The Science and Art of Good Corporate Governance

A Guide for Venture-Funded Companies and Entrepreneurs

In collaboration with

Vital to business growth

Starting and running a business involves addressing a wide range of challenges. The right corporate governance can help you find solutions, keeping your business running smoothly and reducing the growing pains of scaling.

This guide introduces the basic concepts of corporate governance, explains why it matters, and highlights the importance of assembling a board of directors with the skills and experience to guide a business wisely. It provides insight into how a board of directors evolves as a business grows and presents some best practices for successful corporate governance. Finally, it examines some emerging trends that are shaping the corporate governance of today's businesses.

While this guide was primarily written for companies receiving venture capital investments, we believe the advice can be useful for any entrepreneur who decides to incorporate their business. We hope it can help you build a solid foundation to ensure your company can continue to grow for years to come.

This is the first installment of an ongoing series of publications that will further expand and explore this topic for Canadian companies.

Authors

Jack Fraser
Partner, Growth Venture Co-investment Fund
jack.fraser@bdc.ca

David Little
National Lead of the Venture Technology and Emerging Growth Companies Group at Dentons LL
david.little@dentons.com

Summary

1.

What is corporate governance and why does it matter?

Corporate governance might be the last thing on your mind when you start a business. The term might sound like something that applies to large enterprises with vast holdings. But actually, every organization needs corporate governance, even a brand-new start-up with no staff other than the founder.

2.

How corporate governance evolves as a company grows

The time to start thinking about corporate governance is not when you hit a certain revenue milestone or when you start preparing to go public with your shares. Corporate governance needs to be part of your earliest business planning, before you've even officially started the business. That way you won't be stuck trying to resolve conflicts or navigate administrative troubles as you chase a big deal or deliver a big order—the foundations for good governance will already have been established.

3.

Best practices for successful corporate governance

Some elements of corporate governance are fairly straightforward: Put the right tools and processes in place and follow the established steps. Others are more nuanced, calling for careful balancing of competing interests. These two sides can be thought of as the science and the art of corporate governance.

What is corporate governance and why does it matter?

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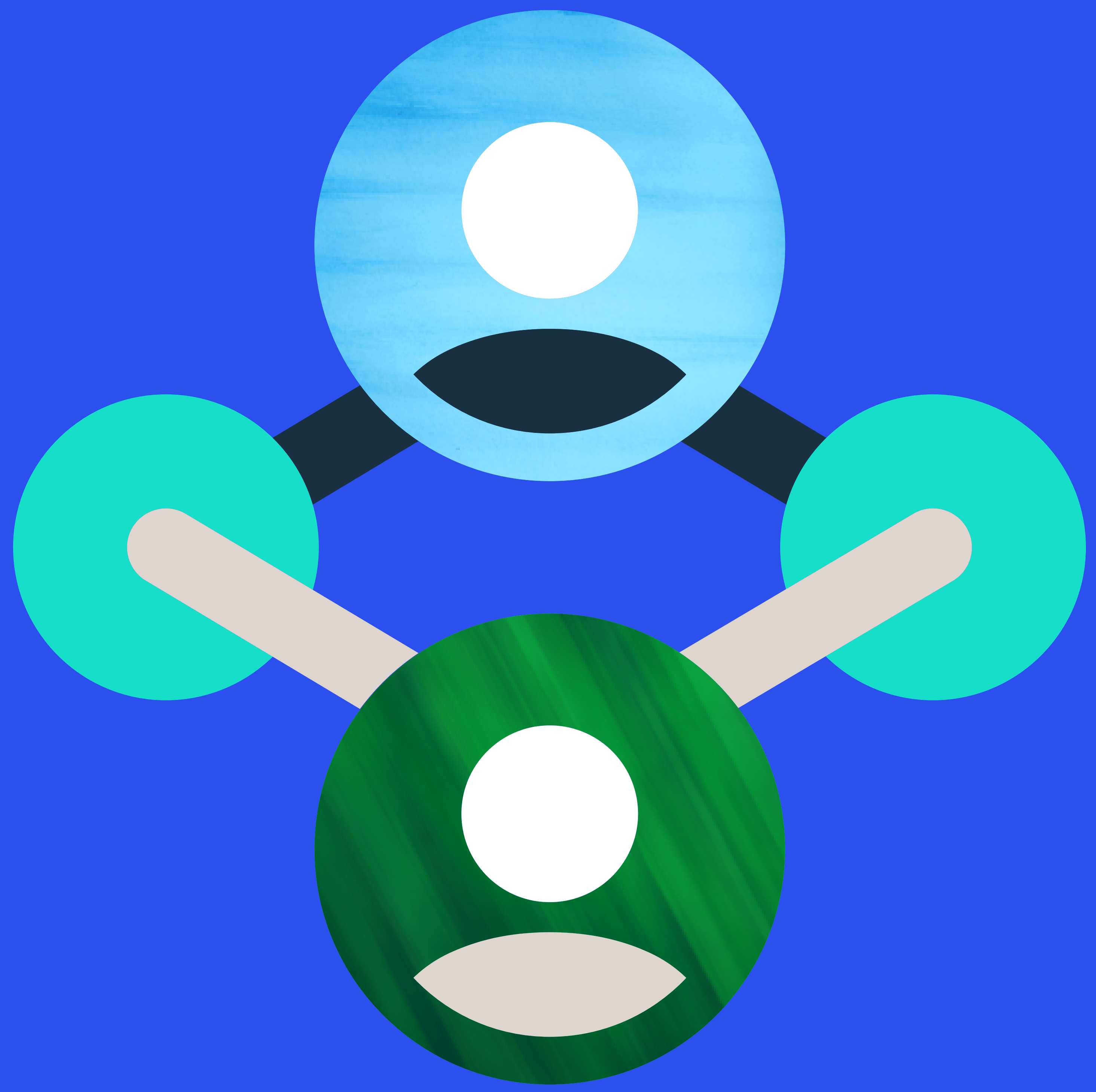


