



Tech Futures:
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By [Michael Volker](#)

Better Boards Build Better Businesses, Innovation and Competition, Innovative Early Stage Funding, Capital Pool Corps Update, Local Events and Footnotes

Better Boards Build Better Businesses

This week, **Catalyst Corporate Finance Lawyers** together with **SFU's TIME Centre** hosted a one-day seminar titled, "Better Boards Build Better Businesses". This was aimed at early stage technology venture (from startups through to junior pubcos) entrepreneurs, executives and directors. The format followed a panel-discussion style along with some brief presentations and lots of handout materials. Attendance was limited to sixty and it was completely sold out. Some twenty seasoned CEOs and directors presented their views on the subject.

There were some excellent points made that I'd like to touch on in this column. These points made were echoed the following day at a **KPMG** breakfast briefing to local technology executives. KPMG put it this way: Management, directors and auditors form the 3-legged corporate governance stool". The **SEC** (Securities and Exchange Commission in the USA) has set some very onerous and tough rules for determining who should be on a company's audit committee and the qualifications of such persons.

There are so many new - and complex - rules that even small public companies will end up hiring a full-time compliance officer just to keep up with these!

Assembling an able and committed board of directors is one of the first, and most important, steps an entrepreneur must take when building a viable venture. However, it is becoming increasingly difficult for a young company to attract quality board members. Due to the poor governance practices we have seen lately in corporate boardrooms, more rules and regulations are imposing an increasing burden on the shoulders of board members. This increased emphasis on good governance is spilling over into the junior public markets and even private companies.

An ideal board for an emerging technology firm is a small, three to five person team composed of experienced and committed directors who can also serve as mentors to the CEO. The panelists noted that low profile hands-on directors are much better than highly visible but less involved people. They also noted that chemistry among board members is very important meaning that they respect each other's views and welcome different perspectives. That's why board members with complimentary backgrounds, expertise and skills make an invaluable team.

A board's first task is to define its mandate. What is expected of board members? What's their role? How can they best contribute their talents? It was noted that, especially for public companies, directors on audit committees must have not only knowledge of accounting matters but also directly related experience. Strategic guidance was noted as being a key part of a board's mandate – helping the CEO formulate the company's vision and monitoring its strategy. And, of course, compliance with all applicable laws is a given responsibility.

Being a director of a company, especially a small closely held one, used to be a loosely defined and not particularly onerous undertaking. That's no longer true. Company directors are facing increasing personal liabilities. These might arise from a company's failure to remit taxes,

labor/wage disputes, or defective and claims for harmful products just to name a few. Although Directors and Officers (D&O) insurance may cover some liabilities, it's virtually impossible to get 100% protection. D&O insurance is very expensive – if you can get it. Corporate indemnification may also help somewhat but for cash-starved companies, it provides little support. Bottom line: there is no safety net for a director.

Active directors know that they'll be spending anywhere from one to three, maybe more, days per month if they're serious about their role. And, they're always on call and at risk.

So, what attracts someone to a company's board? An entrepreneur who exudes passion and commitment to his vision is a great start. An exciting project with interesting people draws others in. Sharing financially in the success of a possible big win, helps too. It's not a charitable proposition with only remote prospects for a distant payoff.

What is a fair compensation package for a director? Historically, companies have been content to simply allocate a percentage of equity (around 5%) in stock and options to the entire board. Cash fees are rarely given. This is rapidly changing to reflect the increased involvement and liability taken on by directors. Although the panelists offered numerous models for coming up with a fair deal, they all equated to a very practical rule of thumb: take the CEO's compensation package – stock options and salary – and divide it by a factor of three to five (depending on the number of directors) and use this number of stock options and fee for each director. For younger companies, the fee component may be reduced in favor of increasing the options. In essence, the company is recognizing that a team of five directors would be at least equivalent in value to the CEO. Although time they spend may be less than one-fifth of the CEO's, the difference is made up by industry experience and know-how. Stock payments should be made up front but should vest over time (usually three to five years).

A company should pay a cash fee to directors. It can start out modestly, and increase this as its revenues and cash flow rise. Some companies like to pay a per diem or per-meeting fee while others prefer a monthly retainer. I like the latter because a per-meeting fee or a per diem rate suggest that the director is only working at those times. I maintain that a director, although not necessarily always engaged, is nonetheless always on call. Even a modest \$1000/month retainer can command a certain level of fiduciary obligation.

Tom O'Flaherty, one of the attendees commented, "I thought that one panelist clarified things a lot when he said that a director was worth about 25% of a CFO. One could re-phrase this to say that a board (we are talking here about smaller tech companies with maybe four or five independents) should cost a company about the same as one VP position. Or, a person serving on about five boards (which is feasible) should be able to earn about what a VP position would pay (which is a decent living). This notion actually scales for the larger companies who may pay a VP position (that is, one level down from the CEO) \$400,000 per year, and may have a board of 12 independents."

