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Assisting Directors in the Discharge of Their Fiduciary Duties

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**The Role of Corporate Governance in Reducing Agency Problems and
Assisting Directors in the Discharge of Their Fiduciary Duties**

Thierry Dorval

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THE ROLE OF CORPORATE GOVERNANCE IN REDUCING AGENCY PROBLEMS AND ASSISTING DIRECTORS IN THE DISCHARGE OF THEIR FIDUCIARY DUTIES¹

INTRODUCTION

The last decade has seen many developments in the corporate governance field. Financial scandals captivated public attention. In response, regulators adopted new rules and guidelines. Academics also devoted substantial time and energy to numerous issues prompted by the ongoing debates in that area.² But what is “corporate governance”? This expression has been defined in many ways.³ Often quoted is a definition provided in the Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, released in 1994 (the “Dey Report”):

“Corporate governance” means the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value, which includes ensuring the financial

¹ The text of this thesis is up to date as at March 3, 2007. The author wishes to thank his family and friends for their constant support, as well as Professor J. Anthony VanDuzer, for his precious advice.

² Corporate governance irregularities at Enron, Worldcom and Hollinger, among others, have triggered the adoption of a multitude of new rules and guidelines described in this thesis. See: Gordon, J.N. “What Enron Means for Management and Control of the Modern Business Corporation: Some Initial Reflections” (Columbia Law School, Working Paper No. 203, Summer 2002), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007); Gordon, J.N., “Governance Failures of the Enron Board and the New Information Order of the Sarbanes-Oxley” (Columbia Law School, Working Paper No. 216, March 2003), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007); Coffee, J.C., “What Caused Enron?: A Capsule Social and Economic History of the 1990’s” (Columbia Law School, Working Paper No. 214, January 2003), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007); Fleischer, V. “Enron’s Dirty Little Secret: Waiting for the Other Shoe to Drop” (Columbia Law School, Working Paper No. 200, February 2002), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007); Perino, M.A., “Enron’s Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002” (Columbia Law School, Working Paper No. 212, October 2002), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007); LeBlanc, R., “Preventing Future Hollingers” (2004) Ivey Bus. J. 1.

³ See for instance Priest, M. & Nathan, H.R., *Directors’ Duties in Canada: Managing Risk*, 2nd ed. (Toronto: CCH, 2002), at 2.

viability of the business. The process and structure define the division of power and establish mechanisms for achieving accountability among shareholders, the board of directors and management. The direction and management of the business should take into account the impact on other stakeholders such as employees, customers, suppliers and communities.⁴

This definition takes into account both the intrinsic particularities of the corporation and the way the organization interacts with its external environment. Some authors have chosen an interpretation of corporate governance more focused on the external environment in describing this expression as “a way to maximize wealth creation in a manner that does not impose inappropriate costs on third parties or on society as a whole”.⁵

The objective one sees for corporate governance will have an impact on the definition he or she chooses for that expression. This thesis studies how corporate governance should promote strong, viable and competitive corporations, with a view to maximizing shareholders’ wealth.⁶ In this thesis, minimizing negative effects on other stakeholders is subordinated to this objective. Although we are aware of the well-developed debate as to whether or not corporate governance should take into account the

⁴ Toronto Stock Exchange Committee on Corporate Governance in Canada, *Where Were the Directors?* (Toronto: TSX, 1994), at 7.

⁵ Kakabadse, A. & Kakabadse, N., *The Geopolitics of Governance* (London: Palgrave, 2001), at 19.

⁶ Hence, in the debate between the shareholder wealth maximization norm and the stakeholder-protection/social responsibility school, we assume the superiority of the former. We endorse the judicial rhetoric used in *Dodge v. Ford Motor Co.*, 170 N.W. 668, (Mich. 1919) at 684: “A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes. See: Bainbridge, S.M., “In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green” (1993) 50 Wash. & Lee L.R. 1423; Winkler, A., “Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History” (2004) 67 L. & Cont. Prob. 109; Friedman, M., “The Social Responsibility of Business is to Increase its Profits” N.Y. Times, Sept. 13, 1970, at 6; Daniels, R.J., “Must Boards Go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance”, [1994-95] 24 C.B.L.J. 229; and Joint Committee on Corporate Governance, *Beyond Compliance: Building a Governance Culture* (Toronto: TSX 2001), at 7. For the opposite view, see: Green, R.M., “Shareholders as Stakeholders: Changing Metaphors of Corporate Governance” (1993) 50 Wash. & Lee L.R. 1409 and Chapman, B., “Corporate Stakeholders, Choice Procedures and Committees” (1995-96) 26 C.B.L.J. 211.

interests of stakeholders other than shareholders,⁷ resolving the debate is far beyond the scope of this thesis. Our focus is on the relationships between shareholders, directors and managers and, in particular, on the role of corporate governance practices in ensuring that directors and managers are accountable to shareholders. We leave the analysis of the protection of non-shareholder stakeholders to others.

The scope of the thesis is thus centered on internal characteristics of the corporation. Along these lines, some authors have proposed that corporate governance be described as “the relationship between the management of public corporations and their shareholders”.⁸ Although this definition is made appealing by its minimalism, it implicitly includes the board of directors as part of management. As this thesis will illustrate, the board of directors is a distinct, essential actor in corporate governance. It should be independent from management in order to best monitor managers. Consequently, for the purpose of this thesis, we would define corporate governance as

⁷ *Ibid.* See also the decision of the Supreme Court of Canada, in *Peoples Department Stores Inc. (Trustee of) v. Wise*, [2004] 3 S.C.R. 461, in which the Court seems to allow directors, when considering the discharge of their duty of care, to take into consideration the interests of various stakeholders. This judicial opening echoes the claim of tenants of the stakeholder model, pursuant to which directors would have a fiduciary duty to “anyone who has a claim or stake in the firm” (See: Kakabadse, A. & Kakabadse, N., *supra* note 3, at 19. In Canada, see: Canadian Democracy and Corporate Accountability Commission, *The New Balance Sheet – Corporate Profits and Responsibility in the 21st Century* (Toronto: 2002). We believe that one should be very cautious in importing stakeholder theory principles into our corporate law. Considering the best interests of a broader group than the corporation’s shareholders may, in many circumstances, have important adverse consequences. Should a conflict arise between the interests of various stakeholders, directors could be in a position to choose whose interest to serve. Should a complaint be made about a decision or a course of action that would not be in the best interests of all stakeholders, the board could always demonstrate that, in its judgment, the interests of one stakeholder took precedence over the interests of another. When directors are able to avoid accountability altogether, fiduciary duties are then eviscerated. The result of a director being allowed to consider the interests of a broad range of different constituencies may be that, in fact, he or she is answerable to none (see: Daniels, R.J., *supra* note 6, at 231; and Chapman, B., *supra* note 6. Opinions on the stakeholder model depend on where one sees the greater danger. Those (like us) who are afraid of a lack of directors’ accountability will prefer a greater consideration to maximize shareholder wealth when considering the best interests of the corporation. Those who see other values at risk, such as potential harm inflicted by a corporation to its creditors, employees or the environment, may prefer that boards be allowed to take into account interests of other constituencies (see: Booth, R.A., “Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)” (1998) 53 Bus. Law. 429, at 442), even if the interests of these constituencies can also be protected through statutory provisions.

⁸ Michael, D.C., “Untenable Status of Corporate Governance Listing Standards Under the Securities Exchange Act” (1992) 47 Bus. Law. 1461, at 1463.

“the allocation of responsibilities and power among corporations’ shareholders, board of directors and management”.

The allocation of responsibilities and power between shareholders, the board of directors and management involves tensions, resulting from conflicting interests between these three groups. As will be demonstrated in the first part of this thesis, the separation of ownership and control in publicly listed corporations creates what economists call “agency costs”. These costs are present in any relationship involving an agent and a principal. In the corporate governance context, the shareholders are the beneficiaries of the corporation’s assets and activities, whereas directors and management (through delegation by the board of directors) can be seen as shareholders’ agents.

As explained in the first part of the thesis, agency problems include costs of misappropriation and costs of mismanagement. Costs of misappropriation represent the loss, for a corporation (and its shareholders), resulting from a wrongful appropriation of corporate assets or opportunities by directors or management of the corporation. As for costs of mismanagement, they represent the loss resulting from the inactivity or from bad decisions or actions of directors and managers who do not devote sufficient time and energy to the business and affairs of the corporation. In corporations that are controlled by particular shareholders, agency costs may be borne unequally between majority and minority shareholders since the majority shareholder may be in a position to influence the directors and management of the corporation to adopt corporate policies and take decisions that are favorable to the majority shareholder but detrimental to minority shareholders’ interests.

After a discussion on the sources and the scope of agency problems, Part I of the thesis will explain that fiduciary duties, which we define as being composed of the duty of loyalty and the duty of care, create potential liability for directors that in itself must be addressed by a board of directors. It then explains the interaction between agency costs and fiduciary duties. It shows that fiduciary duties are the main legal response to agency problems, in that they may help control and, to a certain extent, decrease agency costs.

The thesis describes how the duty of loyalty was developed to protect shareholders against costs of misappropriation by directors and management, while the duty of care protects shareholders, to a certain extent, against costs of mismanagement.

The first part concludes that the effectiveness of fiduciary duties is limited and, in particular, that the duty of care is seriously undermined by the business judgment rule. Empirical data is offered to show that enforcement of directors' liability is rare and not efficient from the point of view of investors, and that left alone, fiduciary duties are inadequate to reduce agency costs.

The second part of the thesis shows how good corporate governance practices may be used to complement fiduciary duties in reducing agency problems and at the same time assist directors in the discharge of their fiduciary duties. The thesis categorizes all corporate governance practices under two concepts. It first introduces the concept of independence and explains why true outsiders who maintain a climate of creative tension (defined as an attitude of constructive skepticism between the board and management) are essential to the decrease of agency costs resulting from misappropriations. We then describe how independence practices can help directors in the discharge of their duty of loyalty.

After having reviewed the benefits of independence, the thesis turns to the concept of active monitoring. This concept is defined as a combination of practices that a board of directors adopts to monitor management and corporate initiatives, directly or through the use of board committees, offering a balance between oversight and micro-management. The thesis explains the role of an active monitoring board in decreasing the costs of mismanagement and in increasing value for shareholders. It also explains that active monitoring is the appropriate solution to the discharge of the duty of care.

The thesis then describes the optimal way to implement corporate governance practices. It builds on the framework developed by Professor Anita I. Anand⁹ for determining which corporate governance practices should be mandatory and which should be voluntary. It finds that disclosure of corporate governance practices should be mandatory, while best practices should generally be described in guidelines adopted by regulators, which are voluntary.

Finally, the thesis reviews the current rules and guidelines of the Canadian Securities Administrators (the “CSA”) relating to corporate governance and proposes certain amendments thereto to implement the conclusions of the thesis regarding independence and active monitoring. In doing so, a very simple matrix is applied based on: i) the independence vs. active monitoring categorization developed in subsection II.A of the thesis; and ii) the proposed hybrid (mandatory/voluntary) framework described in subsection II.B thereof:

	Mandatory	Voluntary
Independence practices	A - Disclosure of independence practices against a mandatory template	B – Voluntary practices related to independence
Active monitoring practices	C - Disclosure of active monitoring practices against a mandatory template	D – Voluntary practices related to active monitoring

In short, the second part of the thesis includes measures for decreasing agency costs and discharging fiduciary duties, a model allowing a categorization of all corporate governance practices under independence and active monitoring principles, a suggested framework to help rationalize which practices should be mandatory and which should be

⁹ Anand, A.I., “Voluntary vs Mandatory Corporate Governance: Toward an Optional Regulatory Framework” (The Berkeley Electronic Press, Working Paper No. 566, 2005), online <<http://law.bepress.com/expresso/eps/566>> (date accessed: 3 March 2007).

voluntary and many proposals for improving Canadian rules and guidelines on corporate governance based on such framework.

Although the arguments and proposals developed in this thesis might be applicable to private corporations, this thesis focuses on rules applicable to public corporations. Specifically, the analysis concentrates on the corporate governance rules applicable to public corporations listed on the Toronto Stock Exchange (the “TSX”). This thesis focuses on the rules applicable to corporations listed on the TSX because it is the most important Canadian exchange and because the rules of the CSA regarding corporate governance¹⁰ have been inspired by, and complement the TSX rules.¹¹ Since the rules of the CSA on corporate governance were also influenced by the rules of the New York Stock Exchange (the “NYSE”),¹² the rules of such exchange and those of the U.S. Securities and Exchange Commission (the “SEC”) applicable to the corporations listed on that exchange will also be referred to, where applicable, in order to provide some historical background and suggested amendments to our rules.

In terms of corporate law, this thesis focuses on corporations governed by the *Canada Business Corporations Act*¹³ (the “CBCA”). However, because many provincial corporate statutes were inspired by the CBCA, most principles developed in this thesis may apply as well to corporations incorporated under provincial statutes. When useful to the discussion, the thesis will also analyze U.S. law. In doing so, it will concentrate on Delaware state law, and on the *Delaware Code on Corporation Law*¹⁴ (the “Delaware Code”) in particular. The reason for analyzing Delaware law is that in the U.S., state law governs such major corporate matters as the allocation of power between managers and shareholders, duties owed by directors to shareholders and fundamental corporate

¹⁰ Available at <http://www.csa-acvm.ca>.

¹¹ Available at <http://www.tsx.com/en/pdf/CompanyManual.pdf>.

¹² Available at http://www.nyse.com/pdfs/section303A_final_rules.pdf.

¹³ R.S.C. 1985, c. C-44, as am. R.S.C. 1985, c. 27 (1st Supp.), R.S.C. 1985, c. 27 (2nd Supp.), R.S.C. 1985, c. 1 (4th Supp.), S.C. 1988, c. 2, 1990, c. 17, 1991, c. 45, 1991, c. 46, 1991, c. 47, 1992, c. 1, 1992, c. 27, 1992, c. 51, 1993, c. 28, 1994, c. 21, 1994, c. 24, 1996, c. 6, 1996, c. 10, 1998, c. 1, 1998, c. 30, 1999, c. 3, 1999, c. 31, 2000, c. 12, 2001, c. 14, 2001, c. 27, 2002, c. 7, 2004, c. 25.

¹⁴ Del. Code Ann. tit. 8.

changes such as mergers and dissolutions.¹⁵ As a result of conscious policy decisions, Delaware has been chosen as the state of incorporation by more listed corporations than any other state, which has allowed for the development of a sophisticated case law. As a consequence of such development, Delaware has become a widely recognized leader in corporate law, and jurisprudence on directors' duties is more developed in Delaware than anywhere else in the U.S.¹⁶

Even though several statutory responsibilities of directors are examined, this thesis is not intended to constitute a full description of all statutory obligations imposed on directors. Hundreds of laws and regulations impose liabilities on directors, in fields such as securities, labour, tax and environmental law.¹⁷ It is not the purpose of this thesis to comment on all of these potential sources of liability, but to examine, in more general terms, the general principles of corporate governance, particularly from the point of view of corporate directors.

This thesis will focus on how corporate governance best practices may reduce agency costs and help directors discharge their fiduciary duties and how legal requirements and best practices should be implemented in order to meet these objectives. Hence, unless they have a direct impact on those questions, several subjects related to the corporate governance debate will not be analysed. For instance, the thesis will not directly focus on ethics and criminal provisions in shaping behaviours and accountability. Similarly, the thesis will not analyse the adequacy of existing accounting standards in fostering corporate controls. Furthermore, the thesis will not describe the

¹⁵ See for instance sections 141, 142, 146 and 251-270 of the Delaware Code; Bebchuk, L.A., "Federalism and the Corporation: the Desirable Limits on State Competition in Corporate Law" (1992) 105 Harv. L. Rev. 1435, at 1438.

¹⁶ Dooley, M.P. & Goldman, M.D., "Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law" (2001) 56 Bus. Law. 737, at 737; and Bebchuk, L.A., *ibid*.

¹⁷ See Sutherland, H., *Fraser & Stewart Company Law of Canada*, 6th ed. (Toronto: Carswell, 1993); Priest, M. & Nathan, R.N., *supra* note 3; McGuinness, K.P., *The Law and Practice of Canadian Business Corporations* (Toronto: Butterworths, 1999); and Bender, M., *Liability of Corporate Officers and Directors*, 7th ed. (New York: Lexis Nexis, 2002).

different roles and responsibilities of all market participants in corporate governance.¹⁸ Because these questions are also important, however, we hope that proposals described in this thesis will help in the development of best practices in those related fields.

¹⁸ For a description of the roles of auditors, legal advisors and other gatekeepers, see for instance: Coffee, J.C., "The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence, the Governance of Accounting" (Columbia Law School, Working Paper No. 191, May 21, 2001), online: <http://www.law.columbia.edu/center_program/law_economics (date accessed: 20 May 2005). See also Coffee, J.C., "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms" (Columbia Law School, Working Paper No. 237, September 2003) online: <http://www.ssrn.com/abstract=225500> (date accessed: 3 March 2007).

I. SOME CHALLENGES FACING BOARDS OF DIRECTORS TODAY

The first part of this thesis describes two challenges facing boards of directors today. The first one relates to agency problems existing between corporate shareholders, on the one hand, and directors and management of corporations, on the other hand. The second challenge concerns the discharge by directors of their fiduciary duties. As it will be explained hereafter, these two challenges are interconnected as fiduciary duties can be considered as an imperfect attempt to address agency problems.

A. AGENCY PROBLEMS

This subsection describes the source and nature of agency problems. It shows how the dispersal of ownership and deterrents to shareholders' involvement have created agency problems. Agency theory demonstrates the inherent conflicts between the interests of shareholders, on the one hand, and directors and management, as their agents, on the other hand. It explains why individual and institutional shareholders under-invest in the monitoring of the corporation and why directors and management may adopt opportunistic behaviours in their relationship to the corporation. It also describes why, in the context of a corporation with a majority shareholder, the agency costs may be borne unequally between majority and minority shareholders. In order to better explain the tensions and conflicts between shareholders and their agents, this subsection categorizes agency costs into costs of misappropriation and costs of mismanagement (as those expressions are defined below) and describes the scope of these costs.

1. THE SOURCE OF AGENCY PROBLEMS: THE SEPARATION OF OWNERSHIP AND CONTROL

This subsection generally describes how the dispersal of ownership creates and accentuates agency problems. It first refers to the Berle and Means model and explains why individual and institutional shareholders have very few incentives to monitor the

board of directors and management of the corporations in which they invest. It then describes the special case of controlled corporations, which, as we will see, is especially relevant in Canada.

(a) The effects of the dispersal of ownership

(i) *The Berle and Means model*

It is not surprising to learn that North American securities rules were born out of financial scandals. Financial scandals often create a climate where the public requests financial reforms. Hence, in the U.S., the Great Crash of 1929 resulted in the adoption of the *1933 Securities Act*¹⁹ (the “1933 Securities Act”) and the *1934 Securities and Exchange Act*²⁰ (the “1934 Securities and Exchange Act”) and the explosion of the Internet bubble and recent financial scandals triggered the adoption of the *Sarbanes-Oxley Act of 2002*²¹ (the “Sarbanes-Oxley Act” or “SOX”). As it will be demonstrated in Part II of this thesis, securities legislation has facilitated the expansion of securities markets by ensuring that minimum standards were met by reporting issuers to respond to the concerns of investors.²²

In the last centuries, many other factors have contributed to the development of securities markets and the creation of widely owned corporations. One of these factors is the limited liability of shareholders, which was implicitly recognized in certain English statutes and first affirmed by the House of Lords in the English case *Salomon v. Salomon & Co., Ltd.*²³ Since that case, corporations have been described as analogous to independent persons, with their own rights and liabilities, their shareholders being

¹⁹ 15 U.S.C. 77a *et seq.*, as amended.

²⁰ 17 U.S.C. 78, as amended.

²¹ 15 U.S.C. 7262, as amended.

²² Glassman, C.A., “Sarbanes-Oxley and the Idea of “Good” Governance” (American Society of Corporate Secretaries, Washington D.C., 27 September 2002), online: <<http://www.sec.gov/news/speech/spch586.htm>> (date accessed: 3 March 2007); see also Michael, D.C., *supra* note 9.

²³ [1897] A.C. 22 (H.L.).

therefore substantially insulated from liability to third parties, except in limited circumstances.²⁴ Because of the decrease in the risk of being liable to third parties, individual shareholders became more inclined to invest their savings in corporate ventures and such diversification contributed to the development of securities markets and the creation of widely held corporations.

Political, technological, legal and economic preconditions have also facilitated the growth of widely owned corporations.²⁵ From the middle 19th century, progress and business conditions increased firm demand for capital.²⁶ Techniques of mass production emerged in North America,²⁷ made possible by lower transportation and communications costs.²⁸ Jensen describes as follows the revolution that started in the middle of the 19th century:²⁹

The mid-nineteenth century witnessed [a] wave of massive change with the birth of modern transportation and communication facilities, including the railroad, telegraph, steamship, and cable systems. Coupled with the invention of high speed consumer packaging technology, these innovations gave rise to the mass production and distribution systems of the late nineteenth and early twentieth centuries [...]. The dramatic changes that occurred from the middle to the end of the century clearly warranted the term "revolution". The invention of the McCormick reaper (1830s), the sewing machine (1844), and high volume canning and

²⁴ For case law and authors on the "lifting of the corporate veil", see: *Houle v. Canadian National Bank*, [1990] 3 S.C.R. 122; *ADGA Systems International Ltd. v. Valcom Ltd* (1999) D.L.R. (4th) 351 (Ont. C.A.); Hamilton, S., "The Corporate Veil Reconsidered: Alternatives to Lifting the Veil", 1997-98, Meredith Lectures, Faculty of Law, McGill University, 257; and Martel, P., "Le "voile corporatif" et l'article 317 du Code civil du Quebec" (1995) 55 R. du B. No. 3, 447.

²⁵ Roe, M.J., "Political Foundations for Separating Ownership from Corporate Control" (Columbia Law School, Working Paper No. 155, August 21, 2000), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 45.

²⁶ *Ibid.*

²⁷ Romer, P. M., "Why, indeed, in America? Theory, History, and the Origins of Modern Economic Growth" (NBER Working Paper No. W5443, January 1996), online: <http://www.ssrn.com/abstract=225500> date accessed: 3 March 2007).

²⁸ Langlois, R. N., "The Vanishing Hand: The Changing Dynamics of Industrial Capitalism" (UConn Center for Institutions, Organizations, & Markets, Working Paper No. 01-1, September 14, 2001), online: <http://www.ssrn.com/abstract=285972> (date accessed: 3 March 2007).

²⁹ Jensen, M. C., "Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems" (Social Science Electronic Publishing (SSEP), Working Paper No. 456), online: <http://www.ssrn.com/abstract=93988> (date accessed: 3 March 2007).

packaging devices (mid-1880s) exemplified a worldwide surge in productivity that substituted machine tools for human craftsmen, interchangeable parts for hand-tooled components, and the energy of coal for that of wood, water, and animals. New technology in the paper industry allowed wood pulp to replace rags as the primary input material. Continuous rod rolling transformed the wire industry: within a decade, wire nails replaced cut nails as the main source of supply. Worsted textiles resulting from advances in combing technology changed the woolen textile industry. Between 1869 and 1899, the capital invested per American manufacturer grew from about \$700 to \$2,000.³⁰

At the same time, the development of stock exchanges allowed businesses to offer their equity to a vast number of potential investors while providing to these investors a market for the resale of securities. Corporate and securities laws were adopted to protect shareholders and investing in securities traded on stock exchanges became increasingly popular, allowing businesses to get a reliable source of financing and individuals to diversify their holdings.³¹

Berle and Means were among the first to foresee that most large public corporations would mature to an end-stage capital structure characterized by the separation of ownership and control.³² Berle and Means explained that since the equity of most U.S. corporations was widely owned through multiple, low-stakes holdings, shareholders were unable to exert meaningful control over management.³³ Under the Berle and Means model, separation of ownership and control is a necessary precondition for efficient corporate decision-making³⁴ and management constitutes a virtually autonomous organ of the corporation.³⁵ For Berle and Means, the words “management”

³⁰ *Ibid.*, at 3.

³¹ Roe, M.J., *supra* note 25, at 45.

³² Coffee, J.C., “The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control” (Columbia Law School, Working Paper No. 182, January, 2001), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 2.

³³ Daniels, R.J. & Waitzer, E.J., *Challenges to the Citadel: A Brief Overview of Recent Trends in Canadian Corporate Governance*, [1994] 23 Can. Bus. L.J. 23, at 24.

³⁴ Bainbridge, S.M., “Why a Board? Group Decisionmaking in Corporate Governance” (2002) 55 Vand. L. Rev. 1, at 4.

³⁵ Berle, A.A. Jr. & Means, G.C., *The Modern Corporation and Private Property* (New York: MacMillan, 1933), at 152.

or “managers” refer broadly to both directors and members of management (*i.e.*, officers) of a corporation. Shareholders contribute capital and bear risk, while directors and managers, through delegation by the board of directors, direct that capital in profit-making ventures. Such separation creates the possibility of significant gains from specialization. Many individuals may have capital to invest in a business enterprise yet lack the business acumen necessary to manage such a business. Others may have such acumen, but nevertheless wish to diversify their holdings by investing small sums in several different firms, without committing permanently to participation in any particular enterprise.³⁶ The multidivisional corporation described by Berle and Means allows shareholders to diversify their holdings and invest in corporations that are run by professionals.

Although the prediction of Berle and Means has been confirmed in the U.S., empirical evidence in other countries during the last century has shown contradictory trends. Instead of converging toward a single dispersed ownership model, the 20th century sometimes saw the growth, in many European countries such as France, Germany and Italy, as well as in Asian countries such as Japan and South Korea, of a concentrated ownership system, in which most corporations are controlled by a significant shareholder.³⁷ Evidence suggests that the Canadian market is somewhere in between, in that it includes many widely held corporations but also many Canadian corporations that are, in fact, controlled by a significant shareholder.³⁸ It has been affirmed that in 1996, in Canada, 75% of publicly listed corporations were controlled by a significant shareholder, compared to only 20% in the United States.³⁹ In this thesis, the expression “significant shareholder” refers to a security holder who owns or controls 10% or more of any class of an issuer’s voting securities, or is able to affect materially the control of the issuer, whether alone or by acting in concert with others, as defined in

³⁶ Meese, A.J., “The Team Production Theory of Corporate Law: A Critical Assessment”, 43 Wm and Mary L. Rev. 1629, at 1637; DeMott, D.A., “Challenges to Corporate Governance: the Figure in the Landscape: a Comparative Sketch of Directors’ Self-Interested Transactions” (1999) 62 Law & Contemp. Prob. 243, at 246.

³⁷ *Ibid.*

³⁸ Parizeau, R., “Multiple Voting Shares and Governance”, Director, Issue 122, October 2005, at 5.

Canadian National Instrument 58-101 – *Disclosure of Corporate Governance Practices* (“National Instrument 58-101”).⁴⁰ The word “control” generally refers to the direct or indirect power to direct or cause the direction of the management and policies of a person or company, whether through ownership of voting securities or otherwise, as defined in the Canadian Multilateral Instrument 52-110 - *Audit Committees* (the “Multilateral Instrument 52-110”).⁴¹

In the case of a corporation with a dispersed ownership, control could be exercised by someone who does not own the majority of the voting shares of a corporation but is nevertheless a significant shareholder. Such a person may own enough shares to direct the policies of the corporation. Similarly, many shareholders can agree, as part of a shareholder voting agreement (often referred to as a pooling agreement), to allow one of them to exercise all the votes attached to their shares. In such a case, the corporation can be considered to have a significant shareholder even though no single person owns a significant percentage of the shares of the corporation.

Accounting practices, culture, the size of corporations and the size of a nation’s capital markets might explain the differences in ownership structure around the world.⁴² Corporate rules and institutions of a country can also affect ownership structures of corporations that operate in that country.⁴³ For instance, it has been shown that the development of minority shareholder legal protections correlates with the evolution of the dispersal of ownership.⁴⁴ For instance, research of Professor La Porta of Harvard University suggests that the extent of legal protection of investors in a country is an

³⁹ *Ibid.*, at 7; See also La Porta, R., “Corporate Ownership Around the World” (1999), 54 J. of Fin. 471.

⁴⁰ (2005) 28 OSCB 3634. National Instrument 58-101 has been implemented in all Canadian provinces and territories.

⁴¹ (2004) 27 OSCB 3252; Multilateral Instrument 52-110 has been implemented in all Canadian provinces and territories except British Columbia.

⁴² Roe, M.J., *supra* note 25, p. 49; Roe, M.J., “A Theory of Path Dependence in Corporate Governance and Ownership” (Columbia Law School, Working Paper No. 131, November 1999), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 36.

⁴³ *Ibid.*, at 23.

⁴⁴ Roe, M.J., “Corporate Law’s Limits” (Columbia Law School, Working Paper No. 186, January 16, 2002), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 6.

important determinant of the development of its financial markets. La Porta used a sample of 539 large corporations in 27 countries and found that where laws protect shareholders and are enforced, investors are generally more willing to finance corporations and financial markets are broader and more valuable. In contrast, where laws are unprotective of investors, the development of financial markets is negatively affected.⁴⁵ A similar study was also conducted by Dyck and Zingales in 39 countries. They measured expropriation of shareholders based on 393 change of control transactions between 1990 and 2000 and found that in countries with a high degree of statutory protection and law enforcement, the levels of expropriation of minority shareholders are lower and capital markets are more developed.⁴⁶ Similarly, it was demonstrated that corporations from countries with strong institutions governing the exchange of securities tend to have a higher dispersal of ownership.⁴⁷

(ii) *The lack of involvement of individual shareholders*

Canadian and U.S. corporate laws are well adapted to the widely owned corporation described by Berle and Means, since those laws contemplate the separation of the ownership and control of corporations. Under subsection 102(1) of the *CBCA*, directors are given the power to manage (or supervise the management of) the business and affairs of the corporation:

102. (1) Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation.

⁴⁵ La Porta, R., Lopez-de-Silanes, F., Shleifer, A. & Vishny, R., "Investor Protection and Corporate Valuation" (2002) 57 J. of Fin. 1147.

⁴⁶ Dyck, A. & Zingales, L., "Private Benefits of Control: An International Comparison" (2004) 59 J. Fin. 537.

⁴⁷ Coffee, J.C., *supra* note 32, at 5, 6 and 69.

Similarly, subsection 141(a) of the Delaware Code provides that directors, rather than shareholders,⁴⁸ manage or direct the management of the business and affairs of the corporation:

141(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

In practice, as will be demonstrated in this thesis, directors delegate most of their powers to management, who run the day-to-day operations of the corporation. If directors may, in special circumstances, take part in the direct management of the corporation, shareholders, in contrast, almost never do. Therefore, as mentioned by the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise*⁴⁹ : “[c]onsiderable power over the deployment and management of financial, human and material resources is vested in the directors and officers of corporations”.⁵⁰

It is true that under the *CBCA*, shareholders keep certain powers. They elect directors and may theoretically remove them in mid-term.⁵¹ Shareholders must also approve certain fundamental corporate changes, including an amalgamation,⁵² continuance under the laws of another jurisdiction,⁵³ changes in the articles of incorporation or the corporate by-laws⁵⁴ and sale of all or substantially all of the assets of the corporation other than in the ordinary course of business.⁵⁵ At the annual meeting of

⁴⁸ See *Aronson v. Lewis*, 473 A.2d 805 (Del. Supr. Ct 1984), at 12.

⁴⁹ [2004] 3 S.C.R. 461.

⁵⁰ *Ibid.*, at 477.

⁵¹ Subsection 106(3) and section 109 of the *CBCA*.

⁵² Section 183 of the *CBCA*.

⁵³ Section 188 of the *CBCA*.

⁵⁴ Section 103 and 173 of the *CBCA*.

⁵⁵ Subsection 189(3) of the *CBCA*.

shareholders, directors must present the annual financial statements to the shareholders⁵⁶ and shareholders appoint auditors.⁵⁷ Shareholders may also make proposals for the nomination of directors, amendments to corporate articles or by-laws, or any other matter connected to the business and affairs of the corporation.⁵⁸

However, despite this list of powers, the statutory decision-making model is one in which the board and management act and shareholders, mostly, react.⁵⁹ This is mainly due to the lack of control by shareholders over the directors they elect and over the members of management who are appointed by those directors.⁶⁰ This problem stems from two sources: the dominance of the board by management and the lack of incentives of shareholders.

With respect to the dominance of the board by management, it has been proposed that in practice, it is often management, as opposed to shareholders, who has the biggest influence on the composition of the board of directors. Indeed, certain authors have demonstrated that the proxy mechanism (*i.e.* the mechanism pursuant to which management solicits procurations from shareholders to vote on the election of directors) was most often tilted in favor of the management slate, and that contested elections of directors rarely occurred outside the takeover context.⁶¹ The very low rate of success of shareholders in imposing their candidates at an election of directors may be explained by the way directors have traditionally been elected. In practice, a slate of directors is proposed by management for approval by the board and adoption by shareholders at the annual meeting of the corporation. Because in Canada corporate legislation only allows

⁵⁶ Subsection 155(1) of the *CBCA*.

⁵⁷ Subsection 162(1) of the *CBCA*.

⁵⁸ Sections 137 and ss of the *CBCA*. See MacIntosh, J.G., "Institutional Shareholders and Corporate Governance in Canada" (1995-96) 26 C.B.L.J. 145, at 153; and Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 47.

⁵⁹ Bainbridge, S.M., *supra* note 34, at 4.

⁶⁰ MacIntosh, J.G., *supra* note 58, at 153.

⁶¹ Bebchuk, L.A., "The Myth of the Shareholder Franchise" (John M. Olin Center for Law, Economics and Business, Discussion Paper No. 565), available online: <http://papers.ssrn.com/abstract=829804> (date accessed: March 3, 2007); Bender, M., *supra* note 17, at 1-4 and 1-5; and Strine, L.E., "Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle" (2002) 57 Bus. Law. 1371, at 1377.

shareholders to vote “for” directors or to “withhold” their vote,⁶² and because directors are often proposed as part of a slate, shareholders are usually unable to vote against directors or against a specific member of the slate.⁶³

Although we are not aware of any Canadian data on the question, in the U.S., empirical research conducted by Professor Bebchuk of the Harvard Law School shows that the incidence of successful electoral challenge of directors by shareholders is relatively low.⁶⁴ Professor Bebchuk summarizes his findings as follows:

During the proxy seasons of the 1996-2005 decade, incumbents faced challenges from rival slates seeking to manage their firm better as a stand-alone entity in only 118 cases, or roughly twelve a year on average. For companies with a market capitalization that exceeds \$200 million, the number diminishes to only twenty-four cases, or less than three a year. Furthermore, during this nine-year period, among targets with a market capitalization exceeding \$200 million, challengers won in only eight cases, less than one a year.⁶⁵

Professor Bebchuk explains that even when shareholder dissatisfaction with board or individual director’s actions and decisions is substantial, challengers face very important costs and uncertainties which are significant impediments to their action. A rival team seeking to replace incumbents may incur significant costs related to communication with other shareholders and dealing with incumbents’ legal challenges. Even when shareholders are dissatisfied with current board members, they must be convinced that the rival team (or individuals) offers a better alternative. In addition, although the challengers must bear the full procedural costs, they can only capture a

⁶² See for instance subsection 54(7) of the Canada Business Corporations Regulations, Can. Reg. 2001-512.

⁶³ In contrast, in the U.S., many states have adopted amendments to their corporate laws which allow corporations to amend their by-laws to specify the votes necessary for the election of directors. The Delaware Code further provides that where shareholders have adopted such provisions for corporate elections, a corporation may not return to plurality voting without shareholder approval. See: Verret, J., “Pandora’s Ballot Box, or a Proxy with Moxie? The Majority Voting Amendments to Delaware Corporate Law”, online: <http://papers.ssrn.com/abstract=800584> (date accessed: 3 March 2007).

⁶⁴ *Supra* note 61.

⁶⁵ *Ibid.*, at 1.

fraction of the benefits that the contest will confer on shareholders collectively, since an improvement of the management team will benefit to all shareholders.⁶⁶

Thus, directors, who should be elected by shareholders, have often been, in fact, chosen by managers. Recently, under the pressure of institutional investors, certain corporations have adopted a policy pursuant to which votes by ballot are taken for the election of directors and if a candidate for election at the board does not receive 50% of the votes expressed, he or she is expected to offer to tender his or her resignation.⁶⁷ However, such practice is not yet widely adopted. In such a context, many directors, who should promote the interests of all shareholders, face an important problem of legitimacy because of their possible gratitude toward the managers who proposed them. Their gratitude creates situations in which agency problems are more likely to exist because directors might feel accountable to and indebted toward management and act at the expense of shareholders.

A second reason why shareholders of widely owned corporations do not exercise control over the directors they elect is their lack of incentive to do so.⁶⁸ Shareholders, who only own a small fraction of the corporation, will not benefit sufficiently from spending the time, effort or money necessary to investigate corporate decisions. With the realization that the benefits of monitoring efforts will accrue to all shareholders but the costs will be borne by the monitoring shareholders only, each shareholder may prefer a free ride on the efforts of others. Of course, if it is rational for one, it is equally rational for all shareholders and sub-optimal monitoring will take place.⁶⁹ When shares are widely dispersed, no single shareholder has the incentive and resources to monitor directors and management closely.⁷⁰ Because mobilizing the large number of disparate

⁶⁶ *Ibid.*, at 10 and 11.

⁶⁷ See for example the proxy circular of the Royal Bank of Canada available on SEDAR at www.sedar.com.

⁶⁸ Daniels, R.J., *supra* note 6, at 238.

⁶⁹ MacIntosh, J.G., *supra* note 58, at 153; Daniels, R.J., *ibid.*, at 238; and Alarie, B.J., "Executive Compensation and Tax Policy: Lessons for Canada from the Experience of the United States in the 1990s" (2003) Vol. 61 No. 1 U.T. Fac. L. Rev. 41, at 47.

⁷⁰ Choi, S.J. & Talley, E.L., "Playing Favorites with Shareholders" (2002) 75 S. Cal. L. Rev. 271, at 314.

shareholders that would be needed to take a meaningful corporate action is difficult and costly, the relatively small financial stake of individual shareholders discourages collective activity.⁷¹

This problem is magnified by the fact that shareholders often lack the information that would be necessary to properly assess the performance of directors and management. Since directors and managers control the information released by the corporation, they have a clear advantage over shareholders who are dependent on what is issued by the corporation. Furthermore, even if all required information was available to shareholders, many would lack the expertise and resources to investigate fully as to whether or not their representatives acted properly. They would not be able to gather and analyse the information provided to them.⁷²

Thus, while the separation of ownership and control can produce important benefits, it comes with potential costs. By placing their capital under the control of specialists, shareholders subject themselves to risks of opportunism. Opportunistic behaviours can be divided in two categories: acts of misappropriation and acts of mismanagement. Those categories will be further described in subsection I.A.2 of this thesis. In both cases, however, as the number of shareholders grows, the temptation for opportunistic behaviours also potentially increases. Even if directors and management own equity interests in the corporation, which is often the case, the proportion of their equity interests compared to equity as a whole becomes smaller as the number of shareholders grows, so that in a publicly owned corporation, the loss that directors and management would incur from their opportunistic behaviours, compared to the benefits resulting from such behaviour, becomes relatively small and there is still an incentive for management and directors to favour their own interests.⁷³

⁷¹ VanDuzer, J.A., *The Law of Partnerships and Corporations* (Toronto: Irwin Law, 2003), at 252.

⁷² *Ibid.*

⁷³ *Ibid.*, at 252.

(iii) *The lack of involvement of institutional shareholders*

Institutional shareholders, with their expertise and important financial resources, are generally better equipped than individual shareholders to monitor the directors and management of a corporation. With larger stakes than individual shareholders, they also have greater incentives to do so, since: (i) holding a larger stake lowers the cost of monitoring relative to its benefit; and (ii) the larger the stake held, the greater the chance that the number of votes exercised by the shareholder will be important in determining the outcome of a shareholder ballot.⁷⁴ The two largest categories of institutional investors are pension funds and mutual funds.⁷⁵

Although, for a long time, the typical reaction of many institutional shareholders when dissatisfied by corporate performance was to “vote with their feet” (*i.e.*, to sell their investment and move on to a better choice),⁷⁶ institutional shareholders are increasingly important advocates of shareholder rights.⁷⁷ This may be due to the important increase in their share ownership over the last decades.⁷⁸ With a bigger financial stake in public corporations, institutional shareholders have greater incentives to monitor such corporations, since they have more to gain from such monitoring and more to lose if the corporation is not managed correctly. Nowadays, more than half of the listed share capital of large public Canadian and U.S. corporations is held by institutional investors.⁷⁹ Given their influence, they are under increasing pressure to become activist shareholders⁸⁰ and they have indeed increased their corporate activism.⁸¹ For instance, in

⁷⁴ MacIntosh, J.G., *supra* note 58, at 154.

⁷⁵ Dimma, W.A., *Excellence in the Boardroom* (Toronto: Wiley, 2001), at 180.

⁷⁶ Montgomery, K.E., *Market Shift – The Role of Institutional Investors in Corporate Governance*, [1995-96] 26 C.B.L.J. 189, at 192.

⁷⁷ Daniels, R.J. & Waitzer, E.J., *supra* note 33, at 33.

⁷⁸ DeMott, D.A., *supra* note 36, at 247.

⁷⁹ Veasey, E.N., “The Defining Tension in Corporate Governance in America” (1997) 52 Bus. Law. 393, at 401; Daniels, R.J. & Waitzer, E.J., *supra* note 33, at 33.; and Bender, M., *supra* note 17, at 1-4; Conference Board, *Commission on Public Trust and Private Enterprise: Findings and Recommendations*, Parts 2 and 3 (New York: Conference Board, January 2003), at 17.

⁸⁰ Pozen, R.C., “Institutional Investors: The Reluctant Activists” (1994) Jan.-Feb. Harv. Bus. Rev. 140, at 140.

Canada, the Canadian Coalition for Good Governance, which includes many institutional investors, is very active in monitoring the governance of public corporations.⁸²

There are many methods by which institutions may influence directors and managers of a corporation. These methods include: (i) voting (or threatening to vote) proxies independently of management; (ii) presenting (or threatening to present) a shareholder proposal at a corporation's annual shareholder meeting;⁸³ and (iii) pressuring management or the board of directors of a corporation to achieve a change in management or strategy.⁸⁴ Of course, better coordination between institutional investors translates into better chances of meeting their common objectives. In Canada, recent changes to the *CBCA* recently have facilitated communications between shareholders.⁸⁵ In the U.S, new rules adopted by the SEC in 1992 also increased the ability of shareholders to communicate with one another.⁸⁶

While new rules allow institutional investors to cooperate more easily to influence directors and managers of corporations, they do not completely solve the free-rider problem that discourages such action. When an institutional investor spends substantial sums in pressuring a corporation to change its policies, the benefits of such activism are reaped by all shareholders, not just the active institution.⁸⁷ In such a case, it may seem unfair to the client of an institutional investor to bear the cost of activism and

⁸¹ MacIntosh, J.G., *supra* note 58, at 171; Veasey, E.N., *supra* note 79, at 401; Millstein, I., "The Evolution of the Certifying Board" (1993) 48 Bus. Law. 1485, at 1486.; and Kakabadse, A. & Kakabadse, N., *supra* note 5, at 86.

⁸² See www.cggg.ca (date accessed: 20 May 2005).

⁸³ Black, B.S., "Shareholder Activism and Corporate Governance in the United States" (Columbia Law School, Working Paper No. 129, 1998), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 5.

⁸⁴ Montgomery, K.E., *supra* note 76, at 195; Black, B.S., *ibid.*, at 2; and Conference Board, *supra* note 79, at 16.

⁸⁵ Section 147 of the *CBCA* and section 68 of the Canada Business Corporations Regulations, 2001 (SOR/2001-512, as am. SOR/2003-317, ss. 1, 2, 3 (Fr.), 4-6, SOR/2005-51) were amended in 2001 to facilitate communication between shareholders. Shareholders can now communicate together without having to prepare a dissent proxy circular, provided that certain conditions are met.

⁸⁶ Millstein, I., *supra* note 81, at 1486, 1491 and 1492; Pozen, R.C., *supra* note 80, at 144; Booth, R.A., *supra* note 7, at 441; and Eisenberg, M.A., "Corporate Law, Social Norms, and Belief-Systems" (Columbia Law School, Working Paper No. 155, 1999), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 57.

⁸⁷ Millstein, I., *ibid.*, at 144.

he or she may be unwilling to do so. Particularly in the U.S., where advisory fees of many mutual funds are set on the assumption that institutional investors will usually function as passive managers rather than activists, these fees do not cover heavy intervention on the part of fund managers.⁸⁸

Other reasons that institutional investors may not be active in monitoring include: (i) the fact that fund managers are themselves agents of their own clients and subject to agency problems; (ii) institutional investors may be subject to a variety of pressures that may prevent optimal monitoring (for instance, a fund manager who confronts directors and management of a corporation may subsequently be denied access to them); (iii) institutional investors have limited monitoring capabilities (few funds may engage in active monitoring for a large portion of their investment portfolio); (iv) legal restraints on institutional activism (for instance, insider trading rules limit the extent to which institutional investors can gain access to privileged information without compromising the liquidity of their portfolios); and (v) short-term assessments (because the performance of money managers is reviewed regularly, institutional shareholders, like any shareholder, may be tempted to focus their attention on short-term trading profits rather than attempting to improve the long-term performance of all individual firms in which they invest).⁸⁹

Even if they were more active, such activism would not necessarily benefit to all shareholders. Because of their nature, institutional investors may value things other than shareholder wealth: for union pension funds, higher wages; for crown corporations, the interests of the electorate.⁹⁰ All the above reasons explain the constraints on the ability

⁸⁸ *Ibid.*

⁸⁹ MacIntosh, J.G., *supra* note 58, at 158-171; referred to in Standing Senate Committee on Banking, Trade and Commerce, *Corporate Governance* (Ottawa, 1996), at 78 and 79; Montgomery, K.E., *supra* note 76, at 192 to 194; The Working Group on Corporate Governance, "A New Compact for Owners and Directors" (1991) Jul.-Aug. Harv. Bus. Rev. 141, at 143; and Black, B.S., *supra* note 83, at 4.

