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The Board of Directors: An Untapped Resource?

By Tilman Bender, President, T. H. Bender & Partners, Chicago

T. H. Bender & Partners ("THB&P") recently announced the results of an analysis comparing corporate governance indicators of publicly traded U.S. biotech and pharmaceutical companies with corporate governance indicators from American subsidiaries of foreign-owned, globally operating corporations. The purpose of the analysis is to provide non-U.S. headquartered companies insight into the best corporate governance practices as exemplified by the leading biotech and pharmaceutical companies. It also aims to demonstrate ways to improve local and global performance and shareholder value.

THB&P is a leading privately held management consulting and executive search firm and counts among its clients many internationally renowned companies entering or expanding their U.S. markets.

It is commonly accepted in the United States that a diverse board (in addition to complying with regulatory demands such as the Sarbanes-Oxley act and numerous, stock exchange driven initiatives) leads to successful corporate performance. However, it appears that this knowledge has only infrequently filtered down to the level of the U.S. subsidiary of overseas companies. For example, less than 20% of directors at the board of U.S. subsidiaries are outside directors while 85% of directors at leading publicly traded U.S. pharmaceutical and biotech companies are classified as outside directors. Examined closer, these numbers are even more lopsided as one realizes that the outside legal counsel is almost always a member of the board. Considering the ties to the client and the small size of the typical board of the subsidiary, one can in fact conclude that the overwhelming majority of boards of U.S. subsidiaries have no truly independent directors. This is amazing considering the fact that most internationally experienced executives admit that the U.S. market and business culture are very different from their home markets – regardless of whether the home market is in Europe or Asia.

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Additional FDA Fast Track Designation for Basilea's Novel First-In-Class Antibiotic

Basilea Pharmaceutica AG announced that it received a second fast track designation from the U.S. Food and Drug Administration (FDA) for its novel broadspectrum, first-in-class antibiotic BAL5788. The additional fast track designation covers hospital-acquired pneumonia including ventilator-associated pneumonia due to suspected or proven methicillin-resistant *Staphylococcus aureus* (MRSA). Fast track designation is designed to expedite the availability of treatments that address unmet medical needs for serious and life-threatening diseases. The growing incidence of serious infections caused by antibiotic-resistant bacteria is a matter of increasing global medical concern. In March 2003 the FDA granted BAL5788 fast track designation for the treatment of complicated skin and skin structure infections due to methicillin resistant *Staphylococcus* species. BAL5788 has completed phase II clinical development and is anticipated to enter phase III later this year. Basilea Pharmaceutica AG is an independent biopharmaceutical company headquartered in Basel, Switzerland.

Key July Events

Trax 2004: Pharmaceutical Supply Chain Summit

July 20-22, 2004
Hilton Washington and Towers
Washington, D.C. (USA)
Website: www.traxsummit.com

BioArrays-2004-New York Meeting

July 26-27, 2004
Holiday Inn Midtown,
New York, N.Y. (USA)
Website: www.expressgenes.com/BioArrays
2004-main.htm

2004 Yeast Genetics & Molecular Biology Mtg (by Genetics Soc. of Amer.)

July 27 – Aug. 1, 2004
University of Washington, Seattle (USA)
Website: genetics.faseb.org/genetics/yeast



Commentary and Analysis

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The Board of Directors: An Untapped Resource?

However, market participants (investors, clients, academia, licensees and licensors, distribution partners, potential recruits etc.) are focusing on the makeup and caliber of the board of directors and are using this to ascertain if the company can expect a positive trajectory in one of the largest markets in the world with significant impact on the overall performance of the parent company.

While building an effective board is a custom made process requiring a serious time commitment, it is a unique opportunity to not only bridge competency gaps but utilize a vast network of industry contacts. In other words, the careful engineering of a local board whose makeup reflects corporate long and mid-term challenges in the United States can add huge value to any company seriously considering a profitable, long-term engagement.

One of the first steps of assessing the potential success of a company's U.S. board is to assess the success of those of other companies. While the current makeup of the boards at publicly traded U.S. companies is frequently designed to meet the requirements of newly introduced corporate governance regulations, comparing a board with that of a respected company leads to valuable insight into ways to improve the performance of an existing board and make it compatible with current market challenges.

Based on the 2003 proxies (as well as some from 2002) the board composition of the ten leading biotech and ten bellwether pharmaceutical companies was reviewed. While it is difficult to gain significant insight into the board structure of companies held by overseas interests, by tapping into the more than 35 years of cumulative firm experience in senior executive level search and organizational development, it is possible to develop an extraordinary level of insight into the inner workings of the U.S. subsidiaries of international companies and their relationship to their corporate parents.

While comparing these publicly traded biotech and pharmaceutical companies demonstrates some important differences, the comparison of the boards of these very successful companies with the makeup of the board of subsidiaries of international companies provides some very telling distinctions.

The results of this analysis showed that there is ample room to improve market performance of both subsidiary and parent by introducing significant changes to the existing makeup of the local board of directors.

Pharmaceutical boards tend to be bigger than the boards of biotech firms while the boards of U.S. subsidiaries are comparatively small. Pharmaceutical and biotech boards are equally independent as measured by the number of outside directors, but the directors of U.S. subsidiaries are mostly insiders whose financial interests are closely aligned to the U.S. subsidiary and the goodwill of her executives.

- While 70% of the biotech boards have 10 or less directors, 60% of pharmaceutical boards have 11 or more directors. Most U.S. corporations owned by

overseas parents have five or less directors. It can be safely assumed that more than half of all subsidiaries with sales of less than \$50 million have three or even less directors. Only when company revenue exceeds \$250 million a significant increase in the number of directors can be measured -- approximately a fifth of the surveyed companies with U.S. revenues exceeding \$250 million have 8 or more directors. But even among these companies, almost two thirds have no more than five directors.