What is corporate governance?

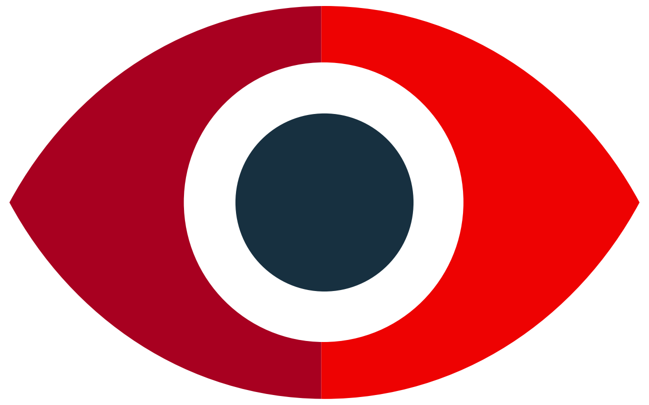
At its most basic level, corporate governance refers to the way a company manages the relationships between executives, shareholders, directors, auditors and other stakeholders—including customers.

It establishes a division of power and sets out accountability for each party. It covers elements from how the company communicates with the public to how employment decisions are made to long-term strategic planning. Decisions as basic as how bank accounts are set up and who has signing power to authorize payment to staff and suppliers are included in corporate governance.

When it's done right, corporate governance helps create a framework for building long-term trust between a company and its stakeholders through predictable behaviour, financial results and other outcomes (such as public perception and social responsibility), all of which is critical to long-term success.

What does the board of directors do?

One of the most important mechanisms for good corporate governance is a strong board of directors.



Entrepreneurs have great ideas, and often a lot of expertise in their fields, but they're not always as skilled at running a business, and their passion for the work can sometimes lead them away from what their business needs to grow and thrive. That's where a board of directors comes in.

At the outset, boards of directors usually include the CEO as well as a mix of other key employees and a few investors. As the company grows, the board will expand to include additional investors and independent directors, often chosen for their specific skills or knowledge. Together, their job is to provide oversight, foresight and insight to help keep the business on track. Earlier stage directors (other than the CEO) often drop off the board as a company progresses in recognition of the different skill sets needed from directors as the business progresses and otherwise matures.