⁹⁰ Camara, K.A.D., "Classifying Institutional Investors" (2005) J. Corp. L 220, at 223.

of institutional investors to act as a check on directors and management's discretion and why agency problems remain important.⁹¹

(b) The special case of controlled corporations

Corporations that are controlled by a significant shareholder⁹² are not exempt from agency problems. Investors often acquire shares of such corporations and rely on the significant shareholder to exercise control and execute his or her strategy for the corporation.⁹³ However, the significant shareholder's decisions do not always reflect the will or the interests of the minority shareholders. Because the significant shareholder may be in a position to influence the decisions of directors and management in its favor, the agency costs may be borne unequally by the significant and minority shareholders, with the minority shareholder bearing most of the burden.

From an economics point of view, it might seem justifiable for a significant shareholder to benefit, to a certain extent, from his or her position within the firm. Because there are costs associated with holding a concentrated position (*i.e.*, the risks associated with non-diversification) and with exercising a monitoring function, some private benefits of control may be necessary to induce a controlling shareholder to play that role.⁹⁴ Theoretically, the presence of a controlling shareholder will be beneficial to non-controlling shareholders until the reduction of costs resulting from its control becomes less important than the level of private benefits extracted by the controlling shareholder.⁹⁵

⁹¹ Booth, R.A., *supra* note 7, at 441. However, it must be noted that organizations such as the Canadian Coalition for Good Governance, which represents many Canadian institutional investors, are more influential than ever before.

⁹² See the definitions of "significant shareholder" and "control" given previously in subsection II.A.1(a)(i) of this thesis.

⁹³ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 25.

⁹⁴ Gilson, R.J. & Gordon, J.N. "Controlling Controlling Shareholders" (Columbia Law School, Working Paper No. 228, June 2003), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 2.

⁹⁵ *Ibid.*, at 7.

There are many ways in which a controlling shareholder, through its control over directors and management of a corporation, may extract private benefits from a corporation, including the appropriation of a disproportionate amount of the corporation's earnings through favorable agreements with companies controlled by the significant shareholder.⁹⁶ Professors Morck and Yeung have demonstrated how significant shareholders can use their control of a publicly listed corporation to "tunnel" wealth out of a publicly listed corporation and into firms whose cash flows accrue mainly to them.⁹⁷ According to their research, this may be observed in pyramidal structures:

To see this, suppose an asset of Firm F [...] rises in value by a million dollars. As already noted, [assuming the Family controls 51% of a public corporation that controls 51% of another public corporation, and so on through 6 levels of corporations], only \$17,596 of this gain ultimately accrues to the family firm at the pyramid's apex. The rest belongs to one level after another of public shareholders. However, the family controls Firm F's board since it controls that of Firm E, which it controls because it controls the board of Firm D, and so on. The Family might order Firm F to sell the asset to a firm in a higher tier of the pyramid at cost. For example, if Firm F sells the asset to Firm A at its old, low price, the additional million dollars shows up in Firm A instead, and now the family's wealth rises by \$510,000 instead of only \$17,596. Tunneling, is an agency problem where the controlling shareholder moves wealth out of firms whose cash flows mainly go to public shareholders and into firms whose cash flows accrue mainly to the controlling shareholder.⁹⁸

These benefits to the controlling shareholder, which are not available to non-controlling shareholders, create agency problems, which are not easily resolved at the level of the board of directors because of the loyalty of directors toward the controlling

⁹⁶ *Ibid.*, at 3.

⁹⁷ Morck, R. & Yeung, B., "Special Issues Relating to Corporate Governance and Family Control" (World Bank Policy Research Paper 3406, Sept. 2004) online: <http://papers.ssrn.com/abstract=800584> (date accessed: 3 March 2007).

⁹⁸ *Ibid.*, at 7.

shareholder who elected them. Significant shareholders generally want their own representatives on the board of directors and have the means to impose their candidates.⁹⁹

In an attempt to give a voice to minority shareholders in the directors' election process, section 107 of the *CBCA* allows constituting documents of a corporation to include cumulative voting provisions. Pursuant to such provisions, shareholders have a number of votes corresponding to the number of shares they own, multiplied by the number of candidates to the office of directors. Shareholders can use this "pool" of votes at their discretion, to vote for one or more candidates. For instance, if a shareholder has 10% of the votes and there are 12 candidates nominated for 11 places on a board, such shareholder could most probably ensure that a particular candidate gets elected by using all his or her votes on such candidate.

Although interesting in theory, these provisions are almost never used in practice, which is itself the evidence of a problem.¹⁰⁰ In the real world, significant shareholders are often in a position to influence management and the board of directors on the voting process and as to who should be included on the slate of candidates proposed at the annual meeting of shareholders. Significant shareholders are frequently in a position to decide how the entire board will be composed. In such a case, the agency problems, from the perspective of minority shareholders, might be equally important as in dispersed ownership corporations, since management may choose to propose only those directors who are "friendly" to the significant shareholder and ignore any other candidate.

⁹⁹ Bhagat, S. & Black, B., "The Uncertain Relationship Between Board Composition and Firm Performance" (Columbia Law School, Working Paper No. 137, 1999), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 21 and 22.

¹⁰⁰ See Management Proxy Circulars of publicly-listed corporations available at www.sedar.com (date accessed: 3 March 2007).

2. THE CATEGORIZATION OF AGENCY PROBLEMS

The agency problems that result from the tensions between shareholders, on the one hand, and directors and management, on the other hand, can be categorized in two groups.¹⁰¹ First, there is a possibility that agents could make decisions that maximize their own utility but fail to maximize shareholder value, *i.e.* costs of misappropriation. Second, there is the prospect that agents will spend too little time and efforts on the shareholders' behalf and will therefore "mismanage" the investment of shareholders.¹⁰²

(a) Costs of misappropriation

The first type of wrongdoing by agents consists in misappropriating the principal's assets or some of their value.¹⁰³ As the number of shareholders in a corporation grows, the incentive for directors and managers to engage in opportunistic behaviour also increases.¹⁰⁴ Indeed, with an increase in the number of shareholders, the agents increasingly come to see the firm as "other people's money" and may be more willing to misallocate corporate assets to their personal advantage.¹⁰⁵ Because the principal owns the corporation but the agents control it, the agents' potential gain from wrongdoing is substantial.¹⁰⁶

The risk of occurrence of this problem is greater in situations where directors' and management's self-interests and those of the shareholders are at odds. This can be the case, for instance, in the context of a takeover bid where directors and management

¹⁰¹ Palmiter, A.R., "Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence" (1989) 67 Tex. L. Rev. 1351, at 1368.

¹⁰² Jensen, M. & Meckling, W., "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305, at 308; Bebchuk, L.A., Fried, J.M. & Walker, D.I., "Managerial Power and Rent Extraction in the Design of Executive Compensation" (2002) 69 U. Chi. L. Rev. 751, at 763; Alarie, B.J., *supra* note 69, at 46; and Bybelezer, H.M., "The 'Corporate Governance' Debate and Modern Theory of the Firm: Some Lessons", in *Corporate Structure, Finance and Operations – Essays on the Law and Business Practice*, ed. by Lazar Sarna (Toronto: Carswell, 1988), at 67.

¹⁰³ Cooter, R. & Freedman, B.J., "The Fiduciary Relationship: Its Economic Character and Legal Consequences" (1991) 66 N.Y.U. L. Rev. 1045, at 1047.

¹⁰⁴ VanDuzer, J.A., *supra* note 71, at 252.

¹⁰⁵ Morck, R.K., *On the Economics of Concentrated Ownership* (1996) 26 Can. Bus. L.J. 63, at 63.

may prefer the *status quo*, in order to keep their positions within the corporation, while shareholders would prefer to be offered a premium and sell their shares.¹⁰⁷ This can also be the case when a director or a member of management wants to sell goods to the corporation above their market value,¹⁰⁸ or sell a division of the corporation to another company in which he or she has an ownership interest at a below-market price.¹⁰⁹

Yet another situation in which a conflict between the interests of agents and the corporation arises is where a director or a manager takes advantage of a corporate opportunity. This situation may occur frequently since directors and managers often have to choose between different ventures in which the corporation may invest. In pursuit of their own interest, agents may be tempted to keep for themselves certain opportunities that they should have sought for the corporation.¹¹⁰ Where a corporation is actively negotiating for an opportunity and has reasonable chances of getting it, it is even more problematic if an agent succeeds in exploiting it in his or her personal capacity.¹¹¹ It is clearly a misappropriation by agents of some potential value for the corporation.

A similar way to misappropriate value from the corporation is by competing with it. Indeed, in the context of their employment or involvement with the corporation, directors and managers may have access to certain information, such as confidential processes, pricing information and client lists, which could be used by them to compete against the corporation.

In the case of a corporation controlled by a significant shareholder who in practice appoints management, such misappropriations may be very subtle. Because the significant shareholder will often have a say in the corporate policies and the general orientation of the businesses of a corporation, it may favour certain relationships between

¹⁰⁶ Cooter, R. & Freedman, B.J., *supra* note 103, at 1051.

¹⁰⁷ Dimma, W.A., *supra* note 75, at 176 to 178.

¹⁰⁸ As illustrated in the case *Aberdeen Railway Company v. Blaikie Brothers* (1854), [1843-60] All E.R. Rep. 249.

¹⁰⁹ Hart, O., "An Economist's View of the Fiduciary Duty" (1993), 43 U. of T. L. J. 299, at 301.

¹¹⁰ VanDuzer, J.A., *supra* note 71, at 279.

¹¹¹ *Ibid.*, at 278.

the corporation and some other businesses that it controls and try to influence directors of the corporation to approve such relationships. If these relationships are advantageous for the significant shareholder but are detrimental to the corporation, other shareholders of the corporation, now or in the future, may suffer from such a misappropriation.

The effects of misappropriation on shareholders may be seen from two angles. First, misappropriation constitutes an accountability failure. Because they manage the wealth of others, directors and management have a responsibility not to divert the assets of a corporation for their own benefit. Should they divert such assets, they fail, as agents, to properly protect the interests of their principal. Fiduciary duties, as described in subsections I.B and I.C of this thesis, are there to maintain the accountability of agents toward their principal.

The second angle from which the costs of misappropriation can be considered is their effect on the efficient operation of capital markets. When investors believe that there is an important risk that agents will divert some (or all) of the value of securities for their own benefit, investors will discount the price of such securities accordingly. When unsure about the importance of potential diversions, investors may well apply a discount that is too large considering the real threat of misappropriation. Such behaviour creates an inefficient allocation of resources due to uncertainty. Because investors are not in a good position to measure in advance the real risk they are taking, they may underestimate the value of the corporation's securities. When generalized, such conduct is detrimental to the operation of capital markets because it undermines the value of all securities and may deter investments.¹¹² As we will see in subsection I.B of this thesis, fiduciary duties constitute an attempt to protect shareholders. They aim at preventing self-dealing and aligning the interests of agents and principals.

¹¹² See subsection II.B.3 of this thesis, and particularly Anand, A.I., "An Analysis of Enabling vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley", available online: <http://papers.ssrn.com/abstract=800584> (date accessed: 20 August 2006), at 37.

(b) Costs of mismanagement

A second type of wrongdoing resulting from the dispersal of ownership is when directors or management neglect the business of the corporation, which is an act of nonfeasance.¹¹³ A fundamental problem of corporate governance when ownership becomes separate from control may be described as follows: how to ensure that those who manage the corporation (officers and directors) work fully in the interests of the principal (the shareholders) given that these agents have control over the information flow to the principal, may not disclose all relevant information about their performance, have superior knowledge of the operations of the corporation, and may have interests that are divergent from those of the principal.¹¹⁴

The principal-agent theory views the firm as a production set in which agents are assumed to be interested in goals beyond the owners' welfare such as an easy life, perks and empire building.¹¹⁵ According to this theory, all agents have a potential interest in working at a slack pace and in avoiding the effort and time involved in adapting to changing situations, such as the emergence of new technologies. This problem is often referred to as "shirking".¹¹⁶ Directors and management may shirk in different ways. For instance, directors may neglect to read the material sent to them in view of important decisions to be taken by the board of directors or simply not attend the board meetings. When attending board meetings, they may avoid asking questions about issues that seem problematic or not require more information on situations that are not sufficiently explained. When confronting a problem, they may choose not to make a thorough analysis or not dissent when they do not agree. They can also avoid looking at alternatives or questioning management's assumptions. As for members of management, they may chose to neglect the affairs of the corporation by not putting enough time and

¹¹³ Cooter, R. & Freedman, B.J., *supra* note 103, at 1047.

¹¹⁴ Allaire, Y. & Firsirotu, M., *Beyond Monks and Minow: From Fiduciary to Value Creating Governance* (Montreal: Forstrat International Press, 2005), p. 97 and 98.

¹¹⁵ Hart, O., *supra* note 109, at 300.

¹¹⁶ Eisenberg, M.A., "The Mandatory Structure of Corporation Law" (1989) 89 Colum. L. R. 1461, at 1471.

energy into their work. If left unchecked by the board of directors, this may result in a lack of competitiveness of the corporation or, more generally, may impair the business.

In the context of a corporation controlled by a significant shareholder, the controlling shareholder will often act as a safeguard against mismanagement. Indeed, because their money is at stake, controlling shareholders will not tolerate a lack of performance by management and directors. Because of their influence, they will make sure that the board takes all appropriate means so that management works hard to produce the best possible results and is replaced if its conduct is lax.

Again, as was the case with respect to the costs of misappropriation, the costs of mismanagement can be seen from two angles. The first one is the accountability angle, which focusses on the relationship between an agent and his or her principal. According to the accountability principles, a principal should be confident that his or her agent will do everything he or she can to maximize the value of the principal's investment. Any deviation from an effort to maximize such value can be seen as a cost for the principal.

From the angle of the efficient operation of capital markets, mismanagement, just like misappropriation, can be seen as a risk that can be priced. Because investors do not know to what extent directors and management will work at a slack pace, they may well exaggerate the discount that they apply on the price of a corporation's securities.¹¹⁷ If systematic, such exaggerations will of course undermine the efficiency of our capital markets and deter investments.

In order to maintain accountability between agents and principals and avoid an inefficient allocation of resources, directors must somehow be responsible (and thus required to pay) for a failure to exercise proper oversight of the business of the corporation and the performance of management. For that purpose, as explained in subsection I.B of this thesis, fiduciary duties provide shareholders with recourse in the event that their agents do not act with care and diligence in the discharge of their duties

¹¹⁷ Anand, A.I., *supra* note 112, at 37.

toward the corporation. Although imperfect in their application, the threat of enforcement of fiduciary duties will nevertheless be an incentive for properly discharging the duty of care, and will also result in a better allocation of resources within our capital markets.

SUMMARY

This subsection explained the source and nature of an important challenge facing shareholders, management and boards of directors of publicly listed corporations: agency problems. Agency problems were described as the result of the dispersal of ownership. In widely owned corporations, because shareholders are not in a position to properly monitor directors and members of management, these agents may be tempted to take more than they should from the firm or to spend less time and energy than they should on the affairs of the corporation. These costs were respectively characterized as misappropriation and mismanagement costs.

The costs of misappropriation result from a misallocation of corporate assets to the personal advantage of an agent, whereas the costs of mismanagement exist when agents neglect the business of the corporation. In the context of a corporation controlled by a significant shareholder, there is a danger that the significant shareholder may be the source of a misappropriation of corporate assets. However, the controlling shareholder is normally interested in reducing the costs of mismanagement. In all cases, there is a need to protect all shareholders by holding directors accountable for these costs. This is done, in part, through the enforcement (or threat of enforcement) of directors' fiduciary duties, as explained in the next subsections of this thesis.

B. FIDUCIARY DUTIES

The duty of loyalty and the duty of care constitute potential sources of liability for directors. Any board member or candidate for a position as a director should understand the scope of these duties. In this subsection, the source and content of these duties will be described. We will also analyse the traditional remedies provided in the *CBCA* to enforce these duties.

Even though many Canadian authors designate the duty of loyalty as the “fiduciary duty” and do not include the duty of care in such expression, this thesis follows the American approach, which tends to include both duties under the expression “fiduciary duties”. Some may view this usage as just a question of semantics, but as it will be shown below, both the duty of loyalty and the duty of care take their source in the fiduciary relationship between shareholders and directors. Because of their common origin, it seems appropriate to group these duties under the same expression.

1. THE SOURCES OF THE FIDUCIARY DUTIES

In Canada, directors’ fiduciary duties are codified under paragraph 122(1) of the *CBCA*,¹¹⁸ which provides that:

122. (1) Every director and officer of a corporation in exercising their powers and discharging their duties shall

(a) act honestly and in good faith with a view to the best interests of the corporation; and

(b) exercise the care, diligence and skill that a reasonable prudent person would exercise in comparable circumstances.

¹¹⁸ See also other Canadian corporate statutes with similar formulations. See for instance section 134 of the Ontario *Business Corporations Act* (R.S.O. 1990, s B.16, as am.). In Quebec, the duty of loyalty is also codified at the first paragraph of section 324 of the Civil Code (S.Q. 1991, c. 64, as am.), which states that: “A director shall avoid placing himself in any situation where his personal interest would be in conflict with his obligations as a director”.

The fiduciary duties take their source from, and are complemented by, the common law. Since the 19th century, directors have often been compared to trustees under the common law.¹¹⁹ In Canada, this comparison possibly stems from previous companies acts, where members of corporate governing bodies were actually called “trustees”.¹²⁰ However, the comparison with a trustee is technically inapt since a trustee, at common law, holds property in equity for the benefit of the trust beneficiary. In the case of a corporation, corporate property is held by the corporation itself, not by the board of directors.¹²¹ The role of a director can also be distinguished from that of a trustee in that the trustee’s role of preserving the trust capital while investing conservatively to produce a reliable income is fundamentally different from the risk-taking behaviours required of corporate directors.¹²²

Nevertheless, directors have certain characteristics of trustees because, like trustees, they stand in a fiduciary relationship with a third party, namely the corporation. As mentioned by the English Chancery Court in *In Re City Equitable Fire Insurance Co.*:¹²³

It has sometimes been said that directors are trustees. If this means no more than that directors in the performance of their duties stand in a fiduciary relationship to the company, the statement is true enough. But if the statement is meant to be an indication by way of analogy of what those duties are, it appears to me to be wholly misleading.¹²⁴

¹¹⁹ Hansell, C., *Corporate Structure, Finance and Operations: Corporate Governance Disclosure in Canada: Background and Compliance*, Vol. 9 (Toronto: Carswell, 1996), at 9-4; and Sutherland, H, *supra* note 17, at 410 and 411.

¹²⁰ See 13-14 Vict., c. 28, s. 4; B.C. (1890) 53 Vict. c. 6, s. 11; Wegenast, F.W., *The Law of Canadian Companies* (Toronto: Carswell, 1979), at 351; and Hansell, C., *Directors and Officers in Canada: Law and Practice* (Toronto: Carswell, 1999), at 9-4.

¹²¹ Hansell, C., *ibid.*

¹²² Welling, B., *Corporate Law in Canada: The Governing Principles*, 2nd ed. (Toronto: Butterworths, 1991), at 378.

¹²³ [1925] Ch. 407 (C.A.), at 426 and 427.

¹²⁴ *Ibid.*, at 426.

In Canada, the opinion of the Honourable Justice Wilson of the Supreme Court, in *Frame v. Smith*,¹²⁵ a decision regarding the custody of and access to a child, is enlightening in the determination of situations in which fiduciary duties are applicable, because it gives insight as to the nature of the duties:

Yet there are common features discernible in the contexts in which fiduciary duties have been found to exist and these common features do provide a rough and ready guide to whether or not the imposition of a fiduciary obligation on a new relationship would be appropriate and consistent.

Relationships in which a fiduciary obligation has been imposed seem to possess three general characteristics:

- (1) The fiduciary has scope for the exercise of some discretion or power.
- (2) The fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's legal or practical interests.
- (3) The beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretionary power.¹²⁶

The common law concept of fiduciary duty was also considered by the Supreme Court of Canada in *K.L.B. v. British Columbia*.¹²⁷ In that case, which involved the relationship between the government and foster children, the court stated:

[...] Fiduciary duties arise in a number of different contexts, including express trusts, relationships marked by discretionary power and trust, and the special responsibilities of the Crown in dealing with aboriginal interests [...]

In *Lac Minerals Ltd. v. International Corona Resources Ltd.* [...] La Forest J. noted that there are certain common threads running through fiduciary duties that arise from relationships marked by discretionary power and trust, such as loyalty and "the avoidance of a conflict of duty and interest and a duty not to profit at the expense of the beneficiary".

¹²⁵ [1987] 2 S.C.R. 99.

¹²⁶ *Ibid.*, at 136.

¹²⁷ [2003] 2 S.C.R. 403, referred to in *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 7, at 477 and 478.

However, he also noted that “[t]he obligation imposed may vary in its specific substance depending on the relationship” [...] ¹²⁸

Although these principles were developed in cases involving children, such principles have also been applied in the context of directors’ fiduciary duties, as stated in *Lac Minerals v. International Corona Resources*. ¹²⁹ In this last case, the Supreme Court of Canada had to decide on the appropriate remedy to be granted when confidential information was used for a purpose other than that for which it was conveyed. The Supreme Court confirmed that the relationship of a director to a corporation falls within the class of relationships that are presumed to give rise to a fiduciary relationship:

[...] in *Frame v. Smith* [...] the issue was whether a certain class of relationship, custodial and non-custodial parents, was a category, analogous to directors and corporations [...] the existence of which relationship would give rise to fiduciary obligations. The focus is on the identification of relationships in which, because of their inherent purpose or their presumed factual or legal incidents, the courts will impose a fiduciary obligation on one party to act or refrain from acting in a certain way. ¹³⁰

By looking at the type of situations which create fiduciary duties, it can be noticed that courts, through these duties, protect individuals who are vulnerable to abuse of discretionary power by people who are entitled to take decisions that affect these individuals. When transposed into the corporate context, one may see the importance of the fiduciary duties in protecting shareholders against opportunistic behaviours. When looking at the relationship between shareholders and directors, the three characteristics described by the Supreme Court of Canada in *Frame v. Smith* ¹³¹ can be found:

- 1- Directors have scope to exercise discretion and power;

¹²⁸ *K.L.B. v. British Columbia, ibid.*, at par. 40-41 and 49.

¹²⁹ [1989] 2 S.C.R. 574, at 644.

¹³⁰ *Ibid.*, at 646; Hansell, C., *supra* note 119, at 9-3.

¹³¹ *Supra* note 125.

2- Directors' exercise of such discretion and power will affect shareholders' legal and practical interests; and

3- Shareholders are vulnerable, to a great extent, to the decision of directors.

Shareholders are particularly vulnerable to the kind of behaviours that represent agency costs (*i.e.*, misappropriation of corporate assets or opportunities, and mismanagement by directors). Such vulnerability calls for the protection of the law, which materializes through the existence of the fiduciary duties. As will be seen in subsection I.C of this thesis, the duty of loyalty aims at decreasing the costs of misappropriation, while the duty of care aims at decreasing the costs of mismanagement. Before going into more details about the relationship between agency problems and fiduciary duties, however, it is important to describe the scope of the fiduciary duties and the resulting potential liability for directors.

2. THE DUTY OF LOYALTY

As it will be described below, the duty of loyalty is complex and directors can breach it in many circumstances. Its basic principle, however, is easy to articulate: directors should be loyal to the corporation and generally avoid situations where their personal interests conflict with those of the corporation.

(a) Loyalty to the corporation

Section 122 of the *CBCA* provides that directors must act honestly and in good faith, with a view to the best interests of the corporation. The Supreme Court of Canada, in *Peoples Department Stores Inc. (Trustee of) v. Wise*,¹³² reviewed the obligations of directors stemming from their duty of loyalty. In that case, the Wise brothers were the majority shareholders, officers and directors of Wise, a chain of retail stores, and the only

¹³² *Supra* note 7.

directors of Peoples, a similar chain of stores purchased by Wise from Marks & Spencer Canada Inc. in 1992. Following inventory problems at both corporations, a joint inventory policy was implemented on the recommendation of the Vice-President of Administration of both Wise and Peoples. After the bankruptcy of Wise and Peoples, the trustee of Peoples filed a petition against the Wise brothers claiming that by adopting the inventory policy they had favoured the interests of Wise over Peoples to the detriment of creditors of the latter, in breach of their duties as directors of Peoples under section 122 (1) of the *CBCA*. With respect to the duty of loyalty, the Supreme Court of Canada stated that:

The statutory fiduciary duty requires directors and officers to act honestly and in good faith vis-à-vis the corporation. They must respect the trust and confidence that have been reposed in them to manage the assets of the corporation in pursuit of the realization of the objects of the corporation. They must avoid conflicts of interest with the corporation. They must avoid abusing their position to gain personal benefit. They must maintain the confidentiality of information they acquire by virtue of their position. Directors and officers must serve the corporation selflessly, honestly and loyally [...]¹³³

The principle that directors should be careful not to see their own interest conflict with the interest of the corporation which they serve is derived from the decision of the English House of Lords in *Aberdeen Railway Company v. Blaikie Brothers*.¹³⁴ In that case, a director entered into a contract, for his own benefit, with the corporation he was serving. The House of Lords described the general prohibition against entering into such contracts in the following statement:

The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents, and it is, of course, the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such an agent has duties to discharge of a fiduciary character towards his principal, and it is a rule of universal application that no one having such duties to discharge shall be allowed to enter into engagements in which he

¹³³ *Ibid.*, at 477.

¹³⁴ *Supra* note 108.

has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect. So strictly is this principle adhered to that no question is allowed to be raised as to the fairness or unfairness of a contract so entered into.¹³⁵

When a person is a director of two corporations that enter into transactions with one another, such person owes a fiduciary duty to each of them. When directors take advantage of their position to promote the interests of one of the corporations to the detriment of the other, they clearly breach their fiduciary duties to such other corporation.¹³⁶ Consequently, a director who owes a fiduciary obligation to a corporation should not accept a conflicting duty to another corporation.¹³⁷ Because he or she must act in the best interests of both corporations, an individual who would be on the board of directors of competing corporations would risk being in breach of his or her fiduciary duties to both of them.¹³⁸

When a director enters into an agreement that imposes upon him or her an obligation inconsistent with his or her fiduciary duties to the corporation or takes certain decisions for his or her own benefit, the director may be in an untenable position of conflict of interest.¹³⁹ It has even been proposed that entering into a potential conflict of interest situation or taking decisions that could lead to such a situation, was a breach of fiduciary duties, whether or not the conflict was operative.¹⁴⁰ For this reason, as will be described below, many corporate statutes, including the *CBCA*, specifically allow directors to fix their own remuneration¹⁴¹ and require directors to declare their interest in certain contracts or transactions in order to be allowed to benefit from them.¹⁴² Without

¹³⁵ *Ibid.*, at 252; referred to in *Cape Breton Cold Storage Co. Ltd. v. Rowlings*, [1929] S.C.R. 505, at 507 and *Regal (Hastings) Ltd. Hastings Ltd. v. Gulliver*, [1942] 1 All E.R. 378, at 382.

¹³⁶ *Gray v. Yellowknife Gold Mines Ltd.*, [1947] O.R. 928 (C.A.)(No. 1) and [1947] O.R. 994 (C.A.)(No. 2); Sutherland, H., *supra* note 17, at 418.

¹³⁷ McGuinness, K.P., *supra* note 17, at 721.

¹³⁸ *Abbey Glen Property Corp. v. Stumborg* (1978) 9 A.R. 234 (C.A.); referred to in VanDuzer, J.A., *supra* note 71, at 288.

¹³⁹ *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.* (1993) 101 D.L.R. (4th) 15, at 60.

¹⁴⁰ See *Aberdeen Railway Company v. Blaikie Brothers*, *supra* note 108; and Hansell, C., *supra* note 119, at 9-7.

¹⁴¹ See for instance s. 120 of the *CBCA*.

¹⁴² See section I.B.2(a) of this thesis.

these provisions, directors, in those circumstances, would be in breach of their fiduciary duties.

Another component of the duty of loyalty is the interdiction for directors to use information or their position to gain an advantage for themselves or any other person or to cause detriment to the corporation.¹⁴³ It is a breach of fiduciary duty for a director to appropriate for his or her own behalf an economic opportunity that belongs to the corporation.¹⁴⁴ A specific doctrine known as the corporate opportunity doctrine has arisen from that premise.¹⁴⁵ The corporate opportunity doctrine was formulated in the English House of Lords in *Regal (Hastings) Ltd. v. Gulliver*¹⁴⁶ and has been reaffirmed by the Supreme Court of Canada in *Canadian Aero v. O'Malley*.¹⁴⁷

An examination of the case law in this Court and in the Courts of other like jurisdictions on the fiduciary duties of directors and senior officers shows the pervasiveness of a strict ethic in this area of the law. In my opinion, this ethic disqualifies a director or senior officer from usurping for himself or diverting to another person or company with whom or with which he is associated a maturing business opportunity which his company is actively pursuing; he is also precluded from so acting even after his resignation where the resignation may fairly be said to have been prompted or influenced by a wish to acquire for himself the opportunity sought by the company, or where it was his position with the company rather than a fresh initiative that led him to the opportunity which he later acquired.¹⁴⁸

Directors, because of their fiduciary obligations, are bound to act with the utmost good faith and their powers can be exercised only for the purposes for which they were intended.¹⁴⁹ Furthermore, directors are obliged to exercise their powers actively.¹⁵⁰

¹⁴³ *Ibid.*; *Zwicker v. Stanbury*, [1953] 2 S.C.R. 438; *Peso Silver Mines Ltd. v. Cropper* (1966) 58 D.L.R. (2d) 1 (S.C.C.); and *Hansell, C.*, *supra* note 119, at 9-5.

¹⁴⁴ *McGuinness, K.P.*, *supra* note 17, at 739 and 740.

¹⁴⁵ *Ellis, M.V.*, *Fiduciary Duties in Canada* (Toronto: Carswell, 2000), at 15-9.

¹⁴⁶ *Supra* note 135.

¹⁴⁷ [1974] S.C.R. 592.

¹⁴⁸ *Regal (Hastings) Ltd. v. Gulliver*, *supra* note 135, at 381.

¹⁴⁹ *Sun Trust Co. v. Bégin*, [1937] S.C.R. 305; and *Sutherland, H.*, *supra* note 17, at 412, 413 and 416.

¹⁵⁰ *Scottish Cooperative Wholesale Society v. Meyer*, [1959] A.C. 324 ; *Bender, M.*, *supra* note 17., at 4-2; and *Sutherland, H.*, *ibid.*, at 417.

They must affirmatively defend and protect the interests entrusted to them. Passive conduct on the part of a director may amount to a breach of his or her duties.¹⁵¹

A gain made through the director's fiduciary position toward a corporation should be the property of the corporation, regardless of the director's good intentions or the absence of knowledge that his or her activity was repugnant to the duty of loyalty.¹⁵² The director or officer who has tried to gain a profit from the use of the corporate property may be held accountable for the profit to the corporation.¹⁵³

Because fiduciary duties aim to ensure that wrongdoing is deterred, awards of punitive damages for breaches of the duty of loyalty have been increasingly popular in the U.S., though this is not yet the case in Canada.¹⁵⁴ The American trend may be explained by the fact that when an agent takes for himself or herself a corporate asset, the agent's gain from appropriating the asset may be large, and the probability of being caught and sanctioned is rather small. Disgorgement, the usual remedy for misappropriation, merely aims to return the agent to a situation similar to the one that he or she would have been in without appropriation. In order to eliminate the incentive to breach the duty of loyalty, courts in the U.S. have thus increasingly condemned directors to punitive damages in addition to disgorgement.¹⁵⁵

(b) Implication for controlled corporations

The high standard involved in discharging the duty of loyalty can sometimes be difficult to meet for directors, especially when they are nominated by the significant shareholder of a corporation. To expect such directors to approach each corporate

¹⁵¹ McGuinness, K.P., *supra* note 17, at 767.

¹⁵² *Hamilton v. Wright* (1842) 9 Cl. & Finn. 111, 43 Digest 864 (H.L.); *Regal (Hastings) Ltd. v. Gulliver*, *supra* note 135, at 395; Ellis, M.V., *supra* note 145, at 15-5; McGuinness, K.P., *supra* note 17, at 384; and Sutherland, H., *supra* note 17, at 420.

¹⁵³ Welling, B., *supra* note 122, at 384, 385 and 419; Ellis, M.V., *ibid*, at 15-7; Priest, M. & Nathan, H.R., *supra* note 3, at 24; and Bender, M., *supra* note 17, at 5-3 and 5-4.

¹⁵⁴ Cooter, R. & Freedman, B.J., *supra* note 103, at 1053, 1054 and 1069.

¹⁵⁵ *Ibid.*, at 1074.

problem with a completely open mind, unaffected by a natural inclination to further the interests of their nominator, may be idealistic considering the realities of the corporate organization.¹⁵⁶ Nevertheless, a director nominated by a particular shareholder is not in any sense relieved of his or her fiduciary duties to the corporation. A nominee director is not accorded an attenuated standard of loyalty to the corporation and nominators cannot compel them to act in a particular manner.¹⁵⁷ As stated by the Supreme Court of Canada in *Ringuet v. Bergeron*:¹⁵⁸

While majority shareholders may agree to vote their shares for certain purposes, they cannot by this agreement tie the hands of directors and compel them to exercise the power of management of the company in a particular way.¹⁵⁹

In case of conflict between the interests of the corporation and those of the director's patron, the interests of the corporation must prevail.¹⁶⁰ Although it may be appropriate for a director to consider the interests of the corporation's shareholders who elected him or her, the director cannot discriminate between shareholders. One way to operationalize this rule is to say that the interests of particular shareholders should always be subordinated to those of the corporation itself, as stated by Justice Farley, of the Ontario Court of Justice (General Division), in *820099 Ont. Inc. v. Harold E. Ballard Ltd.*:¹⁶¹

It seems to me that while it would be appropriate for a director to consider the individual desires of one or more various shareholders (particularly his "appointing" shareholder) in order to come up with a plan for the operation of a corporation, it would be inappropriate for that director (or

¹⁵⁶ Priest, M. & Nathan, H.R., *supra* note 3, at 198; paragraph 122(4) of the *Alberta Business Corporations Act* (R.S.A. 2000, c. B-9) recognizes that in determining whether a particular transaction or course of action is in the best interests of the corporation, a director, if the director is elected or appointed by the holders of a class or series of shares or by employees or creditors or a class of employees or creditors, may give special, but not exclusive, consideration to the interests of those who elected or appointed the director.

¹⁵⁷ *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.*, *supra* note 139, at 59.

¹⁵⁸ [1960] S.C.R. 672.

¹⁵⁹ *Ibid.*, at 683.

¹⁶⁰ *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.*, *supra* note 139, at 59; and Priest, M. & Nathan, H.R., *supra* note 3, at 46.

¹⁶¹ [1991] 3 B.L.R. (2nd) 113.

directors) to only consider the interests of certain shareholders and to either ignore the others or worse still act in a way detrimental to their interests. The safe way to avoid this problem is to have the directors act in the best interests of the corporation (and have the shareholders derive their benefit from a “better” corporation).

It may well be that the corporate life of a nominee director who votes against the interest of his “appointing” shareholder will be neither happy nor long. However, the role that any director must play (whether or not a nominee director) is that he must act in the best interests of the corporation. If the interests of the corporation (and indirectly the interests of the shareholders as a whole) require that the director vote in a certain way, it must be the way that he conscientiously believes after a reasonable review is the best for the corporation. The nominee director’s obligation to his “appointing” shareholder would seem to me to include the duty to tell the appointer that his requested course of action is wrong if the director in fact feels this way. Such advice, although likely initially unwelcome, may well be valuable to the appointer in the long run. The nominee director cannot be a “Yes man”; he must be an analytical person who can say “Yes” or “No” as the occasion requires (or to put it another way, as the corporation requires).¹⁶²

In *Peoples Department Stores Inc. (Trustee of) v. Wise*,¹⁶³ the Supreme Court of Canada approved Justice Farley’s observation that in resolving a conflict between majority and minority shareholders, it is safe for directors and officers to act to make the corporation a “better corporation”, which the Supreme Court associates with maximizing the value of the corporation.¹⁶⁴

(c) Statutory exceptions to the rule

The principles stated above should not mean that directors are always precluded from retaining gains obtained as a result of their involvement with the corporation. In fact, section 120 of the *CBCA* specifically permits certain transactions between directors

¹⁶² *Ibid.*, at 172 and 173.

¹⁶³ *Supra* note 7.

¹⁶⁴ *Ibid.*, at 481.

and the corporation provided certain safeguards are observed in order to protect the interests of the corporation.¹⁶⁵

As stated in the *Proposals for a New Business Corporations Law for Canada* (referred to in this thesis as the "Dickerson Report"),¹⁶⁶ prior to the adoption of section 120 of the *CBCA*, the common law general rule was that a director could not contract with the corporation on the board of which he or she sat. At the same time however, the common law recognized that the articles of the corporation could allow such contracting, almost without restrictions, which could lead to cases of abuse:

The common law, although it was very indulgent toward majority shareholders, was absolutely strict in its treatment of a director having an interest in a contract with the corporation of which he was a director. The common law rule was that a contract between an interested director and a corporation of which he was a director was void and the director had a duty to account to the corporation for any profits he received, irrespective of how fair the contract was to the corporation: *Aberdeen Railway v. Blaikie* (1854) 2 Eq. 1281. But at the same time the common law recognized that there was no legal limitation upon what the parties could agree to in the articles of association, therefore draftsmen tended to employ articles which waived the obligation of the director to disclose his interest, permitted the director to vote in respect of a contract in which he had an interest, and absolved the director altogether from any duty to account for profits he made on the contract.¹⁶⁷

According to the Dickerson Report, the adoption of section 120 of the *CBCA* had two objectives: "first, to stipulate the conditions that must be fulfilled by a director having an interest in a contract with the corporation; and second, to declare that if the director does fulfil these conditions, the contract is not void and the director has no liability to account for profit he may make under the contract".¹⁶⁸ Section 120 of the *CBCA* provides a statutory procedure that requires directors to disclose their conflicts of interest and allows the approval of contracts or transactions if specific conditions are

¹⁶⁵ See section II.(C)(2)(b) of this thesis.

¹⁶⁶ Dickerson, R.W., Howard, J.L., Getz, L., Bertrand, R.J., *Proposals for a New Business Corporations Law for Canada* (Ottawa: Information Canada, 1971).

¹⁶⁷ *Ibid.*, at 78 and 79.

met.¹⁶⁹ If, in accordance with the terms of this provision: (i) a director or officer discloses the nature and extent of any interest that he or she has in a material contract or transaction; (ii) the directors or shareholders duly approve the contract or transaction; and (iii) the contract or transaction is reasonable and fair to the corporation when approved, then such contract or transaction will not be voidable and the director in a position of conflict of interest will not be accountable to the corporation or its shareholders for any profit realized because of the director's or officer's interest in the contract or transaction.

Pursuant to section 120 of the *CBCA*, only "material" contracts and "material" transactions need to be disclosed.¹⁷⁰ The *CBCA* does not define the word "material". For Professor McGuinness, a contract or transaction is material when it represents an important dealing of the corporation, such as one that would have a significant effect upon the profitability, financial strength or operations of the corporation.¹⁷¹

Section 120 of the *CBCA* applies if the director (i) is party to the contract or transaction; (ii) is a director, officer, or an individual acting in a similar capacity, of a party to the contract or transaction; or (iii) has a material interest in a party to the contract or transaction. In order to determine if a director has a material interest in a party to a contract or transaction, one must identify those circumstances in which a director's ability to negotiate effectively on behalf of the corporation may be inhibited by some interest he or she has in such contract of transaction. Any personal relationship or monetary interest he or she may have that might be thought to be an inhibiting factor is a material interest if disclosure of the relationship or interest might be relevant to the corporate decision whether to involve the particular director in the negotiations.¹⁷² The

¹⁶⁸ *Ibid.*, at 79.

¹⁶⁹ Welling, B., *supra* note 122, at 444.

¹⁷⁰ *Ibid.*, at 450.

¹⁷¹ McGuinness, K.P., *supra* note 17, at 755.

¹⁷² Welling, B., *supra* note 122, at 452.

inquiry should focus on whether the interest in question is of the type that would reasonably be expected to exert an influence on the director's judgment.¹⁷³

Where the director's financial interest is clearly immaterial, for instance where the director's only interest in the transaction is through the ownership of a few shares in a publicly held corporation which is transacting with the corporation, the director's judgment is unlikely to be affected, and there is no reason to apply the conflict of interest rules.¹⁷⁴ However, if the financial interest in a party allows the director to influence the affairs of the party or to receive an important benefit from his or her relationship with the party, it would generally be considered as material.¹⁷⁵

Once the materiality tests have been met, three requirements must be satisfied for the protective provisions of section 120 of the CBCA to apply: (i) the conflict of interest must be disclosed; (ii) the contract must be approved by disinterested directors (or shareholders); and (iii) the contract must be fair and reasonable to the corporation.¹⁷⁶

The details of disclosure are set out in subsections 120(2), (3), (4), (6) and (7.1) of the CBCA. The interested director must disclose his or her interest in writing and insist that it be included in the minutes of the corporation, or disclose his or her interest verbally and request to have the details entered into the minutes of the meeting at which such disclosure is made.¹⁷⁷ Disclosure must include the nature and extent of such interest and should be made to the full board, not just to a board committee.¹⁷⁸ Alternately, if the contract is approved by the shareholders instead of the directors, disclosure of the interest

¹⁷³ Brodsky, E. & Adamski, M.P., *Law of Corporate Officers and Directors* (New York: West Group, 2001).

¹⁷⁴ Subject to applicable disclosure if required by securities rules. Brodsky, E. & Adamski, M.P., *ibid.*, chap. 3, at 33.

¹⁷⁵ Priest, M. & Nathan, H.R., *supra* note 3, at 26.

¹⁷⁶ Welling, B., *supra* note 122, at 444.

¹⁷⁷ Sarna, L., *Directors and Officers – A Canadian Legal Manual* (Montreal: Jewel Publications, 2001), at 6-41.

¹⁷⁸ Priest, M. & Nathan, H.R., *supra* note 3, at 26.

must be made to the shareholders in a manner sufficient to indicate its nature before the contract or transaction is approved or confirmed.¹⁷⁹

Once the disclosure has been made, the next step is to get the contract “approved”. Subsections 120(7) and (7.1) of the *CBCA* permit either the board of directors or the shareholders to approve the contract as a step toward making the contract non-voidable and allowing a director to keep any profit realized from a contract or transaction for which disclosure was required under subsection 120(1) *CBCA*.¹⁸⁰ The approval process requires a simple majority obtained through a formal vote of the board of directors or a special resolution (two-thirds of the votes)¹⁸¹ at a meeting of the shareholders. In the case of approval by the directors of a corporation, subsection 120(5) of the *CBCA* states that the director who is interested in the contract cannot vote on the approval.¹⁸² Under the statute, a director who is in a position of conflict of interest need not be formally precluded from being present or being heard at a meeting of the board where a contract in which he or she is interested is discussed. Nevertheless, the circumstances may be such that the director’s fiduciary duty prevents him or her from continuing to attend deliberations where the nature of the discussions may cause the director to breach his or her obligation of confidentiality toward the corporation or another entity. That could be the case if the director is an insider of a client or supplier of the corporation and is presented with very sensitive information that could affect the client or supplier. Such information, if communicated to the director, might place him or her in a position where the director may, even in the best of faith, be or be perceived to be in breach of his or her fiduciary duty to the corporation or to the client or supplier and be potentially liable therefore. In such circumstances, the director should remove himself or herself from that part of the meeting of the board where the sensitive information is

¹⁷⁹ See subsection 120(7.1) of the *CBCA*.

¹⁸⁰ Welling, B., *supra* note 122, at 445.

¹⁸¹ See subsection 2(1) of the *CBCA*.

¹⁸² Welling, B., *supra* note 122, at 446.

discussed and should not be provided with sensitive material relating to the transaction.¹⁸³

Although a director is precluded from voting at a board meeting where a transaction or contract in which he or she is interested is discussed, that director, as a shareholder, will be free to vote at a shareholders' meeting to promote his or her personal interest, provided that such interest is properly disclosed in accordance with applicable securities regulations.¹⁸⁴

In addition to the disclosure and approval requirements, section 120 of the *CBCA* contains a fairness requirement: no contract can be rendered non-voidable unless it is reasonable and fair to the corporation at the time it is approved. Thus, no vote to ratify a contract unfair to the corporation can be effective.¹⁸⁵ The criterion related to the fairness of transactions between directors and their corporation is best satisfied by objective evaluations. Review by independent directors or a special committee of the board composed solely of independent directors may help to provide evidence that the standard has been met.¹⁸⁶

Under subsection 120(8) of the *CBCA*, if a director fails to comply with section 120, a court may, on application of the corporation or of any of its shareholders, set aside the contract or transaction. It can do so on any terms that it thinks fit, including requiring the director to account to the corporation for any profit or gain realized.

Of course, the provisions of section 120 of the *CBCA* do not relieve a director from the duty to act honestly, in good faith and with a view to the best interests of the

¹⁸³ This situation is not ideal as directors are also under an obligation generally to remain informed regarding the corporation's business and the decisions of the board of directors as we will see later, but the reason for not participating (*i.e.* avoiding a conflict) would mitigate the contravention to his or her fiduciary duties.

¹⁸⁴ See National Instrument 51-102 – *Continuous Disclosure Obligations* (2004) 27 OSCB 3439; *Canadian Western Natural Gas Co. v. Central Gas Utilities Ltd.*, [1966] S.C.R. 630; and Ellis, M.V., *supra* note 145, at 15-4.

¹⁸⁵ *Ibid.*

¹⁸⁶ Priest, M. & Nathan, H.R., *supra* note 3, at 27.

corporation. As stated by the Ontario Superior Court in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*:

Disclosure of a director's interest is but the first step. Disclosure does not relieve the director of his duty to act honestly and in good faith with a view to the best interests of the corporation. The director must always place the interests of the corporation ahead of his own.¹⁸⁷

Where an interested director has acted in accordance with his or her fiduciary duties and can avail himself or herself of the protective provisions of section 120 of the *CBCA*, the contract in which he or she has an interest will not be voidable and the profit arising therefrom can be kept by the director.¹⁸⁸

Similarly, directors are generally allowed to keep the gains obtained strictly as shareholders of the corporation and the compensation they draw from the corporation for acting as director.¹⁸⁹ These legal exceptions to the general principle are commented by the Supreme Court of Canada in *Peoples Department Stores Inc. (Trustee of) v. Wise*.¹⁹⁰

However, it is not required that directors and officers in all cases avoid personal gain as a direct or indirect result of their honest and good faith supervision or management of the corporation. In many cases the interests of directors and officers will innocently and genuinely coincide with those of the corporation. If directors and officers are also shareholders, as is often the case, their lot will automatically improve as the corporation's financial condition improves. Another example is the compensation that directors and officers usually draw from the corporations they serve. This benefit, though paid by the corporation, does not, if reasonable, ordinarily place them in breach of their fiduciary duty. Therefore, all the circumstances may be scrutinized to determine whether the directors and officers have acted honestly and in good faith with a view to the best interests of the corporation.¹⁹¹

¹⁸⁷ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, [2002] O.J. No. 2412 (Ont. Sup. Court), at par. 117.

