



TUESDAY 24.10.06

REPORT ON BUSINESS

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S&P/TSX 11,826.44 -39.32 Energy stocks lead first decline in four sessions	DJ Ind. 11,069.06 -46.26 Interest rate worries undermine blue chips	Nasdaq 2,262.96 -19.40 Chip stocks drop as Citigroup cuts recommendation	Dollar 87.18c (U.S.) Unchanged Rate concerns in U.S. and Canada squeeze loonie	Gold \$556.60 (U.S.) +2.00 Renewed inflation concern underpins bullion gain
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VENTURE CAPITAL

Leverage Your Board



SEAN WISE
WISE WORDS

Not only am I currently the Chair of two public companies, but I sit on the Boards of non-profit organizations, as well as the Board of Advisors to a number of other organizations and venture funds. Consequently, I know first hand that strong boards can be an entrepreneur's dream asset or a founding CEO's worst nightmare.

Len Brody, author of several books on Entrepreneurship, put it best:

"Boards are like a flu shot. Nobody likes getting one, it stings at first, then it leaves a long lasting bruise and sucks your energy. But, in the end, it protects you from unforeseen harm and, for all the grief, you are eventually glad you had it done. So much so, you end up getting one every year."

So how can you ensure that you get the most out of your Board? Easy — Leverage.

Archimedes, the Greek mathematician and physicist (and coincidentally, the coiner of the term Eureka), described leverage in 300 BC, as a means for converting a small force into a larger one, often employed to move a heavy obstacle.

The obstacles to an entrepreneur are heavy indeed: under resourced, overworked, underfunded, breaking new ground, lacking product credibility and venture brand. But the same principles can be used by entrepreneurs in small early stage startups to gain traction and move the heavy obstacles in their way (ex. first customers). Just as the lever and fulcrum, through proper deployment enabled Archimedes to lift several times his capacity the leveraging of a Board, enables an entrepreneur to accomplish much more than his resources seem to dictate.

The Board Defined:

By law, incorporated companies must have a Board of Directors.

In the earliest stages of a venture, the Board of Directors is often limited to shareholders, who are simultaneously the active founders and active management of the business. These early Boards tend to be informal and highly unstructured. As the company progresses and outside investment is injected into it, the Board of Directors will usually grow to include new external shareholders, who wish to be kept apprised on the company's activities. If the shareholder base evolves to include institutional financiers or formal investors (ex.

Venture Capitalists) become involved, the Board of Directors may likewise evolve into a more structured and formal entity.

The Role of the Board:

The legal requirements for a Board of Directors are set out in the Corporations Act, under which the company was created. The Board of Directors is typically responsible for supervising management, reviewing the financials, appointing senior management and most importantly safeguarding the best interests of the shareholders. Collectively, these duties are often referred to as Corporate Governance. However, while these duties may satisfy the Boards' legal requirements, the true role of the Board often runs much deeper.

"The right Board of Directors is an important asset to any organization but especially a start-up," states Vikas Gupta. "Boards play many different roles but, for young companies, a board can serve as an extension to the management team and can round-out the requisite experience and expertise that is necessary to launch a start-up to success," Vikas comments. "The board should provide a management team with objective feedback on a company's strategy, should challenge the management team to ensure the team has the appropriate levels of conviction and defensibility for their ideas, and, perhaps most importantly, provide support and motivation towards the successful execution of the approved business plan."

Hence, in addition to providing formal legal governance, a Board often assumes some or all of the following roles:

- **Accountability:** Just as employees report to the CEO, the CEO in turn should report to the shareholder base, but to facilitate such efficiently, a Board is elected by shareholders to represent their interests. Thus the CEO reports to the Board. In doing so, s/he becomes accountable.
- **Sounding Board:** Management needs an echo chamber to bounce ideas off of and to ensure that decisions are made in due course with the use of a deliberative process;
- **Mentoring the CEO:** Being a CEO can be lonely and frustrating, therefore a resolute CEO will often leverage the Board as mentors; Leaning on their experience to enhance his or her own.
- **Extending the Network:** Strong board members will bring access to customers, finance and sales channels; and finally
- **Filling in the Holes:** Startups are often under resourced. Until full-time staff is retained for all positions, Board members can often assist management in specific areas of operations (For example: interviewing key staff, hammering out a financing, arranging bank facilities, etc ...).