Main functions of a board of directors

Oversight

involves looking back at what's been done to confirm that it was done according to relevant policies, regulations or best practices. Financial auditing is one of the biggest parts of oversight.

Foresight

is looking ahead and making strategic decisions about how the business should move forward. This includes setting short-, medium- and long-term business goals and creating plans to achieve them.

Insight

can apply to past, future or current actions. This is where having a diverse board with a range of skill sets and business experience is useful, because they can bring multiple perspectives that help ensure every angle is considered, which supports better decision-making, helps to reduce business risk and can accelerate growth.

Through these functions, the board helps regulate the relationship between management and other stakeholders—particularly shareholders. By helping various groups see eye to eye and providing a mechanism for resolving conflicts when they arise, boards can build trust between parties and reduce agency costs.

Board duties according to the law

Boards of directors also serve a legal function.

The *[Canada Business Corporations Act]* and other similar corporate statutes across Canada set out specific requirements for how incorporated businesses must be governed, including the minimum size of the board, criteria for membership, procedures for selecting or removing directors, and meeting processes. Depending on jurisdiction and industry, boards of directors may also be subject to additional laws and regulations.

By law, boards of directors must supervise the management of the company and carry out their fiduciary duty—that is, to act honestly, in good faith and in the best interests of the company.

Fiduciary duty also includes appropriate handling of conflicts of interest. Because directors are often involved in more than one company, they may occasionally run into situations where they are asked to make decisions on behalf of one company that could benefit them personally through their involvement with another company. In these cases, directors are required to disclose any direct or indirect relationships that could result in a conflict of interest. They may also be required to remove themselves from discussions and votes related to the conflict. All steps taken to mitigate conflicts of interest should be recorded in meeting minutes.

Directors are also expected to perform their job with a duty of care. In other words, they must properly vet all issues they are asked to weigh in on, discuss them adequately and make reasoned decisions based on the best available information.

4 pillars of fulfilling the duty of care for directors in Canada

1.

Dedicate adequate time and attention to the company’s affairs. They must also thoughtfully, independently and critically consider all issues that the board is or should be dealing with.

2.

Understand the company’s business well enough to be able to oversee management.

3.

Hold management accountable to keep them aware of issues affecting the company and to provide the information they need to make informed judgments and decisions.

4.

Hold management accountable to have appropriate internal controls and systems in place to manage business risks and to address any deficiencies.[1]

1 Puri, P. (2021). Pre-Read Materials: *What Corporate Directors Need to Know About the Duty of Care and the Legal Framework in Canada.* Rotman-ICD Directors Education Program, DEP97 Module 1.

What does “the best interests of the company” mean?

When we refer to the best interests of a company, it may be tempting to assume that means primarily maximizing the profits for the shareholders—those who own part or all of the company.

However, in Canada, a Supreme Court decision in 2008 made it clear that shareholders are just one of the groups whose interests must be considered, and boards are not obligated to make decisions that will maximize shareholder profit at the expense of other stakeholders.[2]

Today, boards of directors in Canada are expected to consider the interests of all stakeholders, which may include management, employees, customers, suppliers, the local community, governments, creditors and the environment, as well as shareholders. This can often be very good for companies: By deprioritizing short-term profits, boards can make decisions that will improve long-term outcomes for more stakeholders, which can produce a healthier company overall.

2 Ibid.

Stakeholder challenges

In Canada, a stakeholder or stakeholder group may challenge a board's decision in court. In these cases, the board will be subject to what is known as the Business Judgment Rule. This rule acknowledges that not every board decision will be unanimously approved, and some may even be considered objectively wrong in hindsight.