- Biotech and pharmaceutical boards have virtually the same relationship between outside and inside directors, 15% inside directors versus 85% outside directors. This is almost the opposite of the ratio at most U.S. subsidiaries, where the board is mostly staffed with current employees from the company and its parent corporation. If a stricter, yet commonly accepted definition of "independent director" is used (Pfizer for example defines an "independent" director as one who has no relationship to the Company that may interfere with his or her exercise of independence from management and the Company and who has no material relationship with the Company other than as a director) this means that the outside legal counsel is defined as insider. This results in the fact that the overwhelming majority of directors at U.S. subsidiaries has a direct link to the executive management and can not be considered truly independent.

Biotech firms pay significantly less annual retainers than Pharmaceutical companies. Subsidiaries frequently pay no annual retainers, but higher meeting fees than either biotech or pharmaceutical companies.

- All surveyed publicly traded companies pay an annual retainer to their outside directors. Our research indicates that as many as 40% of subsidiaries do not pay a retainer to their outside directors. However, as legal counsel is frequently the only "outside" board member, the reimbursement for his or her time investment is typically based on the hourly rate usually billed.
- The highest annual retainer documented is \$80,000; the average annual retainer for an outside director is \$26,500 at biotech and \$40,500 at pharmaceutical companies. More than half of the surveyed pharmaceutical companies pay annual retainers of \$40,000 or more, whereas none of the biotech companies pays more than \$40,000 p.a. If a U.S. operation of an international company pays a retainer, research indicates that the retainer is around \$13,000.
- In addition to the annual retainer 90% of the biotech companies and 80% of pharmaceutical companies pay meeting fees. The average meeting fee among the biotech firms which pay these fees the average reimbursement was almost \$1900 versus almost \$1400 at pharmaceutical companies. Directors at U.S. subsidiaries frequently receive a meeting fee in addition to the customary expense reimbursement. Research indicates that these meeting fees are significantly higher (around \$4000). One explanation for this apparent contradiction could be that these "outside" directors are frequently lawyers who



calculate their meeting fee based on an hourly rate. Another explanation is that the board meetings are less frequent and as a result require more up-front work.

- The board of subsidiaries does not meet frequently (more than two-thirds meet only once or twice annually) whereas the average biotech board holds 6.3 meetings per year.

No discussion about the compensation of directors would be complete without mentioning stock options and other compensation mechanisms related to equity. All surveyed publicly traded companies offer attractive stock option plans to their outside directors, whereas participation at the parent's stock option plans is much less utilized as a compensation tool among the U.S. subsidiaries.

The CEOs of pharmaceutical and biotech companies tend to be also Chairman of the board. The U.S. subsidiaries frequently do not follow that trend.

- In all surveyed pharmaceutical companies, the CEO is also the Chairman of the Board. However, in 20% of the sampled biotech firms the post of the Chairman is not taken up by the CEO. Usually, a senior executive of the overseas parent holds the position of Chairman of the Board, reflecting the dependency of the subsidiary from its parent.

The results of the analysis confirm significant room for improvement of the governance of incorporated U.S. subsidiaries. Day to day pressures are much more directly felt by executives of subsidiaries and the time requirements to improve board performance can be significant – especially if no leverage is provided. Therefore, it is in every corporation's and executive's best interest to take a hard look at their current board to determine if it's composition still meets the companies mid- and long term strategy in the United States.

Aligning the local board with the customs and requirements of the U.S. market can have extraordinary, synergistic benefits for the overseas parent company; the American market is in many industries not only the most competitive and mature but one most frequently serving as an indicator of worldwide trends by providing valuable intelligence signaling opportunities and threats.

A more independent U.S. board, staffed with high-caliber individuals who have their pulse on the domestic market, science, technology and best industry practices is probably one of the best and least expensive ways to proactively transmit highly relevant market developments into any global organization.

Additional points to consider:

- How long have your directors served on the board (if longer than 5 years, are they still truly independent)?
- How close are your directors to the U.S. market?
- What motivates your outside directors?
- How knowledgeable are inside and outside directors about current science, technology and business trends in the United States?
- Does the meeting schedule allow directors to focus on specific issues or does the meeting schedule only allow them a cursory look into important events, projects and activities?
- Are the current directors encouraged and motivated to have a meaningful dialogue with decision makers locally and at the overseas parent?
- Does the company offer new board members an orientation program?
- Do directors who are not employees of the company meet without management participation in regular sessions?
- Are a director's fees the sole compensation received from the company?

Tilman Bender
 T. H. Bender & Partners
 500 N. Michigan Avenue, Suite 300
 Chicago, IL 60611 USA
 Tel.: +1 312-396-4120
 Fax: +1 312-264-0202
 Tilman.Bender@thbender.com

How does your board compare?							
	Top* 10 Pharmaceutical Companies			Top* 10 Biotech Companies			Your Board
	Average	Low	High	Average	High	Low	
Number of Directors	11.2	7	15	9.9	15	7	
Percentage of outside directors	85%	57%	93%	86%	91%	67%	
Length of term	1.4	1	3	2.2	1	3	
Average age of directors	61	58	68	60	69	51	
Percentage of female directors	14%	0%	25%	12%	22%	0%	
Average Board retainer	\$40,550	\$20,000	\$80,004	\$26,500	\$40,000	\$10,000	

* as measured by revenue