Bob de Wit provides his insights on the seminar:

When it comes to building a better board, start-ups are confronted with a number of tough issues: Who are the right types of Directors? What makes a good board "tick?" How do we retain good Directors on a shoestring? When is the right time to put together a board?

Experts on the panels included noted independent directors such as **Morgan Sturdy, Jim Fletcher** and **Basil Peters**, along with domain experts like **Jim Heppell, Mark Zastre** and **Michael Hagerman**, among others.

Some key points by the panels included:

- Board compensation should be determined relative to that of senior management. For example, each board member should receive a combination of cash and equity that pays them for their time

equivalent to what the CEO makes, on a per-unit of time basis.

- Two other rules of thumb on board compensation: An HR expert suggested that each board member should receive, annually, one quarter of the CFO's compensation, in the form of cash and/or shares and options. A Venture Capitalist suggested that board members in start-ups should get \$500k at the end of a [successful] 5-year commitment. To determine the number of shares, work backward. Assume that at the end of Year 5, the Director should receive \$500k in capital gains as a result of the shares/options provided.
- The proper role of a board of directors is to protect the interests of shareholders and to challenge management, especially the CEO. They are not there to provide support - that's best left to a board of advisors.
- A good board is put together with functions and chemistry in mind, and it shouldn't be formed too soon.
- A CEO shouldn't also be the Chair of the Board. The Chair needs to be a facilitator who makes sure the other Directors are there to defend the interests of the shareholders, not management.
- If you're paying your board purely with stock options, the options should vest immediately, not over time as in the case of stock and cash-based compensation.
- Board dysfunction most commonly occurs when the board has been picked indiscriminately or if the Board Chair is weak.
- Audit committees are taking on a new importance and new legislation has increased the importance of having someone on your board with substantial competence in finance.
- Liability issues for Directors, in the context of recent scandals, have recently come into focus. Director's and Officer's insurance has become very expensive and out of reach for most start-ups.
- As a Director, if you disagree with the rest of the board on a given topic, vote against it, do not abstain.

The day ended almost as soon as it began and the audience went away well informed. The "Building Better Boards" seminar will be repeated in early 2003. If you're interested in attending, email: time@sfu.ca.

Thanks to Tom O'Flaherty and Bob de Wit for these comments!

Innovation and Competition

Competitively speaking, we ought to be ashamed of ourselves. Canada has slipped to 8th (from #3 last year and #16 in 1994) place in the **World Competitiveness Report**. Our failure to keep up with the competition, our declining secondary school enrolment rates, and our productivity environment are to blame. **Michael Porter**, the **Harvard** expert in these matters, notes that we have poor linkages between the private and public sector. [That's why in B.C. we've got orgs such as the **BC Advanced Systems Institute** and the **NewMedia Innovation Centre**. They do a great job albeit with minimal funding.] Over 10 years ago in his report on competitiveness Porter suggested that we become an innovation-driven economy. Where did Canada score high was in competition in the tech industry, the quality of its business schools, internet access, and its ethical corporations. Other barriers cited included government overspending, regulatory burdens, weak currency, and inadequate credit facilities.

On another measure - changes in per capita GDP - we inched to 10th spot, up from 8th last year.

Here's how the countries ranked in the World Competitiveness Report:

1. USA
2. Finland
3. Taiwan
4. Singapore
5. Sweden
6. Switzerland
7. Australia
8. Canada
9. Norway
10. Denmark
11. UK
12. Iceland
13. Japan
14. Germany
15. Netherlands

Creative Early Stage Funding

Speaking of innovation, we could use some in the early stage financing department. Here's an idea.

One of the biggest weak links in the "innovation chain" is funding for proof-of-concept or prototype development - i.e. taking ideas from the R&D lab to the practical demonstration stage. In B.C., the **Science Council** used to fund such projects and the **BC Advanced Systems Institute** still does, albeit with very constrained funding. Currently, the **SRED** (Scientific Research and Experimental Development) program of our beloved tax department is the best, and cheapest, source of support. And, it still amazes me how many companies continue to leave money on the table even though some \$1.5 Billion is paid out under this program. On R&D salaries, for example, private companies in B.C. (and only in BC) can get back \$.685 on each dollar paid. The only problem with this is that the money has to be spent first and then claimed back (there's no allocation or competition involved - as long as the work is bona fide R&D, you get your dough). That still puts it out of reach of many innovative scientists and entrepreneurs. So, here's a solution.

Let's say you need \$500K to do R&D to get your idea to a prototype stage so that you can then attract investors by showing them more than a pipe dream. If you get investors to put some of their RRSP money into a VCC (B.C. Venture Capital Corporation) which then in turn invests in an R&D project in a private company, investors can get back anywhere from 68% to 141% of their money - if the project fails! If the project is a smashing success, they stand to get many multiples. But the downside of taking such a risk is not too tough to swallow. Hard to believe?