¹⁸⁸ Sutherland, H., *supra* note 17, at 422 and 423.

¹⁸⁹ Section 125 of the *CBCA* specifically allows directors to fix their own remuneration.

¹⁹⁰ *Supra* note 7.

¹⁹¹ *Ibid.*, at 479.

Finally, as provided by subsection 122(3) of the *CBCA*, should a director breach his or her duty of loyalty, a ratification vote by the majority of the shareholders would not preclude other shareholders from requesting compensation for such a breach, on behalf of the corporation, through a derivative action. Prior to the adoption of that subsection, a breach to the duty of loyalty could be ratified by shareholders, unless doing so was oppressive to the interests of minority shareholders or if the ratification was obtained by improper means.¹⁹² If controlling shareholders decided that a transaction was acceptable to them, they could approve it and a conflicted director could even vote on the proposal, which could obviously result in abuse of the ratification process.¹⁹³ With the adoption of subsection 122(3) of the *CBCA*, such a shareholder approval no longer insulates directors against potential recourse, unless the provisions set forth in that subsection are met. Otherwise, the majority vote is only considered by the court when deciding if a specific shareholder has a right to bring a derivative action on behalf of the corporation or in determining if an action of the corporation or its directors is oppressive under section 241 of the *CBCA*.¹⁹⁴

In short, a director breaches his or her duty of loyalty when the director puts his or her interests ahead of his or her duty to act in the best interests of the corporation. The common law principle is that such behaviour should be discouraged by requiring that any financial benefit from engaging in the behaviour be restored to the corporation.¹⁹⁵ In the U.S., punitive damages are also increasingly awarded to plaintiffs in cases of breach to the duty of loyalty. However, in very specific situations such as those described in section 120 of the *CBCA*, directors or shareholders of a corporation may ratify a potential breach to the duty of loyalty, provided that the conditions described in such section are met.

¹⁹² See *Foss v. Harbottle* (1843), 2 Hare 461, 67 E.R. 189 (Ch), referred to in VanDuzer, J.A., *supra* note 71, at 297.

¹⁹³ *North-West Transportation Co. Ltd. and Beatty v. Beatty* (1887), 12 App. Cas. 589 (P.C.); referred to in VanDuzer, J.A., *ibid.*

¹⁹⁴ See sections 241 and 242 of the *CBCA*; see also VanDuzer, J.A., *ibid.*, at 298.

¹⁹⁵ See particularly 242(1) of the *CBCA*; see also VanDuzer, J.A., *ibid.*, at 255 and 284.

3. THE DUTY OF CARE

In order to understand the extent of the duty of care, and the related potential liability of directors, one must review the normal standard of care, the effect of the business judgment rule on such standard and the very particular situations in which the conduct of directors will be assessed through an enhanced scrutiny standard.

(a) The normal standard

As seen previously, directors have an affirmative duty to act diligently and prudently in managing the corporation's affairs. This responsibility is often called the "duty of diligence" or the "duty of care".¹⁹⁶ In Canada, the duty of care is codified in subsection 122(1)(b) of the *CBCA*:

122(1) Every director and officer of a corporation in exercising their powers and discharging their duties shall

[...]

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. [...]

In *Peoples Department Stores Inc. (Trustee of) v. Wise*,¹⁹⁷ the Supreme Court of Canada describes the evolution of the duty of care, from a relaxed subjective standard to an objective standard:

That directors must satisfy a duty of care is a long-standing principle of the common law, although the duty of care has been reinforced by statute to become more demanding. Among the earliest English cases establishing the duty of care were *Dovey v. Cory*, [1901] A.C. 477 (H.L.); *In re Brazilian Rubber Plantations and Estates, Ltd.*, [1911] 1 Ch. 425 (C.A.); and *In re City Equitable Fire Insurance Co.*, [1925] 1 Ch. 407 (C.A.). In substance, these cases held that the standard of care was a reasonable relaxed, subjective standard. The common law required

¹⁹⁶ Bender, M., *supra* note 17, at 3-1.

¹⁹⁷ *Supra* note 7.

directors to avoid being grossly negligent with respect to the affairs of the corporation and judged them according to their own personal skills, knowledge, ability and capacities. [...]

The 1971 report entitled *Proposals for a New Business Corporations Law for Canada* (1971) (“Dickerson Report”) culminated the work of a committee headed by R.W.V. Dickerson which had been appointed by the federal government to study the need for new federal business corporations legislation. This report preceded the enactment of the *CBCA* by four years and influenced the eventual structure of the *CBCA*.

The standard recommended by the Dickerson Report was objective, requiring directors and officers to meet the standard of a “reasonably prudent person” [...]

The statutory duty of care in s. 122(1)(b) of the *CBCA* emulates but does not replicate the language proposed by the Dickerson Report. The main difference is that the enacted version includes the words “in comparable circumstances”, which modifies the statutory standard by requiring the context in which a given decision was made to be taken into account. This is not the introduction of a subjective element relating to the competence of the director, but rather the introduction of a contextual element into the statutory standard of care. It is clear that s. 122(1)(b) requires more of directors and officers than the traditional common law duty of care outlined in, for example, *Re City Equitable Fire Insurance Co.*, *supra*. [...]

The contextual approach dictated by s. 122(1)(b) of the *CBCA* not only emphasizes the primary facts but also permits prevailing socio-economic conditions to be taken into consideration. The emergence of stricter standards puts pressure on corporations to improve the quality of board decisions. [...]¹⁹⁸

As mentioned by the Supreme Court of Canada, the rule of common law in existence prior to the adoption of section 122 of the *CBCA* was subjective. In *In Re City Equitable Fire Insurance Co., Re*,¹⁹⁹ referred to in *Peoples Department Stores Inc. (Trustee of) v. Wise*,²⁰⁰ Mr. Justice Romer noted that in discharging the duties of his or

¹⁹⁸ *Ibid.*, at 489 to 491.

¹⁹⁹ *In Re Standard Trustco Ltd.* (1992), 6 B.L.R. (2d) 241 (Ont. Sec. Comm.).

²⁰⁰ *Supra* note 7.

her position, a director must exercise some degree of both skill and diligence.²⁰¹ Relying on the decision of Mr. Justice Neville in *Brazilian Rubber Plantations Ltd., Re*,²⁰² he held that the standard of care was “reasonable care”, to be measured by the care an ordinary man may be expected to take in the circumstances on his own behalf.²⁰³ He also stated that in the performance of his duties, a director need not exhibit a greater degree of skill than may reasonably be expected from a person of his knowledge and experience:²⁰⁴

[...] A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. A director of a life insurance company, for instance, does not guarantee that he has the skill of an actuary or of a physician. In the words of Lindley M.R.: “If directors act within their powers, if they act with such care as is reasonably to be expected from them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable as well as their legal duty to the company” [...]²⁰⁵

It is this aspect of Mr. Justice Romer’s decision that is generally cited to illustrate the subjective nature of the standard of care imposed on a director by the common law, which was considered too lax by the drafters of the *CBCA* and was replaced by the objective standard of the reasonable person now set out in section 122 of the *CBCA*.²⁰⁶ On that issue, the Dickerson Report commented that it was “[...] cold comfort to a shareholder to know that there is a steady supply of marginally competent people available under the present law to manage his investment”.²⁰⁷ It was thus proposed that the conduct of directors be measured against the objective standard of what a “reasonable prudent person” would do.

²⁰¹ *Ibid.*

²⁰² [1911] 1 Ch. 425 (Eng. Ch. Div.).

²⁰³ *In Re City Equitable Fire Insurance Co.*, *supra* note 123 at 428; and Hansell, C., *supra* note 119, at 9-64.

²⁰⁴ *In Re City Equitable Fire Insurance Co.*, *ibid.*

²⁰⁵ *Ibid.*, p. 428 and 429.

²⁰⁶ Hansell, C., *supra* note 119, at 9-64 and 9-65.

²⁰⁷ *Supra* note 166, at 83.

In *Soper v. Canada*,²⁰⁸ the Canadian Federal Court of Appeal reviewed the standard of care prescribed by section 227.1 of the *Income Tax Act*.²⁰⁹ Like subsection 122(1)(b) of the *CBCA*, this section refers to “the degree of care, diligence and skill [...] that a reasonably prudent person would have exercised in comparable circumstances”. The Federal Court of Appeal found that the standard set out in the *Income Tax Act* and in the *CBCA* could be qualified as an objective-subjective test.²¹⁰ In *Peoples Department Stores Inc. (Trustee of) v. Wise*,²¹¹ the Supreme Court of Canada rejected the “objective subjective” standard, stating that such expression could lead to confusion:

The standard of care embodied in s. 122(1)(b) of the *CBCA* was described by Robertson J.A. of the Federal Court of Appeal in *Soper v. Canada*, [1998] 1 F.C. 124, at para. 41, as being “objective subjective”. [...] With respect, we feel that Robertson J.A.’s characterization of the standard as an “objective subjective” one could lead to confusion. We prefer to describe it as an objective standard. To say that the standard is objective makes it clear that the factual aspects of the circumstances surrounding the actions of the director or officer are important in the case of the s. 122(1)(b) duty of care, as opposed to the subjective motivation of the director or officer, which is the central focus of the statutory duty of s. 122(1)(a) of the *CBCA*.²¹²

As seen in subsection I.B.1(a) of this thesis, the Supreme Court of Canada is of the view that the beneficiary of the duty of loyalty is always the corporation itself. In *Peoples Department Stores Inc. (Trustee of) v. Wise*,²¹³ the Supreme Court of Canada states that the identity of the beneficiary of the duty of care is much more open-ended, and must include creditors:

[...] unlike the statement of the fiduciary duty in s. 122(1)(a) of the *CBCA*, which specifies that directors and officers must act with a view to the best interests of the corporation, the statement of the duty of care in s. 122(1)(b) does not specifically refer to an identifiable party as the beneficiary of the duty. Instead, it provides that “[e]very director and

²⁰⁸ [1998] 1 C.F. 124 (Fed. C.A.).

²⁰⁹ R.S.C. 1985, c.1, as amended.

²¹⁰ Hansell, C., *supra* note 120, at 9-67.

²¹¹ *Supra* note 7.

²¹² *Ibid.*, at 491.

²¹³ *Ibid.*

officer of a corporation in exercising their powers and discharging their duties shall... exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.” Thus, the identity of the beneficiary of the duty of care is much more open-ended, and it appears obvious that it must include creditors [...]²¹⁴

A breach of the duty of care may take the form of active conduct. It can also take the form of passive conduct, such as neglect of the corporation’s interests or concealment of important information to the corporation.²¹⁵ As stated by the House of Lords in *Scottish Cooperative Wholesale Society v. Meyer*,²¹⁶ in which the managing directors of a company were found to breach their fiduciary duties because of their failure to act to protect the interests of the company:

[...] I cannot think that where directors, having power to do something to save a company, lay back and do nothing, they are not conducting the affairs of the company, perhaps foolishly, perhaps negligently, perhaps with some ulterior object in view. They are certainly conducting the affairs of the company in breach of their duty as directors.²¹⁷

The duty of care requires a director to act in good faith and on the basis of adequate information in arriving at business decisions. Directors are expected to spend sufficient time on the affairs of the corporation to comply with such duty.²¹⁸ It includes the responsibility to oversee the activities of the corporation by attending board meetings, requiring the corporation to provide adequate information upon which to make decisions, carefully reviewing documents prepared for the purposes of a meeting and monitoring the activities delegated by the board to committees and management.²¹⁹

²¹⁴ *Ibid.*, at 488.

²¹⁵ Sutherland, H., *supra* note 17, at 459.

²¹⁶ *Supra* note 150.

²¹⁷ *Ibid.*, at 460.

²¹⁸ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 1, at 1.

²¹⁹ *Ibid.*, chap. 2, at 1 and 2.

In the absence of grounds for suspicion, directors are entitled to delegate certain responsibilities to management and to rely on managers in good faith.²²⁰ Under subsection 123(5) of the *CBCA*, they will be deemed to have complied with their fiduciary duties if they can prove that they relied in good faith on: (i) financial statements of the corporation represented to them by an officer of the corporation or in a written report of the auditor of the corporation fairly to reflect the financial condition of the corporation; or (ii) a report of a person whose profession lends credibility to a statement made by the professional person. Although delegation of day-to-day corporate affairs is permissible (and necessary), such delegation must always be consistent with the directors' exercise of due care and the complete failure to institutionalize procedures for monitoring officers or employees' compliance with the law can subject directors to liability.²²¹

In addition to liability for lack of care in authorizing certain decisions, directors may violate their duty of care through a lack of attention or failure to adequately supervise officers or employees. Directors cannot simply close their eyes to the conduct of management and avoid liability.²²² If there is a doubt regarding the integrity or ability of managers, directors should be very careful about the information received from them. As stated by the Ontario Securities Commission in *In Re Standard Trustco Ltd.*, a case in which directors were criticized for failing to exercise proper prudence and diligence given their knowledge of financial difficulties of a corporation and concerns expressed by regulators.²²³

It was not appropriate in the circumstances for the respondent directors to have placed as much reliance on management as they did, both in terms of relying on management's financial statements and relying on management to consult with the outside lawyer and auditor. Directors should not rely

²²⁰ See subsection 123(5) of the *CBCA* discussed in subsection II.B.2(a) of this thesis; see also Hansell, C., *supra* note 120, at 9-112.

²²¹ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 2, at 69.

²²² *Ibid.*, chap. 2, at 68.

²²³ *Supra* note 199.

on management unquestioningly where they have reason to be concerned about the integrity or ability of management or where they have notice of a particular problem relating to management's activities.²²⁴

Management too has fiduciary powers to discharge toward the corporation and even if the analysis of such duties is beyond the scope of this thesis, it is important to understand that they are related. Indeed, as part of their duty of care, directors should oversee managers in the proper discharge of their own fiduciary duties.

When discharging its duties, the board may also delegate some responsibilities to board committees. Generally, all powers of a board can be delegated to board committees, except those that are statutorily excluded, as described in section 115 of the *CBCA*. Section 115 of the *CBCA* includes items that would affect: (i) the balance of powers on the board (such as changing the composition of the board or submitting matters to the shareholders); (ii) the rights attached to securities or distributions to shareholders (such as issuing new securities or declaring dividends); or (iii) the long-term methods of operations of the corporation (such as changing corporate by-laws).²²⁵ Although these matters cannot be delegated to board committees, committees can nevertheless examine issues related to them and report their conclusions and recommendations to the entire board, which can decide on the course of action to be taken.²²⁶

The delegation of responsibilities by the board neither reduces nor extinguishes the power and authority of the full board. The board may act as a whole despite a prior decision to delegate authority. Other than what is required by law or under the by-laws of the corporation,²²⁷ it can remove authority from anyone to whom authority was delegated.²²⁸ In terms of liability, the existence of committees or other delegates does

²²⁴ *Ibid.*, at 285.

²²⁵ Welling, B., *supra* note 122, at 324 and 325; and Priest, M. & Nathan, H.R., *supra* note 3, at 92 and 93.

²²⁶ Priest, M. & Nathan, H.R., *ibid.*, at 93.

²²⁷ Note that the board could even amend the by-laws of the corporation, subject to the ratification of such amendment by the shareholders.

²²⁸ McGuinness, K.P., *supra* note 17, at 781.

not relieve boards of their overall responsibility to manage and govern the corporation.²²⁹ The delegation of authority to a board committee does not insulate non-committee members from claims that they have not fulfilled their fiduciary duties. Relevant factors in assessing whether or not non-member directors complied with such duties include the care used in delegation to the committee and in the supervision of the committee's activities, as well as the knowledge that a particular director has of such activities. If a non-member director is aware of a situation demanding corrective action, or should have been aware of it, and fails to take corrective measures, liability could be imposed on him or her.²³⁰

Directors could be held to a higher standard of care when they serve on a committee²³¹ than the standard applicable to board members generally.²³² In the Ontario Securities Commission's decision in *In Re Standard Trustco Ltd.*,²³³ directors approved financial statements despite warnings by the Office of the Superintendent of Financial Institutions that such statements were based on inappropriate accounting policies. The Ontario Securities Commission stated that members of a committee generally have a greater opportunity to obtain knowledge about the subjects presented to the committee and therefore, more may be expected from them:

[...] However, in our opinion the members of the audit committee should bear somewhat more responsibility than the other directors [...] not because there was a greater standard of care imposed on them, but rather because their circumstances were different. As members of the audit committee, they had a greater opportunity to obtain knowledge about and to examine the affairs of the company than non-members had. As a result, more was expected of them in respect of overseeing the financial reporting process and warning other directors about problems.²³⁴

²²⁹ *In Re Standard Trustco Ltd.*, *supra* note 199; and Priest, M. & Nathan, H.R., *supra* note 3, at 94.

²³⁰ *In Re Standard Trustco Ltd.*, *ibid.*, at 290; and Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 8, at 21.

²³¹ See *In Re Standard Trustco Ltd.*, *ibid.*

²³² Priest, M. & Nathan, H.R., *supra* note 3, at 94.

²³³ *In Re Standard Trustco Ltd.*, *supra* note 199.

²³⁴ *Ibid.*, at 290.

As discussed above and as was the case for the duty of loyalty, directors may also be relieved of liability when they can show, under subsection 123(5) of the *CBCA*, that they relied in good faith on the reports of experts. Hence, reliance on the advice of counsel may be used by a board to prove that it acted with due care. When using such a defence, directors should generally be able to prove that: (i) they made a complete disclosure to the expert of appropriate facts necessary for preparing his or her report; (ii) requested the expert's advice as to the proposed decision; (iii) received advice as to the conduct to adopt; (iv) reviewed the assumptions and methodology of the expert and asked questions where appropriate; and (v) proceeded in reliance on the expert's advice.²³⁵

Reliance on experts is so commonly used that in some situations, obtaining the advice of experts is expected.²³⁶ For instance, in considering the price to be paid for securities of a corporation, Mr. Justice Farley, of the Ontario Court of Justice (General Division), implied in *820099 Ont. Inc. v. Harold E. Ballard Ltd.* that a valuation expert should normally be hired.²³⁷

The transactions complained of were major ones involving substantial amounts of money or key voting power in certain circumstances. One would normally think that in such circumstances proper valuations would have been the watch word. They were not, although I can think of no logical or practical reason why they were not.²³⁸

While a board of directors may rely in good faith upon the information, opinions, reports or statements presented by experts selected with reasonable care, this does not replace or diminish directors' duty of oversight.²³⁹ Directors must always make reasonable inquiries²⁴⁰ and become reasonably familiar with an opinion, report or other

²³⁵ Bender, M., *supra* note 17, at 3-17.

²³⁶ Hansell, C., *supra* note 119, at 9-118; and Bender, M., *ibid.*, at 3-18.

²³⁷ *Supra* note 161.

²³⁸ *Ibid.*, at 178.

²³⁹ *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. Supr. Ct 1989).

²⁴⁰ *In Re Standard Trustco Ltd.*, *supra* note 199, at 286 and 287.

source of advice before being entitled to rely on it.²⁴¹ Directors would generally not be authorized to rely on the opinion of an expert if they did not attend the meetings where such opinion was discussed or if they knew that such opinion was based on false premises or that the expert was not reliable or competent in the matters presented.²⁴² If they learn of suspicious circumstances, directors should make inquiries as an ordinarily prudent person would make under the same or similar circumstances.²⁴³ Reliance on expert opinion or reports will thus be normally justifiable if directors act with care in evaluating the information supplied, and are unaware of facts or discrepancies signaling the need for additional information.²⁴⁴

In addition, it is worth noting that section 123 of the *CBCA* does not refer to all kinds of experts, but only to persons whose profession lends credibility to their statement. In *Peoples v. Wise*,²⁴⁵ the Supreme Court of Canada states that the title of an officer does not make him or her an expert under section 123 of the *CBCA*. For the Court, regulatory overview of the person by a professional organization and independent insurance coverage for professional negligence seem to be clues that the statements of that person may be relied on pursuant to section 123 of the *CBCA*. Considering the previous version of section 123 *CBCA*, which allowed a board to rely on the report of a lawyer, accountant, engineer, appraiser or “other person whose profession lends credibility to a statement made by him”, the Court is of the opinion that the vice-president finance of a firm is not necessarily an expert (profession must not be confused with position):

Although Clément did have a bachelor’s degree in commerce and 15 years of experience in administration and finance with Wise, this experience does not correspond to the level of professionalism required to allow the directors to rely on his advice as a bar to a suit under the duty of care. The named professional groups in s. 123(4)(b) were lawyers, accountants, engineers, and appraisers. Clément was not an accountant, was not

²⁴¹ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 2, at 57.

²⁴² Bender, M., *supra* note 17, at 3-22.

²⁴³ *Ibid.*

²⁴⁴ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 2, at 58.

²⁴⁵ *Supra* note 7.

subject to the regulatory overview of any professional organization and did not carry independent insurance coverage for professional negligence. The title of vice-president of finance should not automatically lead to a conclusion that Clément was a person “whose profession lends credibility to a statement made by him”. It is noteworthy that the word “profession” is used, not “position”. Clément was simply a non-professional employee of Wise. [...] Therefore, in our opinion, the Wise brothers cannot successfully invoke the defence provided by s. 123(4)(b) of the *CBCA* but must rely on the other defences raised.

Another way for directors to escape liability is to prove that they properly dissented from board action, rather than merely abstaining.²⁴⁶ Under section 123 of the *CBCA*, directors will be deemed to have consented to any resolution passed or action taken at a meeting, even if they were not present at the meeting, unless they caused a dissent to be recorded, as described in the *CBCA*.

Directors should spend the time needed and meet as frequently as necessary to properly discharge their responsibilities. Longer meetings may permit directors to explore key issues in depth, whereas shorter but more frequent meetings may help directors to stay up-to-date on emerging corporate trends as well as business and regulatory developments.²⁴⁷ Evidence that directors took sufficient time to consider relevant information, within the limits of any time constraints, may help to establish that they acted with care.

If in some cases restitution and punitive damages may be imposed on directors who breached their duty of loyalty, compensation alone is the usual remedy for those who breach their duty of care.²⁴⁸ Deterrence is effective because compensatory damages leave the agent in a worse position than if he or she had not breached his or her duty of

²⁴⁶ Bender, M., *supra* note 17, at 17-66.

²⁴⁷ The Business Roundtable, *Principles of Corporate Governance* (Washington: May 2002), at 20.

²⁴⁸ Cooter, R. & Freedman, B.J., *supra* note 103, at 1057.

care.²⁴⁹ Liability for the harm resulting from the lack of care is thus usually sufficient to deter it.²⁵⁰

Once the duty of care has been breached, can this breach be ratified by the shareholders? The answer to this question has evolved. Although once recognized as a legitimate way for directors to protect themselves,²⁵¹ the method is now ineffective under subsection 122(3) of the *CBCA*. As it is the case for a breach to the duty of loyalty, a vote by the majority of a corporation's shareholders to forgive a breach of the duty of care should not affect any personal right of a shareholder who has not ratified such a breach, subject to section 242(1) of the *CBCA*, which states that such ratification may be taken into account by the court in making certain orders.²⁵²

It is interesting to mention that in the U.S., section 102(b)(7) of the Delaware Code allows corporations to amend their certificate of incorporation to opt out of monetary liability for non-intentional breaches of the duty of care.²⁵³ The Delaware Code allows such exoneration in most circumstances other than where a director is found to have committed a breach of the duty of loyalty or in cases of acts or omissions not in good faith, intentional misconduct, known violation of the law, improper payment of dividends or improper benefit.²⁵⁴ Obviously, the application of such legislation, which has no equivalent in Canada, undermines the role of the duty of care in the protection of corporate interests.²⁵⁵

²⁴⁹ *Ibid.*, at 1075.

²⁵⁰ *Ibid.*, at 1048.

²⁵¹ *Zwicker v. Stanbury*, *supra* note 143, at 450.

²⁵² *Welling, B.*, *supra* note 122, at 430.

²⁵³ *Rock, E. & Wachter, M.*, "Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants" (2002) 96 *Nw. U.L. Rev.* 651, at 659 and 660; *Strine, L.E.*, *supra* note 61, at 1385; and *Bender, M.*, *supra* note 17, at 3-14 and 3-33.

²⁵⁴ *Veasey, E.N.*, *supra* note 79, at 397.

²⁵⁵ *Elson, C.M. & Thompson, R.B.*, "Van Gorkom's Legacy: The Limits of Judicially Enforced Constraints and the Promise of Proprietary Incentives" (2002) 96 *Nw. U.L. Rev.* 579, at 580.

(b) The effect of the business judgment rule

In Canada, as in the U.S., the duty of care is qualified by the business judgment rule. Under such rule, business decisions are presumed not to be in breach of the duty of care in the absence of fraud, illegality or conflict of interest on the part of the decision maker.²⁵⁶

Authors have mentioned the following reasons for the business judgment rule:

- If directors were liable for mere good faith errors of judgment, competent persons may be deterred from serving as corporate directors for fear of being sued;²⁵⁷
- Courts are generally ill-equipped to evaluate or second-guess business decisions. They are generally not business experts and it would be costly to regularly second-guess business decisions;²⁵⁸
- Hindsight bias is dangerous. What looks obvious after the fact might not have been so apparent to directors in advance;²⁵⁹
- External review may skew decision-making in undesirable ways. Corporate directors should have sufficient latitude to avoid overly conservative decisions that could be the result of excessive exposure to liability. Fear of litigation may encourage directors to be risk-averse. Risk-averse directors may take excessive precautions resulting in sub-optimal return on investment for the shareholders.²⁶⁰

²⁵⁶ See *Shlensky v. Wrigley*, 237 N.E. 2d 776 (Ill. App. 1968); referred to in VanDuzer, J.A., *supra* note 71, at 303.

²⁵⁷ Bender, M., *supra* note 17, at 1-26 and at 2-6; and Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 2, at 33.

²⁵⁸ Bender, M., *ibid.*, at 1-26; Bainbridge, S.M., *supra* note 34, at 48; and Roe, M.J., *supra* note 25, at 15.

²⁵⁹ Strine, L.E., *supra* note 61, at 1390.

²⁶⁰ Bender, M., *supra* note 17, at 1-25 and 1-26; Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 2, at 33; and Bainbridge, S.M., *supra* note 34, at 50.

In *Peoples Department Stores Inc. (Trustee of) v. Wise*,²⁶¹ the Supreme Court of Canada recognized the existence of the business judgment rule:

[...] Canadian courts, like their counterparts in the United States, the United Kingdom, Australia and New Zealand, have tended to take an approach with respect to the enforcement of the duty or care that respects the fact that directors and officers often have business expertise that courts do not. Many decisions made in the course of business, although ultimately unsuccessful, are reasonable and defensible at the time they are made. Business decisions must sometimes be made, with high stakes and under considerable time pressure, in circumstances in which detailed information is not available. It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post facto*. Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the “business judgment rule”, adopting the American name for the rule.²⁶²

The Supreme Court quotes *Maple Leaf Foods Inc. v. Schneider Corp.*,²⁶³ in which the Ontario Court of Appeal, after an analysis of Canadian and Delaware decisions, states that directors’ decisions need not be “perfect” decisions, but rather that directors are protected in as much as they demonstrated diligence in arriving at “reasonable” decisions:

Provided that the directors have acted honestly and reasonably, the court ought not to substitute its own business judgement for that of the Board of Directors [...]

The law as it has evolved in Ontario and Delaware has the common requirements that the court must be satisfied that the directors have acted reasonably and fairly. The court looks to see that the directors made a *reasonable* decision not a *perfect* decision. Provided the decision taken is within a range of reasonableness, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubts on the board’s determination. As long as the directors have

²⁶¹ *Supra* note 7.

²⁶² *Ibid.*, at 491 and 492.

²⁶³ (1998) 42 O.R. (3d) 177 (C.A.).

selected one of several reasonable alternatives, deference is accorded to the board's decision [...]. This formulation of deference to the decision of the Board is known as the "business judgement rule".²⁶⁴

In short, according to the business judgment rule concept, courts will generally not interfere with the board in the performance of its duty to manage the business and affairs of a corporation.²⁶⁵ If the directors are fully informed and are diligent prior to making a decision, their decision should be given deference.²⁶⁶

The effect of the business judgment rule has been described by certain authors as undermining the legal standard of care.²⁶⁷ This description may be attributed to the fact that, as a result of the business judgment rule, so long as a director acts honestly, he or she will generally not be held liable unless he or she is guilty of "gross or culpable negligence in a business sense".²⁶⁸

With respect to the duty of care, in the U.S., the decision *Smith v. Van Gorkom*²⁶⁹ made it clear that reasonable inquiry was a condition to the invocation of the business judgment rule.²⁷⁰ In this famous decision, a shareholder was seeking rescission of a transaction on the basis that directors did not exercise proper care in approving it, and therefore such decision did not warrant business judgment rule protection. In its decision, the Delaware Supreme Court found that the directors of the corporation had breached their duty of care by failing to inform themselves adequately before recommending the sale of their firm to a bidder.²⁷¹ The Court was critical of the board for approving a transaction on very short notice, not insisting on the appropriate information and not subjecting the information before it to an appropriate analysis.²⁷²

²⁶⁴ *Ibid.*, at 191 and 192.

²⁶⁵ McGuinness, K.P., *supra* note 17, at 676.

²⁶⁶ Millstein, I., *supra* note 81, at 1490 and 1491.

²⁶⁷ Bybelezer, H.M., *supra* note 102, at 107.

²⁶⁸ Hansell, C., *supra* note 1120, at 9-64.

²⁶⁹ 488 A.2d 858 (Del. Supr. Ct 1985).

²⁷⁰ Eisenberg, M.A., *supra* note 116, at 22.

²⁷¹ Meese, A.J., *supra* note 36, at 1687.

²⁷² Hansell, C., *supra* note 120, at 9-88 and 9-89.

In Canada as in the U.S., the business judgment rule will not protect directors who have not, prior to making a business decision, considered all material information reasonably available to them and assessed such information with a critical eye.²⁷³ Directors can make informed decisions even when they do not possess complete knowledge, so long as they have sufficient information on the basis of the facts known to them that a reasonable person would consider it sensible and prudent in the circumstances to come to a decision.²⁷⁴ As a consequence, directors have a duty to attend board meetings, read the documents prepared by the corporation to familiarize themselves with the business to be conducted and take an active part in the decisions to be made at such meetings.²⁷⁵ A director is not bound to attend all meetings of the board, but gross inattention to the business of the directors may amount to a breach of fiduciary duties and directors may not be protected by the business judgment doctrine in such a case.²⁷⁶

(c) The enhanced scrutiny standard

Under Canadian and Delaware law, the conduct of directors, in discharging their duty of care, is subject to enhanced scrutiny in certain situations. When there is a greater danger that directors act out of self-interest or engage in self-dealing, courts have ruled that in these circumstances, a director must affirmatively defend the inherent fairness of a challenged transaction.²⁷⁷

This principle stems from the Delaware case *Unocal Corporation v. Mesa Petroleum Co.*²⁷⁸ In that decision, the Delaware Supreme Court acknowledged that

²⁷³ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 187, par. 125; Hansell, C., *supra* note 120, at 9-103; and Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 2, at p. 43.

²⁷⁴ *Aronson v. Lewis*, *supra* note 48, at 812; and McGuinness, K.P., *supra* note 17, at 774.

²⁷⁵ *Compagnie de Mayville v. Whitley*, [1896] 1 Ch. 788 (C.A.); McGuinness, K.P., *ibid.*, at 666; and Priest, M. & Nathan, H.R., *supra* note 3, at 28.

²⁷⁶ Sutherland, H., *supra* note 17, at 462; and Priest, M. & Nathan, H.R., *ibid.*, at 200.

²⁷⁷ *Maple Leaf Foods Inc. v. Schneider Corp.*, *supra* note 263; *Aronson v. Lewis*, *supra* note 48; and Brabson, D.G., "Yanow v. Scientific Leasing, Inc.: "Enhanced Scrutiny" – Delaware's Judicial Standard of Review for a Single Bid Acquisition" (1993) 18 Del. J. Corp. L. 139, at 141.

²⁷⁸ *Unocal Corporation v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. Supr. Ct 1985).

board strategies to prevent a takeover bid may involve the possibility that directors could breach their duty of loyalty by acting primarily for the purpose of retaining control.²⁷⁹ This concern raises the question of directors' good faith and of the subjective motivations of corporate directors.

Directors do not act in good faith when they act for the purpose of retaining control, without the honest belief that their actions are in the corporation's best interest. Subjective motivations, however, are difficult to prove. For that reason, the Delaware Supreme Court shifted to the directors the burden of proving that their conduct was proper, something usually presumed under the business judgment rule.²⁸⁰

The enhanced scrutiny test is rarely applied. When it is, the test generally addresses unilateral board action in the face of a perceived threat, or board action whose primary purpose may appear to be to disenfranchise shareholders.²⁸¹ The test is usually not applicable outside of a change of control context.²⁸² A change of control may occur when a corporation is the target of a formal takeover bid or when its board enters into a merger transaction, initiates an active bidding process seeking to sell the corporation or makes a break-up of the corporate entity inevitable.²⁸³

In Canada, a "proper purpose" test, similar to the enhanced scrutiny test, has been developed and is used by our courts. The Ontario Court of Appeal endorsed the "proper purpose" test in *Maple Leaf Foods Inc. v. Schneider Co.*²⁸⁴

²⁷⁹ Bradbury, S.G., "Corporate Auctions and Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule" (1988) 87 Mich. L. Rev. 276, at 284.

²⁸⁰ *Ibid.*

²⁸¹ *Williams v. Geier*, 671 A.2d 1368 (Del. Supr. Ct 1996), at 1377; and Bender, M., *supra* note 17, at 14-17.

²⁸² Bender, M., *ibid.*, at 2-31.

²⁸³ *Omnicare Inc. v. NCS Healthcare, Inc.*, 2003 Del. LEXIS 195 (Del. Supr. Ct).

²⁸⁴ *Supra* note 263; Despite the explicit adoption of the proper purpose test and the statement of the Ontario Court of Appeal to the effect that it is similar to the U.S. enhanced scrutiny test, certain courts have refused to apply the enhanced scrutiny test in Canada. See for instance: *Corporacion Americana de Equipamientos Urbanos S.L. v. Ovifas Marketing Group Inc.*, [2003] O.J. No. 3368 (Ont. Sup. Court), at 4, referring to *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* (1998) 38 B.L.R. (2d) 196 (Ont. Gen. Div.).

[...] Some Canadian authorities have adopted a proper purpose test, which is similar to the enhanced scrutiny in that it shifts the burden of proof to the directors to show that their acts are consistent only with the best interests of the company and inconsistent with any other interests. These cases recognize that there may be a conflict between the directors who manage the company and the interests of certain groups of shareholders [...] and have espoused shifting the burden of proof as a method of overcoming the potential conflict.²⁸⁵

The Saskatchewan Court of Appeal, in *347883 Alberta Ltd. v. Producers Pipelines*²⁸⁶ was also of the same opinion:

In summary, when a corporation is faced with susceptibility to a take-over bid or an actual take-over bid, the directors must exercise their powers in accordance with their overriding duty to act *bona fide* and in the best interests of the corporation even though they may find themselves, through no fault of their own, in a conflict of interest situation. If, after investigation, they determine that action is necessary to advance the best interests of the company, they may act, but the onus will be on them to show that their acts were reasonable in relation to the threat posed and were directed to the benefit of the corporation and its shareholders as a whole, and not for an improper purpose such as entrenchment of the directors.²⁸⁷

In a change of control context, the directors must also focus on the so-called “Revlon duties”, described below. In those circumstances, directors have a responsibility to secure the transaction that offers the best value reasonably available to the shareholders, and they must exercise their fiduciary duties to further that end.²⁸⁸ In order to know if that special duty is triggered, directors must first determine if the corporation is “in play” (in other words, if a change of control is likely). When a veto block shareholder is entitled to ignore, disregard or reject a proposal that would result in a

²⁸⁵ *Ibid.*, at 191.

²⁸⁶ *347883 Alberta Ltd. v. Producers Pipelines*, [1991] 3 B.L.R. (2nd) 236 (Sask. Court of Appeal).

²⁸⁷ *Ibid.*, at 261.

²⁸⁸ *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. Supr. Ct., 1993); and *Maple Leaf Foods Inc. v. Schneider Corp.*, *supra* note 263.

change of control, the target corporation cannot be considered “in play”.²⁸⁹ As stated by the General Division of the Ontario Court in *Benson. v. Third Canadian General Investment Trust Ltd.*:²⁹⁰

I would also observe that the “in play” concept only becomes relevant in the aspect of concentrating on maximizing shareholder value when a corporation is *truly* in play. If there is a veto block of shareholders who are entitled to ignore, disregard and/or reject an offer, then if that be the circumstances under the prevailing law, how can one say that the corporation is in play? The ball game would only be played if the veto block were disqualified in some legal way. If not, the first pitch is not thrown. If not in play, then it is my view that maximizing shareholder value is only a subset of the best interests of the corporation for which the directors must have regard [...]²⁹¹

When a corporation is “in play”, the duty of directors is to act in the best interests of the shareholders as a whole and to take active and reasonable steps to maximize shareholder value.²⁹² This principle stems from the U.S. decision *Revlon, Inc., v. MacAndrews & Forbes Holdings, Inc.*,²⁹³ in which the Supreme Court of Delaware stated that:

The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company’s value at a sale for the stockholders’ benefit. This significantly altered the board’s responsibilities [...] The directors’ role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.²⁹⁴

There is no single blueprint that directors must follow to discharge their fiduciary duties in the context of a change of control. Although the Court of Appeal of Ontario, in

²⁸⁹ *Benson. v. Third Canadian General Investment Trust Ltd.* (1993) 14 O.R. (3d) 493 (Ont. Ct., Gen. Div.).

²⁹⁰ *Ibid.*

²⁹¹ *Ibid.*, at 500.

²⁹² *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, *supra* note 285.

²⁹³ 506 A.2d 173 (Del. Supr. Ct 1986).

²⁹⁴ *Ibid.*, at 182.

Maple Leaf Foods Inc. v. Schneider Co.,²⁹⁵ has recognized that directors do not have the obligation to conduct an auction of a corporation's shares where the corporation is for sale, auction and market canvass are certainly typical mechanisms used, in practice, to respond to a takeover bid offer. In National Policy 62-202,²⁹⁶ the Canadian Securities Administrators stated that unrestricted auctions often produce the most desirable results in takeover bids:

[...] The Canadian securities regulatory authorities consider that unrestricted auctions produce the most desirable results in take-over bids and they are reluctant to intervene in contested bids. However, they will take appropriate action if they become aware of defensive tactics that will likely result in shareholders being deprived of the ability to respond to a take-over bid or to a competing bid.²⁹⁷

As mentioned in *Maple Leaf Foods Inc. v. Schneider Co.*,²⁹⁸ an auction may help demonstrate that directors have duly discharged their duties:

When it becomes clear that a company is for sale and there are several bidders, an auction is an appropriate mechanism to ensure that the board of a target company acts in a neutral manner to achieve the best value reasonably available to shareholders in the circumstances. When the board has received a single offer and has no reliable grounds upon which to judge its adequacy, a canvass of the market to determine if higher bids may be elicited is appropriate, and may be necessary [...]²⁹⁹

When, after an informed process, a board selects one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's

²⁹⁵ *Supra* note 263, at 199.

²⁹⁶ 20 O.S.C.B. 3525; National Policy 62-202 has been implemented in all Canadian provinces and territories.

²⁹⁷ *Ibid.*

²⁹⁸ *Supra* note 263.

²⁹⁹ *Ibid.*, at 200.

determination.³⁰⁰ In such a case, the board actions are entitled to the protection of the business judgment rule.

4. TRADITIONAL REMEDIES TO ENFORCE FIDUCIARY DUTIES

The main remedies used for enforcing fiduciary duties are direct action taken by the corporation, derivative action and oppression remedy. This subsection consists in a brief presentation of these remedies. The purpose of this subsection is not to explain in detail the sources of those remedies, their procedural aspects or the advantage of using one over the others. Instead, it aims to broadly present the type of recourse that can be used by a corporation or a complainant in the case of a breach of fiduciary duty by corporate directors. Taking into account such traditional recourse, we will be in a better position, in subsection I.C of this thesis, to assess the effectiveness of fiduciary duties themselves, and the need to complement them with prophylactic and curative measures.

As will be demonstrated in subsection II.A.2(b)(ii) of this thesis, the adoption and disclosure of prophylactic and curative measures has the potential for increasing liability for directors, due to the adoption of part XXIII.1 of the *OSA*, which now allows shareholders who purchased shares on the secondary market to sue directors and other influential persons for a misrepresentation or a failure to disclose material information. Combined with securities law provisions, the practices suggested in part II of this thesis could result in more effective use of the traditional remedies described below.

(a) Direct action taken by the corporation

As seen in subsections I.B(2) and (3) of this thesis, fiduciary duties are obligations generally owed to the corporation. Consequently, when directors breach their fiduciary duties, the primary plaintiff in an action to redress a wrong created by such a breach is thus the corporation itself.

³⁰⁰ *Paramount Communications Inc. v. QVC Network Inc.*, *supra* note 288.

The board of directors of a corporation, in using its general powers, can direct the bringing of an action in the name of the corporation.³⁰¹ Corporate officers can also do so.³⁰² But in both cases, it is in fact the corporation, through its agents, that is the plaintiff. The rule that the corporation is the proper party to bring actions for wrongs done to it was developed in the English case *Foss v. Harbottle*.³⁰³ That case also insists on the fact that a law suit should normally not be brought against the will of the majority of shareholders. In that case, the plaintiffs, Foss and Turton, were shareholders of a company that was formed to buy land to be used as a park. The defendants were the other shareholders and directors of the corporation. The plaintiffs accused the defendants of having defrauded the company. The main claim of the plaintiffs was that certain defendants had sold land to the corporation at an exorbitant price. In dismissing the plaintiffs' action, Wilgram V.C. held that since the corporation was still in existence, it should call a meeting of shareholders to deal with the matter. The action of the plaintiff was decided not to be sustainable.³⁰⁴

In *Edwards v. Halliwell*,³⁰⁵ Jenkin L.J. summarizes the principles of *Foss v. Harbottle* as follows:

The rule in *Foss v. Harbottle*, as I understand it, comes to no more than this. First, the proper plaintiff in an action in respect of a wrong alleged to be done to a company or association of persons is *prima facie* the company or the association of persons itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company or association and on all its members by a simple majority of the members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company or association is in favour of what has been done, then *cadit quaestio* [the matter admits of no further argument].³⁰⁶

³⁰¹ Sutherland, H., *supra* note 17 at 671.

³⁰² *Legge v. Legge*, [1939] 4 D.L.R. 740 (Man. K.B.); referred to in Sutherland, H., *ibid.*, at 672.

³⁰³ *Supra* note 192.

³⁰⁴ McGuinness, K.P., *supra* note 17, at 922.

³⁰⁵ [1950] 2 All E.R. 1064.

³⁰⁶ *Ibid.*, at 1066 and 1067; referred to in Sutherland, H., *supra* note 17 at 694.

Pursuant to the principles of *Foss v. Harbottle*, if the corporation is the injured party, no one else but the corporation should be allowed to seek recovery for a wrong inflicted to it and the majority of shareholders should normally be in favour of any suit to redress such a wrong. As stated by Lord Denning M.R. in *Wallersteiner v. Moir*,³⁰⁷ however, where the defendants are also the controlling shareholders of the corporation, such principles raise many problems:

It is a fundamental principle of our law that a company is a legal person, with its own corporate identity, separate and distinct from the directors or shareholders, and with its own property rights and interests to which alone it is entitled. If it is defrauded by a wrongdoer, the company itself is the one person to sue for the damages. [...] The rule is easy enough to apply when the company is defrauded by outsiders. The company itself is the only person who can sue. But suppose it is defrauded by insiders who control its affairs – by directors who hold a majority of shares – who can sue for damages? Those directors are the wrongdoers. If a board meeting is held, they will not authorize proceedings to be taken by the company against themselves. Yet the company is the one person who is damnified. It is the one person who could sue. In one way or another some means must be found for the company to sue. Otherwise the law would fail in its purpose. Injustice would be done without redress.³⁰⁸

In order to avoid potential injustices, the common law accepts that the rules developed in *Foss v. Harbottle* to be modulated in certain circumstances. Hence, it became recognized that: (i) majority shareholders cannot confirm an act which would be *ultra vires* or illegal; (ii) majority shareholders cannot confirm an act which constitutes a fraud or a breach of fiduciary duties if the wrongdoers are themselves in control of the company; and (iii) majority shareholders cannot confirm an act which can only be validly done or sanctioned, not by a simple majority, but by some special majority.³⁰⁹ In most other cases, common law would still require that the corporation itself take action to redress a wrong made to it. As explained below, however, corporate statutes now include provisions allowing complainants to sue on behalf of the corporation, through

³⁰⁷ [1975] 1 Q.B. 373.

³⁰⁸ *Ibid.*, at 398; referred to in McGuinness, K.P., *supra* note 17, at 922.

³⁰⁹ *Edwards v. Halliwell*, *supra* note 305, at 1067; see also Sutherland, H., *supra* note 17, at 697 and McGuinness, K.P., *ibid.*, at 923.

derivative actions, in a much broader range of circumstances, as well as to seek relief through the oppression remedy.

