prone to making decisions that enable them to lead the business at the expense of increasing its value. They are more likely to remain sole founders, to use their own capital instead of taking money from investors, to resist deals that affect their management control, and to attract executives who will not threaten their desire to run the company. For instance, in 2002, the founder-CEO of a

Boston-based information technology venture wanted to raise \$5 million in a first round of financing. During negotiations with potential investors, he realized that all of them would insist on bringing in a professional CEO. Saying that he "was not going to hand the company over to someone else," the entrepreneur decided to raise only \$2 million, and he remained CEO for the next two years.

One factor affecting the founder's choices is the perception of a venture's potential. Founders often make different decisions when they believe their start-ups have the potential to grow into extremely valuable companies than when they believe their ventures won't be that valuable.

For instance, serial entrepreneur Evan Williams built Pyra Labs, the company that coined the term "blogger" and started the Blogger.com site, without the help of outside investors and eventually sold it to Google in 2003. By contrast, two years later, for his next venture, the podcasting company Odeo, Williams quickly brought in Charles River Ventures to invest \$4 million. Asked why, Williams told the *Wall Street Journal* in October 2005: "We thought we had the opportunity to do something more substantial [with Odeo]." Having ceded control quickly in an effort to realize the substantial potential of the company, Williams has had a change of heart, buying back the company in 2006 and regaining his kingship.

Some venture capitalists implicitly use the trade-off between money and control to judge whether they should invest in founder-led companies. A few take it to the extreme by refusing to back founders who aren't motivated by money. Others invest in a start-up only when they're confident the founder has the skills to lead it in the long term. Even these firms, though, have to replace as many as a quarter of the founder-CEOs in the companies they fund.

Rich-or-king choices can also crop up in established companies. One of my favorite examples comes from history. In 1917, Henry Royce was pushed to merge Rolls-Royce with Vickers, a large armaments manufacturer, in order to form a stronger British company. In a chapter in *Creating*

## Keeping Founders on Board

What do boards do with founders after asking them to step down as CEO? Ideally, a board should keep the founder involved in some way, often as a board member, and use his or her relationships and knowledge to help the new CEO succeed. As one investor stated, "You can replace an executive, but you can't replace a founder."

Many times, keeping the founder on board is easier said than done. Founders can act, sometimes unconsciously, as negative forces. They can resist the changes suggested by new CEOs and encourage their loyalists to leave. Some boards and CEOs try to manage those risks by taking half-measures, relegating the founder to a cosmetic role, but that can backfire. For instance, at Wily Technology, Lew Cirne agreed to become chief technology officer after giving up the CEO's post; later he saw that not a single person reported to him. His successor also wanted Cirne to give up his position as board chairman. These moves increased Cirne's unhappiness.

In my study of succession in technology start-ups, I found that 37% of founder-CEOs left their companies when a professional CEO came in, 23% took a position below the CEO, and 40% moved into the chairman's role. Another study of high-growth firms reported that, of the founder-CEOs who were replaced, around 25% left their companies while 50% remained on the board of directors for the next five years.

Boards can sometimes help founders find new roles. When a founder has an affinity for a particular functional area, such as engineering, the board can offer him or her the luxury of focusing on that area and letting the new CEO "take on all the things you don't like to do." That approach helps founders gain an appreciation for the new CEO's abilities. The more concrete value the new CEO adds, the easier it will be for the founder to accept the transition. What's more, the less similar the new CEO is to the founder – if the new CEO is 10 years older, for instance – the easier it is for the founder to accept the change.

Founders who want to be CEO for a longer time in their next venture need to learn new skills. Accordingly, boards can encourage founders to take on new roles in their companies that will enable them to do so. If they do, founders may even become accomplished enough to regain control. For example, in 1998, when E Ink's board appointed a new CEO, cofounder Russ Wilcox identified skills he needed to strengthen. He therefore rotated through roles in finance, product marketing, sales, and even R&D to fill the gaps in his skill set. In 2004, when the board launched a search for the company's next CEO, it couldn't find anyone more qualified for the job than Wilcox himself and made him CEO – a position he has held ever since.


*Modern Capitalism*, Peter Botticelli records Royce's reaction: "From a personal point of view, I prefer to be absolute boss over my own department (even if it was extremely small) rather than to be associated with a much larger technical department over which I had only joint control." Royce wanted control – not money.

Heads of not-for-profit organizations must make similar choices. I recently consulted with a successful Virginia-based nonprofit whose founder-CEO had faced two coup attempts. Early on, a hospital executive who felt he was himself more qualified to lead the organization mounted one takeover bid, and some years later, a board member made the other bid when the venture was beginning to attract notice. The founder realized that if he continued to accept money from outside organizations, he would face more attempts to oust him. Now the question he and his family have to think through is whether to take less money from outside funders even though that means the venture will grow less quickly.

Would-be entrepreneurs can also apply the framework to judge the kind of ideas they should pursue. Those desiring control should restrict themselves to businesses where they

already have the skills and contacts they need or where large amounts of capital aren't required. They may also want to wait until late in their careers before setting up shop, after they have developed broader skills and accumulated some savings. Founders who want to become wealthy should be open to pursuing ideas that require resources. They can make the leap sooner because they won't mind taking money from investors or depending on executives to manage their ventures.

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Choosing between money and power allows entrepreneurs to come to grips with what success means to them. Founders who want to manage empires will not believe they are successes if they lose control, even if they end up rich. Conversely, founders who understand that their goal is to amass wealth will not view themselves as failures when they step down from the top job. Once they realize why they are turning entrepreneur, founders must, as the old Chinese proverb says, "decide on three things at the start: the rules of the game, the stakes, and the quitting time." 

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