The board will generally not be found liable for breaching its duties if it can be shown that directors:

- devoted enough time and attention to understand the situation and consider all relevant facts before making the decision
- reviewed all appropriate materials and requested additional material or information as required before making the decision
- asked hard questions of management, engaged in rigorous discussion of the issue and considered reasonable alternatives to address the underlying issue
- set up an independent committee or engaged external advisors to provide unbiased counsel in cases of conflict
- conducted appropriate follow-up on decisions and action items. If they found deficiencies, they addressed them promptly, up to and including with an internal investigation
- properly documented all discussions to show a reasonably informed evaluation that led to the decision[3]

3 Ibid.

How corporate governance evolves as a company grows

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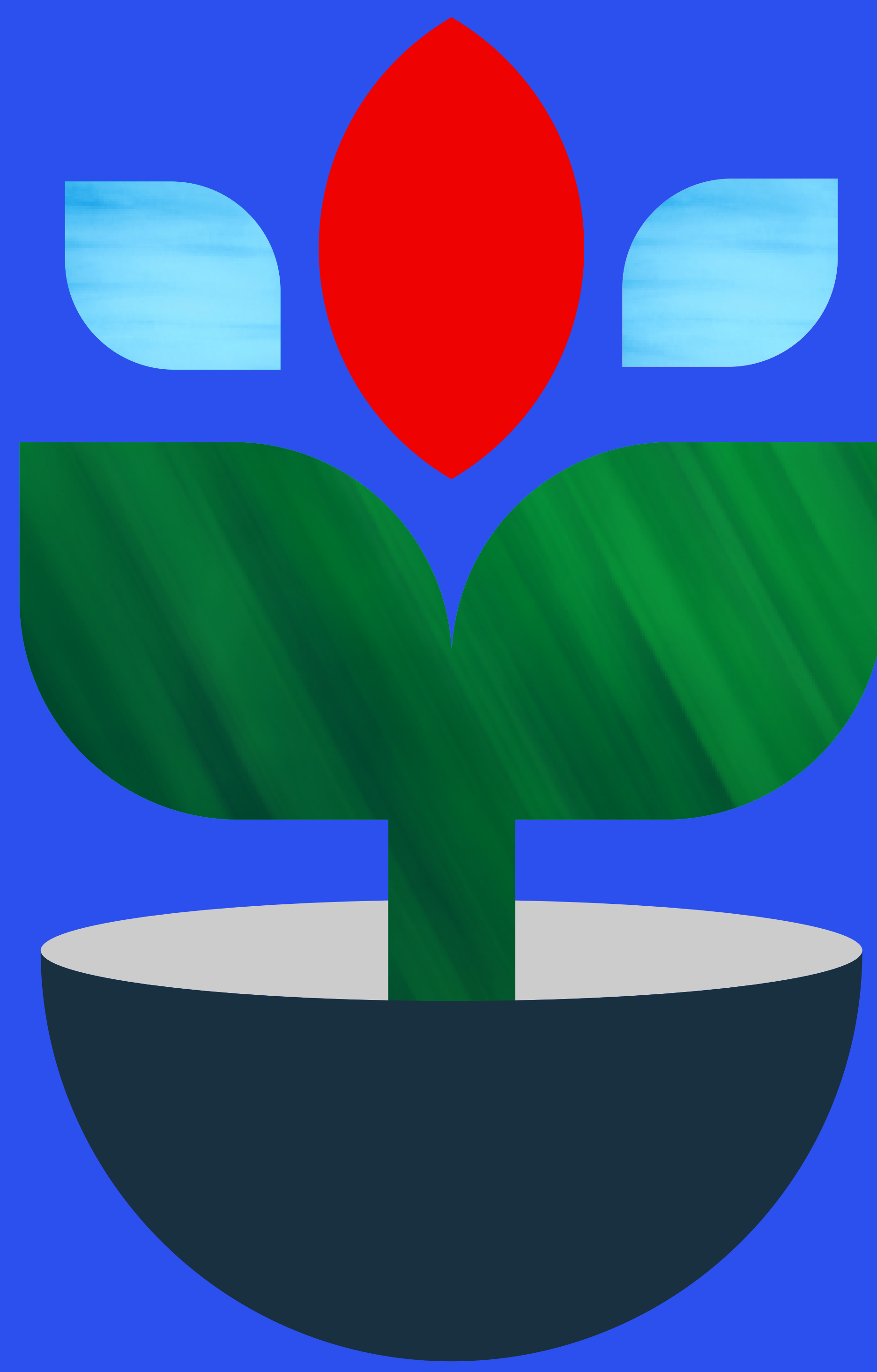
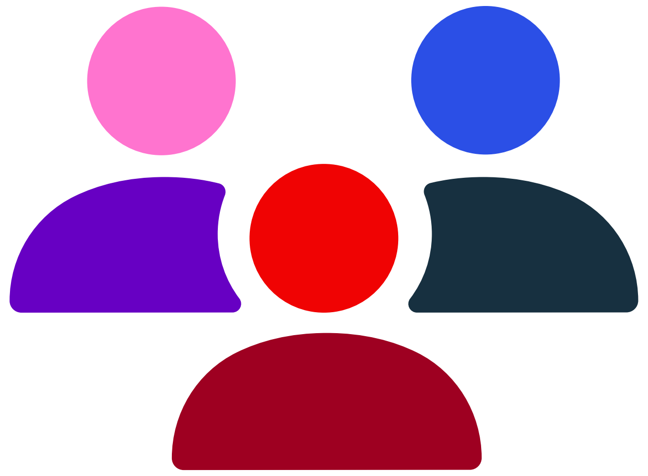