(b) Derivative action

The derivative action is a way of enforcing fiduciary duties when the corporation itself (*i.e.*, through its management or its board of directors) does not want to take action to pursue the corporation's rights. Prior to the adoption of section 239 of the *CBCA*, common law restricted access to derivative actions. A shareholder would only be allowed to bring a derivative action if he or she had exhausted all means of seeking to have the corporation institute an action in the name of the corporation.³¹⁰ Furthermore, as discussed above, the court did not have the authority to overrule a decision not to sue taken by the majority of a corporation's disinterested shareholders where ratification was possible, subject to limited exceptions.³¹¹

This has changed with the adoption of section 239 of the *CBCA*, which now allows complainants to seek leave to sue on behalf of the corporation. Section 238 of the *CBCA* defines "complainant" as:

"complainant" means

- (a) a registered holder or beneficial owner, and a former registered holder or beneficial owner, of a security of a corporation or any of its affiliates,
- (b) a director or an officer or a former director or officer of a corporation or any of its affiliates,
- (c) the Director [defined as the director appointed to carry out the duties and exercise the powers granted to him or her under the *CBCA*], or

³¹⁰ *D'amore v. McDonald*, [1973] 1 O.R. 845, 32 D.L.R. 543 (H.C.); affirmed (1973), 40 D.L.R. (3d) 354 (C.A.); referred to in *McGuinness, K.P.*, *supra* note 17, at 924.

³¹¹ *Prudential Assurance Co. v. Newman Industries (No. 2)*, [1982] Ch. 204 (C.A.); referred to in *McGuinness, K.P.*, *ibid.*, at 924.

(d) any other person who, in the discretion of a court, is a proper person to make an application under this Part.

Pursuant to section 239 of the *CBCA*, in order to commence a derivative action, a complainant must apply to a court for a leave to bring the action in the name and on behalf of the corporation. The application for leave may be brought by way of motion or application.³¹² An action can be brought if the court is satisfied that:

- the complainant has given notice to the directors of the corporation of his or her intention to apply to the court under subsection 239 (1) of the *CBCA* not less than 14 days before bringing the application, or as otherwise ordered by the court if the directors of the corporation did not react;
- the complainant is acting in good faith; and
- the action proposed to be initiated appears to be in the interest of the corporation.

Section 242 of the *CBCA* contains certain provisions designed to encourage the use and completion of derivative actions. Indeed, pursuant to subsection 242(3) of the *CBCA*, a complainant can not be required to give security for costs in any derivative action. Similarly, subsection 242(4) of the *CBCA* allows a court to order that interim costs be paid to a complainant to cover his or her legal fees and disbursements.

The *CBCA* also includes provisions aiming at (i) preventing bilateral negotiations between a corporation and a complainant which would be detrimental to other shareholders and (ii) protecting complainants against undue pressures to stop legal procedures. Under subsection 242(2) of the *CBCA*, once an application is made under section 239 of the *CBCA*, it cannot be discontinued or settled without the approval of the court.

³¹² Sutherland, H., note 17, at 717.

The court has very wide powers in connection with actions brought or intervened in under section 239 of the *CBCA*. Section 240 of the *CBCA* mentions that such powers include orders to give directions for the conduct of the action, orders directing that amount adjudged by the court be paid to security holders instead of the corporation and orders requiring the corporation to pay legal fees to the complainant.

(c) Oppression remedy

Derivative actions must be distinguished from the right of shareholders or other complainants to initiate proceedings concerning independent causes of action to which the complainant is entitled personally.³¹³ Where the complainant has suffered an injury in his or her individual capacity, he or she has a personal right of action and it is possible for the complainant to enforce such right without resort to the derivative action procedure.³¹⁴ In the *CBCA*, such procedure is set forth in section 241.

As in the derivative action, the persons who can bring an action under section 241 of the *CBCA* are the “complainants”, as that expression is defined in section 238 of the *CBCA*. In contrast to relief in the nature of a derivative action, it is not necessary to obtain leave of the court before instituting an application pursuant to the oppression remedy.³¹⁵

Section 241 of the *CBCA* describes the grounds in which an oppression remedy will be available. It will be the case when: (i) acts or omissions by a corporation or an affiliate; (ii) the carrying on of the business or affairs of a corporation or an affiliate; or (iii) the exercise of the powers of the directors of the corporation or an affiliate; are oppressive or unfairly prejudicial to or unfairly disregard the interests of a security holder, creditor, director or officer.

³¹³ McGuinness, K.P., *supra* note 17, at 920.

³¹⁴ McGuinness, K.P., *ibid.*, at 934 and 935.

³¹⁵ *Ibid.*, at 979.

To obtain relief under section 241 of the *CBCA*, a complainant does not need to show that he or she has been the victim of a deliberate misconduct. It is sufficient to show that conduct is oppressive or unfairly prejudicial to the complainant or that it unfairly disregards the complainant's interest.³¹⁶ Because of the wording of section 241 of the *CBCA*, the oppression remedy imposes a substantive standard of behaviour that may be different from what is required under fiduciary duties. However, it is beyond the scope of this thesis to analyse the differences between these standards of behaviours or to identify the full range of cases to which the oppression remedy may apply. For our purposes, it is sufficient to say that a breach of fiduciary duties can result in oppression or unfair prejudice and in those instances the oppression remedy could be used to provide a remedy for such a breach.³¹⁷

As it was the case for derivative actions taken under section 239 of the *CBCA*, subsection 242(2) of the *CBCA* provides that a complainant will not be required to provide a security when bringing an action under section 241 of the *CBCA*. Similarly, subsection 242(4) of the *CBCA* allows a court to order interim costs to be paid to a complainant and subsection 242(2) of the *CBCA* states that once an application is made under section 241 of the *CBCA*, it cannot be discontinued or settled without the approval of the court.

Section 241 of the *CBCA* grants the court broad remedial power, and permits the court to make interim and final orders. Its provisions are interpreted broadly to carry out their intended purpose.³¹⁸ However, the oppression remedy is not available where a dispute does not relate to the conduct of the corporation, its officers and directors. For instance, the oppression remedy could not be used to settle a dispute between two shareholders.³¹⁹

³¹⁶ *Ibid.*, at 952.

³¹⁷ *Ibid.*

³¹⁸ *Ferguson v. Imax Systems Corp.* (1983), 43 O.R. (2d) 128 (C.A.).

³¹⁹ *Bernard v. Montgomery* (1987), 32 B.L.R. 257 (Sask. Q.B.), at 261; referred to in McGuinness, K.P., *supra* note 17, at 978.

SUMMARY

Fiduciary duties are commonly divided into two categories: the duty of loyalty and the duty of care. These fiduciary duties create a potential liability that a board of directors will want to avoid. When discharging their duties, directors must act honestly and in good faith, in the best interests of the corporation. They must also exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. Statutory exceptions apply to the duty of loyalty and the duty of care. The duty of care is also limited by the business judgment rule.

Several remedies can be used to enforce fiduciary duties. These are the direct action by a corporation, the derivative action and the oppression remedy. The use of these remedies is subject to the satisfaction of certain conditions described at common law and in the *CBCA*.

Building on subsections I.A and I.B of this thesis, the next subsection will explain the relationship between agency costs and fiduciary duties and more particularly the limits of fiduciary duties as a way to decrease agency costs.

C. THE INTERACTION BETWEEN AGENCY PROBLEMS AND FIDUCIARY DUTIES

As briefly explained in subsections I.A and I.B of this thesis, there is a strong interaction between agency problems and fiduciary duties. In a consensual relationship in which the principal relinquishes management of his or her assets to an agent, the resulting separation of ownership from control creates opportunities for the agent to appropriate certain assets or be negligent in the management of such assets.³²⁰ Fiduciary duties constitute an attempt at controlling agency problems. Indeed, the duty of loyalty may be considered as a legal way to reduce the risks of misappropriation, while the duty of care can be viewed as a legal attempt to decrease the risks of mismanagement. As it will be explained below, however, compliance with the fiduciary duties alone is an imperfect solution to the agency problems and needs to be complemented by prophylactic and curative measures, such as practices based on independence and active monitoring.

1. THE DUTY OF LOYALTY, AN IMPERFECT WAY OF DECREASING THE COSTS OF MISAPPROPRIATION

As described in subsection I.B of this thesis, the duty of loyalty requires that directors act honestly and in good faith, with a view to the best interest of the corporation on the board of which they sit. In order to be most effective, fiduciary duties should forbid any conduct pursuant to which directors choose to further their own interests to the detriment of the corporation. It should provide important sanctions for any misappropriation by management of corporate assets or corporate opportunities. At the same time, however, it should allow interested behaviour of directors when such behaviour does not harm the corporation or when it is beneficial to it. If perfectly enforced, the duty of loyalty should reduce the risks (and potential costs) of misappropriation.

³²⁰ Cooter, R. & Freedman, B.J., *supra* note 103, at 1048.

In the past, courts have been willing to intervene to rectify situations of abuse by directors of their discretionary powers. Examples of such interventions are set forth in subsection II.A.1(c)(ii) of this thesis. However, in practice, the effectiveness of a judicial enforcement of the duty of loyalty is limited by many factors. First, directors and shareholders do not always know about a misappropriation by a director. As explained in subsection I.B.2(a) of this thesis, section 120 of the *CBCA* requires directors to disclose their interest in material transactions and operations with the corporation. However, a director who is silent may be left unchallenged if his or her opportunistic behaviour is never noticed.

A second limit stems from incentive problems. Even if directors and shareholders are aware of the misappropriation, they may not be ready to take action. From the point of view of directors, rational apathy is a real problem. Without prophylactic and curative rules in place at the corporation (through corporate policies and processes), recommending the removal of a director from office or suing a director on behalf of the corporation may be challenging for a board. Indeed, one or more directors will need to take the lead against the defaulting director. This process may have negative effects on the collegiality of the board and meet some resistance from other board members. Should directors wish to sue the director on behalf of the corporation, such resistance will probably be even larger since legal procedures will attract public attention and potentially be harmful to the reputation of the corporation and of the other directors. With respect to the effect on other directors, the misappropriation may be perceived as a lack of vigilance, which may hurt their reputation and decrease their chances of being elected on other boards. With respect to the effect on the corporation, investors may become worried that other misappropriations could occur and decide to take that risk into account in the pricing of the corporation's securities.³²¹ Management and directors, who often have securities interests in the corporation, would be hurt by a decrease in the price of such securities and therefore may prefer to ignore the misappropriation or to settle the matter internally, even if that means a better outcome for the defaulting director.

³²¹ To that effect, see the description of the "lemon problem" set forth in subsection II.B.3 of this thesis.

An incentive problem may also discourage enforcement action by shareholders. Indeed, as described in subsection I.A.1(a) of this thesis, because of their limited ownership in the corporation, shareholders will likely chose not to invest the time and energy to take action against a director, especially if the outcome may result in a loss of confidence in the corporation (and thus a decrease in the value of their shares), and if the amounts of money restored to the corporation by the director would in any case be divided among all shareholders.

Even if some shareholders know about the misappropriation and are willing to take action against the defaulting director, this may be difficult to do. Hence, it may be difficult to replace such a director. As seen in subsection I.A.1(a) of this thesis, in Canada, shareholders are generally not able to vote against particular directors. They can only vote “for” or “withhold” their vote (a vote withheld does not mean a vote against a candidate) and often cannot even identify a particular director with respect to whom they would have withheld their vote. Even in the corporations where the board of directors is elected on the basis that directors are expected to submit their resignation if the number of votes “withheld” are greater than the votes “for” their nomination, it may be difficult to convince enough shareholders to withhold their vote against a director. Similarly, although shareholders could technically present a motion at the meeting of shareholders to propose another director instead of the defaulting one, convincing enough investors to vote for a new comer may be challenging and the chair of the meeting may well have received enough proxies allowing him or her to vote at his or her discretion to defeat such a proposal on the spot.

The remedies to be used to obtain compensation from a defaulting director may also involve conditions and uncertainties that may discourage a potential complainant. Despite the inclusion of the derivative action and the oppression remedy in the *CBCA*, many potential complainants may prefer not to engage in a potentially long legal battle when their portfolio of shares is diversified and therefore their stake in the company only represents a small part of what they own. Instead of fighting for their rights and those of the corporation, they may prefer using their time and energy on other ventures with

higher potential. If this is true for individual shareholders, it is also true for institutional investors and rational apathy then becomes a generalized problem.

A third factor limiting the effectiveness of fiduciary duties is the potential difference between the financial resources of directors and claimants. Nowadays, most publicly listed corporations have indemnification provisions included as part of their by-laws or have signed indemnification agreements with their board members. In many cases, such provisions or agreements state that a corporation must advance moneys to directors so that they can defend themselves against legal actions. Section 124 of the *CBCA* specifically allows a corporation to indemnify or advance moneys to directors for all costs, charges and expenses reasonably incurred in respect of legal proceedings in which the director is involved because of his or her association with the corporation. It is true that under subsection 124(3) of the *CBCA*, corporations will not be allowed to indemnify or advance moneys to a director who failed to act honestly and in good faith with a view to the best interests of the corporation (*i.e.*, a breach to the duty of loyalty). However, such a breach to the duty of loyalty will normally not be known until the end of the proceedings and therefore a director could have benefited from the financial assistance of the corporation during the whole legal process whereas the claimant, unless the court orders the payment of interim costs under section 242 of the *CBCA*, would not have the same advantage.

To complement the indemnification measures, publicly listed corporations often obtain director and officer (“D&O”) liability insurance. The purchase of such insurances is specifically allowed under subsection 124(6) of the *CBCA*. In practice, insurance policies will typically exclude coverage in cases where there is a breach to the duty of loyalty or in circumstances of gross negligence.³²² Again, however, such a breach or gross negligence may only be known at the end of a trial, the potential claimants not having enough resources to reach such an end. The combined effect of the

³²² Cheffins, B.R., Black, B.S., Klausner, M., “Outside Directors, Liability Risk and Corporate Governance: A Comparative Analysis” (University of Texas Law School, Working Paper No. 31, August 2005), online: <http://papers.ssrn.com/abstract=800584> (date accessed: 3 March 2007), at 30.

indemnification and insurance protections gives directors an advantage over a claimant who does not benefit from the same resources and who could well be discouraged by the potential opposition.

Because of these intrinsic limits to the enforceability of the duty of loyalty, safeguards must be adopted to complement it. Indeed, prophylactic measures to avoid a breach of the duty of loyalty and curative measures to deal with such a breach may be more efficient, in terms of both time and money, than after-the-fact enforcement by a court. As will be demonstrated in subsection II.A(1) of this thesis, the best internal safeguards against costs of misappropriation are based on independence practices. These practices include the adoption of guidelines defining and prescribing the level of independence required for the board, its committees and the board chair, policies requiring meetings of independent directors only and policies allowing access to independent advisors.

As argued in subsection II.B.3 of this thesis, the most efficient way to increase the use of such prophylactic and curative measures and to standardize their content, at a reasonable cost, is by requesting that corporations disclose annually their practices against statutory independence standards. By requiring such disclosure, the legislator forces directors and officers, at least once a year, to focus on the measures they have in place. The monitoring of those practices is made within the corporation, by officers involved in the disclosure and by the directors who approve it. Such monitoring is encouraged by the potential liability resulting from a misrepresentation contained in public statements. The potential liability resulting from a breach to the duty of loyalty is thus complemented by proactive measures to avoid a misappropriation in the first place.

2. THE DUTY OF CARE, AN IMPERFECT WAY OF DECREASING THE COSTS OF MISMANAGEMENT

The duty of care is a legal attempt to decrease the costs of mismanagement. As described in subsection I.B.3 of this thesis, the duty of care postulates that directors have a duty to act diligently and prudently in managing the affairs of the corporation. The potential for mismanagement and the importance of dissuasive rules is described as follows by Professor Brudney of the Harvard Law School:

Indeed, because so much of the performance of the investor-management “contract” is contingent upon behavior of management (to whom broad discretion must be given) over an indeterminate future, and because management is subject to the temptation to shirk in its performance or to divert corporate assets to itself, the “contract” is acknowledged to be “incomplete”, and to require remediation. Not even those who believe the separation of ownership and control in the modern corporation to be the unfolding of a grand scheme of efficiency doubt the power of that temptation, or that the temptation creates significant conflicts between management’s interest and the investors’ interest in maximizing share value.³²³

In order to be most effective, the duty of care should require compensation from directors for any decision made by them that is harmful to the corporation and that was taken without sufficient diligence. At the same time, however, the duty of care should not discourage directors from taking risks that could result in great returns for the shareholders.

As it is the case for the duty of loyalty, the effectiveness of the duty of care, imposed by law and enforced through the judicial system, is limited in many ways. First, potential claimants may not be aware that directors are not diligent. Shareholders are not allowed to participate in boardroom meetings nor to have access to minutes of these meetings. It is thus practically impossible to know the analysis that was made before coming to a decision and how involved the directors were in testing management on the

assumptions underlying its recommendations. The secrecy of board meetings is necessary to protect the strategic and tactical plans of a corporation. Without it, a private entity competing with a public corporation could become a shareholder of the corporation and get access to certain information which would grant it a competitive advantage. However, such secrecy also means that the decisions of directors are more insulated from challenges by investors.

Second, even if they have suspicions, it is difficult for claimants to prove that directors have not dedicated enough time and energy or have acted carelessly in managing the business of the corporation. Indeed, a lot of work done by directors may be done informally, not necessarily in the boardroom, by undertaking research on an individual basis, discussing certain issues with other directors or asking questions to management. Building a strong case based on directors' mismanagement may require the thorough questioning of management and directors and an analysis of the behaviours of each director individually.³²⁴ It would often be complex and difficult to obtain enough testimonies and other relevant proof to demonstrate a lack of care.

Third, even if it could be established that a director was negligent, other directors or shareholders may not have sufficient incentives to take action against the defaulting director. As discussed with respect to the duty of loyalty, the judicial process may be long, costly and uncertain. A claimant may not have the time and resources to challenge board members.

With respect to disincentives applicable to a particular shareholder, even if he or she had the time to pursue the matter, he or she would have to share the benefits of his or her work with all other shareholders and the harm to the reputation of the corporation caused by his or her claim may decrease the value of his or her shares. With respect to directors, instituting an action against a fellow board member may uncover some joint

³²³ Brudney, V. "Corporate Governance, Agency Costs, and the Rhetoric of Contract" (1985) 85 Colum. L. Rev. 1403, at 1406 and 1407.

³²⁴ Such analysis was done in *In Re the Walt Disney Company Derivative Litigation*, 731 A.2d 342 (Del. Ch. 2003).

breaches to the duty of care or result in retaliation by the director under attack, alleging mismanagement by his or her fellow directors. Those potential consequences would certainly constitute a strong basis for rational apathy.

Finally, most importantly, there is an important uncertainty related to any claim for a breach of the duty of care because of the role played by the business judgement rule. Indeed, as explained in subsection I.B.3 of this thesis, the business judgment rule acts to insulate directors against liability for wrong decisions in absence of fraud, illegality or conflict of interest. This allows directors to take business risks that are essential to a profitable venture but seriously undermines the effectiveness of the duty of care.

Hence, the efficiency of the duty of care imposed through the judicial system is seriously limited. Consequently, as is the case for the duty of loyalty, it must be complemented by prophylactic and curative measures that will foster the diligence of directors and facilitate the monitoring of their performance by shareholders. These procedures and practices should be based on active monitoring by the board of directors, as demonstrated in subsection II.A.2 of this thesis. These practices include the adoption of charters for the board and its committees, position descriptions for the board chair, committee chairs and for the chief executive officer, policies related to the assessment of the board, its committees and individual directors and directors' orientation and education policies.

The annual disclosure obligations proposed in subsection II.B.3 of this thesis should increase the use of such measures and standardize their content. Such annual disclosure would also imply a regular assessment of the respective roles of the board and management, which would result in an empowerment of the board. Such disclosure may also increase the standards of conduct of directors, because the non-respect of disclosed duties could be considered as a misrepresentation. Prophylactic measures, in addition to preventing mismanagement, would thus facilitate recourse against directors.

3. RECENT EMPIRICAL OBSERVATIONS

In 2005, Professors Cheffins, Black and Klausner released the results of many studies underlining the limits, in terms of effectiveness, of legal recourses against corporate directors. Such studies support our conclusions regarding the ineffectiveness of enforcing fiduciary duties through litigation. Their research studied enforcement against directors for wrongdoings in seven countries (Australia, Britain, Canada, France, Germany, Japan and the United States).³²⁵ Although not limited to the enforcement of fiduciary duties, this research is instructive with respect to the potential threat (and dissuasive effect) of legal recourse against directors.

To understand the effectiveness of director liability in the various jurisdictions, the authors distinguished between “out-of-pocket liability”, which occurs when directors personally pay financial penalties and legal expenses, from situations where liability is nominal, because someone pays on behalf of directors. The latter would occur when a corporation indemnifies its directors or when the corporation’s director and officer (“D&O”) insurance policy covers the event giving rise to liability.

The authors found that in most countries, other than the United States, directors of publicly listed corporations rarely encounter any form of liability.³²⁶ They also found that in the United States, where directors are most often sued, directors are almost always indemnified or covered by D&O insurance, so that liability almost invariably ends up being nominal and that the risk of out-of-pocket liability is rather small.³²⁷

The authors acknowledge that numerous proceedings launched every year against directors are successful in the sense that plaintiff and defendants settle. However, their research indicates that even these cases rarely translate into out-of-pocket liability. They

³²⁵ Cheffins, B.R., Black, B.S., Klausner, M., *supra* note 322.

³²⁶ This may be due, in part, to a collective action problem because the cost of bringing a lawsuit, while less than the shareholders’ aggregate gain, is typically greater than a shareholder (plaintiff) pro rata benefit. See: Romano, R., “The Shareholder Suit: Litigation without Foundation?” (1991) 7 J.L.E.O. 55.

³²⁷ Cheffins, B.R., Black, B.S., Klausner, M., *supra* note 322, at 5 and 6.

found that between 1991 and 2003, 2930 securities cases were filed in U.S. federal courts against directors, but only three culminated in trials. With other types of lawsuits, they found only a few instances where directors of public corporations were condemned to pay damages.³²⁸

The authors observed that when plaintiffs pursue a case until trial, directors generally spend a lot of money on their own defence, on the presumption that the corporation or the D&O policy will cover the legal costs. If the plaintiffs win at trial, an appeal is often very likely. Prolonged litigation seems to be a real disincentive for plaintiffs, who may have to support their own costs pending the resolution of their claim.³²⁹

Nevertheless, in certain circumstances, which the authors refer to as “perfect storms”, directors are personally vulnerable to a claim. For example, if a plaintiff convinces a judge that the directors knowingly participated in a wrongdoing, this may give grounds for a corporation and its insurer to deny coverage based on fraud or dishonesty.³³⁰ If the corporation on the board of which the director sits is in financial difficulties and cannot indemnify him or her, such director is also truly at risk of incurring important financial consequences. Other examples of situations where directors are vulnerable are cases where a corporation does not provide indemnification or a claim falls within the scope of an exclusion of the D&O policy. While those scenarios are possible and may act as powerful incentives to oblige directors to correctly discharge their fiduciary duties, perfect storms are apparently rare.³³¹

To appreciate fully the risks facing directors, it is necessary to discuss some of the exceptional cases where directors recently had to pay from their own pockets. On this count, settlements reached following the Enron and WorldCom scandals are

³²⁸ *Ibid.*, at 9.

³²⁹ However, in certain circumstances, courts may order a corporation to pay certain fees of complainants. For instance, under section 240 of the *CBCA*, Canadian courts may make orders requiring a corporation to pay reasonable legal fees incurred by a complainant in connection with a derivative action.

³³⁰ Cheffins, B.R., Black, B.S., Klausner, M., *supra* note 322, at 13.

³³¹ *Ibid.*, at 14.

interesting.³³² Although these cases are based on U.S. fraud on the market provisions,³³³ which do not have a real equivalent in Canada, their principles could be applied to many cases brought against directors. With Enron, an energy company whose 2001 bankruptcy was the largest in U.S. history, ten former directors agreed to pay personally US\$13 million as part of a US\$168 million settlement. In the case of WorldCom, eleven directors agreed to pay US\$20 million as part of a US\$55 million settlement.

In both instances, elements of the perfect storm were present since both corporations were in a situation of bankruptcy. In the case of WorldCom, the insurers had certain grounds to deny the claim. In the case of Enron, the coverage still available was being rapidly eroded due to escalating legal costs.³³⁴ Both cases were widely covered by the media and were perceived as perfect examples of abuse by management and of a lax board of directors. In both situations, it seems that the plaintiffs were very persistent in wanting to get directors to pay out of their own pocket.³³⁵ Those combined circumstances are rather rare.

In an article published in 2006, Professor Gordon, of Columbia Law School, reviews the studies of Professors Cheffins, Black and Klausner.³³⁶ Although he confirms that monetary recovery for breach of fiduciary duties is rare in the United States and in other industrialized countries, he nevertheless demonstrates that reputational risks seem to be perceived as an important threat amongst directors. Furthermore, he explains that courts, particularly Delaware courts, have recently been more receptive to theories that could expose directors to liability, and monetary sanctions are emerging as a way to enhance directors' standards of conduct.³³⁷ The threat of liability is even more credible with the increased involvement of institutional shareholders in class actions. As

³³² *Ibid.*, at 22.

³³³ See Rule 10b-5 of the 1934 Securities and Exchange Act.

³³⁴ Cheffins, R.C., Black, B.S. & Klausner, M., *supra* note 32, at 24

³³⁵ *Ibid.*

³³⁶ Gordon, J., "Independent Directors and Stock Market Prices: The New Corporate Governance Paradigm", Columbia Law and Economics Working Paper No. 301, available online: <http://papers.ssrn.com/abstract=800584> (date accessed: 3 March 2007).

³³⁷ *Ibid.*, at 20 to 22.

explained by Professor Perino, of St. John's University School of Law, institutional investors are more involved in litigation than they have ever been.³³⁸ Furthermore, cases led by institutional investor plaintiffs have larger settlements and recover a greater percentage of the stakes at issue than cases with other types of lead plaintiffs.³³⁹

In addition to the threat of financial sanctions, one must consider the increased risk, for a director, to lose his or her seat during or following a lawsuit. Professor Roberta Romano, of the Yale Law School, demonstrated, using a sample of 535 public corporations trading on U.S. stock exchanges between 1960 and 1987, that occurrences of changes to a board are slightly higher if the corporation is or has been sued by its shareholders than it would otherwise.³⁴⁰

Hence, one must be careful in accepting the results of Cheffins, Black and Klausner. The fact that in most cases directors do not have to pay from their own pocket does not mean that the threat of litigation is not an important incentive for directors to comply with their fiduciary duties. For a director, reputational costs related to the bad publicity surrounding a lawsuit and the risk of losing his or her seat on the board may be more important than what is claimed. The research of Cheffins, Black and Klausner nevertheless confirms the limits on the practical utility of fiduciary duties. Because directors are rarely exposed to pay personally for a breach to their fiduciary duties, the above mentioned empirical observations reinforce the need to complement fiduciary duties with good corporate governance practices in order to reduce agency costs and help directors to avoid cases of litigation.

From that perspective, one may ask oneself if corporate governance practices should be implemented through corporate or securities law provisions. We believe the latter is more appropriate, for both philosophical and practical reasons. From a

³³⁸ Perino, M., "Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions", St. John's University School of Law, Legal Studies Research Paper Series, available online: <http://papers.ssrn.com/abstract=800584> (date accessed: 3 March 2007), at 10.

³³⁹ *Ibid.*, at 11.

³⁴⁰ Romano, R., *supra* note 326 at 76.

philosophical standpoint, as we have seen in subsection I.A.1 of this thesis, the more diluted the ownership of a corporation, the greater will be the need to protect shareholders against agency costs. Because securities law focuses on widely-held corporations, its institutions have developed a well recognized specialization in protecting those who need protection the most. As a result of such specialization, securities authorities have gained the expertise and ability to quickly develop and modify detailed rules in response to the needs of market participants and empirical evidence of best practices.

From a practical point of view, securities authorities have thus become well-financed, bureaucratic organizations, capable of issuing and enforcing mandatory rules. The agencies entrusted with the administration of corporate law are entirely lacking expertise or resources necessary to play a similar role and it would be unduly expensive and inefficient to put in place an administrative structure under corporate law to implement to the recommended changes to corporate governance rules that is similar to (and parallels) that which already exists under the securities regime. The mandatory rules and guidelines described in part II of this thesis should thus be developed and, in the case of mandatory rules, enforced by securities authorities, through securities law.

SUMMARY

This subsection explained how the duty of loyalty and the duty of care constitute imperfect attempts to decrease costs of misappropriation and of mismanagement. It was shown that the efficiency of these legal duties is undermined by a lack of incentives and by procedural limits, which reduce the likelihood of their enforcement. Empirical research confirmed those limits. Consequently, prophylactic and curative measures, within a corporation, are required to reduce agency problems and help directors in the discharge of their fiduciary duties. The next part of this thesis will demonstrate that such measures should be based on independence and active monitoring.

**GOOD CORPORATE GOVERNANCE PRACTICES AS A WAY OF REDUCING
AGENCY PROBLEMS AND ASSISTING DIRECTORS IN THE DISCHARGE
OF THEIR FIDUCIARY DUTIES**

In this second part of the thesis, prophylactic and curative measures are proposed as means of reducing agency problems and helping directors in the discharge of their fiduciary duties. These measures are divided in two categories: those relating to independence and those which fall under the active monitoring umbrella. This part of the thesis first describes the independence concept and is followed by a theoretical and empirical discussion on its benefits. Active monitoring is then reviewed in the same way.

The thesis then proposes a framework to determine which corporate governance should be mandatory and which should be voluntary. It explains why the disclosure of corporate governance practices should be legislated, whereas the implementation of such practices should be left to the discretion of the board of directors.

Following the categorization proposed above and taking into account the theoretical and empirical discussion on independence and active monitoring as well as the mandatory vs. voluntary implementation framework, the last subsection of the thesis reviews the current rules and guidelines of the CSA, evaluates their effectiveness in achieving the benefits associated with independence and active monitoring practices and, where applicable, proposes changes to enhance such effectiveness.

D. INDEPENDENCE AND ACTIVE MONITORING AS WAYS OF REDUCING AGENCY COSTS AND DISCHARGING FIDUCIARY DUTIES

1. INDEPENDENCE

This subsection will first describe the independence concept. It will then describe the theoretical benefits of independence by explaining how independence practices may decrease costs of misappropriation and can help directors in discharging their duty of loyalty.³⁴¹ It is followed by an empirical discussion, which calls for a flexible approach and supports the mandatory vs. voluntary framework developed in subsection II.B of the thesis, as well as the recommendations made in subsection II.C thereof.

(a) The concept of independence

The concept of independence is not easy to define. In this thesis, the expression “independent director” refers to someone who is free from the control or influence of the management of a corporation or of its significant shareholder. It is submitted that the most important characteristics of an independent director consist of being a “true outsider”, who contributes to put in place a climate of “creative tension” within the boardroom.

³⁴¹ This subsection of the thesis focuses on the effects of independence practices on the decrease of misappropriation costs and how such practices assist directors in the discharge of their duty of loyalty. It should not be interpreted as meaning that independence has no impact on mismanagement costs or on the discharge of the duty of care. On the contrary, the existence of certain independence practices underlies the adoption of active monitoring behaviours which reduce mismanagement cost and have a positive impact on the discharge of duty of care, as highlighted in subsection II.A.2 of this thesis. Conversely, certain active monitoring practices are implicit to the reduction of misappropriation costs and assist directors in the discharge of their duty of loyalty. Further research should be conducted on the combined and inter-related effects of independence and active monitoring practices on agency costs and the discharge of fiduciary duties.

(i) The importance of “true outsiders”

Independence being first and foremost a state of mind, it is difficult to assess. However, it is argued that the benefits of independence are felt the most when directors are “true outsiders”.³⁴² Independence criteria, as adopted by securities authorities and complemented by our recommendations, are reviewed in subsection II.C.1 of this thesis. At the heart of these criteria, however, lies the following principle: in order to be considered independent, a director should be free from financial, intellectual and emotional control or influence.³⁴³ Directors who are free from any such control or influence are referred to in this thesis as “true outsiders”.

The absence of known relationships between a director and management of a corporation should not be taken as a guarantee of independent judgment, as board independence does not only depend upon individual relationships, but also on the overall attitude toward management and the relative importance of advantages to directors flowing from their position on the board.³⁴⁴

Skepticism has existed, in the past, about whether true outsiders can be elected and survive in a corporation, given the role management has traditionally played in selecting directors as well as the social and financial affinities that often exist between directors and managers.³⁴⁵ Authors have discussed how the independence of boards of directors can be substantially neutralized in many corporations.³⁴⁶ Enron was an example of such a case. Although its board of directors included only two employees of the corporation out of more than ten directors, the independence of virtually every other board member, including audit committee members, was compromised by side payments of one kind or another, such as consulting fees and contributions by the corporation to

³⁴² Bybelezer, H.M., *supra* note 102, at 116 and 117.

³⁴³ Institute of Corporate Directors, *Guidelines for Corporate Directors in Canada: Recommendations and Guidance on Boardroom Practice*, 2nd ed. (Toronto: Institute of Corporate Directors, 1992), at 25.

³⁴⁴ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 24; The Business Roundtable, *supra* note 247, at 9 and 10.

³⁴⁵ Strine, L.E., *supra* note 61, at 1374.

³⁴⁶ Black, B.S., *supra* note 83, at 16.

charitable organizations managed or favoured by its directors.³⁴⁷ Independence was also jeopardized by the bonds created by long service and familiarity.³⁴⁸

Objective elements may assist a board in identifying factors that may have an impact on the control or influence of management or of a significant shareholder over a director. Hence, if the director is an employee of the corporation or of the significant shareholder or if he or she receives important consultation fees, it may certainly affect his or her judgment. Intellectual and emotional factors, however, are much more difficult to assess and require an honest and true introspection from each director and by the board. As further described below, among the characteristics that will help increase the chances of success of such introspection, are processes that foster the selection by independent directors of board and committee members, and a strong and independent board chair.

(ii) *The importance of a climate of “creative tension”*

Board independence will be most useful if directors are allowed to install within the boardroom what can be described as a culture of “creative tension”. In this thesis, the expression “creative tension” refers to an attitude of constructive skepticism between the board and management. Even when a board of directors is perceived to be independent, it cannot capture the full benefits of such independence unless it nurtures such a culture.

A climate of “creative tension” is essential to avoid the neutralization of board independence resulting from the interventions of management or of a significant shareholder. In such a climate, directors have the power to ask incisive, probing questions that require accurate, honest answers, and to check the accuracy of those answers.³⁴⁹ “Creative tension” does not require directors to take an adversarial attitude toward management, but rather requires them to adopt healthy skepticism and vigilance

³⁴⁷ Gordon, J.N. *supra*, note 2, at 11; and Strine, L.E., *supra* note 61, at 1379.

³⁴⁸ *Ibid.*

³⁴⁹ The Business Roundtable, *supra* note 247, at 3.

regarding incomplete or inaccurate answers or possible wrongdoing.³⁵⁰ The relationship must be open, honest and constructive, based upon mutual respect and trust.³⁵¹

A climate of creative tension implies that directors must be able to dissent from management when they do not agree.³⁵² Many factors may discourage disagreement or dissent from directors. The following are examples of such factors:

- Board culture inhibits dissent. Boards operate on long-standing, unspoken assumptions and rules of behaviour that are seldom critically examined or discussed. Directors and management often know and like each other and respect each other's ideas, skills and experience. They tend to share many basic values and have close business and social ties.³⁵³ As mentioned by Vice Chancellor Strine of the Delaware Court of Chancery, "U.S. courts have been reluctant to conclude that friendship could compromise independence. A judicial intuition that boards must act collegially and cohesively, and not as adversaries or strangers underscores this approach".³⁵⁴
- Dissent involves large risks and costs; conformity seldom does. Dissent has the potential to produce huge personal costs in terms of stress and social, economic and political losses. On the other hand, the personal rewards from effective dissent tend to be muted, intangible and long-term.³⁵⁵
- When more than one member of management is on the board (usually the chief executive officer and a vice-president), the board member who reports to the chief executive officer is unlikely to be vocal against the views of the

³⁵⁰ Bender, M., *supra* note 17, at 1-34.

³⁵¹ Conference Board, *supra* note 79, at 6; Dimma, W.A., *supra* note 75, at 6; Canadian Institute of Chartered Accountants, *Guidance for Directors – Dealing with Risk in the Boardroom* (Toronto: Institute of Chartered Accountants, April 2000), at 2.

³⁵² Institute of Corporate Directors, *supra* note 343, at 37.

³⁵³ *Ibid.*, at 43 and 44.

³⁵⁴ Strine, L.E., *supra* note 61, at 1378. Vice Chancellor Strine refers to *Crescent/Mach I Partners L.P. v. Turner*, No. 17455, 2000 WL 1481002 (Del. Ch.), at 11.

³⁵⁵ Institute of Corporate Directors, *supra* note 343, at 46.

chief executive officer. Furthermore, the chief executive officer may himself or herself be less candid when a vice-president is present.³⁵⁶

Certain structural elements may assist a board of directors in creating a climate of creative tension, which will allow directors to express their dissent and empower the board. Professor Lorsch, of the Harvard Business School, believes that the characteristics that constitute the foundation on which board empowerment is built include the following:

- Directors represent a range of business and leadership experiences pertinent to understanding the issues the corporation faces;
- Directors communicate freely with one another in board and committee meetings and outside such settings with and without management;
- If the chief executive officer chairs the board, the independent directors select their own leader from among themselves to lead their deliberations and to work closely with the chief executive officer to plan board activities;
- Committees are made up entirely of outside directors;
- Directors receive information about the corporation's financial and product-market performance in a format that is intelligible and enables the directors to understand the corporation's performance relative to its competitors.³⁵⁷

As explained in the next subsection, these characteristics, at the heart of the concept of independence, will constitute an important complement to the duty of loyalty in decreasing costs of misappropriation.

³⁵⁶ Dimma, W.A., *supra* note 75, at 12.

³⁵⁷ Lorsch, J.W., "Empowering the Board" (1995) Jan.-Feb., Harv. Bus. Rev. 107; referred to in Bender, M., *supra* note 17, at 1-2.

(b) Independence practices as an essential complement to the duty of loyalty in decreasing costs of misappropriation

Subsection I.C of this thesis explained that the duty of loyalty can be considered as a legal attempt to control the costs of misappropriation. However, it was shown that the effectiveness of the duty of loyalty in decreasing agency costs is limited by many factors, including: (i) the difficulty of detecting a breach of such duty; (ii) the lack of incentives to monitor and to sue a director who breaches his or her duty; (iii) the limited resources of claimants compared to those of directors; and (iv) the inefficiency of the judicial process.

Independence practices can help decrease costs of misappropriation because they pick-up where the duty of loyalty reaches its limits. The next subsection will briefly explain how independence practices decrease costs of misappropriation. An overview of independence practices will then be made, together with a description of how they can prevent misappropriation costs (prophylactic measures), or limit and help recover such costs (curative measures). Subsections II.C.1 and 2 of this thesis will link the principles mentioned in this section to the existing rules and guidelines of the CSA and propose amendments to such rules and guidelines in order to induce more independence practices.

(i) How independence practices decrease costs of misappropriation

Independence practices can be used to decrease costs of misappropriation on three fronts: by reducing the likelihood that a director be in a situation of conflict of interest, by improving the oversight of management (and thus reducing the risks of misappropriation by senior officers) and by improving the monitoring by directors of their fellow board members.

(1) Reducing the likelihood of conflicts of interests

The first way independence practices may decrease costs of misappropriation is by dissuading directors from entering into situations in which conflicts of interests exist. If they know that independence is important for their re-election as director, board members should be more careful not to enter into any kind of situation which could have a negative impact on the assessment of their independence by the board. For instance, they should avoid entering into transactions in which they would receive special benefits from the corporation, because these transactions will likely have to be disclosed to the board and may impede their nomination as director the next year.³⁵⁸ By wanting to remain independent from management (and significant shareholders), directors may thus avoid many situations which could potentially lead to misappropriation.

(2) Improving the oversight of management

Another way of reducing costs of misappropriation is by having independent directors oversee management's decisions and actions. Indeed, directors who are free from the influence or control of management (and of a significant shareholder) should be more objective when evaluating transactions or contracts between the corporation and those persons. He or she should also be more comfortable to identify and sanction any case of misappropriation by them.

Independence practices help to transform the natural inclination of directors to be loyal to management into loyalty of directors to the corporation. Professor Morck, of the University of Alberta, has studied such phenomenon.³⁵⁹ Referring to recent scandals he notes that:

³⁵⁸ See *Radtke v. Machel*, [2000] O.J. No. 3019 (QL)(Sup. Ct. J); and VanDuzer, J.A., *supra* note 71, at 238.

³⁵⁹ Morck, R., "Behavioral Finance in Corporate Governance – Independent Directors and Non-Executive Chairs" (Harv. Inst. Econ. Res. Paper 2037, May 2004) online: <http://papers.ssrn.com/abstract=800584> (date accessed: 3 March 2007).

Misplaced loyalty lies at the heart of numerous recent scandals in corporate governance. Corporate officers and directors, who should have known better, placed loyalty to a dynamic Chief Executive Officer above the duty to shareholders and obedience to the law. The officers and directors of Enron, Worldcom, Hollinger, and virtually every other allegedly misgoverned company could have asked questions, demanded answers, and blown whistles, but did not. Ultimately they sacrificed their careers and reputation for their CEO.³⁶⁰

Based on research in social psychology, he suggests that independence practices be used as a way to better monitor management:

Empirical findings in social psychology suggests that introducing dissenting peers or alternative authority figures [...] undermine subjects' loyalty and revive their internal moral reasoning. Corporate governance reforms that envision independent directors (dissenting peers) and non-executive chairs (alternative authority figures) aspire to a similar effect on corporate boards – a fostering of debate to expose flawed policies before they become lethal – and thereby render corporate governance disasters rarer. [...] ³⁶¹

In other words, the presence, on a board, of independent directors, empowers the board and decreases the risks of misappropriation by management.

(3) Improving the monitoring by directors of their fellow board members

A third way to decrease misappropriation costs is through the monitoring by directors of their fellow board members. Independent directors are in a better position than these who are not to assess the conduct of their fellow directors and to detect potential conflicts of interest. Indeed, a director should be more inquisitive about the status of other directors if he or she is familiar with and respects strict standards of independence. Similarly, a director should be less inclined to ignore some potential

³⁶⁰ *Ibid* at 3.

³⁶¹ *Ibid* at 4 referring to Milgram, S., *Obedience to Authority* (New York: Harper and Row, 1974).

sources of conflict of interest involving other directors if he or she does not have to fear that the assessment of his or her status by other directors could disqualify him or her for board membership.

(ii) *Prophylactic measures based on independence*

Because the duty of loyalty does not in itself include mechanisms to detect potential conflicts of interest and because the difficulties in the enforcement of the duty of loyalty may affect its dissuasive effect on wrongdoers, as evidenced by empirical studies described in the first part of this thesis, such duty must be complemented by independence prophylactic measures. In order to be informed of and prevent misappropriation, it is submitted that corporations should adopt independence practices, such as: (i) independence criteria and policies for identifying potential situations of conflicts of interest; (ii) the presence of independent directors on the board; (iii) committees composed of independent directors; (iv) policies discouraging wrongful conduct administered by an independent committee; (v) the appointment of an independent board chair; (vi) *in camera* meetings; and (vii) policies allowing directors to consult independent advisors when needed. The concrete benefits of each of these practices in reducing costs of misappropriation are presented in this section. The technical aspects of those practices and recommendations relating thereto will be more fully described in subsection II.C of this thesis.

(1) Independence criteria and identification of conflicts of interests

One of the first actions that may be taken to ensure a certain level of independence on a board is to adopt processes to identify independent directors. This can be done through the adoption of independence criteria, which consist of guidelines to be used by a corporation to assess the level of independence of its directors. In developing such criteria, a board of directors should take into account the definitions of independence adopted by regulators and mentioned in subsection II.C.1 of this thesis.

Such definitions can not be ignored since disclosure will have to be made, pursuant to National Instrument 58-101, against the regulators' definitions. However, in developing independence criteria, each board of directors should also consider its particular circumstances. Hence, the board of a corporation controlled by a family should be sensitive to any relationship between a director and the family. Even though the director is independent under applicable regulatory definitions, if he or she is related to the controlling shareholder, that may affect his or her judgement.

As explained above, the presence of independent directors on the board empowers the board and decreases the risks of misappropriation by management. Because it is the foundation on which other independence practices are based, it is therefore crucial to be able to correctly identify who are the independent board members. As described in subsection II.C.2 of this thesis, such identification is often done using questionnaires prepared for that purpose by management. These questionnaires request directors to assess their situation against the presumptions of non-independence described in securities regulations and those developed as part of the corporation's independence criteria. Such questionnaires also often request directors to state any potential conflict of interest that could affect their status.

The results of those questionnaires not only assist the board in determining which director is independent. The identification of potential conflicts also helps management and the board to monitor situations that could lead to temptation. Hence, if a director has disclosed his or her interest in a supplier of the corporation, the board and management could notify the director that information concerning negotiations with the supplier will not be sent to him or her. That would prevent a potential leak, which could be prejudicial to the corporation (the supplier could be informed about the corporation's negotiation strategy).

Similarly, if management and the board know, through the use of a questionnaire, that the family member of a director is involved in the development of a product which could compete against a future product line of the corporation, the director could be

asked to leave the board meetings where information is disclosed concerning that product line, or the board could decide to replace the director, in order to avoid that confidential information be disclosed to a potential competitor.

Another example demonstrating that the use of questionnaires may reduce the risks of misappropriation is when a questionnaire allows a board to be aware of a specific agreement between the corporation and a director (for instance a consulting agreement). In such a case, the board, directly or through one of its committees, can monitor the relationship and determine if such agreement is likely to affect the independence of the director.

(2) Ensuring the presence of independent directors on the board

Whether implicit or explicit, corporate policies requesting a certain number of independent directors on a board of directors (for instance by requesting that a majority of board members be independent), are a prerequisite to the adoption of other independence practices.³⁶² Indeed, many of the practices mentioned in this thesis, including independent committees and *in camera* meetings, would not be possible without such policies.

Many corporations publicly disclose, as part of their corporate governance guidelines posted on their website, the number of independent directors they intend to have on their board.³⁶³ Others prefer to fix such amount every year.³⁶⁴ As will be

³⁶² Many institutional investors are of the opinion that independent directors should form the majority of boards of directors. See Canadian Coalition for Good Governance, "Corporate Governance Guidelines for Building High Performance Boards" (Toronto: CCGG, 2005), online: <http://www.ccg.ca> (date accessed: 3 March 2007) at 11; Ontario Teachers' Pension Plan, "Good Governance is Good Business" (Toronto: OTPP, 2007), online: <http://www.otpp.com> (date accessed: 3 March 2007) at 9; and Caisse de dépôt et placement du Québec, "Policy on the Principles Governing the Exercise of Voting Rights of Public Companies" (Montréal: CDPQ, 2007), online: <http://www.lacaisse.com> (date accessed: 3 March 2007) at 3.