It works like this. Suppose you put \$10K into your RRSP this year. You'll get back \$4.3K immediately in tax savings (assuming you're in the top bracket). Then when your RRSP puts \$10K into a VCC, you'll get \$3K back from the Province (i.e. 30% VCC tax credit). If the money is spent entirely on R&D and the company agrees to discontinue its efforts if the outcome of the R&D is unfavorable, it should receive as much as 68.5% (SRED program) back on its R&D costs, i.e. \$6.85K on \$10K. The company liquidates and this cash flows back to investors (via the VCC). Add it up: \$14.1K. Not bad for a flop! Even if you don't use an RRSP or the VCC, you'd still get back as much as 68 cents on the dollar from the SREDS alone. This may just be the way to deal with the disappearance of funds for this type of seed investment.

Another federal program that shouldn't be overlooked is **Technology Partnerships Canada** (TPC). This program, often criticized by the press as a give-away, makes \$300 million per year available to companies to fund the gap between R&D and commercial release. This fund is for large projects and provides capital in the form of a loan that is repaid from project revenues. There are three technology areas that are supported: environmental, enabling, and Aerospace. Of the \$1.9B already spent under the program, B.C. firms have received \$229M. There's a less well-known

component of this program, i.e. \$30M allocated to projects of less than \$1.5M. Since TPC contributes one-third of project costs, that means that up to \$500K in support is possible.

For much smaller projects, e.g. under \$50K, NRC's popular IRAP program, is still a great resource.

Capital Pool Corporation (CPC) Comments and Update

In this column, I keep track of **Capital Pool Corporation** ("CPC") companies as defined by the TSX Venture Exchange (the former CDNX) because they may provide funding and management to, and in the process acquire, technology companies. They provide companies with an alternative to traditional venture capital financing. It lets the public investor get into the game.

Originally, these CPCs were limited to raising \$750K. After legal and accounting fees, this didn't leave much for actually doing acquisition. Recently, though, the Exchange has permitted a combination of CPCs in order to up the ante. A good example of this is a recent pioneering effort by **David Raffa** of **Catalyst Corporate Lawyers**. The combined three CPCs to provide a pool in excess of \$1.5M.

They merged three CPCs: **Stratos Biotechnologies Inc.**, **Nucleus Bioscience Inc.** and **Brightwave Ventures Inc.** This gives the three merging CPCs a number of advantages over all of the other CPCs out there:

- * it gives them more capital to work with (\$1.5M vs. \$500K)
- * it gives them enough capital to complete a QT without a financing should same not be possible because of market conditions
- * it gives them the ability to advance down \$375,000 prior to completion - thus eliminating the need for a separate bridge financing
- * it gives them another 15 months of life before suspension (90 days to merge and then a year to do the QT)
- * no one is diluted in the transaction as everyone merges on cash value - in fact, it is partially anti-dilutive as many of the stock options held by the principals of each CPC will drop off the table as not everyone will stay involved.

This will put the combined CPC way ahead of all of the other CPCs in terms of being competitive. It should mean that it will be able to attract better deals and negotiate better deals because of the amount of capital on hand.

Got a hot one? Let them know about it!

Check our [Capital Pool Corporation chart](#) (in .pdf format) for a complete list of the CDNX's CPC and VCP companies, thanks to **David Ing** of **Pacific International Securities**. This list is updated on a regular, e.g. monthly basis. It is current to the end of October, 2002.

An introductory article explaining CPCs may be found at <http://www.bctechnology.com/statics/mvolker-jun0200.html>.

Local Events

A complete calendar of technology events can be found on [T-Net's Events page](#). There's a new group in town called **TACI** (Technology Associations Collaborative Initiative) which also has a tech

calendar - check www.techvenue.com/calendars/taci.

Footnotes

If you're an entrepreneur looking for a place to get your company started; there's some great space available at Harbour Centre downtown. The **New Media Innovation Centre** (NewMIC) and **SFU's TIME Centre** have teamed up to provide not only office space but also access to various resources, e.g. tech advisors, access to capital, mentors, etc. Worried about the high cost of being downtown? Well, not to worry - they'll even reduce the fees and take some payment in the form of equity. Check www.sfu.ca/time for contact info.

A reminder: SFU's TIME Centre is open for business - business folks, that is. TIME is an acronym for **Technology, Innovation, Management, and Entrepreneurship**. TIME supports the growth and development of the tech industry in B.C. TIME features a "BusinessCentre" (looks like an airport business lounge) which is open to technology entrepreneurs and business people to use as a drop-in downtown office facility. Need to plug-in? Make some calls? Do some work? Hold a meeting? There are some great facilities for holding your company's AGM. Why hang out at MacDonald's when you can work productively at the TIME Centre? Drop by and check it out! It is located at SFU's downtown campus at 515 West Hastings St.

Michael Volker, a technology entrepreneur, is Director of the University/Industry [Liaison Office](#) at Simon Fraser University, Chair of the B.C. Advanced Systems Institute, Chair of the [Vancouver Angel Network](#) and past Chair of the [Vancouver Enterprise Forum](#). He owns shares in many of the companies he writes about. Copyright, 2002.

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Tech Futures is a bi-weekly column that focuses attention on new and emerging BC publicly listed technology companies.

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