How corporate governance evolves as a company grows

Taking the time to set out your governance framework early ensures you'll be prepared as your business grows.

This way, as your executive team expands and investors come on board, you'll know who's responsible for what decisions, how those decisions should be made, how disagreements should be resolved and more. That means it will be much less likely that you will have to shift your focus from the core business at a critical moment to sort out a conflict. You'll already have established how it should be handled. The resulting stability and predictability will help maintain value and attract investors.



The role of the chair

One member of the board should be designated as the chair. In public companies, the chair is elected by fellow board members. In private companies, the chair may be elected or appointed by lead investors and the CEO. The chair serves as the key liaison between the board and the CEO and generally runs the meetings. Outside these duties, they have the same responsibilities and voting rights as other directors.

The types of directors every board needs

In general, your board will be made up of three types of directors:

Founder/CEO

This person provides the critical knowledge and understanding of the business. They oversee the day-to-day operations of the company and have relationships with staff, suppliers, customers and partners. Nearly every board includes the company CEO. In certain cases, a key employee or cofounder may also be on the board at the earlier stages.

Investors

These directors represent stakeholders who have contributed financially, but are likely not as fully immersed in the ins and outs of the company.

Independent directors

These directors are often recruited to boards for their industry expertise or specific skills other directors don't have. As their name suggests, they are not beholden to either the CEO or the investors and are intended to provide a more neutral perspective, including in case of disagreement.

In some cases, you might also invite board observers to attend meetings. These are often shareholders. While they are not directors and do not have voting rights, they can contribute additional perspectives to a discussion or serve as sounding boards. You can also call on board advisors (who might have skills or knowledge not currently included in your board) or even establish a separate advisory board to provide additional insight and guidance on specific matters.

Roadmap for board evolution

In its earliest stages, a company only needs a small board of directors and fairly simple processes. However, as the business grows and matures, it will need more directors and more defined processes to address the increasing complexity of the decisions required as well as the different situations that will be encountered.

This section offers a roadmap of how a board of directors may evolve through its early funding and growth process. In general, it's wise to look ahead to the next stage so you can make adjustments and get your board ready in advance.

Seed stage

- Three to five directors: Usually one or two founders, an investor and one or two independent directors
- Discussions centred primarily on operations, with a focus on how the directors can help
- Minimal reporting processes: A basic template highlighting key performance indicators (KPIs) to be shared with the board
- No committees are required

Series A funding

- Five directors: CEO (if appointed) or the same founder(s) from the seed stage, plus two investors and one or two independents
- Discussions focused on operations, with exploration of ways to build competitive advantage in key market segments
- More formal reporting processes: Structured, concise KPIs
- Committees may include audit and compensation

Series B funding

- Seven directors: CEO plus four investors and two independents
- Directors from new investors typically replace early-stage investor directors
- Discussions primarily strategic, focused on building competitive advantage in key market segments and expanding target market segments
- Reporting processes continue to mature and become more formal
- Audit and compensation committees established and functioning

Series C funding

- Little change to board composition
- Typically, directors from earlier financings rounds are replaced with directors that have late-stage growth expertise
- Board diversity can become an important focus as companies also prepare to go public or position themselves for other exits
- Discussions entirely strategy-focused, with key topics including scaling and human resources
- Formal reporting processes fully established, including regular KPI reporting and bonus structures
- Committees formalized or evolved or added as required (e.g., audit committees may take on broader financial matters, compensation committee may become HR committee)

Best practices for successful corporate governance

3

The science:
Implementing the right tools and processes

The following are some of the key tools you should have in place and processes you should implement to support your corporate governance.