³⁶³ See for instance the Corporate Governance Manual of Canadian National Railways, available at www.cn.com.

³⁶⁴ See for instance the practice of RONA inc., as described in its management proxy circular available on www.sedar.com and at www.rona.ca.

discussed under subsection II.A.1(d) of this thesis, the optimal number of independent directors on a board seems to vary from one corporation to another.

(3) Committees composed of independent directors

The use of committees composed solely of independent directors may also be an important safeguard against misappropriation.³⁶⁵ Independent committees may help to empower the board (and thus reduce the risks of misappropriation by management) and may reduce potential situations of conflicts of interest for directors (and thus reduce the risks of misappropriation by directors). Some examples may be used to show the potential influence of independent committees.

With respect to a potential misappropriation by management, a committee composed of members who are free from control or influence of management should be in the best position to monitor the use by management of the corporate assets and ensure that managers do not use confidential information or corporate opportunities for their own profit. An independent committee should also theoretically be in the best position to assess the performance of managers and to ensure that they do not extract value from the corporation in excess of what should be a fair compensation.³⁶⁶

With respect to potential misappropriations by directors, a committee composed solely of members who are free from the influence and control of management is likely to be more objective in assessing whether a potential conflict of interest could preclude a person from being independent. By recommending that individuals who are in a

³⁶⁵ See Canadian Coalition for Good Governance, *supra* note 362, at 13.

³⁶⁶ As we will see in subsection II.A.1(d) of this thesis, some authors doubt that independent committees can play that role and insist on the fact that the recent increase in executive salaries has occurred in a period where regulators recommended that executive compensation be determined by independent committees. However, such increase may be explained by many other factors such as the requirement to disclose the compensation packages which resulted in a race to the top, the composition of independent committees (if a committee is composed of directors who are all chief executive officers, these directors could honestly believe that the chief executive officer of the corporation on the board of which they sit should receive a higher compensation) and the use of compensation consultants who are under the control and influence of management because they are selected and paid by management.

situation of conflict of interest be excluded from the list of candidates to become board members, such a committee reduces the risk of misappropriations.

The use of independent committees may create a chain reaction in empowering the board of directors. As mentioned by Professor Gordon, of the Columbia Law School, once the members of a committee start to act independently in one area, they may decide to do the same in others, which may further assist in reducing agency costs:

Independence-in-fact may be enhanced in two respects. First, the ownership and accountability [of a committee] for a specific critical task may lead to greater autonomy from the CEO in performing the task. Second, the practice of acting jointly and autonomously in a targeted area may carry over to other important roles of the board, such as evaluating managerial performance and strategy.³⁶⁷

The Ontario Securities Commission Rule 61-501 – *Insider bids, issuer bids, business combinations and related party transactions*³⁶⁸ and Quebec Policy Statement Q-27 – *Protection of minority securityholders in the course of certain transactions*³⁶⁹ recommend the use of independent committees as a way to avoid potential situations of conflicts of interest (and decrease the risks of misappropriation). As stated in section 7.1(6) of Companion Policy 61-501:

To safeguard against the potential for unfair advantage for an interested party as a result of that party's conflict of interest or informational or other advantage in respect of the proposed transaction, it is good practice for negotiations for a transaction involving an interested party to be carried out by or reviewed and reported upon by a special committee of disinterested directors. Following this practice normally would assist in addressing the Commission's interest in maintaining capital markets that operate efficiently, fairly and with integrity. While the Rule only mandates an independent committee in limited circumstances, the Commission is of the view that it generally would be appropriate for issuers involved in a material transaction to which the Rule applies to constitute an independent committee of the board of directors for the

³⁶⁷ Gordon, J.N., *supra* note 336, at 26.

³⁶⁸ 23 O.S.C.B. 971; 25 O.S.C.B. 943; and 27 O.S.C.B. 5975.

³⁶⁹ (2001) Q.S.C.B. Vol. XXXII, no. 25.

transaction. Where a formal valuation is involved, the Commission also would encourage an independent committee to select the valuator, supervise the preparation of the valuation and review the disclosure respecting the valuation.

These principles, applicable to specific transactions described in those rules, could be generalized to many other circumstances where some of the directors are in a situation of conflict of interest.

- (4) Policies discouraging wrongful conduct administered by an independent committee

Another prophylactic measure to prevent misappropriation by directors and managers, is the adoption of policies condemning wrongful acts, which policies are monitored by an independent committee. Hence, it is a good practice for a board to adopt a code of business conduct and ethics applicable to directors and employees of a corporation and to delegate its monitoring to a committee composed solely of independent directors. The fact that independent directors are in charge of the implementation of the code adds credibility to the process. Managers and directors will know that if they do not comply with certain provisions of the code they will be judged by a group of people on which they have limited influence or control.

In order to be the most effective, such code should contain enough details about what is unacceptable and the potential sanctions in a case of misappropriation. To ensure that it is read and understood, directors and management could be required to acknowledge in writing that they have read the code, that they understand its scope and agree to be bound by the rules of conduct contained therein.

(5) The appointment of an independent board chair

Many commentators believe that appointing an independent board chair is one of the best ways to ensure the ability of the board to act independently in carrying out its responsibilities,³⁷⁰ and therefore to empower the board. Indeed, an independent board chair may act as a person with whom independent directors will discuss their concerns and complaints regarding management and he or she can act as a catalyst in identifying and finding solutions to problems involving conflicted directors or members of management.

In a recent article, Professors Catherine and Dan Dalton explain that important benefits of having an independent lead director are that he or she personifies the structure of independence. In addition, he or she is in the best position to chair *in camera* sessions (described below), which further empower the board of directors:

[...] The installation of a lead independent director (LID) creates a structural barrier between firm management and non-executive directors. Rather than have leadership of the board and the executive team reside in a single individual, leaving the impression, if not the reality, of the proverbial fox guarding the henhouse, the LID provides a focal point for non-executive directors and establishes some measure of independence between executives and non-executive directors. [...]

The LID, by acting as the liaison between executives and non-executives directors, frees the CEO from serving as the primary point of contact for outside directors. Non-executive directors with questions or concerns regarding management or organizational practices bring these to the attention of the LID, who vets the information, resulting in focused feedback that does not unnecessarily distract the CEO from company operations or overburden the CEO who would otherwise have a number of directors with whom to interact “off-line”.

A second primary benefit of the LID is that the board has clearly defined leadership for the conduct of executive sessions of the board without management present. These sessions provide an essential forum for independent directors to discuss sensitive issues such as executive

³⁷⁰ Joint Committee on Corporate Governance, *supra* note 6, at 18. See also Canadian Coalition for Good Governance, *supra* note 362, at 12; Ontario Teachers’ Pension Plan, *supra* note 362, at 18; and Caisse de dépôt et placement du Québec, *supra* note 362, at 4.

compensation and performance reviews. The LID also serves an important role in coordinating with the CEO and corporate secretary to establish the board agenda and ensure that all directors receive meeting materials in a timely fashion. With the increasing emphasis placed on evaluation of boards and board committees, the LID can also serve a vital role in the oversight of these evaluation processes.³⁷¹

The lead independent director to which Professors Dalton refer is not necessarily the board chair. Indeed, certain corporations prefer to have a board chair who is not independent and in such a case, having a lead independent director is the best substitute to install a climate of independence. Nevertheless, as discussed in subsection II.C.2 of this thesis, having an independent board chair is generally a better practice as it removes any confusion as to who is “in charge” of board procedures and of the interface between management and the board.

(6) *In camera* meetings

Another independence practice that may empower the board of directors is the use of *in camera* meetings. *In camera* meetings are meetings of the board of directors³⁷² or its committees³⁷³ conducted without the presence of management or a significant shareholder. *In camera* meetings aim at creating a spirit of independent deliberation among directors.

Such meetings, sometimes called “executive sessions”, give directors the opportunity for candid discussion, without a potentially inhibiting presence. Directors can use such a forum to talk about certain practices that they find suspect. For instance, they can discuss the personal use of corporate assets by senior management or protections that should be put in place to avoid potential competition by managers if they leave the corporation. When institutionalized, such meetings create a private deliberative

³⁷¹ Dalton, C.M. & Dalton, D.R., “Boards of Directors: Utilizing Empirical Evidence in Developing Practical Prescriptions” (2005) 16 Brit. J. of Man. S91, at S94.

³⁷² See Canadian Coalition for Good Governance, *supra* note 362, at 12.

³⁷³ *Ibid.* at 13.

space. Otherwise, discussions of this kind could be taken by management as a hostile act.³⁷⁴

- (7) Policies allowing directors to consult independent advisors when needed

In certain circumstances, directors may be ignorant as to the most appropriate conduct to adopt in order to prevent an act of misappropriation. In these cases, corporate policies stating that they can consult independent advisors if needed can be important safeguards to a potential misappropriation of corporate assets.

The use of independent advisors can also assist directors in performing delicate tasks such as developing independence criteria, assessing the independence of board members or finding the optimal level of executive compensation to motivate management without misappropriating corporate assets.³⁷⁵

As mentioned in subsection II.C.2 of this thesis, independent advisors should generally be paid from the board budget, which budget should be managed by an independent chair or lead director in order to reduce the influence of management or of a significant shareholder over the choice and opinion of the advisor. As described by Professors Dalton and Dalton:

This arrangement clarifies the nature of the relationship between the board and external advisors such as auditors, compensation consultants and counsel. A board budget helps eliminate potential conflicts of interest that might arise from such engagements were those professionals retained by the board question to whom they are accountable when one group, the board, retains them and another group, management, pays them.³⁷⁶

³⁷⁴ See Gordon, J.N., *supra* note 336, at 29.

³⁷⁵ See Canadian Coalition for Good Governance, *supra* note 362, at 19.

³⁷⁶ *Ibid.*

(iii) Curative measures based on independence

Prophylactic measures based on independence may fail to prevent certain acts of misappropriation. In cases where a misappropriation does occur, independence practices may be the best curative measures to limit or to recover the costs associated to it.

(1) A majority of independent directors on the board

Independent directors are in the best position to make sure that policies discouraging wrongful conduct are followed and enforced. Because they are free from the control and influence of management, they should not be biased in judging the conduct of managers. A board composed of a majority of independent directors can be management's greatest ally in order to ascertain that a corporation is pursuing the appropriate course of action (for instance terminating the employment of a manager or suing him or her). If it has a general practice of acting independently, it will be comfortable acting as such in times of crisis.³⁷⁷ Such a board is then not only capable of operating more independently, but appears more credible to third parties (including shareholders).³⁷⁸

(2) Independent committees

Should there be an act of misappropriation by management, an independent board committee responsible for assessing management and reviewing executive compensation would potentially be in the best position to recommend the right solution to the board. Indeed, if one of the responsibilities of the committee is to assess the performance of senior officers and make recommendations to the board as to who should be part of management, it will have the credibility and legitimacy to propose the removal of the person from office and potentially a lawsuit against him or her. Alternately, the

³⁷⁷ Veasey, E.N., *supra* note 79.

³⁷⁸ Millstein, I., *supra* note 81, at 1494.

committee could request that adjustments be made to the remuneration of management to take into account such misappropriation.

Similarly, with respect to misappropriation by directors, an independent committee responsible for recommending the candidates for board membership would be in the best position to request that a director be removed from office or be sued.

(3) *In camera* meetings and independent board chair

In camera meetings can also be used to discuss the best course of action to be taken against a manager or a board member. The independent board chair or the independent lead director would thus have an important role to play in chairing the meeting and reporting the results to the entire board. If the chief executive officer is involved in the act of mismanagement, the board chair may in fact be the only person with sufficient authority to lead other directors toward the right course of action.

(4) Policies sanctioning wrongful conduct administered by an independent committee

In a case of crisis, the prior adoption of a code of business conduct and ethics may also be very helpful. If such code describes sanctions applicable in certain situations, it will be easier to apply objectively these sanctions when the misappropriation occurs. The CSA take very seriously any departure by directors or management from such a code. Section 3.8 of National Policy 58-201 – *Corporate Governance Guidelines* (“National Policy 58-201”)³⁷⁹ states that waivers to codes of business conduct and ethics should be granted by the board or a committee only, and that material departure from the code should trigger public disclosure thereof:

³⁷⁹ (2005) 28 O.S.C.B. 5382; National Policy 58-201 has been implemented in all Canadian provinces and territories.

3.9 The board should be responsible for monitoring compliance with the code. Any waivers from the code that are granted for the benefit of the issuer's directors or executive officers should be granted by the board (or a board committee) only.

Although issuers must exercise their own judgement in making materiality determinations, the Canadian securities regulatory authorities consider that conduct by a director or executive officer which constitutes a material departure from the code will likely constitute a "material change" withing the meaning of National Instrument 51-102 *Continuous Disclosure Obligations*. National Instrument 51-102 requires every material change report to include a full description of the material change. Where a material departure from the code constitutes a material change to the issuer, we expect that the material change report will disclose, among other things:

- the date of the departure(s),
- the party(ies) involved in the departure(s),
- the reason why the board has or has not sanctioned the departure(s), and
- any measures the board has taken to address or remedy the departure(s).

(5) Recourse to independent advisors when needed

Finally, the use of independent advisors may also be of assistance in suggesting proper standards of conduct and the best course of action in the case of a misappropriation. Advisors may have been retained by other corporations, in the past, to provide opinions in similar circumstances and their experience may be very useful. Coming from the outside, they can also bring a new perspective to the table with the objective of helping the board resolve the problem in the best interest of the corporation.

As we see, independence practices may not only be helpful as safeguards against misappropriation but may also be of assistance in the case of the actual occurrence of a wrongdoing.

(c) Independence as a loyalty “facilitator” – helping to discharge the duty of loyalty

The duty of loyalty creates liability for directors who take advantage of their position, directly or indirectly, to divert corporate assets or corporate profits for their own benefit. Although directors who breach their fiduciary duties seem to rarely pay damages from their own pocket, the risks of a “perfect storm”³⁸⁰ and a potential threat to their reputation as mentioned in subsection 1.C of this thesis should induce directors to discharge their duty of loyalty properly. This subsection identifies the theoretical benefits of adopting the independence practices mentioned in the previous subsections on the discharge of the duty of loyalty. Since the impact of independence practices on the duty of loyalty is difficult to demonstrate, we then use real cases in which directors failed to fulfill their duty of loyalty to show how independent practices could have operated as a loyalty facilitator.

(i) *Theoretical benefits of independence practices on the discharge of the duty of loyalty*

An important problem surrounding the duty of loyalty is that it is conceptual in nature and therefore directors do not always know if their conduct may be considered, now or in the future, as a breach of such duty. For instance, if the director of a corporation is also an executive officer of an entity that becomes an important client or supplier of the corporation, then such director could potentially be placed in a very uncomfortable situation, since his or her interests as an executive officer may conflict with those of the corporation. How should the director behave in order to reduce the risks of breach to his or her duty of loyalty toward the corporation? What can be done by a board to prevent a breach of such duty?

³⁸⁰ See subsection I.C.3 of this thesis.

Since the principles developed in common law regarding the duty of loyalty are not always of great assistance to directors who look for guidance in a particular situation, such principles must be complemented by independence practices. The same prophylactic measures used to decrease costs of misappropriation will be of great value as guidelines in the discharge of the duty of loyalty.

Hence, a majority of independent directors on a board, committees composed solely of independent directors, *in camera* meetings, an independent board chair and access to independent advisors are likely to foster a climate of creative tension, which will favour the discharge of the duty of loyalty.

Independence criteria and policies for identifying potential situations of conflicts, which are generally implemented through annual questionnaires, will allow the board to prevent potential breaches to the duty of loyalty by taking particular actions to protect the conflicted directors (as seen previously, some information may not be sent to a director or he or she may be asked to leave a meeting during which a decision regarding a corporation in which he or she is interested would be taken).

Independence measures can also dissuade directors from entering into situations which could lead to a breach of their duty of loyalty. Hence, directors should be less inclined to divert for themselves corporate assets or to take advantage of corporate opportunities and confidential information of the corporation if they have been specifically warned that such behaviours may constitute a breach of their duty of loyalty and know their actions are monitored by independent directors.

Codes of business conduct and ethics administered by independent committees will assist directors in identifying which situations they should avoid and how to react in a case of temptation. Many codes of business conduct and ethics specifically describe fiduciary duties and remind directors that they must disclose any conflict of interest, in accordance with section 120 of the *CBCA* and other similar legislation.

By adopting policies for identifying potential situations of conflicts of interest, by regularly assessing the independence of directors, by ensuring that independent directors monitor the independence of all directors and the occurrence of conflicts of interest, by appointing an independent board chair and by allowing access to independent advisors, boards of directors will prevent potential breaches to the duty of loyalty. Independence then becomes a loyalty “facilitator”.

(ii) Application of independence practices to case law

To illustrate the potential implications of independence practices on the discharge of the duty of loyalty, a few Canadian cases in which directors failed to discharge their duty of loyalty are summarized herunder. It is then explained that with proper independence practices, directors could have avoided a breach to their duty of loyalty. Such illustration is not scientific as many of those cases were assessed against legal provisions that are different from section 122 of the *CBCA* and date from a time when the standards of loyalty may have been different from those in existence today. Caution must also be taken in concluding that directors who would follow independence practices would not have been held liable since many of the elements considered by the courts may not be reflected in the wording of those decisions. Such exercise is nevertheless interesting as it shows the potential implications of independence practices in the real life.

(1) *PWA Corp. v. Gemini*

In *PWA Corp. v. Gemini Group Automated Distribution Systems Inc.*,³⁸¹ two airlines, PWA and Air Canada, entered into a limited partnership agreement for the purpose of operating a computer reservations system. During the partnership, PWA entered into negotiations with a third party, which negotiations contemplated the loss of

³⁸¹ *Supra* note 139.

the computer service by the partnership. The Ontario Court of Appeal found that the PWA nominees on the board of directors of the general partner of the partnership, who knew about those negotiations, were in breach of their fiduciary duties since they failed to disclose them to the board of directors of the general partner, they attempted to find legal escape routes for PWA and failed to advise the general partner of PWA's manoeuvres to request the dissolution of the partnership. The court confirmed the decision of the trial judge pursuant to which the directors had placed themselves in an "untenable position of conflict of interest".³⁸²

The adoption of the independence practices described in this thesis could have acted as a safeguard against the breach of the duty of loyalty in a case like this one. For instance, had the board of directors of the partnership been composed of independent directors, a distance would have been created between the partners and the directors, potentially allowing directors to avoid the conflict of interest. Similarly, a code of business conduct and ethics administered by an independent committee could have acted as a disincentive for the defaulting directors. Also, had the PWA nominees consulted an independent board chair or independent advisors, the breach to their duty of loyalty could have been avoided.

(2) Producers Pipelines

In 347883 *Alberta v. Producers Pipelines Ltd.*,³⁸³ the directors of Producers Pipelines approved and implemented a shareholders' rights agreement (poison pill) to protect Producers Pipelines against a hostile take-over bid by a third party. Directors were accused of having adopted such a measure to remain in office, in contravention to their duty of obtaining the best value for the corporation. The Saskatchewan Court of Appeal found that directors could not prove that in adopting such defensive tactics they acted in the best interests of the corporation as a whole or that their actions were

³⁸² *Ibid.*, at 646.

³⁸³ *Supra* note 286.

reasonable in relation to the threat posed. The Court considered that directors had breached their duty of loyalty since they made no effort to increase or maximize the value of the shares of Producers Pipelines or to obtain a better offer. It was proven that their only objective was to prohibit any take-over until after completion of an issuer bid, the result of which would be that the directors group would control a majority of the shares of the corporation.³⁸⁴ In other words, it was shown that they had pursued a strategy of self-entrenchment in order to keep control of the corporation and thus breached their duty of loyalty.

In a case where managers of a corporation have a personal interest in the outcome of a transaction, such as a take-over on the corporation, independence practices can help avoid a breach by directors of their duty of loyalty. Hence, the creation of a committee composed only of independent directors (to reduce the influence of management) and the advice of independent counsel and financial advisors may be of great help in assisting directors to take the best decision for the corporation as a whole. These measures were recognized as a good way of dealing with a potential conflict of interest by the Ontario Court (General Division) in *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*,³⁸⁵ another case in which directors of a corporation had to assess the value of a take-over bid proposal:

Retaining independent legal and financial advisors, and the establishment of independent or special directors' committees to assess and respond to the hostile bid, are the classic mechanisms to which boards of directors have traditionally resorted in order to cope with their difficult duties and conflicting position [...] Resort to these devices enables the directors to investigate and consider the circumstances – including the triggering bid, and the various alternatives available to the corporation in respect of it, having regard to the interest of the shareholders – with a degree of independence. In the end, they must make a decision and exercise their judgment in an informed and independent fashion, after a reasonable analysis of the situation and acting on a rational basis with reasonable

³⁸⁴ *Ibid.*, at 266 to 270.

³⁸⁵ *Supra* note 292.

grounds for believing that their actions will promote and maximize shareholder value [...]³⁸⁶

(3) Ballard

In *820099 Ont. Inc. v. Harold E. Ballard Ltd.*,³⁸⁷ directors of Ballard Ltd. were accused of having approved many transactions between the corporation and relatives of its controlling shareholder in breach of their duty of loyalty toward the corporation. The transactions central to the case were important real estate transactions and purchase of shares involving relatives of the controlling shareholder done without regard to fair market value to the detriment of the corporation and its minority shareholders. The Ontario Court of Justice (General Division) stated that proper valuations should have been conducted in order to justify the pricing of the various transactions and that directors had not taken the appropriate measures to ensure a fair pricing.³⁸⁸

In circumstances such as those found in the Ballard case, independence practices could have assisted directors to properly discharge their duty of loyalty in many ways. Hence, the presence of a majority of independent directors, free from the influence of the controlling shareholder, would have probably resulted in questions being asked about the fairness of the transaction. Should directors have been concerned about that issue, they could have discussed it with the independent chair or amongst themselves during *in camera* sessions. If they had been concerned about the independence of the process, they could have appointed an independent committee to assess the proposed transactions and hire independent experts to establish fair pricing in order to protect themselves.

³⁸⁶ *Ibid.*, at 145 and 146.

³⁸⁷ *Supra* note 161.

³⁸⁸ *Ibid.*, at 178.

(4) Deluce Holdings

In *Deluce Holdings v. Air Canada*,³⁸⁹ the nominees of the controlling shareholder (Air Canada) on the board of directors of Deluce Holdings voted to terminate the employment of its chief executive officer. The controlling shareholder was then able to buy-out a minority shareholder pursuant to the terms of a shareholders' agreement previously entered into between the shareholders of Deluce Holdings and according to which, upon the termination of the employment of the chief executive officer, Air Canada could acquire the shares of the minority shareholder at a price to be agreed between the parties and, failing agreement, at fair market value.

The nominees of the controlling directors were blamed for having followed a course of action that benefited their nominator without taking into account the best interests of the corporation. The Ontario Court of Justice (General Division) found that no independent analysis had been conducted by the directors of Deluce Holdings regarding what would constitute the best decision for the corporation, the question on the uppermost of their minds being to accomplish the controlling shareholder's agenda. Although the Court did not conclude that there had been bad faith in the part of the directors, it nevertheless found that the result of their decision was oppressive to the interests of the corporation and its minority shareholder.

Like in the Ballard case, independent practices would have been helpful in assisting directors in the discharge of their duty of loyalty. A majority of independent directors would probably have raised questions as to the appropriateness of the decision to dismiss the chief executive officer. Should an independent committee have been in charge of assessing the performance of management and of succession planning, chances are that the chief executive officer would not have been terminated without good reasons. Independent directors suspecting the real motive behind the reasons of the controlling shareholder for replacing the chief executive officer could have discussed the appropriate course of action in an *in camera* meeting, with the independent board chair or with

independent counsel. Independence practices would have helped them to ensure that they properly discharged their duty of loyalty toward the corporation.

(d) Empirical research on the benefits of independence

Even if independence practices may theoretically decrease agency costs and facilitate the discharge of the duty of loyalty, one may argue that independence practices should not be recommended unless it is empirically proven that such practices increase the value of the corporation (and thus shareholders' wealth), which should be the primary objective of corporate governance. As we will see below, there is currently no conclusive empirical evidence that independence practices will increase the value of a corporation. This may be explained by many factors, which we will see argue for more research in that field. In this subsection, we will review recent studies on the impact of certain independence practices on corporate performance. Such studies relate to the composition of the board, the composition of board committees and the appointing of an independent board chair. We will then explain why current empirical results should not discourage corporations from adopting independence practices.

(i) Studies related to the composition of the board

Professors Bhagat and Black convincingly argue, in a recent study, that there is no strong evidence that greater board independence correlates with greater profitability.³⁹⁰ In their study, Bhagat and Black use a sample of 205 U.S. public companies to examine whether the change between 1988 and 1991 in the degree of board independence (measured by the number of outside directors on a board) correlates with firms' profitability or growth rate (where profitability was assessed using different

³⁸⁹ *Deluce Holdings Inc. v. Air Canada* (1992) 8 B.L.R. (2d) 294 (Ont. Ct. Gen. Div.).

³⁹⁰ Bhagat, S. & Black, B., "Board Independence and Long-Term Firm Performance" (Columbia Law School, Working Paper No. 143, 2000), online: <http://www.law.columbia.edu/center_program/law_economics> (date accessed: 3 March 2007), at 1; See also Kakabadse, A. & Kakabadse, N., *supra* note 5, at 1.

variables such as return on assets, operating margin and market-adjusted stock price returns, while growth rate was assessed by measuring the growth in variables such as assets, sales, operating income and cash flow). They found that there was little evidence that a firm's past growth or profitability was related to board composition.³⁹¹

In another study published in 2002, the same authors came to similar conclusions.³⁹² The authors studied the financial performance and practices of 934 large U.S. firms from 1985 to 1995 and found that firms with more independent boards do not achieve better profitability. They found evidence that firms with low profitability tend to respond to financial problems by increasing the number of independent directors on their board, but could not prove that such a strategy had a positive result.

In yet another study, using a database containing information on 957 large U.S. public corporations from mid-1990s, they concluded that more independent directors on a board does not correlate with better corporate performance. In fact, a negative correlation could even be found if almost all directors are independent:

Contrary to conventional wisdom, we find evidence of a negative relationship between the degree of board independence (proxied by an "independence" variable that equals the proportion of independent directors minus the proportion of inside directors). These results are driven by poor performance at firms with supermajority-independent boards. Firms with an independence level of 0.4 or higher (which corresponds, for a typical eleven-member board, to eight or nine independent directors and only one or two insiders) perform worse than other firms. We find no strong correlation between board independence and firm performance for other firms. This suggests that it may be valuable for boards to include at least a moderate number of inside directors. A high proportion of independent directors also correlates with slower growth.³⁹³

³⁹¹ *Ibid.*

³⁹² Bhagat, S. & Black, B., "The Non-Correlation Between Board Independence and Long-Term Firm Performance" (2002) 27 Iowa J. Corp. L. 1

³⁹³ Bhagat, S. & Black, B., *supra* note 99, at 28.

Bhagat and Black mention that such conclusion can be explained by factors such as the fact that inside directors are more knowledgeable about a corporation's operations and understand the corporation's strengths and weaknesses better than independent directors, that the presence of inside directors on a board may make it easier for other directors to evaluate them as future chief executive officers, that inside directors would be better at strategic planning decisions and that they would generally be more financially committed to the corporation.³⁹⁴

Although we must be careful in referring to European empirical studies, which may use different measures for determining which directors are independent, the meta-analysis of Professors Catherine and Dan Dalton is also worth mentioning.³⁹⁵ The authors reviewed 159 studies made over a 40-year timeframe, and found no evidence of a systematic relationship between board composition and corporate performance.³⁹⁶ As they state in a recent article:

[...] Not only were independent directors not associated with [better] firm performance, but inside, outside and affiliated directors were not associated with higher or lower firm financial performance either.³⁹⁷

Professors Dalton and Dalton found no evidence of a relationship between board composition and firm financial performance, whether measured using accounting or market-based methods.³⁹⁸

Not all studies are unable to find positive effects in having a majority of independent directors on a board. Indeed, many studies show that independent directors make a positive difference with respect to important discrete tasks undertaken by boards of directors. Hence, Weisbach has shown that between 1974 and 1983, boards with at least 60% independent directors were more likely than other boards to fire a poorly

³⁹⁴ *Ibid.*, at 33, 34 and 39.

³⁹⁵ Dalton, C.M. & Dalton, D.R., *supra* note 371.

³⁹⁶ *Ibid.*, at S92.

³⁹⁷ *Ibid.*

³⁹⁸ *Ibid.*

performing chief executive officer, which is a central task of the board.³⁹⁹ The economic significance of his finding is however small since he found that the chief executive officer termination rate for corporations that ranked in the bottom decile for stock price performance is only 1.3% higher for corporations with 60% or more of independent directors on their board than for corporations with 40% or fewer independent directors.

Bebchuk, Grinstein and Peyer provide results were more convincing. In a recent study, they found evidence that a majority of independent directors reduces the risk of opportunistic option grant manipulation.⁴⁰⁰ The focus of their research was to study how grant date prices rank within the price distribution of a grant month. Investigating the incidence of “lucky grants” (defined as grants for which the exercise price is based on the lowest trading price of securities during a month) within a sample of 41,397 grants between 1996 and 2005, they found that 12% of the firms under study provided one or more lucky grant due to manipulation during that period. Examining the circumstances and consequences of lucky grants, they found that such grants were more likely when the corporation did not have a majority of independent directors on the board.⁴⁰¹ Empirically speaking, they found that having a majority of independent directors on a board reduces the odds of a lucky grant by an average of 33%.⁴⁰²

In yet another study, Cotter, Shivdasani and Zenner reported that between 1989 and 1992, corporations that were the targets of tender offers realized roughly 20% higher stock price returns when their boards were composed of a majority of independent directors compared to targets without majority-independent boards.⁴⁰³ Similarly, Lee, Rosenstein, Rangan and Davidson found that the presence of a majority of independent

³⁹⁹ Weisbach, M.S. “Outside Directors and CEO Turnover” (1988) 20 J. Fin. Econ. 431.

⁴⁰⁰ Bebchuk, L.A., Grinstein, Y., Peyer, U., “Lucky CEOs” (John M. Olin Center for Law, Economics, and Business, Discussion Paper No. 566) online: <http://papers.ssrn.com/abstract=945392> (date accessed: 3 March 2007).

⁴⁰¹ *Ibid.*, at 2.

⁴⁰² *Ibid.*, at 26.

⁴⁰³ Cotter, J.F., Shivdasani, A. & Zenner, M., “Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers” (1997) 43 J. Fin. Econ. 195.

directors on a board increases shareholder return upon the announcement of a management buyout.⁴⁰⁴

As we see from these results, although it seems difficult to prove that an increase in the number of independent directors is generally correlated with improved corporate performance, these studies tend to show that the presence of independent directors can nevertheless benefit shareholders when directors have to discharge certain tasks for which independence makes a difference.

(ii) Studies on the composition of board committees

We are not aware of studies that would assess the impact of having board committees, in general, composed solely of independent directors. However, certain studies have been conducted regarding the impact of having independent directors on the audit committee. Hence in a meta-analysis, Professor Romano reviewed studies which attempted to establish a relation between audit committee composition on one hand, and firm performance or financial misconduct on the other hand. Of the sixteen studies reviewed by Professor Romano, ten did not find that an audit committee composed solely of independent directors improves performance or reduces financial fraud. The data was mixed, however on whether a majority of independent directors on the audit committee improves performance or reduces financial fraud.⁴⁰⁵ The following table, extracted from a recent article of Professor Romano, summarizes the results of the studies she reviewed:⁴⁰⁶

⁴⁰⁴ Lee, I.L., Rosenstein, S., Rangan, N. and Davidson III, W.N., "Board Composition and Shareholder Wealth: The Case of Management Buyout" (1992) *Fin. Mgmt* 66.

⁴⁰⁵ Romano, R., "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2005) 114 *Yale L.J.*, 1521, at 1532.

⁴⁰⁶ *Ibid.*, at appendix 4.

Studies on Audit Committee Independence

Study	Sample	Performance measure	Findings
Abbott et al. (2000)	78 pairs of firms, 1980-1996	Financial statement fraud	Negative relation with variable combining 100% independent and two meetings a year
Abbott et al. (2002)	129 pairs of firms, 1991-1999	Financial reporting misstatements or fraud	Negative relation with 100% independent or absence of financial expert on committee
Agrawal & Chadha (2003)	159 pairs of firms, 2000-2001	Earnings restatements	No association with percent independent or 100% independent; negative relation with financial expert on committee
Anderson et al. (2003)	1241 firms, 2001	Stock market response to unexpected earnings (earnings informativeness)	Earnings response significantly related to board independence with no incremental significance of audit committee independence
Beasley (1996)	75 firms, 1980-1991; 26 pairs with audit committees	Financial statement fraud	No association with percent independent
Beasley et al. (2000)	66 firms in high technology, health care, and financial services, 1987-1997	Financial statement fraud	Univariate test: negative relation for 100% independent in two of three industries
Bédard et al. (2004)	300 firms, 1996	Aggressive abnormal accruals	Negative relation with 100% independent and presence of financial expert; no association with majority independent
Cotter & Silvester (2003)	109 large Australian firms, 1997	Market value	No association

Study	Sample	Performance measure	Findings
Felo et al. (2003)	119 firms, 1992-1993; 130 in 1995-1996 (77 in both periods)	Financial analysts' score for quality of financial reporting	No association with percent independent; positive relation with proportion of financial experts on committee in 1995-1996; no association with expert with accounting background; change in score from 1992-1993 to 1995-1996 positively related to percentage experts in 1992-1993 and to change in number of experts over the period
Klein (1998)	485 S&P 500 firms, 1992; 486 in 1993	Return on assets; Jensen productivity; one-year raw market return	No association with percent independent and any measure; no stock market effect for change in composition of committee
Klein (2002)	692 S&P 500 firms, 1992-1993	Abnormal accruals	No association with 100% independent; negative relation with majority independent or percent independent
McMullen & Raghunandan (1996)	51 firms with financial problems pre-1989; 77 control firms	SEC enforcement action or quarterly earnings restatement	Univariate test: negative relation for 100% independent and for presence of accounting expert on committee
Uzun et al. (2004)	133 firms accused of fraud from 1978-2001 paired with no-fraud firms	Allegations of third-party and government contract fraud; financial statement fraud; regulatory violations	No association for percent independent; positive association for percent of "gray" (affiliated) directors
Vafeas & Theodorou (1998)	250 U.K. firms, 1994	Market-to-book ratio; stock return; accounting measures	No association
Weir et al. (2002)	311 Times 1000 (U.K.) firms, 1996	Tobin's Q	No association
Xie et al. (2003)	282 S&P 500 firms, 1992, 1994, 1996	Abnormal accruals	No association; negative association with proportion of investment bankers or other corporate officers on committee

With respect to corporate performance, she found that:

There are fewer studies of the relation between audit committee composition and firm performance (four in total). None of these studies have found any relation between audit committee independence and performance, using a variety of performance measures including both accounting and market measures as well as measures of investment strategies and productivity of long-term assets.⁴⁰⁷

About the impact of an audit committee composed only of independent directors on a potential reduction of financial statement misconduct she writes:

While not as extensive as the literature on board composition and performance, many more studies have examined the impact of the independence of audit committees on the probability of financial statement misconduct than on performance [...] The compelling thrust of the literature on the composition of audit committees, in short, does not support the proposition that requiring audit committees to consist solely of independent directors will reduce the probability of financial statement wrongdoing or otherwise improve corporate performance. Not only is that the case for the overwhelming majority of studies, but also, and more importantly, that is so for the studies using the more sophisticated techniques.⁴⁰⁸

Hence, the most recent studies on audit committee composition can not provide conclusive results as to correlations between having independent directors sitting on the committee and the improvement of corporate performance or the reduction of financial fraud.

(iii) *Studies on the impact of an independent board chair*

Studies on the impact of an independent board chair on corporate performance are not very conclusive either. In an examination of 69 studies over a 40-year period, Professors Dalton and Dalton found that firms where the chief executive officer and board chair positions are separate do not outperform firms where these positions are

⁴⁰⁷ *Ibid.*, at 1530.

combined.⁴⁰⁹ Their studies were based on both accounting and market performance indicators.

When referring to these studies, it is important to note that they did not analyse the impact of having an independent chair, but simply of having a board chair different than the chief executive officer. That explains why Professors Dalton and Dalton are optimistic as to the potential impact of an independent board chair, particularly if he or she manages the budget of the board:

There are two areas we believe hold great promise for developing a relationship between board independence and firm performance. These are the installation of a lead independent director, and a board of director's budget.⁴¹⁰

Of course, more research is needed on the impact of independence practices on corporate performance. What would be of particular interest would be to study the combined effect of those practices.

(iv) Reasons why current empirical results should not discourage corporations to adopt independence practices

Many reasons exist why directors should not be discouraged from adopting independence practices, despite the lack of conclusive demonstration of the benefits of doing so in most current empirical research. First, there are fundamental problems with studies relating to the impact of independence practices on corporate performance, or on the reduction of financial fraud. The primary problem is their definition of independence. Many of these studies were made at a time where the standards of independence were very low. Since then, Canadian and U.S. regulators, as well as stock exchanges, have adopted guidelines that are more rigorous than ever, with presumptions

⁴⁰⁸ *Ibid.*, at 1530 and 1533.

⁴⁰⁹ Dalton, C.M. & Dalton, D.R., *supra* note 371 at S93.

⁴¹⁰ *Ibid.*, at S93.

of non-independence that did not exist to that extent before.⁴¹¹ Consequently, many directors who were categorized as independent under previous standards would not be independent under the current ones, which of course undermines previous results.

A second problem of these studies is that they generally do not take into account the interaction of different practices to promote and maintain independent behaviours.⁴¹² Independence should not be assessed only by calculating the number of independent directors on a board of directors or one of its committees. A board could be composed of independent directors but if it does not allow the exercise of independent judgment, the corporation will probably not benefit as it could from such independence. Factors to be taken into account when assessing the impact of independence should also include the presence of an independent chair, the existence and frequency of *in camera* meetings, and policies allowing an access to independent advisors.

A third problem is that the most important effects of independent directors may be systematic (*i.e.*, on the market as a whole) instead of idiosyncratic (*i.e.*, firm specific). As mentioned by Professor Gordon, of Columbia Law School:⁴¹³

The evidence is also consistent with a view that the main effects of the change in board composition are systematic and that the firm-specific effects are very hard to isolate. In the US environment of substantial ownership by economically-motivated institutional investors, a dominant pattern of board independence locks in shareholder value as the corporation's principal objective. This pattern changes the competitive environment for all firms, regardless of the board structure of any particular firm. Thus any firm-specific effects that might be associated with "early adoption" of greater board independence will be muted, possibly even obscured, by competitive imitation.⁴¹⁴

⁴¹¹ See subsection II.C of this thesis.

⁴¹² Dalton, C.M. & Dalton, D.R., *supra* note 371 at S93.

⁴¹³ Gordon, J.N., *supra* note 336, at 39.

⁴¹⁴ *Ibid.*, at 41.

The impact of new independence practices may be particularly difficult to measure in developed economies, where most large corporation endorse the same values and practices. Professor Black admits such difficulty:

And yet, perhaps the problem is with the data, not the proposition that firms' corporate governance behavior affects their market value. The minimum quality of American corporate governance, set by law and by norms so widely accepted that almost no public firms depart from them, is quite high. The variation in firm behavior is small, perhaps too small for us to observe large performance differences due to this variation.⁴¹⁵

By looking at emerging economies, it might be easier to study the real impact of independent directors on a firm's performance. This hypothesis seems to be confirmed by the premium that investors are ready to pay for firms with good governance practices (including independent directors) in emerging markets.⁴¹⁶ Using a sample of Russian corporations, Professor Black found that governance behaviours of Russian firms greatly affect their market value.⁴¹⁷ More specifically with respect to board independence, Black, Jang and Kim found that in Korea, large firms with 50% outside directors have a stock price 40% higher than firms without an outside board.⁴¹⁸

Other related reasons may explain why independence practices seems to be beneficial in certain situations and neutral (or even a negative factor) in others. Professor Gordon refers to a potential tradeoff between the different attributes that independent and non-independent board members bring to a board:

Yes, a higher fraction of independent directors may produce outcomes that could be associated with value-increasing superior governance, for example: greater capacity to monitor the CEO and make appropriate

⁴¹⁵ Black, B., "Does Corporate Governance Matter? A Crude Test Using Russian Data" (2001) 149 U. Pa. L. Rev. 2131, at 2132.

⁴¹⁶ McKinsey & Company, *Global Investor Opinion Survey: Key Findings*, online: <http://62.26.120.101/downloads/Presse/global_investor_opinion_survey_2002.pdf> (date accessed: 3 March 2007).

⁴¹⁷ Black, B., *supra* note 415, at 2134.

⁴¹⁸ Black, B.S., Jang, H. & Kim, W., "Does Corporate Governance Predict Firms' Market Value? Evidence from Korea", unpublished paper, available at <http://papers.ssrn.com/abstract=311275> (date accessed: 3 March 2007).

termination decisions. But there may well be costs. Inside directors or affiliated – outsiders with an interest – may contribute valuable advice and insights that are lost in a thoroughly independent board.⁴¹⁹

Another explanation for the different impact of independence practices on different corporations may be that corporations' optimal mix of independent and non-independent directors are different from one corporation to another. As explained by Professor Gordon:

Assume that firms differ in the optimal fraction because of firm-specific tradeoffs: for particular firms inside directors or affiliated outsiders may be more (less) useful, influenced perhaps by the relevant ownership structure or product market competition that reduces (increases) the managerial agency costs addressed by independent directors. In any event, in a competitive market, we would expect firms to move toward their optimal governance structure. On this view, the regression results are expectedly economically insignificant – as is the general pattern – but only because out-of-equilibrium governance structures do not persist, not because director independence has little value for many firms.⁴²⁰

Finally, Professor Gordon, postulates that another persuasive explanation for the empirical pattern may be that director independence may well be positive for shareholder value but that above a critical degree, the returns are diminishing, and given the possibility of firm-specific tradeoffs referred to above, may even be negative. He calls this phenomenon the diminishing marginal returns hypothesis.⁴²¹

Taking into account those three explanations suggested by Professor Gordon: the potential tradeoffs, the optimal mix and the diminishing marginal returns hypotheses, one sees that legislators must be very careful in designing measures to increase the independence of boards. Although independence is arguably beneficial for corporations, the optimal recipe may be different from one corporation to the next. While in theory the benefits of having boards and board committees composed of independent directors seem

⁴¹⁹ *Ibid.*, at 39.

⁴²⁰ *Ibid.*, at 40.

⁴²¹ *Ibid.*

important, requiring that such boards or committees be composed solely of independent directors may not necessarily enhance shareholder value in all cases. This supports our hypothesis detailed in subsection II.C of this thesis to the effect that although common definitions of independence and the disclosure of independence practices are required, rules should be flexible enough to allow boards of directors to decide on the kind of measures that are the most appropriate for their corporation, on a case by case basis.

The merit in having a few members of the board who are not independent directors should not be denied. It is possible that an optimal board generally contains a mix of inside and independent directors, who bring different skills and knowledge to the board. As explained by Bhagat and Black:

Inside directors are highly knowledgeable about the company's operations, but conflicted. Independent directors are independent, but often ignorant about what is happening inside the company. The independent directors may be quicker to act in a crisis because they are independent, but more likely to do the wrong thing because they are ignorant.⁴²²

However, it must be admitted that many of the advantages of having inside directors on a board can generally be reached without compromising independence. For instance, managers may be invited to board meetings without being members of the board.⁴²³ Directors can then benefit from their knowledge and evaluate them as future senior officers even if the managers are not allowed to vote on matters presented to the board.

It is difficult to prove that on an idiosyncratic basis (for any individual firm), independence practices always increase performance. However, the empirical research described above tends to recognize the benefits, until a "saturation point" is reached, of board independence. The saturation point (*i.e.*, the point where the disadvantages of

⁴²² Bhagat, S. & Black, B., *supra* note 390. The Dey report recognizes the desirability of having two members of management on a typical board of directors (composed of 10 to 15 members). See Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 32.

⁴²³ Canadian Coalition for Good Governance, *supra* note 362, at 17.

independence practices are higher than their advantages), is most likely different for each corporation.

As explained in this subsection, independence practices can be used to reduce the risks (and costs) of misappropriation and assist directors in their discharge of the duty of loyalty. Even if empirical research is not conclusive on the impact of these practices on corporate performance or the reduction of fraud in the market, we would generally encourage the adoption of independence practices. As it will be explained in subsection II.B of this thesis, however, in order to mitigate the potential negative impact, on an idiosyncratic basis, of specific independence practices, we would argue that such practices should not be imposed by regulators but simply suggested, subject to mandatory disclosure.

SUMMARY

As described above, independence is an abstract concept. The essential elements of board independence are directors who are true outsiders and who can create a climate of creative tension in the boardroom. In theory, an independent board will be a powerful tool to complement the duty of loyalty in decreasing agency problems caused by misappropriation. Independence practices will also help directors avoid potential liability stemming from the duty of loyalty.

Empirical studies, however, suggest prudence in the adoption of independence requirements, as corporations with a super-majority of independent directors are not necessarily associated with better performance. As we will see in subsection II.C of this thesis, rules should be flexible enough to allow boards to determine board and committee composition, as well as which independence practices should be adopted, subject to appropriate disclosure.

Measures based on independence will be of great assistance in aligning the conduct of directors with the best interests of the corporation. However, independence should not be seen as a dogma to be followed without deviation but rather as a tool to help directors navigate between risks and opportunities of the business world, and avoid the rocks of temptation.

2. ACTIVE MONITORING

Subsection I.C.2 of this thesis has demonstrated the limits of the duty of care in decreasing the costs of mismanagement. In this subsection, active monitoring by a board of directors is proposed as a way of further reducing agency costs, while at the same time helping directors discharge their fiduciary duties.