Board Composition:

The size of the Board of Directors is established by constituting documents of the company, but is always subject to change. So in the end, the size of your Board is a matter of choice. For pre-revenue companies, I usually recommend a three-person Board, but for later stage companies, a five-person board is often more suitable. If the Board is too large, it may become unwieldy and difficult

to co-ordinate schedules for meetings, which early on, should be held monthly. In contrast, if the Board is too small, you will fall short on the opportunity to maximize the leverage that a Board can generate. Once the Board's overall size has been determined, you should balance its composition by recruiting from management, the shareholder base and most importantly, from the industry.

On a five person Board of Directors, post outside investment, the following structure is recommended:

- The CEO;
- Another key member of Management i.e. possibly the CTO or the VP of Sales;
- A representative of the founding shareholders or the early investors;
- A representative of shareholders from the last round of investment; and
- An independent Chairperson

Since they themselves have no vested interest, it is key to have an independent Chair, who will often act as a balance between competing interests. With regard to filling the independent seat(s) on the Board of Directors, founders should use these opportunities, to fill holes in the venture's Talent Triangle.

In an earlier article, I discussed the theory of the **Talent Triangle**. It outlined the three equal components of a well-rounded management team, as being Business Acumen, Domain Knowledge and Operational Experience. Commonly, startups cannot afford to recruit top talent to fill these corners, in such cases, the composition of the Board can be used to compensate. A few examples include the following:

1. If management has never taken a startup to greatness, they might be weak in the area Business Acumen (i.e. How to run the business). In this scenario, it might be best to recruit a mentor who has experience for the Board. This mentor might come in the form of a serial entrepreneur, an Angel Investor, or a professional service provider.
2. If management lacks in depth client knowledge or needs a better customer network, then its Domain Expertise is inadequate. To compensate, leverage the Board, by nominating either future clients, those who sell to your future clients or leading experts in the field i.e. anyone who is exceptionally knowledgeable about your industry or has an incessant domain rolodex.
3. If management's operations experience is low, then recruit to the Board those who have built and distributed similar products and leverage their experience. In high tech startups, operational experience can be obtained, by recruiting experts from companies in different domains with similar product lines, i.e. selling shoes on-line is different than selling books, but from an operational perspective they are more similar than different.

One final note on independents and the Board, comes from a reformed venture capitalist and a current manager at Calgary Technologies Inc., Kerri Lee Knull who shares with us another key benefit of having independents on the Board:

"An uneven balance of VC's (investors) and founders on your

board can often set the stage for tension-filled meetings where the business of the company's growth is secondary. To avoid such a situation, work closely with your investors to select independent board members that balance the blend of personalities on your board along with relevant domain experience and a history of business success."

Investors and the Board:

As mentioned above, investors often want to take a seat on the Board, to monitor the activities and growth of the company and their investment. In the case of venture capital investors, this is almost always the case. But what role does the Board play, pre-investment?

I asked Robin Axon, Vice-President of one of the oldest VC funds in Canada, Ventures West, the role that Boards play pre and post investment. "We wouldn't invest in a company because of the Board makeup alone, but an impressive Board made up of relevant industry experts is great validation for a company and provides an easy starting point for a VC's due diligence. You are definitely judged by company you keep. And your Board is the greatest example of that."

Therefore, if raising capital is a future goal, you might want to recruit Board members that are well respected by potential funding sources. Moreover, if you are raising funds, you might want to add members to your Board, who have reputable VC contacts, as was discussed in a previous column on the **importance of relationships in the capital raising process**. After all Venture Capital is a business, that like so many others, is heavily based on relationships.

The Advisory Board:

For the past half decade, the liability associated with being a director, even an independent one for a private company, has continued to grow. This has led to a decrease in the availability of independent directors and even for those businesses with full DnO i.e. Directors' and Officers', liability insurance, the pool continues to shrink. The easiest way to get past this is to have potential Directors join an Advisory Board.

While a Board of Directors is required by corporate law, a Board of Advisors (i.e. an Advisory Board) is a loosely established committee, formed by management to undertake and enhance the formal Board of Directors and management as a whole. Corporate law spells out a list of minimum tasks that a Board of Directors must undertake. For the Board of Advisors however, no such list exists. (Note: For the remainder of this article, the term "Board(s)," shall be used to describe both the Board of Directors and Advisors).

You should recruit your Advisory Board based once again on the Talent Triangle model. Fill perceived or actual holes in management expertise and experience with seasoned veterans.

Compensation and Recruitment:

Irrespective of which Board they sit on, all independent members, i.e. those not receiving compensation as management, should be offered a reward to offset the risk they take and the opportunity cost of dedicating their time to the venture. Once upon a time, options (i.e. stock options from the Employee Stock Option Plan)

might have been enough, but today, my experience shows this is rarely still the case. If you expect Board members to dedicate several hours a month to increasing shareholder value, then you need to reward them accordingly.