Charters

Board charters and committee charters are highly useful documents that set out basic information including the purpose of the entity, its responsibilities and the processes it will follow to carry out those responsibilities. Charters may also include decision protocols that explicitly identify the types of decisions the board or committee is required to make and the types of actions they are expected to take. They should also outline the process for voting and decision-making, including key points such as:

- what constitutes a quorum
- what kind of majority is required for various types of decisions
- what voting process is to be used

Some of the foregoing may also be set out in a shareholders agreement.

We are including a sample board charter you can use as a starting point for your own board of directors. Each committee should have a similar charter to guide its activities. Committee charters in particular should be clear on the areas where the committee is empowered to make decisions (which must usually still be ratified by the board) and those where it can make recommendations, with the board ultimately making the decision.

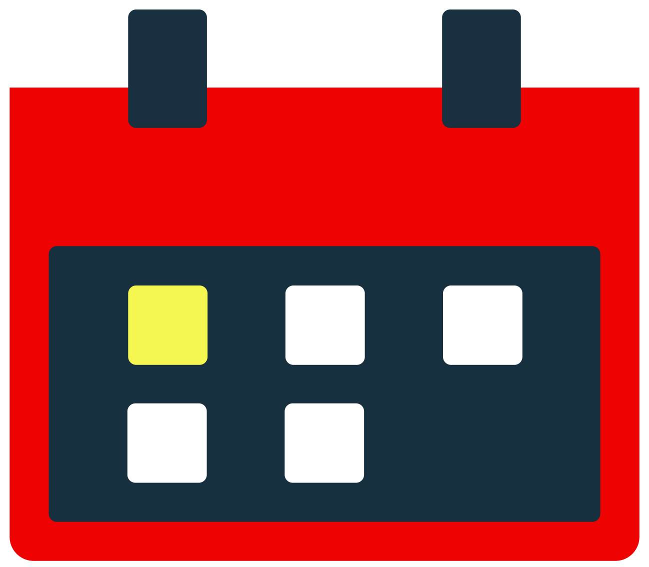
Sample board charter

The board maintains a culture based on the values of teamwork, trust, ethical decision-making and innovation. The board strives for a consensual approach to decision-making, while respecting and valuing constructive debate.

The board's responsibilities are to:

1. Establish strategic direction
   - Set the company's mission, vision and values
   - Periodically review the company's mission, vision and values
2. Foster excellent management
   - Select and appoint the CEO
   - Periodically review the performance of the CEO and other executives
3. Ensure product/service quality and effectiveness
   - Ensure management has identified and applied appropriate measures of performance related to the quality and effectiveness of the company's products and services
4. Ensure financial and organizational viability and risk management
   - Ensure the availability of financial resources
   - Ensure financial resources are allocated in alignment with the strategic plan
   - Optimize the use of resources to achieve at minimum any corporate undertakings to the shareholders
5. Ensure board effectiveness
   - Maintain a skills matrix for the board

The science:
Implementing the right tools and processes (cont'd)



Annual calendars

Many organizations have found it helpful to set a fixed schedule, outlining the topics to be considered at each meeting throughout the year. This predictability helps ensure any organizational information can be easily collected and board members can prepare adequately for each meeting. Below is a sample annual calendar for board meetings. Similar schedules can be created for any board committees. All schedules should be tailored to individual business needs.

Sample annual calendar[4]

February: Review annual plan and quarterly results; evaluate board and committee performance

March: Conduct annual review of executives and equity awards

April: Review committees' reports and quarterly results

June: Conduct annual review of quality of products/services

July: Review committees' reports and quarterly results

September: Review compliance and internal audit

October: Review committees' reports and quarterly results

December: Review following year's budget

4 Useem, M. (2006). How Well-Run Boards Make Decisions. *Harvard Business Review.*

Meeting agendas

Based on the annual calendar, agendas should be drafted for each board and committee meeting, outlining exactly what is to be discussed. Agendas should be circulated, along with any background documents, with enough time for members to review the material. Where possible, these packages should indicate what decisions are to be made at the meeting. This will help ensure all members come to meetings prepared to discuss and make decisions on the specific issues.