This subsection will first define the active monitoring concept and will describe the theoretical benefits of such a concept. It will then show why active monitoring is an essential complement to the duty of care in reducing costs of mismanagement and how it can help directors comply with their duty of care. The limited empirical studies regarding active monitoring will then be reviewed and topics for further research will be proposed. This subsection does not review the rules of the CSA relating to active monitoring. Such review and proposed amendments thereto will instead be made in subsections II.C.3 and 4 of the thesis.

(a) The meaning of active monitoring

In this thesis, active monitoring can be defined as the active supervision of management and corporate initiatives by the board of directors, directly or through the use of board committees. Active monitoring implies that the board is actively involved in approving the strategic direction of the corporation and in overseeing the decisions and actions of management in implementing such strategy, but without being part of day-to-day management. It also implies that the board may create committees, when needed, to better perform its tasks. On an individual level, active monitoring requires directors to devote time and energy to the affairs of the corporation and to dissent when they do not agree with decisions of their fellow board members.

(i) *The source of the active monitoring concept*

The dominant theoretical model once was that the board was responsible for managing the business of the corporation. This model was based on the inherent assumption that the shareholders who elect or appoint directors do so in reliance upon directors' personal skills and experience and that directors' power of delegation should consequently be limited.⁴²⁴ In the context of publicly listed corporations, this model soon became unrealistic, because part-time directors cannot manage the business of a complex organization.⁴²⁵ The suitability of corporations as vehicles for organizing productive enterprise would be seriously compromised if directors were totally constrained in their ability to delegate their corporate responsibilities.⁴²⁶

Hence, the monitoring board model was developed and increasingly became accepted by the business community and adopted by large publicly held corporations.⁴²⁷ Investors came to believe in its economic value, and began to put pressure on corporations that did not adopt it.⁴²⁸ Under the monitoring model, senior executives manage the business of the corporation and the board monitors senior executives.⁴²⁹ Proponents of such model argue that a business, just like a government, needs an organ responsible for policy-making and general oversight, and an organ of execution and action.⁴³⁰ Under the monitoring board model, boards govern and provide oversight,⁴³¹ while management organizes and executes.⁴³² Management proposes and the board disposes.⁴³³

⁴²⁴ McGuinness, K.P., *supra* note 17, at 778 and 779.

⁴²⁵ Eisenberg, M.A., *supra* note 116, at 44 and 45.

⁴²⁶ McGuinness, K.P., *supra* note 17, at 779.

⁴²⁷ Dent, G.W., "The Revolution in Corporate Governance, the Monitoring Board, and the Director's Duty of Care" (1981) 61 B.U. L. Rev. 622, at 623; and Eisenberg, M.A., *supra* note 116, at 47.

⁴²⁸ Eisenberg, M.A., *ibid.*

⁴²⁹ *Ibid.*, at 45 and 46.

⁴³⁰ Institute of Corporate Directors, *supra* note 343, at 1.

⁴³¹ Dimma, W.A., *supra* note 75, at 5.

⁴³² *Ibid.*

⁴³³ Thain, D.H. & Leighton, D.S.R., "Effective director dissent" (1994) Bus. Quart. 35, at 37.

As a consequence of the rise of the monitoring board model, the delegation to management of the day-to-day conduct of the business of a corporation has been increasingly recognized and allowed. Section 102 of the *CBCA* was amended, in 2001, to formally allow a boards of directors to “supervise” the management of the business and affairs of a corporation, and not necessarily manage them directly. This amendment followed the recommendations of the Dey Report and the Saucier Report, both of which stated that section 102 of the *CBCA* was no longer in touch with reality, in that today, the boards of most public corporations supervise, direct or oversee the business of the corporation, but the day-to-day management is delegated to management.⁴³⁴

It is well recognized with regard to the exigencies of business that directors of a public corporation are not in a good position to undertake the day-to-day administration of the corporation.⁴³⁵ Even if they wanted to manage on a day-to-day basis, directors, and particularly independent, part-time directors, would be ill-equipped for such an activist role.⁴³⁶ When compared to management, they have a distinct disadvantage: they do not have management’s intimate knowledge of the business, and, in fact, are dependent upon management for the relevant information.⁴³⁷ Furthermore, the involvement of directors in the day-to-day operations of the business is often considered inefficient. As stated in the Dey Report:

[...] At the board level, it is important that the board not participate in the day-to-day management of the business of the corporation. Involvement in day-to-day management may be required in exceptional circumstances but as a general matter it is inefficient, destructive of good management, and precludes the board from discharging its obligation to take a longer term view of the direction of the corporation.⁴³⁸

⁴³⁴ Joint Committee on Corporate Governance, *supra* note 6, at 12; and Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 40.

⁴³⁵ McGuinness, K.P., *supra* note 17, at 787.

⁴³⁶ Bybelezer, H.M., *supra* note 102, at 87; and McGuinness, K.P., *supra* note 17, at 776.

⁴³⁷ Millstein, I., “The Professional Board” (1995) 50 Bus. Law. 1427, at 1432; and Dent, G.W., *supra* note 427, at 627 and 628.

⁴³⁸ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 40.

In addition, too deep and frequent intervention by the board may make managers risk-averse and conditioned to await board guidance.⁴³⁹ In a world where quick reaction time may make an important difference between leaders and laggards, a corporation that always relies on its board for guidance may be at a disadvantage.

The existence of the duty of care is an incentive for directors to be involved in the monitoring of their corporation. As mentioned in subsection I.B.3 of this thesis, when delegating the day-to-day running of the corporation, directors must keep in mind that they are statutorily bound to supervise the persons to whom such powers have been granted. Directors may be held responsible for their delegates' actions.⁴⁴⁰ Like a trustee who retains an agent, the directors must be able to show that reasonable care was exercised in the agent's selection.⁴⁴¹ Directors must also exercise care and prudence in supervising the acts of officers and agents to whom they delegate authority.⁴⁴² Directors cannot place blind reliance in a person to whom authority has been delegated by the corporation. Delegation does not mean abdication of responsibility. In that sense, as we will see below, the exercise of active monitoring by a board will assist directors in the discharge of their duty of care.

(ii) *The components of the active monitoring concept*

As stated above, active monitoring refers to the active supervision of management and corporate initiatives by the board of directors, directly or through the use of board committees. Boards have been compared, by Bainbridge, to production teams (*i.e.* teams who produce a tangible good). But instead of being responsible for producing a tangible output, they should: (i) have broad policy-making prerogatives and provide advice and guidance to top managers with respect to corporate decisions (a leadership role); and (ii)

⁴³⁹ Millstein, I., *supra* note 437, at 1433.

⁴⁴⁰ Welling, B., *supra* note 122, at 325.

⁴⁴¹ *Ibid.*

⁴⁴² Bender, M., *supra* note 17, at 3-28.

oversee corporate controls and monitor and discipline management (an oversight role).⁴⁴³ Active monitoring practices should assist the board in performing one or both of those two roles.

It is not difficult to imagine the theoretical benefits of an active involvement of corporate directors in policy-making and in advising management. Directors are often business people or experts with vast experience. Their knowledge and judgment can assist the board in performing better and in avoiding mistakes that have been made by other corporations in which directors have been involved in the past. Even if directors do not know the answer to a problem or the best policy to adopt, they can often provide guidance in the search for the best course of action. Furthermore, because of their network of contacts, directors can often direct managers toward useful resources and best practices.

Directors are also in the best position to monitor corporate controls and monitor and discipline management. The oversight function of a board of directors is the logical extension of our corporate model. Due to the separation of ownership and control, directors need to evaluate corporate processes and procedures and create appropriate systems of rewards and punishment to motivate managers to always perform better.⁴⁴⁴ When performance is not satisfactory, the board of directors constitutes the ultimate structure that will provide balance to the corporation by using disciplinary measures to correct the situation.

Of course, it is precisely those leadership and oversight roles that will allow a board to reduce the potential risks (and costs) of mismanagement. The next subsection will describe in more detail which active monitoring practices can reduce the costs of mismanagement and how they can do so.

⁴⁴³ Bainbridge, S.M., *supra* note 34, at 8.

⁴⁴⁴ Dent, G.W., *supra* note 427, at 664 and 665.

(b) Active monitoring as the essential complement to the duty of care to decrease costs of mismanagement

Subsection I.C of this thesis described the limits of the duty of care in decreasing the costs of mismanagement. It explained that a breach of the duty of care is very difficult to detect and difficult to prove, that shareholders may not have sufficient incentive to sue a defaulting director and that the business judgement rule insulates directors, at least in part, against claims of shareholders.

Active monitoring is proposed as a way to constrain agency costs by allowing for a more effective pursuit of the corporation's best interests. The next subsection will briefly describe how active monitoring practices decrease costs of mismanagement. Corporate governance practices based on active monitoring will better be described. It will be shown that such practices complement the duty of care through: (i) prophylactic measures to avoid mismanagement and (ii) curative measures for dealing with acts of mismanagement. Subsections II.C.3 and 4 of this thesis will link the principles contained in this section to the existing rules and guidelines of the CSA and propose amendments to such rules and guidelines in order to improve active monitoring.

(i) How active monitoring practices decrease costs of mismanagement

Active monitoring practices can be used to decrease costs of misappropriation in three ways by: (i) reducing the likelihood that a director will be inactive; (ii) improving the oversight of management (and thus reducing the risks of mismanagement by senior officers); and (iii) improving the monitoring by directors of their fellow board members.

(1) Reducing the likelihood of inactive directors

It is very difficult for shareholders to assess or even estimate the amount of time and energy dedicated by directors and management to the affairs of a corporation.

Indeed, since our corporate laws do not allow shareholders to have access to the minutes of the meetings of directors and members of management, and that even if they had access to such minutes the work being done (or not done) by directors and management would not necessarily appear from reading them, shareholders generally do not know how the corporation in which they invest is managed and cannot easily estimate the risks of mismanagement.

It is submitted that active monitoring practices reduce the negative impact of this information deficit. They act as safeguards against mismanagement by setting forth specific responsibilities to be discharged by management and the board of directors and provide structures to facilitate the discharge of these responsibilities. As explained in subsection II.A.1 of this thesis, independence practices are essential to permit board empowerment. But independence practices must be complemented by structures and practices that will encourage directors to be active. The full benefits of independence practices will only be reached if directors are involved in the affairs of the corporation.

As we will see below, by adopting board and committee charters describing the responsibilities to be discharged and by scheduling frequent meetings to which certain tasks are assigned, boards increase the involvement of their members. On an individual level, by stating in the board charter what the board expects from its directors in terms of time, energy and availabilities, boards also reduce the likelihood that directors be inactive.⁴⁴⁵ Since National Instrument 58-101 requires that both the board charter and the record of attendance be disclosed by public corporations, a low attendance would quickly be noticed by shareholders and the director would risk losing his or her seat on the board. In certain situations, it could be used by a plaintiff to show that a director did not take his or her role seriously.

⁴⁴⁵ See Canadian Coalition for Good Governance, *supra* note 362, at 16.

(2) Improving the oversight of management

Under the traditional monitoring model described in subsection I.A.1 of this thesis, boards often operate as the reviewers of ideas and performance of corporate management.⁴⁴⁶ They operate largely as advisory bodies, and leave the details of how to accomplish corporate goals to their delegates, the corporation's officers.⁴⁴⁷ Active monitoring requires board members to play a more active role.⁴⁴⁸ They must put in place structures and processes that follow best practices and ensure that the corporation is well managed. In order to do that, directors must have the capabilities and independence to monitor the performance of top management and the corporation, to influence management to change the strategic direction of the corporation if its performance does not meet the board's expectations and, in the most extreme cases, to change corporate leadership.⁴⁴⁹

Legally, the board has such powers. A board has all the powers it did not specifically or implicitly delegate to a committee or to management. In practice, however, unless a corporation adopts board and committee charters, management may consider that certain powers are its prerogative, that they have been implicitly delegated to it. Active monitoring ensures that there is a clear understanding by the board, management and all shareholders as to who is in charge of what. It also empowers the board by signaling that it is the one to decide on the delegation to management. It is not management's decision.

(3) Improving the monitoring by directors of their fellow board members

Active monitoring also improves the monitoring by directors of their fellow board members. This is mostly done at the board level and through the nominating and

⁴⁴⁶ Welling, B., *supra* note 122, at 299.

⁴⁴⁷ *Ibid.*, at 317.

⁴⁴⁸ Sonnenfeld, J.A., "What Makes Great Boards Great" (2002) Sept. Harv. Bus. Rev. 106, at 112.

corporate governance committee, which should assess the performance of the board, its committees, the chairs of the board and of each committee and each individual director.

By including the responsibility for assessing such performance in the charter of the board and the charter of the nominating and corporate governance committee, members of the board and those who sit on that committee are compelled to follow and evaluate their fellow members. Knowing that they will be evaluated, directors will likely be more active in discharging their duties.

(ii) *Prophylactic measures based on active monitoring*

In order to prevent, limit and recover misappropriation costs, corporations should adopt active monitoring practices. This subsection reviews specific prophylactic measures to be put in place to prevent mismanagement costs, whereas the next subsection will focus on curative measures to be put in place to limit and recover those costs.

It is submitted that in order to prevent the risks of mismanagement, board should adopt and disclose: (i) board and committee charters describing in detail the responsibilities of the board and its committees; (ii) position descriptions for the board chair and the chairs of each board committee; (iii) a position description for the chief executive officer; (iv) policies related to the assessment of the board, its committees and individual directors; and (v) directors' orientation and continuing education programs. The potential benefits of each of these practices and their disclosure are highlighted in this section. More details and best practices relating thereto will be provided in subsection II.C.4 of this thesis.

⁴⁴⁹ Lorsch, J.W., *supra* note 357, at 107.

(1) Board and committee charters describing the responsibilities of the board and its committees

It is submitted that the adoption of board and committee charters describing in great detail the responsibilities of the board and its committees may have a powerful impact on the involvement of directors in the supervision of management and corporate initiatives.⁴⁵⁰ This may be explained by two reasons.

First, as mentioned above, by developing charters in which the responsibilities of the board and its committees are described, the board empowers itself. For instance, by mentioning in a charter that the board must approve corporate strategy and annually review action plans to implement such strategy, the board signals to management that it intends to be involved in the strategic process and that it will follow-up on its implementation. Without a clear charter, expectations may not be clear, creating a situation in which management is free to dominate.

The CSA have adopted guidelines recommending items to be included in board and committee charters. Such guidelines will be reviewed and commented on in subsection II.C.4 of this thesis. At a minimum, the board charter should mention the board's involvement in approving corporate strategy, in the selection of corporate management, in overseeing corporate controls and in monitoring management's decisions and actions. Committee charters should state that an independent committee will assess the performance of corporate managers annually and make recommendations to the board with respect to their compensation. Other important roles of board committees include reviewing financial documents and internal controls, proposing candidates to become corporate directors and reviewing corporate governance practices as well as practices relating to health and safety, environmental questions and pensions.

⁴⁵⁰ See Canadian Coalition for Good Governance, *supra* note 362, at 12 and 13; and See Caisse de dépôt et placement du Québec, *supra* note 362, at 3.

The second reason why board and committee charters have the potential to increase the involvement of directors is that once disclosed, these charters may constitute higher standards against which directors can be held liable. Indeed, as a result of the adoption of part XXIII.1 of the *OSA*, which now allows shareholders who purchased shares on the secondary market to sue directors and other influential persons for a misrepresentation or a failure to disclose material information, directors now have a powerful incentive to be more active.

The new potential basis of liability is described in section 138.3 of the Ontario Securities Act⁴⁵¹ (the “*OSA*”), which states that:

138.3 Where a responsible issuer or a person or company with actual, implied or apparent authority to act on behalf of a responsible issuer releases a document that contains a misrepresentation, a person or company who acquires or disposes of the issuer’s security during the period between the time when the document was released and the time when the misrepresentation contained in the document was publicly corrected has, without regard to whether the person or company relied on the misrepresentation, a right of action for damages against,

- (a) the responsible issuer;
- (b) each director of the responsible issuer at the time the document was released;
- (c) each officer of the responsible issuer who authorized, permitted or acquiesced in the release of the document [...]

This provision, which came into effect on December 31, 2005, creates a civil right of action in favour of secondary market participants⁴⁵² during a period in which there exists a continuous disclosure violation. Continuous disclosure violations may result from misrepresentations contained in documents or made in oral public statements,

⁴⁵¹ R.S.O 1990, c. S.5, as am. S.O. 1992, c. 18, 1993, c. 27, 1994, c. 11, 1994, c. 33, 1997, c. 10, 1997, c. 19, 1997, c. 31, 1997, c. 43, 1999, c. 6, 1999, c. 9, 2001, c. 23, 2002, c. 18, 2002, c. 22, 2004, c. 8, 2004, c. 16, 2004, c. 17, 2004, c. 31, 2005, c. 5.

⁴⁵² Secondary market participants are investors who purchase securities on stock markets from current shareholders of a corporation, as opposed to primary market participants, who buy securities through of a public offering of the corporation.

or from a failure of an issuer to make timely disclosure of a material change.⁴⁵³ In case of continuous disclosure violations, Part XXIII.1 of the *OSA* provides investors with a right of action against directors.⁴⁵⁴

That new potential right of action is in addition to the traditional remedies described in subsection I.B.4 of this thesis. Unlike those remedies, however, Part XXIII.1 of the *OSA* does not require a claimant to establish a causal link between the fault (the misrepresentation) and the damage he or she suffered. Instead, in order to establish liability for a misrepresentation in a document (other than a core document as discussed below), a claimant must prove that the director: (i) knew of the misrepresentation; (ii) deliberately avoided acquiring knowledge of the violation; or (iii) was guilty of gross misconduct in connection with the violation either through action or a failure to act.⁴⁵⁵ If a misrepresentation is contained in a core document, an investor need not establish knowledge, avoidance of knowledge or gross misconduct of a defendant. Core documents are prospectuses, takeover bid circulars, issuer bid circulars, directors' circulars, rights offering circulars, annual information forms, information circulars, annual and interim financial statements and MD&A.⁴⁵⁶

In the case of a director, the potential liability limit per claim, under Part XXIII.1 of the *OSA* is the highest of \$25,000 and 50% of the director's compensation from the corporation and its affiliates during the preceding 12 months. However, such limit does not apply if the claimant proves that the director authorized, permitted, acquiesced or influenced the making of the misrepresentation while knowing that it was a misrepresentation.⁴⁵⁷

⁴⁵³ See subsections 138.3 (1), (2) and (4) of the *OSA*.

⁴⁵⁴ Ogilvy Renault LLP, "New Legislation for Liability for Continuous Disclosure Violations in Force on December 31, 2005" (Ogilvy Renault LLP, Bulletin, 2005), online<<http://www.ogilvyrenault.com/en/ResourceCenter/ResourceCenterDetails.aspx?id=1017&pId=17&print=1>> (date accessed: 3 March 2007).

⁴⁵⁵ See section 138.4 of the *OSA*.

⁴⁵⁶ See sections 138.1 and 138.4 of the *OSA*.

⁴⁵⁷ See section 138.1 of the *OSA*, under "liability limit" and section 138.7 of the *OSA*.

In order to avoid liability under the *OSA*, directors should thus make sure that the duties described in board and committee charters are duly discharged. This of course assumes that these charters are disclosed, which, as discussed in subsection II.C.3 of this thesis, is one of our recommendations.

By establishing in advance the principal duties of directors, active monitoring practices somewhat picks-up where the business judgment rule ends. Indeed, as seen in subsection I.B.3(b) of this thesis, under the business judgment rules, courts generally will not interfere with the board of directors in the performance of its duty to manage the business and affairs of a corporation. When a board publicly discloses charters and policies, this may induce shareholders to believe that the board will discharge the responsibilities publicly disclosed. If directors do not fulfill their duties, shareholders could potentially be entitled to a claim based on misrepresentation.

Combined with the provisions contained in Part XXIII.1 of the *OSA*, the requirement to disclose board and committee charters and board policies in a management proxy circular (a core document) could create more pressure on directors to be more active in monitoring the activities of the corporation and consequently in reducing the potential for mismanagement. Not only a failure to act according to what has been disclosed in such charter or policy could result in a claim for misrepresentation, but since board responsibilities are described in a core document, the burden would be on the defendant (*i.e.*, the director) to prove that he or she has been diligent.

One may be skeptical regarding whether the provisions of Part XXIII.1 of the *OSA* will induce directors to be more active in managing the business of a corporation. One may argue that such provisions are subject to the same limitations as those described in subsection I.C.3 of this thesis (*i.e.*, that there are few claims against directors and even when such claims are successful, directors almost never have to pay damages from their own pocket). Although it is true that indemnification and insurance mechanisms reduce considerably the threat for directors, the adoption of Part XXIII.1 of the *OSA* has nevertheless generated fears among board members. The following sentence was

quoted as being representative of the discomfort of many directors in a survey of The Strategic Counsel conducted for PriceWaterhouseCoopers and the Institute of Corporate Directors:⁴⁵⁸

Certainly with Bill 198 [the bill introducing Part XXIII.1 in the OSA] effective in January, I'm terrified! People are afraid of the unknown and the as yet undefined. We don't know what the true implications will be for some of these implemented changes. [...]

This perception may not have been generalized, but it nevertheless exemplifies the fact that many directors now take Part XXIII.1 of the *OSA* very seriously, and it shows the potential effectiveness of requiring the disclosure of board responsibilities and policies for encouraging active management. If the potential of being sued is higher because of such disclosure, and if such disclosure is mandatory, then many directors will likely insist that actions be taken to ensure that all responsibilities that are disclosed as part of charters or policies be duly discharged.

For corporations and directors, one way of ensuring the discharge of the specific responsibilities disclosed is by developing working plans, pursuant to which the discharge of a specific responsibility is assigned to a particular meeting of the board or of one of its committees. If not enough meetings are scheduled to allow the board and committees to discharge all of their responsibilities, additional meetings can then be added. That should allow boards to be more involved in the business and affairs of the corporation and consequently reduce the risks (and costs) of mismanagement.

- (2) Position descriptions for the board chair and the chairs of each board committee

⁴⁵⁸ The Strategic Counsel, *Who Do Boards Really Work For?* - The challenge of creating value in an age of control (Toronto, The Strategic Counsel, 2006).

Another active monitoring practice which may reduce the risks of mismanagement is the adoption of position descriptions for the board chair and the chairs of each board committee. Such position descriptions play the same role as board and committee charters. They empower the chairs and increase the standards of conduct applicable to them.

With respect to empowerment, these position descriptions will signal to management that those chairs are real leaders. In order to ensure that such signal is clear, position descriptions should include, amongst the responsibilities of a chair, that he or she is responsible for developing, together with management, agendas for meetings.⁴⁵⁹ By having a say on which topics are to be discussed, chairs can better ensure that the responsibilities described in board and committee charters are duly discharged.

Referring to research in social psychology, Professor Morck explained how important was the control of board and committee agenda and that even if a board was composed of many independent directors, the potential empowerment resulting from such independence could be largely constrained when management (represented by the chief executive officer) sets the agenda.⁴⁶⁰

But even a substantial number of genuinely independent directors might not be sufficient to undermine the CEO's dominance. Asch (1951) shows that people tend to go along with a "group consensus" – even one rigged to be obviously wrong. Kahneman and Tversky (2000) summarize a large literature that shows that people's decisions depend critically on how their options are "framed". Even fully independent directors probably feel a need to conform to a group consensus. The CEO sets the agenda for board meetings, and therefore can control how issues are "framed" to direct the formation of such a consensus – even in boards nominally dominated by genuinely independent directors.⁴⁶¹

⁴⁵⁹ See Canadian Coalition for Good Governance, *supra* note 362, at 12.

⁴⁶⁰ Morck, R., *supra* note 359.

⁴⁶¹ *Ibid.* at 19, referring to: Asch, S.E., *Effects of Group Pressure upon the Modification and Distortion of Judgment* (Pittsburgh: Carnegie Press, 1951); and Kahneman, D. & Tversky, A., *Choices, Values and Frames* (Cambridge: Cambridge University Press, 2000).

With respect to increased standards of conduct, position descriptions, when disclosed, may induce shareholders to expect that board and committee chairs play an important role in the oversight of management and corporate initiatives. Should the chairs fail to discharge their role, shareholders could potentially have a claim for misrepresentation under part XXIII.1 of the *OSA*.

(3) Position description for the chief executive officer

The adoption of a position description for the chief executive officer can be seen as the complement and the counterpart of the charters and position descriptions mentioned above. It is their complement because like these charters and position descriptions, it creates expectations from the board and the shareholders that the chief executive officer will discharge the duties described in his or her position description. When drafted carefully, such position description will complement board and committee charters. It will ensure that all important tasks are assigned to the board, its committees or the chief executive officer, and that no ground remains uncovered.

At the same time, however, the position description of the chief executive officer can be seen as the counterpart of board and committee charters and board and committee chair position descriptions because it documents the fine balance between the supervision duties of the board and the day-to-day managerial powers of the chief executive officer. The position description of the chief executive officer describes the prerogatives and duties of management (represented by the chief executive officer).⁴⁶² Hence, if the position description of the chief executive officer states that he or she is responsible for submitting management succession plans to the approval of the board, it clearly signals that the board has the last say on who will be part of the senior management team. Similarly, if the position description states that the chief executive officer is responsible for formulating and recommending to the board environmental policies, it means that the board should be involved in reviewing and adopting (as opposed to developing) these

⁴⁶² See Canadian Coalition for Good Governance, *supra* note 362, at 17

policies. It helps to balance the expectations and initiatives of the board and management and to ensure that corporate resources are managed in an efficient manner, further reducing the risks of mismanagement.

(4) Policies related to the assessment of the board, its committees and individual directors

Another powerful tool to decrease the costs of mismanagement is the adoption of policies requesting that the board, its committees, board and committee chairs and individual directors be assessed annually.⁴⁶³ Without such periodic assessment, the conduct of the board and its members may be left widely unchecked.

As explained in subsection I.C of this thesis, even though in theory shareholders could discipline underperforming directors by not electing them at the next annual meeting of shareholders, such threat is not very powerful because in practice shareholders rarely succeed in imposing new directors. Hence, in order to motivate directors to perform, the assessment process must be done from within.

A good assessment process should allow directors to express confidentially what they think about the board and its members. By following independence practices in the assessment process, the board will reduce the influence and control of management and therefore increase the credibility of the process. Therefore, board assessment should be conducted by the board chair or an independent committee chair if the board chair is not independent. The evaluation questionnaires should be reviewed by a committee composed solely of independent members and the results of the evaluation process should be reported to the entire board by the board chair or the chair of an independent committee. These results should be accompanied by recommendations to improve corporate practices and to replace underperforming board members.

⁴⁶³ See Caisse de dépôt et placement du Québec, *supra* note 362, at 4.

Through the assessment process, directors should be able to comment on how the board, its committees, the board and committee chairs and each director individually discharge their responsibilities. With respect to the board and committees, this assessment should take into account the responsibilities listed in the board and committee charters. With respect to board and committee chairs, it should take into account the responsibilities described in their position description. As for the assessment of individual directors, it should review the overall contribution of each director.

(5) Directors' orientation and continuing education programs

Another example of practices that can allow directors to be more involved in reducing agency costs is the adoption of orientation and continuing education programs for directors.⁴⁶⁴ One of the main advantages of such programs should be to increase the effectiveness of directors. An orientation program consists of ensuring that new directors receive comprehensive training about the strengths, weaknesses, opportunities and threats facing the corporation, as well as its internal methods of operation. Directors should be much more effective if they understand the industry and the competitive environment in which the corporation evolves and if they know the principal officers in charge of implementing corporate strategy.

For the same reasons, boards of directors should adopt continuous education programs, in which every director (not only the new ones) are provided with up-to-date information on factors affecting the corporation. Such programs could include, for instance, seminars on the last improvements relating to methods of production or best practices with respect to corporate governance. By increasing the level of awareness of directors and by improving their skills and knowledge, corporations can reduce the risks of wrong decisions by the board and therefore reduce the risks of mismanagement.

⁴⁶⁴ See Canadian Coalition for Good Governance, *supra* note 362, at 8.

(iii) Curative measures based on active monitoring

As seen above, by adopting charters and policies, the board reinforces its own empowerment, and creates a dynamics in which it can ensure that directors and management dedicate enough time and energy to their tasks and appropriately discharge their responsibilities. Curative measures are the counterpart to prophylactic ones. Curative measures allow the board to discipline management and individual directors where the intervention of shareholders is not effective. As seen in subsection I.C of this thesis, it is difficult for shareholders to enforce the duty of care. They cannot easily assess the conduct of directors, prove that directors breached their duties and there is a substantial uncertainty related to any claim for a breach to the duty of care because of the role played by the business judgment rule. In addition, the power of shareholders to dismiss underperforming directors is also limited.

Some authors have argued that legislators should reform the way directors are elected. For instance, they propose that corporations reimburse shareholders for their expenses involved in challenging the candidates of management and that corporate law be amended so that shareholders be allowed to vote “against” (as opposed to voting “for” or “withhold” their votes) each candidate.⁴⁶⁵ Those reforms, if adopted, could also come with important disadvantages. With respect to the reimbursement of costs, protective measures would have to be put in place in order to avoid abuse by shareholders who could decide to spend considerable amounts to challenge management’s candidates without a real expectation of success, or for frivolous or inappropriate purposes, at the corporation’s expense. With respect to voting “against” directors, the legislator would have to be very careful not to allow a potential vote against a majority or against all candidates, without substituting new candidates or without introducing a back-up system that would allow the board to continue to conduct the affairs of the corporation. A vote against a majority of candidates could paralyse the corporation if a quorum of directors is not elected and would certainly make it harder to operate if the board does not have an

⁴⁶⁵ See for instance: Bebchuk, L.A., *supra*, note 61.

optimal number of directors to monitor the affairs of the corporation, including through its committees.

More importantly, any reform to make it easier for shareholders to challenge the composition of the board may result in intershareholder opportunism. As explained by Professor Stout, of the UCLA School of Law,⁴⁶⁶ intershareholder opportunism can be defined as the risk that a shareholder might try to influence corporate decisions in a self-serving way that harms other shareholders.⁴⁶⁷ By making it easier for large shareholders to elect their own representatives on the board of a public corporation, this increases the risk that certain directors act in a way that would favor their nominator (the large shareholder) at the expense of other shareholders.

With the increased popularity of hedge funds and other similar investment vehicles that often aim at obtaining the highest return on capital in the shortest period of time, the risk of intershareholder opportunism as never been so real. In a recent article, Professor Bratton, of the Georgetown University Law Center, demonstrates that hedge funds have an enviable record in getting targets to comply with their demands, using the proxy system with unprecedented success.⁴⁶⁸ Using a sample of 130 hedge funds, he describes how they often succeed in making short term gains and then selling their shares, leaving behind more vulnerable corporations. He quotes some of the critics of hedge funds who condemn their strategies:

The [hedge funds] survey a target with a bias toward near-term gain, regardless of its future, the interests of its long term investors, and the productivity of the wider economy. Hedge fund pressure on present and potential targets is thought negatively to constrain investment policy, skewing managers away from promising but difficult to value projects toward less promising but more easily valued projects. Where [...] an activist extracts a payout financed by debt, the ongoing cash drain could leave the target vulnerable to distress in the economy's next downturn.

⁴⁶⁶ Stout, L.A., "The Mythical Benefits of Shareholder Control" (UCLA School of Law, Law & Economics Research Paper No. 06-19) online: <http://papers.ssrn.com/abstract=929530> (date accessed: 3 March 2007).

⁴⁶⁷ *Ibid.*, at 5.

⁴⁶⁸ Bratton, W.W., "Hedge Funds and Governance Targets", working paper, available online: <http://papers.ssrn.com/abstract=929530> (date accessed: 3 March 2007).

Others warn of darker possibilities like lucrative side deals between unscrupulous funds and frightened managers or foreigned interventions that create short term trading opportunities.⁴⁶⁹

Active monitoring curative measures provide a solution to the limits of shareholders' powers in sanctioning underperforming managers and directors, while reducing the risks of intershareholder opportunism. Once active monitoring procedures are in place, it becomes easier to evaluate the performance of the board and its individual members, to confront someone who has mismanaged and to take appropriate disciplinary measures if needed. Active monitoring curative measures include some of the same practices as prophylactic ones, namely: (i) the adoption of board and committee charters, position descriptions and assessment procedures; and (ii) the disclosure of board and committee charters, position descriptions, assesement procedures and other corporate policies.

(1) Adoption of board and committee charters, position descriptions and assessment procedures

The adoption of board and committee charters, position descriptions and assessment procedures, focuses the attention of directors on the process to be followed and provides benchmarks to directors as to what should be assessed. With respect to the process to be followed, assessment policies should mention who will be in charge of the assessment process and how it will be made. The use of questionnaires and interviews with directors are some methods that may assist the assessors in discharging their responsibilities.

As mentioned in our description of prophylactic measures, assessment policies often refer to board and committee charters and position descriptions as benchmarks against which directors will be assessed. By referring to such charters and position

⁴⁶⁹ *Ibid.*, at 5 and 6.

descriptions, assessment policies facilitate the identification of deficiencies in directors and managers' behaviours.⁴⁷⁰ Once all actors know what they are supposed to do and the contribution the others are supposed to make, it becomes easier to identify an act of mismanagement and to initiate successful disciplinary action. The more formalized and detailed the assessment process is, the smaller should be the risks that the board neglect to perform a thorough assessment.

The chances that directors would let mismanagement go unpunished should decrease if, for instance, the charter of an independent committee states that the committee must assess the performance of directors annually and recommend candidates for election at the next annual meeting of shareholders. Should directors close their eyes to an individual who does not attend board meetings or does not contribute to board discussions and recommend him or her as a candidate to the board for the next year, they could be held liable for not doing what the charter stated.

Similarly, if the charter of an independent committee states that the committee is responsible for evaluating the performance of senior management annually and for recommending the appointment of new managers if needed, directors should be more inclined to perform a serious assessment. By formalizing curative measures in board and committee charters, the board encourages directors to be active in a case of mismanagement and therefore reduce the risks (and costs) related to mismanagement.

(2) Disclosure of board and committee charters, position descriptions, assessment procedures and other corporate policies

The disclosure of board and committee charters, position descriptions, assessment procedures and other corporate policies have the potential for inducing more involvement

⁴⁷⁰ See Canadian Coalition for Good Governance, *supra* note 362, at 15 and 17; and Caisse de dépôt et placement du Québec, *supra* note 362, at 4.

by directors in the assessment process and to assist shareholders in taking remedies in case of wrongdoing.⁴⁷¹

Indeed, as explained in our discussion on active monitoring prophylactic measures, directors' potential liability has been increased as a result of the inclusion of part XXIII.1 in the *OSA*. Directors can now be held liable for a misrepresentation mentioned in corporate documents. Hence, if the corporation discloses an assessment process and such process is not followed, directors could potentially be sued for such deficiency. Furthermore, by disclosing charters, position description and corporate policies, the corporation may well raise the standards of conduct to be followed by directors and thus facilitate proof by a plaintiff that directors did not meet such standards.

In short, because they have the potential to empower the board, active monitoring curative measures may thus be useful in limiting the costs of mismanagement. Similarly, because they raise the standards to be followed by directors, they may facilitate the proof of mismanagement and help plaintiff to be indemnified for such costs.

(c) Active monitoring as a way to discharge the duty of care

The previous subsections have described active monitoring practices and explained that such practices could reduce the costs of mismanagement. This subsection argues that active monitoring practices are also an important way to protect directors against a potential claim for a breach to their duty of care. In this subsection, the theoretical benefits of active monitoring will be described, and such description will be followed by a brief review of the impact that active monitoring practices could have had on selected decisions of Canadian courts.

⁴⁷¹ See Canadian Coalition for Good Governance, *ibid.*, at 12, 13 and 17.

(i) *Theoretical benefits of active monitoring practices on the discharge of the duty of care*

The next subsection will explain how active monitoring practices can assist directors in ensuring that their duty of care is properly discharged. It will show how active monitoring may do so by helping directors define proper norms of conduct. In addition, it will demonstrate that active monitoring practices allow directors to benefit from statutory defenses in the case of a claim and are a good complement to other protective measures.

(1) Active monitoring helps to define proper norms of conduct

In *Peoples Department Stores Inc. (Trustee of) v. Wise*,⁴⁷² the Supreme Court of Canada stated that “[t]he establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care”.⁴⁷³ We submit that the concept of active monitoring practices is at the heart of what the Supreme Court describes as “good corporate governance rules”. The establishment of processes to ensure active supervision of management and corporate initiatives by the board of directors and its committees should thus act as a shield that protects directors from potential liability.

Evolving standards in corporate governance put pressure on corporations to adopt better practices, as recognized by the Supreme Court:

The contextual approach dictated by s. 122(1)(b) of the *CBCA* not only emphasizes the primary facts but also permits prevailing socio-economic conditions to be taken into consideration. The emergence of stricter standards puts pressure on corporations to improve the quality of board decisions.⁴⁷⁴

⁴⁷² *Supra* note 7.

⁴⁷³ *Ibid.*, at 491 and 492.

⁴⁷⁴ *Ibid.*, at 491.

The duty of care creates an incentive for directors to be diligent in overseeing the affairs of the corporation, but it does not provide a full set of guidelines or even general standards for how directors should act or react in order to ensure that they will properly discharge their duties. Although Canadian and American case law include decisions that may enlighten a director as to the extent of his or her obligations, the principles developed in such decisions are often very specific to each case and cannot be widely applied. By way of example, should a board approve the remuneration of the chief executive officer without properly meeting to discuss it, such behaviour could be considered as a breach to the duty of care in certain circumstances (for instance if the chief executive officer's compensation is excessive without proper justifications) but not in other circumstances (for instance if a committee of the board has reviewed such matter with an external consultant and has recommended the remuneration to the board based on a cost – benefit analysis).⁴⁷⁵

Active monitoring requires fleshing out the general standards created by the duty of care by providing a set of responsibilities against which directors will be assessed. If active monitoring guidelines are well drafted, they should assist directors in knowing what is expected from them and how to discharge their duties. Because active monitoring practices require directors to be closely involved in the affairs of the corporation, in the case of a lawsuit against them for a breach of their duty of care, active monitoring will help them to prove that they exercised the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances.

Corporate governance guidelines cannot be a “one-size fits all” because different corporations have different needs and priorities. The directors of a corporation involved in the transportation of goods and people should probably be very cautious about energy costs, safety and environmental hazards and ensure that corporate practices related to those areas are reviewed by committees of the board, whereas the directors of a corporation involved in retail sales should probably focus more on real estate

⁴⁷⁵ See *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 187.

opportunities and trade barriers. However, as will be described in subsection II.C of this thesis, many corporate governance best practices may be appropriate for most types of corporations.

(2) Active monitoring allows directors to benefit from statutory defences

As discussed above, active monitoring practices should allow directors to benefit from a due diligence defense. Active monitoring practices may also allow the board to benefit from other statutory defences. That is the case when board members, in supervising management and corporate initiatives, consult independent experts or dissent from the decisions of the board. As explained in subsection I.B.3(a) of this thesis, directors can avoid liability for a breach of their duty of care if they can establish, pursuant to subsection 123(5) of the *CBCA*, that they relied in good faith on financial statements presented to them by an officer of the corporation or on a report of a person whose profession lends credibility to a statement made by the person. As we will described under subsection II.C of this thesis, the access to experts by the board and its committees, which should be mentioned in board and committee charters, should help protect directors against potential liability.

(3) Active monitoring complements other protective measures

Two other common methods allowing directors to decrease their exposure to the risk of being held liable for a breach to the duty of care are the indemnification mechanism and personal insurance. These methods often complement each other. Although the indemnification mechanism is now specifically described in Canadian and U.S. corporate statutes,⁴⁷⁶ a director's right to indemnification or reimbursement, at

⁴⁷⁶ See section 124 of the *CBCA* and section 145 of the Delaware Code. See also Welling, B., *supra* note 122, at 312; and Bender, M., *supra* note 17, at 17-3.

common law, has been subject to uncertainty in the past.⁴⁷⁷ Particularly in the U.S., there were doubts as to whether or not a corporation could protect its directors from personal liability. Some early decisions indicated that corporate expenditures for purposes of protecting directors were prohibited because such payments were not considered to be for the direct benefit of the corporation itself.⁴⁷⁸ Other decisions recognized that indemnification and reimbursement were permissible and consistent with public policy because such protections encouraged good corporate management, a prerequisite to responsible corporate activity.⁴⁷⁹

Today, corporate statutes expressly permit or require indemnification of directors under certain circumstances.⁴⁸⁰ Hence, section 124 of the *CBCA* requires the indemnification of a director against expenses incurred by him or her in respect of proceedings in which he or she is involved because the individual is or was a director of the corporation. However, as stated in this section, directors will not be indemnified if they did not act in good faith or if their conduct was unlawful. Similarly, it is important to point out that an indemnification from a corporation is only as good as the financial solvency of such corporation.⁴⁸¹

In the event that the corporation becomes insolvent, directors' liability insurance may serve as a supplement to indemnification.⁴⁸² Under section 124 of the *CBCA*, insurance may be obtained by the corporation for the benefit of a director or officer or any other individual eligible to be indemnified against any liability incurred by such person in his or her capacity as a director or officer or similar capacity.⁴⁸³ Like the indemnification mechanism, insurance coverage is a good way to manage the risk

⁴⁷⁷ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 19, at 2.

⁴⁷⁸ *New York Dock v. McCollum* (1939) 173 Misc. 106, 16 N.Y.S.2d 844; and Bender, M., *supra* note 17, at 22-64.

⁴⁷⁹ *In re E.C. Warner Co.* (1950) 232 Minn. 207, 45 N.W.2d 388; and Bender, M., *supra* note 17, at 22-64; McGuinness, K.P., *supra* note 17, at 829 and 830.

⁴⁸⁰ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 19, at 2.

⁴⁸¹ VanDuzer, J.A., *supra* note 71, at 239; and Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 37.

⁴⁸² Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 19, at 2.

⁴⁸³ VanDuzer, J.A., *supra* note 71, at 242.

associated with directors' potential liability. Again, however, insurance policies will generally not protect corporate directors against costs incurred as a result of directors not acting honestly and in good faith or if directors do not have reasonable grounds for believing that their conduct was lawful.⁴⁸⁴ Furthermore, many risks are usually excluded from insurance coverage and the maximum amount of coverage is typically limited.⁴⁸⁵

Because the indemnification and the insurance mechanisms only protect corporate directors partially, the best shield for directors against potential liability is still to ensure that all their duties are duly discharged. This is best achieved through an active monitoring board. Through active monitoring, a board will: (i) reduce the liability exposure of directors and officers (as well as the exposure of the corporation to provide indemnification); (ii) avoid distracting, time-consuming and potentially embarrassing claims and expensive litigation; (iii) enhance defences against frivolous claims; (iv) reduce the amounts of potential adverse judgments; and (v) improve the ability of the corporation to obtain maximum-benefit director and officer's insurance at reasonable costs.⁴⁸⁶

(ii) Application of active monitoring practices to case law

To illustrate the potential implications of active monitoring measures on the discharge of the duty of care, two Canadian cases in which directors failed to discharge such duty are discussed below. Case law is very limited in Canada with respect to such failure, in part because of the effect of the business judgment rule which, as we have seen, insulates directors against lawsuits to the extent they followed a reasonable process. As with the demonstration regarding the duty of loyalty, the following exercise is not scientific. Standards change over time and we do not benefit from the entire factual

⁴⁸⁴ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 37; and Welling, B., *supra* note 122, at 314.

⁴⁸⁵ *Ibid.*, at 37.

⁴⁸⁶ Bender, M., *supra* note 17, at 17-3.

background presented to the courts in these cases. It is nevertheless an interesting way to exemplify how active monitoring could have a real impact on lawsuits and their results.

(1) Repap decision

In *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*,⁴⁸⁷ (often referred to as the Repap decision), the Ontario Superior Court of Justice reviewed the conduct of directors in approving an employment contract with the Chairman and chief executive officer of Repap. In that decision, the Court reviewed the principles applicable to the compliance of directors with their duty of loyalty and with their duty of care. With respect to the duty of care, the Court noticed that although the corporation had a Compensation Committee, such committee exercised no oversight role over the assessment of the employment contract. It took no step to obtain the report of an independent advisor and did not have or seek sufficient information upon which to ground a reasonable judgment about whether to recommend the agreement, yet other directors relied upon the assumption that a full review had been done.

The Court referred to a decision of the U.S. Court of Appeal for the Second Circuit in *Hanson Trust PLC v. ML SCM Acquisition Inc.*,⁴⁸⁸ in which the U.S. Court held that a *prima facie* case was made that the directors breached their fiduciary duties in taking their decision after a three-hour, late-night meeting relying on their financial advisors' opinion without asking enough questions to such advisors. In the Repap case, the Court decided that the circumstances were no different since the board did not engage in any serious analysis and never challenged the content of the draft management employment agreement. The Court stated that the protective effect of the business judgement rule could not apply because directors had not been careful enough:

The business judgment rule protects Boards and directors from those that might second-guess their decisions. The court looks to see that the

⁴⁸⁷ *Supra* note 187.

⁴⁸⁸ 781 F. (2d) 264 [14-16 (Lexis)] (2nd Cir. 1986).

directors made a reasonable decision, not a perfect decision. This approach recognizes the autonomy and integrity of a corporation and the expertise of its directors.

However, directors are only protected to the extent that their actions actually evidence their business judgment. The principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions. Courts are entitled to consider the content of their decision and the extent of the information on which it was based and to measure this against the facts as they existed at the time the impugned decision was made. Although Board decisions are not subject to microscopic examination with the perfect vision of hindsight, they are subject to examination. [...]

A contract, such as the one in issue between the Chairman and the Company, should be the subject of careful, objective analysis, and it was not. The process leading up to the March 23, 1999, meeting and the proceedings there fell far short of the exercise of prudent judgment in the interests of the shareholders that is expected of directors. In the space of thirty minutes [...] without questions or discussion, with comment from the only director who had served for longer than two months, the Board of Directors of Repap approved an Agreement that gave someone it did not know, had not recruited, and had just met, a generous salary with a lengthy term of employment, an unprecedented bonus structure, termination and change of control protection inconsistent with the employment objective, and stock options amounting to 13.4% of the company. The directors did not fulfil their duties to Repap. Their decision was not an informed or reasoned one. The business judgment rule cannot be applied in these circumstances to protect their decision from judicial intervention.⁴⁸⁹

It is submitted that directors would not have breached their duty of care if appropriate active monitoring practices had been in place at the corporation. A proper charter describing the responsibilities of a compensation committee would have stated that it was the responsibility of the committee to recommend to the board of directors the compensation of the chief executive officer, after having assessed his or her objectives and goals. The charter should have also stated that the committee could hire an independent advisor to properly assess the market value of the chief executive officer.