Founders should be prepared to set aside real funds, in return for a Board member's time and energy. This can be paid on a per meeting basis or quarterly and should be an addition to stock options in the company. Fees may vary from \$500 a meeting, to \$20,000 a year, (although the latter would be rare for a startup and the result of a Board member dedicating much more than just a few hours a month).

Examining the opportunity cost, serves as the easiest way to determine the appropriate level of compensation for a Board member. If you expect an active Board member to dedicate half a day per month to formal meetings and another half for supporting management informally, then you need to examine the opportunity cost of that Board Member. For instance, if that person is a professional service provider, with a per diem rate of \$1000/day, and want them to meet at least half a day a month, then you should offer them a total compensation package, including options and cash, of at least \$3000 a quarter (\$3000 in forgone fees, plus a multiple to offset the liability being incurred). The divide between how much of the compensation should be cash and how much should be equity, is up to you, but I recommend that the cash be equal to at least the opportunity cost, which allows the equity to offset the risk. Members of the Advisory Board, typically get paid less than members of the Board of Directors, because of the variance in liability (see below), associated with their role.

Board Alignment:

Regardless if they are joining the Advisory Board or the Board of Directors, founders need to ensure alignment with management, before nominating a person to the Board. Make sure all parties agree to not only where the company is going, but on the role they will play.

Some candidates for Board positions see their role, as purely fiduciary in nature and believe that the Board should be strategic and not tactical. As a result, they refrain from getting involved in the day to day operations of the business. Others however, believe that management is simply overtaxed and feel that an effective Board is one that is more active. When recruiting, it is imperative that management discuss these perspectives openly and in depth. You need to ensure that you are "getting what you pay for" and that members of the Boards are willing to put in the time and energy management is seeking. If not, you will not be able to fully leverage your board and will only end up with unused potential.

The Dark Side of Boards:

No discussion of Boards would be complete, without drawing attention to the down side or dark side of having one. To some, Boards are the ultimate double edged sword.

Some entrepreneurs are not prepared to fetter their authority, while others resent having to report to someone else. An additional group, fears that the formalities and costs associated with proper board governance, will outweigh the benefits associated with such, while others fear for their

job, as one of the prima facie duties of a Board is the hiring, supervision and firing of the CEO. For some founders, this heavily influences their decision to expand a Board, as they feel it will expose them to intense scrutiny and job insecurity. This is another reason why, investors refer to the Boards of pre-funded companies. If such companies lack a formally active Board, the VC might grow concerned over the entrepreneur's willingness, to accept outside guidance, be accountable to others, or ability to undergo scrutiny and most of all, do what is right for all of the shareholders and not just the founders.

Likewise, there is a downside to being on a Board. As mentioned above, over the last decade the liabilities associated with being on Boards have grown considerably, as have the duty of care expected by each member of the Board. Even with DnO insurance, which can cost upwards of \$20,000, even for a small private company, Directors are still exposed to more risk than can be discussed in this article. It is sufficient to say, that agreeing to join a Board is a decision that should not be taken lightly. Wikipedia, has a **great review** of the duties and liabilities that Board members should be willing to accept, before formally signing on. And while that article is a good starting point, each potential Board member should seek independent legal advice before accepting their role on the Board.

The Bottom Line:

As the Chair of the Boards for several progressive companies, I prefer active Board members, i.e. those who are willing to dedicate a minimum of 100 hours per year to supporting the company. This time will be deployed, not just at meetings, but when mentoring the CEO, opening doors to the network and helping to shape the growth strategy of the venture.

Despite how much time you want Board members to invest, when recruiting members to your Board(s), seek those with the skill sets, networks and experiences that management does not have. By doing so, you will be able to leverage the talent triangle, into a fulcrum that will move obstacles with much less applied force and perhaps one day, like Archimedes, you can shout "Eureka!" in celebration of your success.

Sean Wise, BA, LLB, MBA is the Managing Director of Wise Mentor Capital, a national venture capital consultancy focusing on bridging the gap between entrepreneurs and capital. He is the on-line host of the CBC's new venture capital reality show Dragons' Den.

Sean is a former Director with Ernst & Young's Venture Capital Advisory Group for Canada, and currently sits on the Boards of the Canadian Venture Forum, the Banff Venture Forum, the Toronto Venture Group and Silicon Valley's IBDNetwork as well as a number of high growth companies in the public and private sectors.

You can read his blog and listen to his podcasts at www.SeanWise.com.