Effective meetings

Sharing agendas ahead of time is one of the most important steps to running an effective meeting, but how the meeting itself is run is also key. Ensure every meeting includes some time to hear from the CEO. As the board member most familiar with the ins and outs of the business, it's important for them to have the opportunity to raise any concerns or issues the board needs to know about.

Before getting into the main agenda, members should be invited to add any pressing items that are not already covered. Proceed through the agenda, allowing enough time for a fulsome discussion of each point, but trying not to get too far off schedule. If the agenda calls for a decision to be made, ensure the decision is made and recorded before moving on to the next item.

It is also advisable to schedule an in camera portion of each meeting where the non-executive directors can also discuss matters without management present.

After the meeting is over, it can be beneficial to solicit feedback from attendees on what worked and what could be improved for the next meeting.

The art: Balancing perspectives

Many aspects of corporate governance are vitally important but difficult to apply hard-and-fast rules to. Experimentation and collaboration may be required to find the right approach for each individual company. The following sections outline some matters for consideration.

Open communication and transparency

For a board to be effective and make the best decisions for a company, directors must understand what's going on with the business. That means the CEO and other executives need to communicate with the board, and the board needs to be open to that communication.

Directors should read all reports and briefings they receive and ask questions about anything that's not clear. CEOs should not seek to hide any relevant information from the board—even if it doesn't reflect particularly well on them. It is also critical for the information to be presented in an accessible way so directors can understand what they're being told and get up to speed on key issues without getting bogged down in unnecessary details. At the same time, boards should be prepared to explain their rationale for making decisions.

Keeping the lines of communication open in both directions will help create a culture where management and the board work together instead of seeing each other as adversaries.

Director commitment

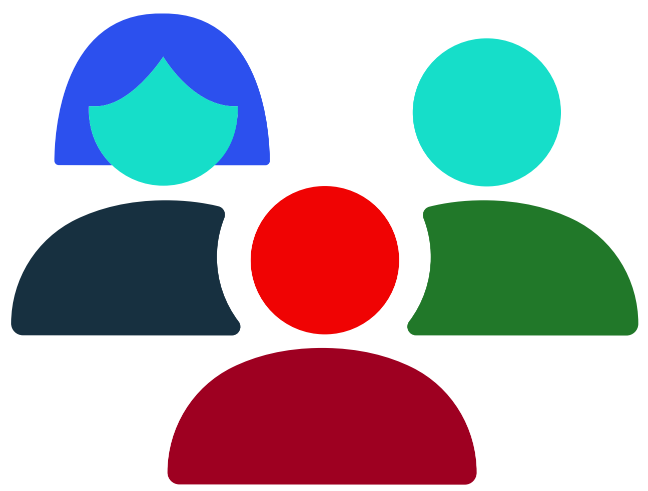
One of the challenges a company may face is absenteeism and lack of commitment or availability from some directors. Directors, particularly those chosen for their skills or expertise, often develop that expertise through their involvement with multiple businesses. However, that involvement can sometimes lead to a split focus, and some directors may not be able to devote as much of their time and energy to a company as is required.

For this reason, it's wise to develop a policy on expectations of individual board members, including specifics on absenteeism and how to deal with a director who routinely demonstrates a lack of commitment to the company or is simply not available—up to and including dismissal from the board. The policy should be clear enough to be enforceable, but flexible enough to allow individual circumstances to be taken into account.

Conflict management

In any situation involving multiple people, conflict is inevitable. Whether it's conflict between management and the board, between individual board members, or between various stakeholder groups, there needs to be a process in place that ensures all perspectives are considered so a fair and reasonable decision can be made. Depending on the conflict, this can range from informal discussion to more formal negotiation. In extreme cases, it could even involve the use of an external mediator or arbiter.