⁴⁸⁹ *Ibid.*, at 33 to 35.

The charter of the board would have mentioned that the board was ultimately responsible for approving the compensation of the chief executive officer.

Position descriptions empowering the board chair and the chair of the compensation committee by requiring that they review the board and committee agenda and call meetings of directors when needed, could also have assisted the entire board in discharging its duties. Indeed, the board and the compensation committee chairs could have made sure that the board and the committee had sufficient time to evaluate if the candidate proposed by management was the best person to become chief executive officer and if his compensation package was reasonable. A policy describing the process to be followed by the board and its compensation committee in determining the remuneration of the chief executive officer could also have been helpful in formalizing such process.

(2) Standard Trustco

Although decided by the Ontario Securities Commission and not by a Canadian court *per se*, the decision in *In Re Standard Trustco Ltd.*⁴⁹⁰ is nevertheless very interesting in that it reviews the duties of a board of directors where concerns exist as to management's integrity or ability to manage.

In that case, Standard Trustco Ltd. was in financial difficulties and the regulatory authorities had made known to the board of directors certain concerns relating to the financial reporting practices of the corporation. Directors approved the release of the corporation's interim financial statements without taking actions to address the concerns of the regulators. In the opinion of the Commission, the directors failed to exercise the care, diligence and skill that a reasonably prudent person would have exercised in comparable circumstances by voting to approve unaudited interim financial statements without making appropriate inquiries in relation to such concerns. The Commission was

⁴⁹⁰ *Supra* note 199.

of the view that it was incumbent upon all directors to make inquiries to obtain the necessary information and advice in order to satisfy themselves about the integrity of the interim financial statements.⁴⁹¹

Again, in that case, active monitoring practices would have helped directors in discharging their duty of care. For instance, the charter of the audit committee should have required that the committee be responsible to review the interim financial statements before recommending their approval by the board. Similarly, the charter of the board should have stated that it was the ultimate responsibility of the board to ensure that such review had been made properly. Working plans should have been adopted by the board allowing the audit committee to meet in private with external auditors to discuss the positions taken by management and to challenge the auditors. A position description empowering the chairs of the board and of the audit committee could also have improved the chances that they require a meeting to discuss the concerns of the regulators. All these practices would have been helpful in assisting directors in the discharge of their duty of care.

(d) Lack of empirical research on the benefits of active monitoring practices

There is a lack of empirical research on the impact of active monitoring, as defined above, on corporate performance. The following subsections of this thesis will identify some studies that have considered certain active monitoring practices, and will provide some potential explanations for the lack of empirical results in that field. It will also explain why the lack of empirical research should not discourage corporations for adopting active monitoring practices.

⁴⁹¹ *Ibid.*, at 286 and 290.

(i) Studies related to active monitoring practices

Few empirical studies demonstrate that specific active monitoring practices have a positive impact on corporate performance. As noted by Professor Clark when referring to good corporate governance practices in general: “in principle, a “bundle” of supposed good governance practices should have a decisive positive impact that is measurable when one looks at evidence. However, the few studies to date are only modestly encouraging.”⁴⁹²

Empirical studies relating to active monitoring are rather indirect because they often consider the impact of the qualifications of board members. For instance, the impact of financial experts on audit committees, which is often required in audit committee charters, has been studied. In a recent article, Professor Romano describes many studies relating to the correlation between the nomination of financial experts sitting on audit committees and the financial performance of corporations.⁴⁹³ Those studies find that having directors with financial expertise improves performance.

The same studies also suggest that complete independence of board committees is less significant than expertise when reviewing accounting statement quality.⁴⁹⁴ Professor Romano finds paradoxical that the U.S. *Sarbanes-Oxley Act of 2002*⁴⁹⁵ (“SOX”) mandates the presence of only one financial expert on the audit committee (which appears to be correlated with good performance) while it requires the audit committee to be composed solely of independent directors (for which the correlation with good performance is not apparent).⁴⁹⁶

⁴⁹² Clark, R.C., “Corporate Governance Changes in the wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too” (John M. Olin Center for Law, Economics, and Business, Harvard, Discussion Paper No. 525, September 2005), online: <http://www.law.harvard.edu/programs/olin_center> (date accessed: 3 March 2007), at 37.

⁴⁹³ Romano, R., *supra*, note 405, at 1532, referring to Agrawal, A. & Chadha, S., “Corporate Governance and Accounting Scandals” (Unpublished manuscript, 2004), online <<http://ssrn.com/abstract=595138>> (date accessed: 3 March 2007);

⁴⁹⁴ *Ibid.*

⁴⁹⁵ P.L. 107-204.

⁴⁹⁶ Romano, R., *supra*, note 405, at 1532.

Other than studies relating to the characteristics of board and committee members, which are only incidental to what we define as active monitoring practices, we have not been able to identify any research on the impact of the practices proposed above on corporate performance.

(ii) Potential explanations for the lack of empirical research on the benefits of active monitoring practices

Many reasons may explain the lack of empirical research on the benefits of active monitoring practices on corporate performance. First, active monitoring practices may be difficult to study due to the lack of reliable information on the decision process within corporations. Indeed, as mentioned before, the debates and decisions of boards of directors are confidential. Even if corporations disclose the charters of its board and committees as well certain corporate policies, there is always an uncertainty as to whether or not the responsibilities mentioned therein are properly discharged. Professors Becht, Bolton and Roëll explain that it is not easy to measure the way boards work:

Recommendations of “best practices” advance the practical hypothesis that the working as well as the composition of boards matters for performance. This proposition has been tested indirectly since it is virtually impossible to devise a quantitative measure of the way a board is run on the inside. Hence a practitioner’s interpretation of the results of this empirical literature might be that the studies have simply failed to measure the dimension of boards that matters most for corporate performance – their functioning.⁴⁹⁷

A second reason why it may be difficult to identify active monitoring best practices is that it is very difficult to isolate one practice common to many corporations, and correlate it with better performance. So many variables may explain the changes in

⁴⁹⁷ Becht, M., Bolton, P. & Roëll, A., “Corporate Governance and Control” (European Corporate Governance Institute, Finance Working Paper No. 02-2002), online: <http://www.ecgi.org/wp> (date accessed: 20 August 2006), at 56 and 57.

the performance of corporations, that associating one practice to a change in performance may be hazardous. When considering a set of practices, it is even more difficult to do, as corporations have different methods of operations and the success of one practice for a corporation may be explained by its association with another practice, unique to that corporation.

Yet a third reason why it is difficult to determine which active monitoring practices add value may be that the practices that work best for a corporation are different than those that work best for another. As explained by Professor Stout of the UCLA School of Law:

There may be a more fundamental reason, however, why the business world has stubbornly refused to give hungry academics the evidence they crave about how they can improve the corporate performance through one or another governance “reform”. In brief, business firms enjoy a wide range of choice over the governance rules they adopt and work under. Sensibly enough, they choose the rules that work best for their particular business (and, in the process, for their investors). This means that we should not expect to see a strong connection between any particular governance structure and corporate performance, because different structures work well for different firms. In other words, corporate law is *endogenous*.⁴⁹⁸

More research is needed in order to get a clear sense of the importance of active monitoring practices and to determine which practices are likely to have a positive impact for most corporations. In Canada, a good starting point would be to review the compliance of corporations with each item of disclosure of National Instrument 58-101, since most of these items relate to tasks involving the supervision of management and corporate initiatives by the board. The level of compliance by corporations should then be compared with their performance. As explained above, it may remain difficult to establish a causal link between a specific item of compliance and the performance of the corporation, but, at the very least, it would inform the investor as to how certain tasks are discharged by boards of highly performing corporations. This would assist investors in

identifying best practices, which could then lead investors to request that underperforming corporations adopt such practices or provide clear explanations why they do not.

(iii) *Reasons why the lack of empirical results should not discourage corporations to adopt active monitoring practices*

The lack of empirical results showing a correlation between active monitoring practices and corporate performance does not mean that such practices do not have an important impact on corporate results. In fact, as explained in the last subsection, it could well be that the practices that would be the most beneficial are not the same for all corporations.

It is not difficult to imagine that the adoption of alternative best practices by different firms may have a similar impact on each firm. For instance, the board of directors of corporation “A” could decide to supervise corporate disclosure by creating a disclosure committee that would review public documents before they are issued. Alternately, the board of directors of corporation “B” could request certificates of different officers to the effect that they have reviewed each section of the documents and that the documents are complete and accurate. In that example, both practices would reduce the risks of mismanagement since it would aim at ensuring that the disclosure documents prepared by management have gone through a verification process to ensure their adequacy. However, should someone study the impact of disclosure committees, only corporation “A” would be identified as having followed that practice. The acknowledgement that there are alternative best practices makes it more difficult to identify optimal active monitoring measures for all corporations.

Second, if most corporations listed on our stock exchanges already follow good corporate governance standards, it makes it even more difficult to find distinctions

⁴⁹⁸ Stout, L.A., *supra* note 466, at 10.

between leaders and laggards. Because corporations have a variety of good practices to choose from the most important impact of active monitoring practices may be systematic (*i.e.*, may have an impact on the economy as a whole) as opposed to idiosyncratic (*i.e.* having an impact on specific firms).

Professor Black noticed that in most empirical research made in developed countries, firm-specific corporate governance actions have not been found to have a significant effect on a corporation's market value, but he believes that such weak results reflect limited variations in the quality of governance structures among corporations from those countries.⁴⁹⁹ In contrast, the quality of governance structures of corporations from developing countries varies widely, showing a strong correlation between good corporate governance practices and the increase in corporations' value. Although his studies were performed in a single country and used a small sample (16 corporations), they suggest that corporate governance practices have positive effects on a corporation's market value. This finding is similar to the conclusion of surveys of McKinsey & Company in Asia, pursuant to which investors are ready to pay a premium for corporations with good governance practices.⁵⁰⁰

Professors Dalton and Dalton compare the search for effective governance nowadays to the search for a unicorn:

In this era of increased attention to corporate governance, effective boards of directors have taken on the aura of the mythical unicorn. Some pundits would have us believe that such animal does not exist. We know better. One need not search in vain for the magical forest where the mythical unicorn resides. One need only look to the many examples of boards whose members work diligently toward improving the companies they serve and enhancing shareholder value.⁵⁰¹

⁴⁹⁹ Black, B., *supra* note 415.

⁵⁰⁰ McKinsey & Company, *supra* note 416.

⁵⁰¹ Dalton, C.M. & Dalton, D.R., *supra* note 371, at S96 and S97.

The same comment applies to active monitoring. One should not be discouraged by the difficulty of proving the impact of specific practices on corporate performance. Generalizations may be difficult to make about the benefits of specific practices on all corporations, but this does not mean that best practices should not be recommended. It rather supports our argument, described in the next subsection, that a unique set of practices should not be imposed but that a flexible approach should instead be followed. Furthermore, if doubtful about the positive (or negative) impact of active monitoring practices on corporate governance, one should take the “risk” of adopting the structures and policies described in this thesis, since they will help directors to reduce agency costs and assist them in discharging their duty of care, which are significant issues, as described in Part I of this thesis.

SUMMARY

As described above, active monitoring refers to the active supervision of management and corporate initiatives by the board of directors, directly or through the use of board committees. Active monitoring practices can have an important effect in decreasing costs of mismanagement. This can be done by empowering the board through the adoption of board and committee charters and position descriptions for board and committee chairs and for the chief executive officer. Policies related to the assessment of the board and orientation and continuous education programs for directors may also reduce the risks of mismanagement.

This subsection also explained that active monitoring practices can assist directors in the discharge of their duty of care. It was explained that active monitoring does so by helping directors in defining appropriate norms of conduct. Other advantages of those practices are that they can allow directors to benefit from statutory defenses and are essential to complement other protective measures.

Empirical research is very scarce on the effects of specific active monitoring practices on corporate performance and more research should be done to identify best practices. In this context, the adoption, by the Canadian Securities Administrators, of rules requiring mandatory disclosure against voluntary guidelines seems to be an important way to disseminate best practices. Because board meetings are obviously private, disclosure requirements are certainly a good way to assist investors and issuers in understanding and comparing the practices of highly performing corporations. However, because specific best practices do not necessarily work well for every corporation and because alternative measures may produce similar effects in different corporations, regulators should be cautious before making specific practices mandatory, as it will be discussed in the next subsection of this thesis.

E. PROPOSED FRAMEWORK TO DETERMINE WHICH CORPORATE GOVERNANCE PRACTICES SHOULD BE MANDATORY AND WHICH SHOULD BE VOLUNTARY

Once it has been demonstrated that practices based on independence and active monitoring assist directors to decrease of agency costs and discharge their fiduciary duties, it is important to determine if these practices should be imposed through mandatory rules or if they should be left to the discretion of the board. In order to proceed to such a determination, a template developed by Professor Anita Anand⁵⁰² is helpful. It can be used to highlight the benefits and costs of fully mandatory and fully voluntary regimes, and to explain why an optimal regime is hybrid.

In this subsection, a “mandatory regime” refers to a regime that Professor Anand describes as “legally mandated with penalties imposed on those who fail to comply with the legal rule”.⁵⁰³ These penalties may include fines, delisting of the corporation’s shares, cease trade orders on those shares, or damages.

As for the expression “voluntary regime”, it refers to what Professor Anand describes as one that “denotes a firm’s adoption of corporate governance practices or standards in the absence of a legal requirement to do so.”⁵⁰⁴ Such practices or standards may be inspired from guidelines or policies issued by securities regulators, stock exchanges or institutional shareholders, or stem from the initiative of corporate boards.⁵⁰⁵

Like Professor Anand, we will show why a hybrid regime, based on some characteristics of the mandatory and the voluntary regimes, is optimal. For the purpose of this thesis, the “optimal” regime is defined as the one with the highest surplus between its benefits and its costs.⁵⁰⁶ We will explain that the optimal model requires disclosure of independence and active monitoring practices against a list of standards provided by

⁵⁰² Anand, A.I., *supra* note 9.

⁵⁰³ *Ibid.*, at 6.

⁵⁰⁴ *Ibid.*

⁵⁰⁵ *Ibid.*, at 4.

regulators, but that subject to such disclosure, corporations should be free to comply or not with such standards.

1. THE MANDATORY REGIME

A mandatory regime is the traditional way to regulate conduct. In such a regime, behaviour is influenced by fear of sanctions.⁵⁰⁷ The mandatory structure prescribes rules of conduct and penalties are imposed to sanction any deviation from those rules. Many laws governing individual behaviour are constructed on that model.⁵⁰⁸

(a) Benefits of a mandatory regime

In the corporate context, the mandatory regime has at least two advantages. First, from the point of view of the legislator, it is arguably the structure that will best guarantee that desirable behaviours are followed.⁵⁰⁹ If the legislator wants to achieve an objective, it adopts a rule with important sanctions, and if rigorously enforced by regulatory authorities, it will likely be followed, individuals being fearful that a deviation to the rule be punished.⁵¹⁰ Theoretically, the more onerous the penalties, the higher should be the degree of compliance by market participants to the imposed behaviour.⁵¹¹

A second advantage of a mandatory regime, from the point of view of market participants, is that it provides predictability by reducing the uncertainty related to the behaviour of management and directors.⁵¹² Especially when rules have been in place for a certain time and are known by market participants, these participants are in a better position to predict how management and directors should act in a given situation. From

⁵⁰⁶ *Ibid.*, at 4 and 5.

⁵⁰⁷ *Ibid.*, at 7 and 8.

⁵⁰⁸ Such as the Canadian *Criminal Code* (R.S.C. 1985, c. C-46), to give an example.

⁵⁰⁹ Anand, A.I., *supra* note 9, at 4.

⁵¹⁰ Anand, A.I., *supra* note 112, at 17.

⁵¹¹ Anand, A.I., *supra* note 9, at 9.

⁵¹² *Ibid.*, at 8.

an investor's point of view, provided that monitoring and enforcement is effective, he or she would generally be confident that minimum safeguards are in place in corporations in which he or she invests. An investor will not need to assume the costs of finding out if there are processes in place to protect his or her investment. The investor would normally be confident that corporations follow the mandatory rule.

Furthermore, mandatory rules reduce the costs associated with the assessment of corporate practices. Indeed, if all corporations have to follow the same set of rules, investors' spending on comparing their effectiveness will be minimal. They will likely assess once the protection offered by the rules, and assume that all corporations comply with them.

(b) Costs of a mandatory regime

While a mandatory regime may protect market participants against wrongful conduct and provide predictability, it also comes with costs. First, a mandatory regime can be very expensive for the state, since it involves costs in creating the system and in funding the monitoring and enforcement of the rules. If funded by the state, these costs will be ultimately paid by taxpayers. If self-funded by the regulators, they will most likely have to be paid by corporations, through participation fees or fines, and investors will ultimately bear the costs of the system.⁵¹³

From the point of view of the corporation, the mandatory regime involves other costs. A corporation may need to change its structures, policies or practices to comply with new rules. The proliferation of mandatory rules increases compliance costs and may require the hiring of specialists and new staff to ensure compliance. For instance, new rules relating to internal controls⁵¹⁴ obliged corporations to hire accounting experts

⁵¹³ *Ibid.*

⁵¹⁴ Such as those described in section 404 of SOX in the United States.

to work with their internal auditors in making sure that such controls were in place.⁵¹⁵ Those are direct costs of compliance.

The mandatory regime may also impose indirect costs on corporations, such as costs resulting from inefficiencies. Those costs stem from two sources. First, they may result from imposing rules of conduct that are later determined to be counterproductive. Those costs are systematic because they are imposed on, and paid by all corporations and may be detrimental to all. The second category of indirect costs imposed on corporations results from the different impact of new rules in different situations. Such indirect costs come from imposing the same requirements on all corporations, whether or not these requirements are suitable for them. These costs are idiosyncratic in nature because they harm different corporations in different ways.

With respect to the first category of indirect costs, regulators must be very careful when adopting corporate governance rules. At the very least, a cost-benefit assessment should be made regarding the proposed measures. Many authors have criticized the inclusion in securities legislations of restrictive or expensive provisions without any serious research on their net effect on shareholders and the market.⁵¹⁶ For instance, as mentioned in subsection II.A.1(d) of this thesis, it has not been established convincingly that requiring an audit committee composed solely of independent directors (a restrictive measure) increases performance or improves the quality of accounting statements.

Section 404 of *SOX* is another good example of a very expensive measure adopted without strong evidence of its beneficial effects. Section 404 of *SOX* requires corporations to publish a report on their internal controls and to obtain a certification related thereto from the corporation's external auditors. Professor Clark of the Harvard Law School highlights five concerns which raise serious doubts about whether the

⁵¹⁵ As mentioned in subsection II.A.2(d) of this thesis, compliance with section 404 of *SOX*, which relates to internal controls, is very expensive in the U.S.

⁵¹⁶ See, for instance, Romano, R., *supra* note 405, Clark, R.C., *supra* note 492; and Allaire, Y. & Firsiroty, M., *supra* note 114.

benefits of section 404 of *SOX* exceed its costs.⁵¹⁷ First, he notes that the implementation of such provision was very expensive:

First, the measurable costs of section 404 to American corporations in its first year of implementation were very large. One December 2004 estimate by the AeA (American Electronics Association) put compliance costs for American corporations in the aggregate of \$35 billion. A survey by Charles River Associates of 90 companies in the Fortune 1000 list found total average compliance costs of \$7.8 million per company (\$1.9 million extra to external auditors, plus \$5.9 million of new internal and other costs). Given average annual company revenues of \$8.1 billion in the sample, the costs amounted to a 10 basis points charge on revenues and, of course, a much higher percentage of their net income. Similarly, a survey in March 2005 by Financial Executives International (FEI) of 217 public companies with average revenues of \$5 billion found average section 404 compliance costs of \$4.36 million, up 39 percent from what the companies expected to pay in mid-2004. Reports from particular companies indicate that the relative burden on certain kinds of large public companies – for example, those with numerous relatively small subsidiaries, such as advertising and marketing companies – was significantly higher. One such company with nearly \$10 billion in annual revenues and over \$700 million in net income estimated that the cost of complying with section 404 was \$70 million and that, contrary to earlier hopes, the ongoing costs of compliance would be only moderately lower. Ongoing compliance costs are expected to decline sharply at most companies, but are likely to remain very significant, despite pronouncements by the PCAOB [the Public Company Accounting Oversight Board] and SEC that try to encourage more targeted and therefore less costly approaches to testing internal controls.⁵¹⁸

Second, Professor Clark notes that regulators are not necessarily good at estimating in advance the costs of a mandatory measure. The costs of section 404 are vastly higher than originally predicted:

[...] At the time of *SOX*'s enactment, the SEC estimated compliance costs of \$91 thousand per company, or \$1.24 billion in the aggregate. The cost to companies in the FEI [Financial Executive International] spring 2005 survey was 48 times the SEC average estimate and the AeA [American

⁵¹⁷ Clark, R.C., *ibid.*, at 28 to 30.

⁵¹⁸ *Ibid.*, at 28 and 29.

Electronics Association] tally for American companies was 28 times the SEC aggregate estimate. Whatever the best survey or measure of actual compliance costs may be, it seems quite clear that original predictions were not just off, but wildly off. This conclusion highlights an important puzzle: How should we understand the fact that well-intentioned policymakers with genuine expertise and rich experience can predict the future so badly?⁵¹⁹

Third, Professor Clark finds it worrying that the costs of section 404 are regressive, in that they are not proportional to company size. Professor Clark explains that the higher costs on small corporations could mean that certain of them would decide not to list securities on our financial markets to avoid costly requirements:

The AeA [American Electronics Association] survey of smaller public companies indicated that those with less than \$100 million in annual revenues had compliance costs amounting to 2.55 percent of revenues, and those in the \$100 to \$499 million range had compliance costs amounting to 0.53 percent of revenue. Obviously, a 53 basis points charge on smaller company revenues is notably higher than the 8 to 12 basis points estimated for large public companies on the basis of surveys like those noted above. Put another way, there are economies of scale in the implementation and testing of internal controls. These differences were not anticipated in cost predictions at the time of enactment of SOX. There is now real concern that some smaller public companies are going private to avoid SOX-related costs, and other smaller companies will be deterred from going public.⁵²⁰

Fourth, Professor Clark notes that there is some circumstantial evidence suggesting that incremental improvements in fraud detection because of section 404 of *SOX* will probably be modest. He refers to a study by the Association of Certified Fraud Examiners which found that in cases of fraud causing \$1 million or more in losses, only 8.2 percent of the cases were detected by internal controls. He also explains that high-

⁵¹⁹ *Ibid.*, at 29.

⁵²⁰ *Ibid.*

level fraud is much more influenced by extremely aggressive or irresponsible accounting judgments than failures of corporate internal controls *per se*.⁵²¹

Finally, he provides concrete examples to illustrate why costs related to section 404 of *SOX* are high but its benefits are modest. He explains that the attestation by auditors is costly because it has pressed companies to document control processes much more fully, to define and enforce restrictions on access to information technology systems, to separate accounting and financial functions (even in small corporations) and to improve many financial procedures. However, the financial benefits of those measures are difficult to detect.⁵²²

Because no formal studies have demonstrated, through a cost-benefit analysis, that section 404 of *SOX* was good for shareholders, it would seem premature to impose such a requirement on all corporations in light of the concerns set out above. In Canada, the CSA, initially proposed an approach similar to section 404 of *SOX*.⁵²³ But the CSA announced in March 2006 that they had decided to change their approach. Chief executive officers and chief financial officers will have to certify that they have evaluated the effectiveness of internal controls but external auditors will not have to provide an opinion on such evaluation, as it is the case in the U.S.:

After careful consideration of the feedback received and recent developments internationally, particularly in the US, we propose to expand MI 52-109 to include the internal control reporting requirements discussed below.

- The CEO and CFO of a reporting issuer, or persons performing similar functions, will be required to certify in their annual certificates that they have evaluated the effectiveness of the issuer's internal control over financial reporting as of the end of the financial year. They will also be required to certify that, based on their evaluation, they have caused the issuer to disclose in its annual MD&A their conclusions about the effectiveness of internal control over financial reporting as of the end of the financial year.

⁵²¹ *Ibid.*, at 30.

⁵²² *Ibid.*

⁵²³ See proposed Multilateral Instrument 52-111 (2005) 28 OSCB 1302.

- As noted above, the issuer's annual MD&A will include disclosure regarding its internal control over financial reporting. This disclosure will include a description of the process for evaluating the effectiveness of the issuer's internal control over financial reporting and the conclusions about the effectiveness of internal control over financial reporting as of the end of the financial year.

The issuer will not be required to obtain from its auditor an internal control audit opinion concerning management's assessment of the effectiveness of internal control over financial reporting.⁵²⁴

Based on the observations of Professor Clark, one may argue that no higher standard of conduct should be imposed on corporations unless it is empirically proven that its benefits will be larger than its costs. In an article commenting on certain provisions of *SOX*, Professor Clark urges legislators to perform more research on that topic:

To some observers, the changes still seem likely to generate a net benefit. To others, the costs appear so large that a finding of net social benefit seems wildly implausible. In this context, good empirical studies that put numbers on both sides of the equation could be extraordinarily useful.

Early experience under SOX 404 dramatizes both the problem and the need for careful study [...] reports about the first year of implementation (2004) indicate staggering costs, but survey evidence and other consideration raise genuine doubts about whether the benefits exceed the costs.⁵²⁵

Such comments apply to the establishment of mandatory rules by any regulator. When introducing new mandatory provisions, there is a risk that costs of implementing measures to comply with such provisions be higher than the benefits relating thereto.

With respect to the second category of indirect costs mentioned above, the empirical research described in sections II.A.1(d) and II.A.2(d) also signals that one must be cautious when applying rules uniformly to all corporations, without regard to their

⁵²⁴ See CSA Notice 52-313 – Status of Multilateral Instrument 52-111 (2006) 29 OSCB 2011.

⁵²⁵ Clark, R.C., *supra* note 492 at 10.

own characteristics and needs. As mentioned above, “while Section 404 costs the average multibillion-dollar firm about 0.05% of revenue, the figure can approach 3% for the small companies”.⁵²⁶ The burden of new legislation is especially heavy for small corporations because unlike larger corporations, many of them lack accounting staff to monitor the effectiveness of their internal controls.⁵²⁷ Commissioners of the SEC themselves have recently voiced concerns about the unfair burden imposed on small issuers because of the non-adaptability of rules on internal controls.⁵²⁸ Since corporations listed on the TSX are smaller in terms of revenues, assets and market capitalization than those listed on the NYSE, Canadian regulators must be very careful not to impose burdens that would be too heavy on our businesses.⁵²⁹

From the point of view of investors, another indirect cost, which might be surprising but is nevertheless real, is the fact that imposing sanctions on corporations may ultimately hurt shareholders. For instance, if a corporation does not follow a mandatory rule, a monetary sanction would affect the value of its assets and a cease trade order would affect its reputation. However, in both cases, ultimately it will be the shareholders who will likely bear the price of those penalties. A sanction paid from corporate assets will have a direct impact on the value of shareholders’ claim in the corporation and a blow to the reputation of the firm will likely have a negative effect on the price of the shares of the corporation.⁵³⁰

Finally, from the point of view of all market participants, an expensive mandatory system can repel certain issuers, that may prefer to list securities abroad or to remain privately held corporations. In recent years, it has been demonstrated that Sarbanes-Oxley-related implementation costs deterred a number of firms from engaging in a U.S.

⁵²⁶ *Ibid.*, at 9.

⁵²⁷ *Ibid.*

⁵²⁸ See the report of Commissioner Janet Dolan, Chair of the Subcommittee of the SEC on Internal Controls, available at <http://www.sec.gov/info/smallbus/acspc/pr-intcontrol.pdf> (at 45) and <http://www.sec.gov/info/smallbus/acspc/acspctranscript121405.pdf> (at 195) (date accessed: 3 March 2007).

⁵²⁹ McFarland, J., “Board Games”, *The Globe & Mail* (7 October 2002) B1.

⁵³⁰ *Ibid.*

listing because the direct costs of being a registered firm exceeded the expected benefits.⁵³¹ There is evidence that corporations are less willing to list in the United States since the adoption of *SOX*.⁵³² It has also been argued that provisions of *SOX*, such as section 404, may induce small corporations to exit the public capital market.⁵³³ Expensive regulations which drive corporations out of a market have an impact on investors because it prevents them from further diversifying their holdings, which constitutes a cost in itself.

In short, the benefits of the mandatory regime (protection against wrongful conduct and predictability) must be weighed against several costs, direct and indirect, including the expense of complying with the rules, the fact that rules may be counterproductive, their inflexibility to adapt to different situations, the end-result for shareholders and their general effect on listings (or rather non-listings) of securities. As we will explain in subsection II.B.3 of this thesis, a hybrid regime should aim to capitalize on the strengths of the mandatory regime, while reducing as much as possible the costs related to it.

2. THE VOLUNTARY REGIME

A voluntary regime characterized the Canadian corporate governance environment prior to the adoption of the corporate governance disclosure standards by the TSX in 1995 (which were replaced by National Instrument 58-101 in 2004) and the rules regarding the composition and responsibilities of audit committees described in Multilateral Instrument 52-110. Prior to the adoption of such standards and rules, corporations were generally free to adopt the corporate governance practices they

⁵³¹ See also Litvak, K., "Sarbanes-Oxley and the Cross-Listing Premium" (University of Texas Law School Law and Economics Research Paper 94, Dec. 2006) online: <http://papers.ssrn.com/abstract=800584> (date accessed: 3 March 2007); and Piotroski, J.D. & Srinivasan, S., "The Sarbanes-Oxley Act and the Flow of International Listings", online: <http://papers.ssrn.com/abstract=800584> (date accessed: 3 March 2007).

⁵³² Anand, A.I., *supra* note 112, at 25.

⁵³³ Kamar, E, Karaca-Mandic, P. & Talley, E., "Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis" (University of Southern California, Center in Law, Economics and

thought were best suited for their needs.⁵³⁴ Such a voluntary regime, just like the mandatory regime, is characterized by benefits and costs that must be taken into consideration in developing an optimal regime.

(a) Benefits of a voluntary regime

The first advantage of the voluntary regime over the mandatory regime is of course that it is not as expensive for the state.⁵³⁵ In a voluntary regime, the state does not have to incur costs related to policy design, implementation or enforcement.⁵³⁶ It may monitor corporate activities in general but would not police corporate governance practices against a set of pre-established rules.

From a corporation's point of view, the voluntary regime means that the corporation does not need to implement new policies and structures in order to comply with mandatory rules and that it will save on administrative costs that would have been involved in monitoring compliance with mandatory rules. Another advantage of the voluntary regime is its flexibility, in that it allows corporations to choose a set of practices that really suits their needs.⁵³⁷ This choice may be influenced by how much governance costs corporations are willing to absorb. Hence, if at the earliest stage of its existence, a corporation may prefer to invest more in research and development, marketing and operations, and less on internal controls and independent consultants, the situation may be different when the corporation has matured. Similarly, a board may chose not to adopt certain practices if a corporation is in financial difficulties, the

Organization Research Paper Series, August 2006), online <<http://ssrn.com/abstract=901769>> (date accessed: 3 March 2007).

⁵³⁴ Corporate laws, such as the *CBCA* included certain requirements relating to corporate governance. For instance, the *CBCA* regulates to a certain extent the composition of the audit committee, as explained in subsection II.C of this thesis.

⁵³⁵ At least in terms of direct costs. It may be argued that the voluntary regime comes with indirect costs such as those created within a corporation to develop corporate practices. As well, it may be argued that uncertainty imposes a cost on the system as a whole since investors may assume additional costs to protect their investment or may decide not to invest at all in such the market.

⁵³⁶ Anand, A.I., *supra* note 112.

⁵³⁷ *Ibid.*, at 15.

implementation of those practices is costly and their positive impact would mostly be felt in the long-term.⁵³⁸

Because of the nature of the Canadian economy, flexibility is particularly important in our market. Indeed, the TSX index shows important differences between issuers, reaching from the relatively small to the multinational corporation and from the corporation controlled by a significant shareholder to the one widely-held. As mentioned in subsections I.A.1(a) and (b) of this thesis, much more corporations listed on the TSX are controlled by a significant shareholder than those listed on the NYSE.⁵³⁹ The TSX also includes far smaller companies than the NYSE.⁵⁴⁰

Corporations controlled by a significant shareholder have different needs in terms of independence and active monitoring than widely owned corporations. In those corporations, the significant shareholder has strong incentives to monitor the business of the corporation because, as a shareholder, it will benefit from such monitoring. In those circumstances, the focus should be on making sure that the significant shareholder does not divert value to its own benefit, at the detriment of other shareholders.

The needs and means of small corporations are also different from those of most major corporations. It may be sensible that a corporation in the early stages of its growth be managed by a small group of related directors closely involved in the business of the corporation, whereas it would not be in the interest of a mature corporation.

Acknowledging that “one size does not fit all” and that flexibility is important in promoting effective corporate governance, the Dey Report recommended that every corporation incorporated in Canada be allowed to adopt its own set of corporate governance practices, subject to disclosing on an annual basis its approach to corporate governance by describing the corporation’s system of corporate governance with reference to the guidelines proposed in the report. Where the corporation’s system was

⁵³⁸ *Ibid.*, at 21.

⁵³⁹ Parizeau, R., *supra* note 38.

different from the guidelines, the Dey Report further recommended that an explanation for the difference be provided.⁵⁴¹ The Dey Report recommendations were implemented by the TSX in 1995 as part of its corporate governance guidelines.⁵⁴² Under that system, every corporation had the flexibility to develop its own approach to corporate governance.⁵⁴³ The only requirement was to disclose actual practices in relation to the guidelines and, where the corporation's system was different from the guidelines, to provide an explanation for the differences or their inapplicability.⁵⁴⁴ The authors of the Dey Report believed that their recommendations should not become mandatory rules, but should be kept voluntary:

We have received some inquiries for our views on the desirability of legislating our guidelines. We would regret embarking on this exercise if our guidelines ended up being legislated. Guidelines by their nature are not appropriate for legislation. Guidelines accommodate the flexibility of approach to governance which we think is critical for our proposals to have the desired impact.⁵⁴⁵

Such regime was viewed as an acceptable compromise to foster the adoption of best practices while at the same time allowing flexibility in their implementation.⁵⁴⁶

(b) Costs of a voluntary regime

Although a voluntary regime means that a corporation may save on compliance expenses, it does not mean that a corporation would not incur any cost related to corporate governance. Indeed, for corporations, there are costs involved in deciding whether or not to comply with market standards, and in adopting substitute practices to replace a given standard. Under the guidance of directors, who have an incentive to

⁵⁴⁰ McFarland, J., *supra* note 530.

⁵⁴¹ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 2, 51 and 52; see also Joint Committee on Corporate Governance, *supra* note 6, at 8.

⁵⁴² Available at www.tsx.com (date accessed: 3 March 2007).

⁵⁴³ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 51.

⁵⁴⁴ Joint Committee on Corporate Governance, *supra* note 6.

⁵⁴⁵ *Ibid.*, at 10.

⁵⁴⁶ *Ibid.*

make sure that their duties are fully discharged, and under the pressure of institutional investors, corporations may voluntarily hire specialists to determine which practices they should adopt and how to implement them.

From the point of view of investors, important costs of the voluntary regime relate to the fact that the level of compliance with best practices will most likely be lower if no sanction is imposed on corporations that deviate from the proposed standards.⁵⁴⁷ The higher risk of wrongful conduct that may result (or be perceived to result) from such deviation, is in itself a cost that needs to be accounted for.

In addition, investors will have to bear the costs involved in assessing and monitoring the governance practices of corporations in which they invest, to ensure that minimum standards acceptable to them are met. Without being able to compare the practices of different corporations, because of different approaches to corporate governance, investors have two choices. They may investigate thoroughly the practices of each corporation, to the extent they can, and try to assess how efficient are the safeguards in place at each corporation, or they may assume the worst and discount the prices they are ready to pay for the shares of all corporations, in order to take into account the uncertainties related to their investments.⁵⁴⁸ In both cases, the costs resulting from such choices will ultimately be paid by investors. In the first case, as costs of investigations (resulting in higher management fees), and in the second case, through what is described, in the next subsection, as the “lemon problem”.

Such disadvantages are reduced, to a certain extent, by what Professor Anand calls the “snowball” effect. This expression refers to the fact that over time, as more and more firms adopt best practices, these practices become expected by market participants and are adopted by many corporations. An example of such effect is the separation of

⁵⁴⁷ *Ibid.*, at 8.

⁵⁴⁸ *Ibid.*, at 37.

the roles of the board chair and chief executive officer, in Canada, over the last decade, stemming from the recommendations of market participants and best practices.⁵⁴⁹

Like the mandatory regime, the voluntary regime comes with costs and benefits. As we will see in the next subsection, the main purpose of the hybrid regime is to capitalize on the advantages of the voluntary regime, while avoiding as much of its disadvantages as possible.

3. THE HYBRID REGIME

For Professor Anand, neither the fully mandatory nor the fully voluntary regimes are satisfactory. She believes that the optimal regime is a partially mandatory one, which yields a high level of compliance at low cost.⁵⁵⁰ A purely mandatory regime should be rejected because it is expensive and inflexible, while a purely voluntary regime should be avoided because of the uncertainty it creates for market participants. As explained by Professor Anand, in an optimal regime, the board has the flexibility to design its own practices, subject to mandatory disclosure thereof.⁵⁵¹

In terms of design of governance rules, this means that regulators should suggest governance standards to which corporations may adhere or not, and require that corporations disclose their practices against such standards, with an explanation as to what they do instead if they diverge from the suggested standards. As we will explain in subsection II.C of this thesis, the CSA have adopted that approach, in National Policy 58-201 and National Instrument 58-101. However, the CSA preferred the mandatory regime when they adopted Multilateral Instrument 52-110. From our point of view, there are no compelling reason (whether empirical or theoretical) for such a distinction. The hybrid regime should be favoured in all cases, as discussed in subsection II.C of this thesis.

⁵⁴⁹ Even without a formal requirement to that effect, more than 80% of corporations listed on the TSX have separated the roles of chairman and chief executive officer: *ibid.*, at 10.

⁵⁵⁰ *Ibid.*, at 4.

⁵⁵¹ *Ibid.*, at 7.

(a) Disclosure should be mandatory

When adequate laws exist to force the disclosure of voluntary corporate practices, it allows market participants to benefit from important advantages of the mandatory and the voluntary regimes without having to bear most of their costs. In order to ensure the comparability between corporations, in such a system, corporations must disclose how they measure against guidelines proposed by regulators, and describe which substitutes have been put in place if they do not fully adopt a suggested guideline.

An important benefit of mandatory disclosure is the standardization of information presentation, which reduces the costs of comparing corporate practices.⁵⁵² As mentioned by Professor Gillen, of the Faculty of Law of the University of Victoria:

Standardization in the presentation of information can reduce the cost to securities market analysts of gathering information and in comparing information between securities issuers. The reduced information costs will permit more gathering and assessing of information and better information comparisons thereby allowing more accurate assessments of securities prices.⁵⁵³

Professor Gordon, of the Columbia Law School, is of the same opinion. In a recent article, he analysed many studies relating to the effect of mandatory disclosure regulations in the U.S. and concludes that disclosure standardization made disclosure more valuable by reducing the information processing costs for analysts and investors.⁵⁵⁴

The requirement to disclose mandatory information to investors is not a recent concept. The first disclosure obligations included in North American securities laws and regulations date back to the Great Depression. President Franklin D. Roosevelt, in proposing what would become the U.S. Securities Act of 1933, declared:

⁵⁵² Brudney, V. *supra* note 323, 1411.

⁵⁵³ Gillen, M.R., *Securities Regulation in Canada* (Toronto: Carswell, 1998), at 316 and 317.

⁵⁵⁴ Gordon, J.N., *supra* note 336, at 85.

I recommend to Congress legislation for Federal supervision of traffic in investment securities in interstate commerce [...] There is [...] an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine “let the seller also beware”. It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.⁵⁵⁵

This statement is still relevant today. In practice, it has been found that if left unregulated, corporations do not, in fact, disclose the optimal amount of financial information. Professor Prentice, of the University of Texas at Austin, explains that voluntary corporate disclosure was seriously inadequate before the adoption of the 1933 Securities Act and 1934 Securities and Exchange Act.⁵⁵⁶ Professor Prentice states that:

The best history of accounting in the United States that has been written points out how spotty voluntary corporate disclosure was before 1933. Previts and Merino note that “balance sheet secrecy was a distinctive characteristic of financial statement disclosure by railroads” in the late 1800s and that Westinghouse issued no annual financial statements between 1897 and 1905 [...] When audits did happen to be done on a company’s books, “two out of three new audit engagements during the 1890s were likely to reveal defalcations.” [...]

As stated by Eastbrook and Fischel, mandatory disclosure has substantially changed the securities regulatory landscape and its effects are fundamental:

In a world with an anti-fraud rule but no mandatory disclosure system, firms could remain silent with impunity. If they disclosed, they could do

⁵⁵⁵ H.R. Rep. No. 85, at 1-2, 73d Cong., 1st Sess. (1933); and Bender, M., *supra* note 17, at 15-2.

⁵⁵⁶ Prentice, R., “Whiter Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future” (2002) 51 Duke L.J. 1397, at 1418 and 1419.

so in any way they wished, provided they did not lie... A mandatory disclosure system substantially limits firms' ability to remain silent.⁵⁵⁷

As mentioned by Professor Clark of the Harvard Law School, there is now good empirical evidence that major regulatory efforts to require more disclosure have had positive effects on investors.⁵⁵⁸ Professor Clark refers to a study of Professor Allen Ferrell, also of the Harvard Law School, that shows that the 1964 extension of mandatory disclosure requirements to stocks of corporations trading over-the-counter in the U.S.⁵⁵⁹ was accompanied by an important reduction in the volatility of returns for investors and positive returns to holders of over-the-counter stocks.⁵⁶⁰ This study is important because until then most important studies which attempted to measure the impact of mandated disclosure on capital markets referred to the effects of the adoption of the U.S. Securities Act of 1933 and the Exchange Act of 1934 on financial markets. Unfortunately, such studies suffered from the lack of control for changing economic conditions (including the effects of the Great Depression) during the period they reviewed.⁵⁶¹ The main advantage of Professor Ferrell's research is that it uses a natural control group against which variables unrelated to the new provisions on mandatory disclosure can be measured. That control group is simply the exchange-listed corporations that had been subject to disclosure requirements since 1934.⁵⁶²

Professor Ferrell particularly emphasized on the results of his research regarding a decrease in securities volatility:

In terms of stock return volatility, both cross-sectionally and over time, two findings stand out. First, relative to the listed market, OTC [over-the-counter] stock volatility fell substantially after the imposition of mandated

⁵⁵⁷ Eastbrook, F.H. & Fischel, D.R., "Mandatory Disclosure and the Protection of Investors" (1984) 70 Va. L. Rev. 669, at 681.

⁵⁵⁸ *Supra* note 492, at 37.

⁵⁵⁹ Until then the disclosure requirements of the U.S. Exchange Act of 1934 did not apply to such corporations.

⁵⁶⁰ Ferrell, A., "Mandated Disclosure and Stock Returns: Evidence from the Over-the-Counter Market" (Olin Paper No. 453, 2004), online: http://www.law.harvard.edu/programs/olin_center/corporate_governance/ (date accessed: 20 August 2006).

⁵⁶¹ *Ibid.*, at 1.

⁵⁶² *Ibid.*, at 5 and 6.

disclosure. The findings with respect to volatility over time are especially dramatic. Second, in the post-mandated disclosure period the OTC and listed market behaved in a far more parallel manner than was the case in the pre-mandated disclosure period. A variety of statistical techniques are used to measure volatility, all of which support these two basic findings.⁵⁶³

In a 2000 study, Morck, Yeung and Yu found that movements of U.S. stock prices had become less “synchronous” over time (meaning that a decreasing fraction of stocks moved up or down together), due in large part to disclosure obligations.⁵⁶⁴ Using a sample of 400 stocks listed in the U.S. randomly chosen each month for a period of time covering 1926 to 1995 as well as similar cross-country evidence, they demonstrated that economies without mandatory disclosure rules exhibit a high degree of synchronous stock price movement compared with developed market economies which are characterized by mandatory rules of disclosure.⁵⁶⁵ As explained hereunder, less synchronous movements in the stock price is an indication that investors are better able to evaluate the risks associated with each investment (as opposed to assessing the risks of investing in a particular country), that the share price of such corporations is likely to be closer to actual value, and that investors will be in a position to better diversify their investments.⁵⁶⁶

For Professor Gordon, mandatory disclosure provides several types of benefits: corporate-specific benefits, benefits for all corporations and more informative stock prices which benefits all investors:

To be sure, better disclosure has firm-specific benefits, insofar as it facilitates market monitoring of managerial performance. This occurs through more accurate stock price information that can be used in both within-firm performance comparisons over time and cross-sectional comparisons with other comparably situated firms. It also occurs through

⁵⁶³ *Ibid.*, at 33.

⁵⁶⁴ Morck, R., Yeung, B. & Yu, W., “The Information Content of Stock Markets: Why Do Emerging Markets Have Synchronous Stock Price Movements?” (2000) 58 J. Fin. Econ. 215.

⁵⁶⁵ *Ibid.*

⁵⁶⁶ Fox, M.B., “Retaining Mandatory Securities Disclosure: Why Issuer Choice is not Investor Empowerment” (1999) 85 Va. L. Rev. 1335, at 1369.

more informative securities analyst evaluation of managerial performance, which can be reflected in narrative form as well as in stock-picking advice. But better disclosure also generates benefits for other firms, interfirm externalities. By providing useful comparative information, it facilitates monitoring of other firms' management (and thus may improve a rival's performance). It also provides competitively valuable information that other firms can use in their planning (and also may therefore improve a rival's performance). More generally, more accurate disclosure can lead to more informative stock prices, as well as more accurate narratives, that can more efficiently guide the behavior of market actors.⁵⁶⁷

Such findings are consistent with the conclusions of the report of the Committee of the Ontario Securities Commission on the Problems of Disclosure Raised for Investors by Business Combinations and Private Placements,⁵⁶⁸ which found that: "if securities are evaluated on the basis of complete and current information, the pricing mechanisms of the capital markets operate in a more rational and accurate fashion".⁵⁶⁹ This enhanced accuracy represents a gain to the less than fully diversified investor, because it reduces his or her risk.⁵⁷⁰ When relevant information is available about an issuer, its share price is likely to be closer to actual value.⁵⁷¹ This may be explained by the fact that a lack of information increases the risks (and therefore the costs) related to an investment (investors having to discount the value of shares to account for the worst possible situation), and conversely, disclosure of corporate governance practices will decrease such risks (and therefore such costs).