The art:
Balancing perspectives (cont'd)



Board refreshment

To keep them functioning at their best, boards need to be refreshed periodically. This involves replacing existing directors with new ones who bring fresh perspectives and insights.

Refreshment processes may include term limits, age limits and/or regular board evaluations. Ideally, refreshment will be achieved through a combination of all three and otherwise in accordance with established expectations.

Board diversity

In general, recruitment efforts, whether for refreshment or expansion, should consider not only the desired skills, but also diversity characteristics. Companies should consider setting targets (for the company overall as well as the board) to ensure diversity remains a priority.

While some have argued that setting targets risks diluting the quality of the board, the evidence does not support this concern. Studies have shown repeatedly that there is no lack of quality candidates who are women, Indigenous, members of visible minorities or who have disabilities, and that their inclusion is associated with better performance overall.[5]

Advantages of board refreshment

- Need for independent directors: The longer an independent director stays on the board, the less independent they become, which diminishes some of what they bring to the table. While they still have their skills and expertise, they lose the external perspective that enables them to provide more impartial third-party counsel. Refreshment allows new directors to come on board to provide that independent perspective.
- Emerging areas: As a business grows, it may expand into new areas that require new skills that current directors may not have. Refreshment enables those skills to be added to the board.
- Diversity: An expanding body of research is showing that diverse companies (including boards of directors) perform better economically, environmentally and culturally. Refreshment enables a company to recruit more women, Indigenous people, members of visible minorities, people with disabilities and others with valuable perspectives.

5 Dey, P. & Kaplan, S. (2021). 360° Governance: Where Are the Directors in a World in Crisis?

What's next for corporate governance?

While the basic principles of corporate governance remain the same, shifting priorities and contexts change what it looks like over time.

Today, [environmental, social and corporate governance (ESG)] are top of mind for many companies, investors and consumers. This makes issues like environmental impact and diversity, equity and inclusion (DEI) more important than ever. Where ESG initiatives once generally took a backseat to profitability, today they are just as important—and often contribute positively to profitability. Many investors and stock indexes require listed companies to report on ESG metrics, and some investment portfolios specifically prioritize them, so companies can no longer consider these aspects "bonuses." They are now core parts of a company's offering, and boards need to account for that in their decision-making processes.

A related issue is corporate activism. Historically, many businesses avoided taking an explicit stand on political or social issues, preferring to focus on their product or service. However, younger generations of consumers tend to consider their own values when making purchasing decisions. They expect businesses to make their positions known and prefer to buy from companies whose values align with theirs. While stating a position does risk alienating consumers on the other side of the issue, remaining silent may be an even bigger risk, leaving both sides unsatisfied. This requires boards and companies to take a bolder approach to public statements about potentially controversial issues and weigh the risks of such statements differently than in the past.

Technology is also changing the face of corporate governance. The emergence of generative artificial intelligence (AI) is causing massive disruptions, with effects that can't even be predicted yet. The rapid proliferation of cloud-based services is decreasing start-up costs and causing its own shift in governance. Older technology required significant investments of capital, which meant businesses were often highly dependent on investors, and this tended to give those investors greater influence on boards of directors. With cloud-based services, investment demands are lower, enabling founders and CEOs to retain more control over their companies for longer.[6]

6 Ewens, M. & Malenko, N. (2022). Board Dynamics over the Startup Life Cycle.

Corporate governance matters

Corporate governance is a vital part of any business that affects everything from long-term strategic planning to basic operational decisions. It can have a tremendous impact on a business's ability to grow and succeed, so it's important to take time to get it right.

Choose your board of directors carefully and foster an environment of open communication and collaboration between management and the board. Draft charters with clear expectations to keep everyone aligned and accountable.

As your company and your board grow, keep the lines of communication open. Develop and follow key processes, but be prepared to adjust them according to the specific needs of your business. Look for ways to incorporate a wide range of perspectives and aim to balance ongoing board refreshment with knowledge transfer and continuity.

Keep abreast of trends in the business world that can affect how your business is governed, including the growing role of ESG concerns and the ways technology affects governance needs and processes.

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1-888-INFO-BDC
info@bdc.ca

bdc.ca

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