Professor Anand discusses the problem of not disclosing enough information and its effects on the market as a whole, which is referred to as the "lemon problem":

While there are incentives for voluntary behaviour relating to disclosure, there are powerful disincentives. In particular, issuers always have an incentive to disclose only the minimum amount of information that they are required to disclose and they will be disinclined to disclose

⁵⁶⁷ Gordon, J.N., *supra* note 336, at 42.

⁵⁶⁸ (Toronto, 1970), at 15; referred to in Gillen, M.R., *supra* note 553, at 53.

⁵⁶⁹ *Ibid.*

⁵⁷⁰ See Gillen, M.R., *supra* note 553, at 296 to 302.

⁵⁷¹ Fox, M.B., *supra* note 566, at 1369.

information which may be viewed by the market as “bad news”. Market pressure to disclose will be weak if an issuer’s competitors choose not to disclose such information. Therefore investors may not be able to rely on voluntary behaviour with respect to this (often crucial) news.

The possibility that firms might not disclose information which the market is likely to consider “bad news” gives rise [...] to the well-known lemon problem. Investors are unable to discern which issuers are truthful to investors therefore discount the prices that they will offer for all securities. High-quality issuers exit the public market, forgoing a potentially valuable investment opportunity, because they are unable to obtain a fair price for their securities. Low-quality issuers remain in the market and, as a result, investors discount still more the prices they will pay. This in turn only drives more honest issuers away from the market and exacerbates the adverse selection problem. Mandatory disclosure can prevent [...] the downward cycle that the lemon problem can pose.⁵⁷²

Disclosure requirements such as those described in National Instrument 58-101, Multilateral Instrument 52-110 and their equivalent in the U.S., are generally beneficial for our financial markets because they allow investors to better understand the corporate governance practices of our corporations and avoid the “lemon effect”. As mentioned by Professor Gillen, by being more efficient, the market better protects investors because securities prices more closely reflect the underlying values of the securities.⁵⁷³

Other advantages of the mandatory system, with respect to the dissemination of minimum standards, can also be found in the hybrid regime. Indeed, mandatory disclosure against a set of guidelines will encourage corporations to adopt minimum standards and provide some level of protection for investors. Because institutional shareholders and the media increasingly follow corporate governance practices of public corporations, corporate boards will often want to limit divergences from guidelines against which corporations must disclose, for fear that such divergences may be considered harmful to shareholders and may have a negative impact on share prices.⁵⁷⁴ This prediction is confirmed by empirical work. Indeed, as reported by Professor Anand,

⁵⁷² Anand, A.I., *supra* note 112, at 40; and Gillen, M.R., *supra* note 553, at 302.

⁵⁷³ Anand, A.I., *ibid.*, at 64.

⁵⁷⁴ *Ibid.*

it was demonstrated that surveys made annually by national newspapers on corporate governance induced corporations to improve their practices in order to obtain better rankings.⁵⁷⁵ Of course, without appropriate disclosure, very few people would be able to assess (and compare) the practices of corporations and such rankings would be difficult to make.

Some may argue that a partially mandatory regime, in which best practices are suggested but not imposed, will have no teeth and will not be taken seriously by corporations. This argument has at least three flaws. First, even if they are not mandatory, directors may be afraid that by not following best practices they could ultimately expose themselves to a breach of their fiduciary duties. As we have seen in subsection II.A of this thesis, ignoring corporate governance best practices could potentially be risky for directors. The continuous emergence of stricter standards puts pressure on corporations to improve the quality of board decisions.⁵⁷⁶

Second, even when sanctions are not imposed by legislators, a deviation from best practices can be sanctioned by the market. Indeed, investors may request changes and ultimately sell their shares if the corporation does not follow best practices. Even if shareholders do not sell their investment, management may fear that they could. Since many investors value good governance, firms will have an incentive to adopt good practices.⁵⁷⁷

Third, even under a mandatory system, compliance is not guaranteed. If legal penalties are low or enforcement is lax, a corporation may choose to bear the risks of non-compliance.⁵⁷⁸

A final advantage of the hybrid regime over the mandatory regime is that from the point of view of the state, in a system where disclosure against guidelines is

⁵⁷⁵ *Ibid.*

⁵⁷⁶ *Peoples Department Stores Inc. (Trustee of) v. Wise*, *supra* note 7 at 491.

⁵⁷⁷ Anand, A.I., *supra* note 112, at 20.

⁵⁷⁸ *Ibid.*, at 17.

mandatory but the observance of such guidelines is voluntary, the state would bear the costs related to policy design and implementation but save on enforcement and market surveillance costs.⁵⁷⁹

In practice, we thus believe that an optimal regime should require issuers to disclose their corporate governance practices against a set of standards provided by regulatory authorities. When an issuer does not follow the proposed standard, it should explain why it does not follow it and what it does instead. Such a regime ensures comparability between issuers without imposing a heavy burden on regulatory authorities.

In Canada, our regulators have already adopted, to an important extent many characteristics of such a hybrid system. The requirement that corporations disclose their practices against the template provided in National Instrument 58-101 helps to avoid many disadvantages of a voluntary regime while at the same time assisting market participants to compare the practices of different corporations.

One may wonder how disclosure requirements can be enforced. Do Canadian corporations comply with the requirement to disclose their practices against specific standards? A survey of the TSX, conducted in 2002, shows that only 40% of public corporations listed on the TSX were fully or partially addressing the 14 corporate guidelines of the TSX then in existence, even though disclosure against such guidelines were required by the exchange.⁵⁸⁰ Although we are not aware of surveys relating to the compliance with National Instrument 58-101, we tend to believe that compliance is much higher than it was when the disclosure obligations were prescribed by the TSX Company Manual.

The fact that disclosure requirements are now enforced by securities commissions makes an important difference. The most important change, in terms of enforcement,

⁵⁷⁹ *Ibid.*, at 14.

between the former guidelines of the TSX and the requirements of National Instrument 58-101 which replaced them, is the range of potential sanctions applicable to an issuer that does not comply with disclosure requirements. Under the former TSX regime, should an issuer neglect to disclose its practices, the only two sanctions that could be imposed by the TSX were to delist or to halt the trading of the securities of the issuer, two measures that were extreme compared to the gravity of the omission. Because they could practically not be applied, issuers most likely did not feel threatened by a potential sanction for a failure to disclose.

Under the current regime, the range of potential sanctions is much broader. In addition to general enforcement fines and penalties under securities laws,⁵⁸¹ securities commissions can include the name of the corporation on a list of defaulting issuers.⁵⁸² When an issuer is in default, securities commission may refuse to allow it to issue new securities, until the default is corrected.⁵⁸³ This is a powerful incentive to comply with disclosure rules. In addition, securities commissions have in place continuous disclosure review programs⁵⁸⁴ pursuant to which their staff members periodically assess the disclosure practices of issuers and can require, among other things, that documents be refiled with a press release explaining any omission. There is no need to explain that such refiling is generally not well perceived by the market and issuers want to avoid refiling as much as possible. As a result, corporations have many reasons to comply with the new disclosure requirements and we would anticipate that a survey would confirm that compliance is very high. Empirical research would be helpful in that area.

⁵⁸⁰ Toronto Stock Exchange, *Corporate Governance Disclosure – 2002 Toronto Stock Exchange Survey Results* (Toronto, 2002), at 2.

⁵⁸¹ See for instance s. 122 of the *OSA*.

⁵⁸² See for instance Ontario Securities Commission Policy 51-601 – *Reporting Issuer Default*, 24 O.S.C.B. 6587.

⁵⁸³ See for instance s. 61(2) of the *OSA*.

⁵⁸⁴ See for instance Ontario Securities Commission Notice 51-706 – *Continuous Disclosure Review Program*, 24 O.S.C.B. 6842.

(b) Other board practices should be voluntary

It has been explained that the mandatory regime offers two important advantages: it insures that certain minimum standards are respected and allows for predictability. As described above, these advantages are also present, to an important degree, under the hybrid regime. With respect to costs, it was shown that the hybrid regime can decrease significantly the direct costs that government and market participants will incur. It will be shown, in this subsection, that it can also reduce indirect costs significantly.

Because corporations are most likely better equipped than legislators to decide which practices will best suit their specific needs, efficiency calls for allowing boards of directors to decide which corporate governance standards to prioritize.⁵⁸⁵ There are many aspects of corporate governance that may be more appropriately addressed by a corporation's board of directors than by regulators.⁵⁸⁶ For instance, directors will be better equipped to decide the degree of independence required on the board, depending on the probability that management or a significant shareholder may try to influence board decisions. Similarly, the board will be in a better position to decide which directors' education or board assessment process should be followed, depending on the personalities of directors and management and the resources of the corporation. Board discretion will be superior to rules when the problem requiring a solution varies significantly from corporation to corporation and when the identification of an optimal solution depends on particular features of each corporation.⁵⁸⁷

One of the main advantages of the hybrid regime is its flexibility and adaptability to various circumstances, which reduces inefficiency costs.⁵⁸⁸ Because it is not possible to foresee all potential problems resulting from the implementation of a proposed legal provision across the market, legislators will necessarily chose rules that are not the most

⁵⁸⁵ Anand, A.I., *supra* note 112, at 21.

⁵⁸⁶ Hansell, C., *supra* note 120, at 39.

⁵⁸⁷ Bebchuk, L.A., "Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments" (1989) 102 Harv. L. Rev. 1820, at 1847.

⁵⁸⁸ Kennedy, D., "Form and Substance in Private Law Adjudication" (1976) 89 Harv. L. Rev. 1685, at 1710.

efficient for all corporations to which they apply. Even if it was possible to predict and rectify in advance all potential implementation problems, the cost of making advance rulings on thousands of possibilities would be excessive. Where rules are not capable of covering a vast majority of circumstances, the generality of a guideline means that gaps are less likely.⁵⁸⁹

As explained in subsections II.A.1(b) and II.A.2(b), independence and active monitoring practices should help reduce agency costs. However, the question is which practices are the most efficient for a specific corporation? It seems very difficult to predict which practices will be beneficial and which will be detrimental for the performance of most corporation, let alone on all corporations. With respect to independence practices, as mentioned in subsection II.A.1(d), it has not yet been demonstrated, for instance, that the requirement to have an audit committee composed solely of independent directors is positively correlated with the reduction of financial statement fraud, earnings restatement, or an increase in market value of corporate shares or return on assets. However, studies have shown that having a majority of independent directors was generally beneficial. Similarly, with respect to active monitoring practices, the lack of empirical studies showing the benefits of specific active monitoring measures, as mentioned in subsection II.A.2(d) of this thesis, calls for prudence in mandating specific active monitoring practices. Regulators must be very careful not to impose standardized measures on all corporations, without taking into account the particular needs and characteristics of each of them. This is particularly true in Canadian markets characterized by more significant diversity in the size of publicly listed corporations, ranging from small family businesses to the Canada's large banks, and the fact that many publicly listed corporations are controlled by a significant shareholder. In this context, even if empirical analyses based on US data clearly showed that certain corporate

⁵⁸⁹ *Ibid.*, at 1690.

governance practices were beneficial, one would have to remain skeptical about the desirability of making such practices mandatory in Canada.⁵⁹⁰

Flexibility should thus generally be preferred to mandatory rules when it comes to the content and implementation of corporate governance rules. In recent years, some of the reordering of boardroom processes to improve directors' ability to monitor management and corporate performance has been self-made by boards, without legislative or regulatory intervention⁵⁹¹ and there is evidence that major corporations have made significant reforms to their corporate governance systems beyond what is required by law.⁵⁹² Corporate leaders have good reasons to think proactively about corporate governance improvement. If they do not, government will rush into the vacuum and respond to the social demands that something be done about corporate misbehaviour.⁵⁹³ There is an element of self-interest that motivates corporate leaders to address issues of public concern before legislative or regulatory action is demanded by shareholders and other stakeholders.⁵⁹⁴ Economic scandals are dangerous not only for the obvious harm they cause to investor confidence in the capital markets, but also because they generate the potential for over-reaction by rulemakers, to the potential detriment of overall economic well-being.⁵⁹⁵

Despite this call for flexibility, it must be recognized that corporate governance improvements will not be as efficient if appropriate disclosure rules are not in place. As explained in the last subsection, since share prices tend to reflect all publicly available information on a corporation,⁵⁹⁶ a meaningful disclosure of corporate practices against

⁵⁹⁰ *Supra* note 40. Before adopting new mandatory rules in Canada, certain basic questions should thus be answered, such as the costs and benefits of such new rules on corporations of different sizes and the empirical impact of a significant shareholder on corporate governance practices.

⁵⁹¹ Millstein, I., *supra* note 437, at 1429.

⁵⁹² VanDuzer, J.A., *supra* note 71, at 260.

⁵⁹³ Chapman, B., *supra* note 6, at 211.

⁵⁹⁴ Hansell, C., *supra* note 120, at 40.

⁵⁹⁵ Strine, L.E., *supra* note 61, at 1401.

⁵⁹⁶ *Ibid.*

specific guidelines of regulators will help shareholders assess the corporate governance practices adopted by a board.⁵⁹⁷

One may question the efficiency of disclosure requirements in encouraging the compliance with best practices. In 1999, the Toronto Stock Exchange and the Institute of Corporate Directors undertook a survey of the state of corporate governance among TSX (known as TSE) listed corporations five years after the release of the Dey Report (and four years after the introduction by the TSX of rules requiring mandatory disclosure against suggested guidelines).⁵⁹⁸ The authors of the survey found that:

The research findings present a complex picture. On one hand, it is clear that most corporations take the TSE guidelines seriously. Many of the largest companies that account for the greatest proportion of Canadian equity investments are leaders in corporate governance. A number of the TSE guidelines are now broadly accepted business practices. On the other hand, important areas remain where general practice falls short of the guidelines' intent. We see real opportunities for the TSE and ICD to help foster sound practices.⁵⁹⁹

Since that survey, the listing requirements of the TSX have been replaced by rules of the CSA that are far more reaching. Following the increased involvement of the CSA in corporate governance, compliance with best practices has improved consistently.⁶⁰⁰ Such improvements are certainly due in part to the will of directors to adopt best practices in order to protect themselves from criticisms of institutional investors and other market participants. Directors may prefer to sit on corporations who follow best practices, for fear that laxity in that field may harm their reputation and, in some cases, result in legal action against them.⁶⁰¹ By adopting best practices, corporations not only

⁵⁹⁷ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 9.

⁵⁹⁸ Toronto Stock Exchange & Institute of Corporate Directors, *Five years to the Dey* (Toronto: TSX & ICD, 1999).

⁵⁹⁹ *Ibid.*, at ii.

⁶⁰⁰ The Globe & Mail, "Board Games" online: <<http://theglobeandmail.com/v5/content/boardgames2006>> (date accessed: 3 March 2007).

⁶⁰¹ See for instance Sahlman, W.A., "Why Sane People Shouldn't Serve on Public Boards" (1990) May Harv. Bus. Rev. 28.

provide comfort to their current directors, but facilitate efforts in attracting new directors to the board.⁶⁰²

Having to comply with mandatory rules of conduct, instead of voluntary best practices, would certainly add to the difficulty of persuading the best people to act on a board. Many commentators have observed that recruiting experienced directors is more difficult than it used to be.⁶⁰³ When asked why they refused to join a board or decide to leave a board, many directors or potential directors refer to liabilities created by new mandatory rules.⁶⁰⁴ Adding new rules, without the flexibility to diverge if directors consider that it is in the best interest of the corporation, does certainly not facilitate the search for talent. The flexible approach suggested in this thesis is a better way to encourage good governance without acting as a repellent *vis-à-vis* potential candidates to the board.

In short, we believe that the hybrid regime provides the flexibility required to approach the optimal regime, since it allows issuers to choose whether or not to follow the standards suggested by securities commissions. At the same time, through its disclosure requirements, it facilitates comparisons between practices of different corporations and encourages the adoption of best practices. Although section II.C of this thesis proposes many amendments to be made to the current disclosure rules of the CSA and suggests new guidelines to improve corporate governance practices, we nevertheless believe that the foundations on which the Canadian regime is based are generally sound and are closer to the theoretically optimal regime than the American model.

⁶⁰² *Ibid.* See also Hanks, J.F. & Scruggins, L.P., "Protecting Directors and Officers from Liability" (2000) 56 Bus. Law. 3.

⁶⁰³ Sahlman, W.A., *supra* note 600.

⁶⁰⁴ Daniels, R.J., *supra* note 6, at 230, 255 and 258. At 258 he mentions: "My concern is that if left unchecked, burgeoning dependence on directors' liability will undermine the capacity of the public corporation to generate the wealth surplus necessary to fund the most cherished goals of the welfare state."

SUMMARY

As described above, both mandatory and voluntary regimes have benefits and costs. An optimal regime should allow corporations to benefit from the most important advantages of both regimes while avoiding their most important disadvantages. As suggested by Professor Anand, a hybrid regime, pursuant to which disclosure against specific guidelines is mandatory while the selection and implementation of board practices is voluntary, approaches such an optimal regime.

A hybrid regime is less expensive than the mandatory regime in terms of direct costs for the state and the corporation, and is more efficient than the voluntary regime in assisting directors to assess corporate governance practices against a mandatory framework. Empirical research confirms the benefits of mandatory disclosure. Because of its flexible nature, the hybrid regime, at the same time, allows directors to adopt practices that are well adapted to the specific needs of their corporation.

The Canadian regime possesses many attributes of a hybrid regime but it could still be improved. In the following section, the current rules of the CSA will be reviewed and critically assessed based on the findings of this thesis, and on suggestions of authors and market participants. A matrix will be used to show how, in practice, the independence vs. active monitoring categorization can be combined with the mandatory vs. voluntary framework proposed above to provide a roadmap for implementing optimal prophylactic and curative measures to decrease agency costs and assisting directors in the discharge of their fiduciary duties.

F. REVIEW OF CURRENT CANADIAN CORPORATE GOVERNANCE RULES
AND GUIDELINES AND PROPOSALS FOR IMPROVEMENTS

This subsection uses a bidimensional approach (referred to as the “Categorization/Implementation Matrix”) to show how the findings of subsections II.A and II.B of this thesis can be combined to suggest improvements to current Canadian corporate governance rules and guidelines. The Categorization/Implementation Matrix is based on: i) the independence vs. active monitoring categorization made in subsection II.A of the thesis; and ii) the proposed hybrid (mandatory/voluntary) framework described in subsection II.B thereof. It is a very simple but yet powerful way to identify deficiencies to be corrected in order to move closer to an optimal system.

The Categorization/Implementation Matrix helps to visualize our proposed bidimensional approach to corporate governance:

	Mandatory	Voluntary
Independence practices	A - Disclosure of independence practices against a mandatory template	B – Voluntary practices related to independence
Active monitoring practices	C - Disclosure of active monitoring practices against a mandatory template	D – Voluntary practices related to active monitoring

The intent of this subsection is not to propose a “perfect” system, but rather to help identify certain areas where improvement could be made, both in terms of legislative choices and board policies. The categorization made using the Categorization/Implementation Matrix should be helpful in tying theory to practice. The scope of each item of the matrix (A, B, C and D), could change following the evolution of empirical research. For instance, if convincing studies were to show that mandatory disclosure can have unsuspected negative effects on corporate performance, we would reassess our framework. Similarly, if empirical studies demonstrated that certain active monitoring practices are always correlated with improved corporate performance, there

could be good arguments to make them mandatory. However, judging from the results (or lack of results) of current empirical research, we believe that the above matrix is unlikely to change in the short term.

Based on the principles developed in this thesis, the following subsections suggest changes to Multilateral Instrument 52-110,⁶⁰⁵ National Instrument 58-101⁶⁰⁶ and National Policy 58-201⁶⁰⁷ of the CSA. These CSA instruments and policy are attached as Appendices A, B and C of this thesis, respectively. Our review and suggestions follow the order of the matrix described above.

1. DISCLOSURE OF INDEPENDENCE PRACTICES AGAINST A MANDATORY TEMPLATE

Item A of the Categorization/Implementation Matrix calls for the disclosure of independence practices of a corporation against a mandatory template (*i.e.*, a set of guidelines prescribed by regulatory authorities). This subsection reviews the current requirements of the CSA relating to the disclosure of independence practices and suggests improvements to be made to those requirements.

Section 2.1 of National Instrument 58-101 provides that an issuer must include annually in its management information circular the disclosure required by Form 58-101F1. The disclosure required in that form is divided in nine topics: Board of directors, Board mandate, Position Descriptions, Orientation and Continuing Education, Ethical Business Conduct, Nomination of Directors, Compensation, Other Board Committees and Assessments. Such categorization does not seem to follow any specific order or a particular logic. As a preliminary comment, we would classify corporate governance practices based on the objective to be reached. In accordance with the framework

⁶⁰⁵ Multilateral Instrument 52-110 has been implemented in all Canadian provinces and territories except British Columbia. It prescribes mandatory rules regarding the composition and responsibilities of audit committees to which reporting issuers must comply.

⁶⁰⁶ National Instrument 58-101 has been implemented in all Canadian provinces and territories. It requires reporting issuers to disclose their practices against a list of standards described in the instrument.

⁶⁰⁷ National Policy 58-201 has been implemented in all Canadian provinces and territories. It does not include mandatory rules. Instead, it suggests best practices that reporting are free to follow or not.

developed in this thesis, we would categorize them under the headings “independence” and “active monitoring”. Such amendment would not only be cosmetic. It would emphasize the importance of each of the two categories under which all practices should be sorted. Although the content of the Form 58-101F1 is generally good, its structure could certainly be improved.

Another preliminary comment, which will be mentioned a few times in this subsection II.C of the thesis, is that the requirements contained in Multilateral Instrument 52-110, concerning the composition and the responsibilities of the Audit Committee, should be included in Form 58-101F1 and in National Policy 58-201. There is no obvious reason for having a set of rules for the audit committee distinct from the rules and guidelines applicable to the board and other committees.

In the following subsections, we will review the rules of the CSA relating to the disclosure of independence practices. We will first analyse the current definition of independence and suggest improvements to be made thereto. We will then review the rules relating to the disclosure of board and committee composition and review the other rules regarding the disclosure of independence practices.

(a) Disclosure against a common definition of independence

In order to describe the independence practices of a board, a regulatory definition of independence is needed. It would be difficult to compare the level of independence of different corporations without a common definition. One could argue that such a definition would not be necessary if all relationships between a director and a corporation were disclosed, no matter if material or not, leaving it to the market to decide who should be considered independent. Such solution would not be totally satisfactory, for two reasons. First, it would deprive the market from the benefit of the assessment of the board. Because it is very difficult to assess the state of mind of a director, allowing the board to exercise its judgement in this matter (as opposed to simply listing the relations

between the director and the corporation) is helpful. In addition, by avoiding the dissemination of non-material information, the board performs an important task, that of reducing information overflow to shareholders.

The second reason why it would not be appropriate to disclose all relationships between a director and a corporation is the difficulty of defining what is a “relationship”. Indeed, without limiting the disclosure by using certain criteria or the judgement of the board, the disclosure could become endless and inconsistent. Without a common mindframe, some corporations could decide to disclose certain types of relations, such as bounds of familiarity, common backgrounds or common memberships between directors and management of the corporation, while others might not consider them as “relationships”.

The current model in force in Canada generally appears, in its approach, to be a good compromise as it allows boards to exercise their judgement while at the same time prescribing which relationships give rise to a presumption of non-independence.⁶⁰⁸ The next subsections will review the definition of independence provided in Instrument 52-110, National Instrument 58-101 and National Policy 58-201. We will then provide suggestions to improve the current definition in order to disclose additional relevant information to the market while at the same time keeping the board involved in determining which relationships affect independence.

(i) *The securities law definition of independence*

Subsection 1.2(1) of National Instrument 58-101 states that a director is independent if he or she qualifies as such within the meaning of section 1.4 of Multilateral Instrument 52-110. Section 1.4 of Multilateral Instrument 52-110 provides the following definition of independence:

⁶⁰⁸ The same approach is taken under section 303A(2) of the NYSE Company Manual.

1.4 Meaning of Independence

(1) An audit committee member is independent if he or she has no direct or indirect material relationship with the issuer.

(2) For the purposes of subsection (1), a “material relationship” is a relationship which could, in the view of the issuer’s board of directors, be reasonably expected to interfere with the exercise of a member’s independent judgement.

(3) Despite subsection (2), the following individuals are considered to have a material relationship with an issuer:

(a) an individual who is, or has been within the last three years, an employee or executive officer of the issuer;

(b) an individual whose immediate family member is, or has been within the last three years, an executive officer of the issuer;

(c) an individual who

(i) is a partner of a firm that is the issuer’s internal or external auditor,

(ii) is an employee of that firm, or

(iii) was within the last three years a partner or employee of that firm and personally worked on the issuer’s audit within that time;

(d) an individual whose spouse, minor child or stepchild, or child or stepchild who shares a home with the individual:

(i) is a partner of a firm that is the issuer’s internal or external auditor,

(ii) is an employee of that firm and participates in its audit, assurance or tax compliance (but not tax planning) practice, or

(iii) was within the last three years a partner or employee of that firm and personally worked on the issuer’s audit within that time;

(e) an individual who, or whose immediate family member, is or has been within the last three years, an executive officer of an entity if any of the issuer’s current executive officer serves or served at that time on the entity’s compensation committee; and

(f) an individual who received, or whose immediate family member who is employed as an executive officer of the issuer received, more than \$75,000 in direct compensation from the issuer during any 12 month period within the last three years.

(4) Despite subsection (3), an individual will not be considered to have a material relationship with the issuer solely because

(a) he or she had a relationship identified in subsection (3) if that relationship ended before March 30, 2004; or

(b) he or she had a relationship identified in subsection (3) by virtue of subsection (8) if that relationship ended before June 30, 2005.

(5) For the purposes of clauses (3)(c) and (3)(d), a partner does not include a fixed income partner whose interest in the firm that is the internal or external auditor is limited to the receipt of fixed amounts of compensation (including deferred compensation) for prior service with that firm if the compensation is not contingent in any way on continued service.

(6) For the purposes of clause (3)(f), direct compensation does not include:

(a) remuneration for acting as a member of the board of directors or of any board committee of the issuer, and

(b) the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer if the compensation is not contingent in any way on continued service.

(7) Despite subsection (3), an individual will not be considered to have a material relationship with the issuer solely because the individual or his or her immediate family member

(a) has previously acted as an interim chief executive officer of the issuer, or

(b) acts, or has previously acted, as a chair or vice-chair of the board of directors or any board committee of the issuer on a part-time basis.

(8) For the purpose of section 1.4, an issuer includes a subsidiary entity of the issuer and a parent of the issuer.

As we see, section 1.4(1) of Multilateral Instrument 52-110 allows the board to exercise its judgement as to the independence of a director, by stating a general independence principle according to which a director having a direct or indirect material relationship with the issuer will not be considered to be independent. Subsection 1.4(2) then defines what is a “material relationship” and subsection 1.4(3) describes certain

situations in which individuals will be presumed to have a material relationship with the corporation and therefore will not qualify as independent.

For the purposes of audit committees, section 1.5 of Multilateral Instrument 52-110 adds other criteria to be met by directors in order to be considered independent. Those criteria are to be considered by a board only when determining and disclosing the independence of audit members, not when determining the independence of directors in general or for the purposes of other committees:

1.5 Additional Independence Requirement

- (1) Despite any determination made under section 1.4, an individual who
 - (a) accepts, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or any subsidiary entity of the issuer, other than as remuneration for acting in his or her capacity as a member of the board of directors or any board committee, or as a part-time chair or vice-chair of the board or any board committee; or
 - (b) is an affiliated entity of the issuer or any of its subsidiary entities,is considered to have a material relationship with the issuer.
- (2) For the purposes of subsection (1), the indirect acceptance by an individual of any consulting, advisory or other compensatory fee includes acceptance of a fee by
 - (a) an individual's spouse, minor child or stepchild, or a child or stepchild who shares the individual's home; or
 - (b) an entity in which such individual is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary entity of the issuer.
- (3) For the purposes of subsection (1), compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer if the compensation is not contingent in any way on continued service.

To be clear, the provisions of sections 1.4 and 1.5 of Multilateral Instrument 52-110 are used to determine the independence of audit committee members whereas only section 1.4 is used to determine the independence of board members generally and of members of other committees.

(ii) Proposed improvements to the definition of independence

Many improvements could be made to the above mentioned definition of independence and to the requirement described in section 1(a) and (b) of Form 58-101 F1 pursuant to which the identity of independent and non-independent directors should be disclosed. First, unless justification can be found for having a distinct definition which applies to audit committees and for other purposes, the definition should be the same. This would reduce confusion. It could be argued that the stricter definition of independence should apply in all circumstances. However, that could mean that someone would not be considered independent because of non-material relationships. A better solution would be to allow the board, in all cases, to decide whether or not an individual is independent, while requiring the corporation to disclose any relationship described in both subsections 1.4 and 1.5 of Multilateral Instrument 52-110.

Section 1.4 of Multilateral Instrument 52-110 currently reduces, to an important extent, the involvement of the board in determining who should be qualified as independent, because under such provision certain individuals are “considered to have a material relationship with an issuer”. Instead, we would suggest that the board, whose members know best each individual, determine who is independent, subject to disclosure of all prescribed relationships. This suggestion would achieve two objectives. It would (i) provide meaningful information to investors as to the relationships between board members and the corporation, and (ii) allow the public to benefit from the opinion of the board on the materiality of such relationships. At the same time, this approach would

allow shareholders to question the board, at the annual meeting, on its characterizations of independent board members.⁶⁰⁹

In a system where disclosure of prescribed relationships would be mandatory, the factors currently triggering the non-independence presumption under current subsection 1.4(3) of Multilateral Instrument 52-110 would have to be disclosed. In addition, other factors should be the object of mandatory disclosure. In order to assist investors in making their own determination as to the right level of independence on a board, it seems that when amounts above a certain threshold are paid to individuals or to an organization with which a director is related, including, for instance, a charitable organization in which the director is involved, the fact that such payment was made should be disclosed.⁶¹⁰ Side payments need not be paid directly to a director to impair his or her independence. “Soft conflicts”, such as charitable contributions to a not-for-profit organization with which a director has a strong affiliation may also impact on his or her independent judgement.⁶¹¹ The effect of such contributions on a director’s independence should thus be assessed by the board of the corporation and the fact that the corporation has contributed to such charitable organizations should be disclosed.⁶¹²

Decisions of U.S. courts have found that certain relationships between an outside director and a corporation did not legally compromise independence. For example, US\$ 50,000 consulting fees paid to a director did not raise reasonable doubts on a director’s independence in one case.⁶¹³ However, decisions of this nature have not gone uncriticized.⁶¹⁴ Some have even argued that important director fees received by someone

⁶⁰⁹ See the definition of “affiliated entity” provided in subsection 1.3 of Multilateral Instrument 52-110, attached as Appendix A to this thesis.

⁶¹⁰ Subsection 1.4(3)(f) of Multilateral Instrument 52-110 states that individuals are considered to have a material relationship with an issuer if the individual or one of his/her immediate family member who is employed as an executive officer of the issuer received more than \$75,000 in director compensation in any 12 month period within the last three years. The amount of \$75,000 could also be chosen as the threshold for contributions to charitable and other organizations to which the director is related. Amounts are, inevitably, arbitrary.

⁶¹¹ Gordon, J.N., *supra* note 336, at 12; and Veasey, E.N., *supra* note 79, at 405.

⁶¹² The Business Roundtable, *supra* note 247, at 11.

⁶¹³ *In Re the Walt Disney Company Derivative Litigation*, *supra* note 324, at 360.

⁶¹⁴ Strine, L.E., *supra* note 61, at 1378.

who is not as wealthy as his or her fellow directors could compromise the independence of such person since the director's sharp questioning of senior management may lead to subtle (or not so subtle) pressures against his or her re-nomination.⁶¹⁵

In addition to relationships resulting from the fees paid directly or indirectly to directors or to organizations with which a director is related, market participants should also be aware of certain other ties that exist between the corporation and its directors. Certain boards of directors might qualify their members as independent even though their independence is compromised by subtle factors such as bonds of previous service with the corporation.⁶¹⁶ In order to assess the independence of a director, investors should be informed of any former employment relationship between the director and the corporation. Currently, such relationship does not have to be disclosed and is not deemed to affect independence if it ended more than three years ago.⁶¹⁷

Finally, relationships between a director and a significant shareholder should be disclosed.⁶¹⁸ Even though a board could decide that such relationship does not preclude a director to be considered independent, disclosure of such relationships would assist shareholders to better understand the dynamics of the board and to assess potential risks of intershareholder opportunism.

Before a board determines that a director is independent, the board should be convinced that the loyalty of the director toward the corporation and all of its shareholders will in all cases be unaffected by his or her relationships with management or a significant shareholder of the corporation. Directors who are truly independent should be sensitive to appearances.⁶¹⁹ Hence, a retired executive of a corporation can be a very valuable director, but in many cases should not be considered independent of the corporation. Even if the executive has left the corporation for long enough to be

⁶¹⁵ Gordon, J.N., "The Mandatory Structure of Corporate Law" (1989) 89 Colum. L. Rev. 1549, at 12.

⁶¹⁶ That was the case for the Board of Directors of Enron. See Gordon, J.N., *supra* note 336, at 11.

⁶¹⁷ See subsection 1.4(3)(a) of Multilateral Instrument 52-110.

⁶¹⁸ See Caisse de dépôt et placement du Québec, *supra* note 362, at 3.

⁶¹⁹ American Bar Association, Section of Business Law, "Corporate Director's Guidebook – Third Edition" (2001) 56 Bus. Law. 1571, at 1590.

considered independent under the current rules, he or she may have prior experiences and ties that may affect his or her decisions. Of course, it is precisely these experiences that may make him or her very valuable.⁶²⁰ In such a case, the board may want to benefit from his or her presence, but should consider and disclose his or her previous link with the corporation.

Hence, the mandatory definition of independence should be relaxed, in that factors described in the current subsection 1.4(3) of Multilateral Instrument 52-110 should no longer be presumptions of non-independence but items to be disclosed. In addition, other elements that may have an influence on the status of the director, such as the fact that monetary contribution above a certain level are made to an individual or any organization with which such individual is associated, as well as any past employment or consulting relationship between the director and the corporation, should have to be disclosed. Cases such as Enron have shown that directors who are considered independent according to rules and presumptions of securities regulators might nevertheless have relationships with corporations that affect their judgement.⁶²¹ Those relationships should be disclosed in order to allow investors to better assess the potential for self-interested conduct. As explained in subsection II.B.3(a) of this thesis, additional disclosure would allow investors to better evaluate the risks associated with a particular investment and to price the stock of the corporation accordingly.

(b) Disclosure related to the composition of the board

Section 1(a) and (b) of Form 58-101F1 require that the identity of independent and non-independent directors as well as the basis for determining that a director is not independent, be disclosed, and section 1(c) requires disclosure of whether or not a majority of directors are independent. Subject to the recommendations made in the previous subsection related to the definition of independence and the additional items to

⁶²⁰ Institute of Corporate Directors, *supra* note 343, at 20.

⁶²¹ Gordon, J.N., *supra*, note 2, at 11; Strine, L.E., *supra* note 61, at 1379.

be disclosed, we agree with such approach, since it provides investors with information to assess the independence of the board.

(c) Disclosure related to the composition of board committees

With respect to board committees, section 2 of Form 52-110F1 requires the corporation to disclose the names of the audit committee members and state if they are independent.⁶²² Sections 6(b) and 7(b) of Form 58-101F1 require the same disclosure with respect to the nominating and the compensation committees. We submit that it could be useful for an investor to know the composition of other board committees as well and that a requirement related thereto should be part of Form 58-101F1.⁶²³ In cases where the board appoints special committees to review certain transactions or to take certain decisions that are important for the future of the corporation, the disclosure of the existence and composition of such committees would be particularly interesting.

(d) Disclosure of other independence practices

In addition to the requirements relating to the identification of directors who are independent and those who are not, section 1 of Form 58-101F1 requires issuers to disclose other items related to board independence. The following subsections will review these requirements and propose other elements of information which could be useful to investors.

⁶²² As discussed below, audit committees must be composed solely of independent directors under Multilateral Instrument 52-110.

⁶²³ See Canadian Coalition for Good Governance, *supra* note 362, at 15.

(i) General board practices which facilitate the exercise of independent judgement

Section 1(c) of Form 58-101F1 states that: “If a majority of directors are not independent, describe what the board of directors [...] does to facilitate its exercise of independent judgement in carrying out its responsibilities.” Similarly, sections 6(b) and 7(b) of Form 58-101F1 require the disclosure of the steps the board takes to encourage an objective nomination process, if the nominating committee is not composed solely of independent directors, and the steps it takes to ensure an objective process for determining the compensation of the issuer’s directors and officers, if the compensation committee is not composed solely of independent directors.⁶²⁴

As mentioned in subsection II.A of this thesis, electing independent directors is only the first step toward the obtaining of an independent board. Other independence practices are also paramount in obtaining the required level of independence. The same principle applies to board committees. Hence, sections 1(c), 6(b) and 7(b) of Form 58-101F1 should not only require that disclosure of general independence practices be made in cases where a majority of directors are not independent. It should require such disclosure in all cases.⁶²⁵

Furthermore, sections 6(b) and 7(b) currently restrict disclosure of independence practices to certain tasks performed by the nominating and the compensation committees, for which such independence practices are considered an advantage. However, other responsibilities would also benefit from independence practices. In the next subsection of this thesis, many other tasks are described as “sensitive”, in that conflicts are likely to exist between the interests of the corporation, on the one hand, and those of directors or management of the corporation, on the other hand. The presence of independent

⁶²⁴ Please note that as mentioned in subsection II.C.4 of this thesis, it may be more appropriate that the compensation of directors be reviewed by the committee responsible for directors’ evaluation, which is often the nominating committee.

⁶²⁵ See Canadian Coalition for Good Governance, *supra* note 362, at 21.

directors and the existence of other independence practices would be an advantage in discharging these tasks. In order to allow investors to assess the risks of misappropriation or mismanagement with respect to those sensitive areas, disclosure of all independence practices should be mandatory.

(ii) Specific independence practices

In addition to a general requirement to disclose independence practices, issuers should be required to disclose if they have adopted certain practices that in our opinion are particularly important to enhance and maintain an appropriate level of independence. Hence, they should disclose: (i) whether *in camera* meetings of independent directors are held, (ii) if the corporation has adopted policies for identifying and discouraging conflicts of interest, (iii) if the board chair is independent, and (iv) the power of the board and its committees to hire independent advisors.⁶²⁶ The current rules of the CSA already require certain elements of disclosure related to those practices but these rules could be improved. The next subsections will review existing rules in that area and suggest ways to make them more effective.

(1) *In camera* meetings

Section 1(e) of Form 58-101F1 requires disclosure of “whether or not the independent directors hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance” (in this thesis, these meetings are referred to as “*in camera*” meetings). It also requires issuers to disclose the number of such meetings held in the past year. Section 1(e) should be amended to also include a disclosure requirement regarding whether or not committees hold such meetings and the number of such meetings held in the past year. Indeed, many sensitive topics may be discussed by committees, and open and candid discussion may be

⁶²⁶ The importance of those practices is analysed in subsection II.A.1(b) of this thesis

facilitated if management and non-independent directors are not present. Examples of sensitive issues discussed by committees include:

With respect to audit committee matters:

- Reviewing with the external auditors any audit problems or difficulties and management's response thereto;
- Discussing disagreements between management and the external auditors regarding accounting, financial reporting, internal controls, disclosure controls and procedures, risk assessment and compliance with applicable legal and regulatory requirements;
- Discussing complaints or concerns received by the corporation regarding accounting or auditing matters;
- Reviewing the internal audit program, its scope and capacity to ensure the effectiveness of the systems of internal control and reporting accuracy;
- Reviewing any relationships and services provided by the external auditors that may impact on their objectivity and independence; and
- Determining which non-audit services the external auditors are prohibited from providing.

With respect to nominating and corporate governance committee matters:

- Developing and reviewing criteria for selecting directors and identifying candidates to become board members;
- Proposing board committee membership; and

- Identifying corporate decisions requiring approval of the board.

With respect to compensation and human resources committee matters:

- Ensuring that appropriate processes are in place regarding succession planning for members of senior management;
- Recommending to the board senior management appointments and the terms and conditions of their appointment and retirement or termination;
- Reviewing the evaluation of senior managers' performance and recommending to the board their compensation; and
- Making recommendations to the board with respect to incentive-compensation plans, including equity-based plans.

These are only a few reasons why committees should hold meetings that are not attended by managers and why disclosure on the nature and frequency of such meetings would assist investors in assessing the independence practices of the board. As it will be explained below, instead of requiring that board committees be composed exclusively of independent directors and allowing management to be present when committee members meet, the requirement should instead focus on the disclosure of "*in camera*" meetings.

(2) Policies for identifying and discouraging conflicts of interest

Subsections 5(b) and (c) of Form 58-101F1 require corporations to disclose any steps the board takes to ensure that directors exercise independent judgement in cases of conflicts of interests. We would add a requirement to disclose any steps the board takes to identify and discourage conflicts of interests.⁶²⁷ As explained in subsection II.A.1(b) of this thesis, because the duty of loyalty does not in itself include mechanisms to detect

⁶²⁷ See Canadian Coalition for Good Governance, *supra* note 362, at 21.

potential conflicts of interest and because problems related to the enforcement of the duty of loyalty may decrease its dissuasive effect on wrongdoers, independence prophylactic measures should be put in place to complement the duty of loyalty. As will be demonstrated in subsection II.C.2 of this thesis below, policies aiming at identifying and discouraging such conflicts can be considered important independence practices.

National Instrument 58-101 already requires that codes of ethics be disclosed by corporations. This instrument should be amended to require that disclosure be also made with respect to any stand-alone policy aiming at identifying or discouraging conflicts of interests.

(3) Independent chair

Section 1(f) of Form 58-101F1 requires issuers to disclose whether or not the board has an independent chair or lead director. As discussed in subsection II.A of this thesis, the presence of an independent chair or lead director is often an excellent tool to encourage independence. Such disclosure requirement should be maintained. For the same reasons, it would also be useful to disclose if committee chairs are independent as well.

(4) Availability of independent advisors

Section 1 of Form 58-101F1 should be amended to require issuers to disclose if the board and its committees have access to independent advisors. Such access is often a good way to obtain a disinterested opinion on transactions in which certain directors and members of management are interested.⁶²⁸ The existence of such a right of access could

⁶²⁸ See section II.A.1(b) of this thesis.

provide an interesting benchmark on the real autonomy of the board and on its ability to obtain the required tools to challenge management if there is a need to do so.⁶²⁹

Subsection 7(d) of National Instrument 58-101 requires the disclosure of the name and mandate of consultants retained to assist the board in determining the compensation of directors and management. In order to provide an idea as to the level of independence of such consultants, fees paid to them should be disclosed. Ideally, fees paid for compensation services should be disclosed separately from the other fees paid to such consultants.⁶³⁰ This last suggestion is inspired from what is required by section 9 of Form 52-110F1 with respect to fees paid to external auditors. In the same way that external auditors who perform many services other than audit services could be the subject of subtle (or not so subtle) threats by management to take-away those other services if management is not pleased by auditing, the compensation consultants who perform pension or recruitment services could certainly be or be viewed as less objective if their mandates related to other matters are more profitable than those related to their compensation services. The disclosure of the proportion of fees related to compensation versus other fees paid to them would help investors to assess the potential influence of management over such consultants and thus the potential for bias in the advice to the board, which could result in higher agency costs.

2. VOLUNTARY BOARD PRACTICES RELATED TO INDEPENDENCE

Because many Canadian corporations aim at complying with all guidelines contained in National Policy 58-201,⁶³¹ the content of such instrument, although not mandatory, is very important. In this subsection and in subsection II.C.4 of this thesis, improvements, derived from empirical research, principles developed in this thesis and the suggestions of market participants, will be proposed to National Policy 58-201. The

⁶²⁹ See Canadian Coalition for Good Governance, *supra* note 362, at 13.

⁶³⁰ See the suggestion of The Globe & Mail, *supra* note 599, item 23

⁶³¹ See for instance the disclosure included on page 40 of the management proxy circular of the Canadian National Railway Company, available on sedar at: www.sedar.com (date accessed: March 3, 2007).

rationale behind existing guidelines described therein will also be questioned where appropriate.

With respect to the general layout of National Policy 58-201, taking into account our proposed categorization of corporate governance practices, we would suggest that Part 2 be renamed “Independence” and that the current sections 3.1 to 3.3 of the policy, which relate to the composition of the board and meetings of independent directors, be transferred in it. As for Part 3 of National Policy 58-201, it would be more appropriate to rename it “Active Monitoring”. This subsection of the thesis will focus on current Part 2 of National Policy 58-101, while subsection II.C.4 of this thesis will focus more on Part 3 thereof.

(a) Composition of the board

(i) *In widely held corporations*

Section 3.1 of National Policy 58-201 recommends that “The board should have a majority of independent directors”. As described in subsection II.A.1(d) of this thesis, many recent empirical studies acknowledge the merits of having independent directors on a board. However, it seems difficult to establish a positive correlation between having a majority of independent directors and better corporate performance. In addition, a super majority of independent directors on a board (*i.e.*, having only a few non independent directors) seems to be negatively correlated with increased performance.

Taking into account the advantages of independence practices described in this thesis, we strongly believe that having a majority of independent directors on a board should generally be beneficial to a corporation. If it does not have a major impact on corporate performance, it will at least create a dynamics which will empower the board, allowing directors to reduce agency costs⁶³² and helping them in the discharge of their

⁶³² See subsection II.A.1(b) of this thesis.

fiduciary duties.⁶³³ That being stated, it is not possible to infer that having a majority of directors on a board will be beneficial for all corporations, all of the time, and it seems impossible to infer from current research the optimal proportion of independent directors for any particular corporation. There are just too many factors to be considered and the specific impact of different independence practices on the performance of a corporation is too difficult to measure.

In order to avoid the potential costs of imposing rules that are not efficient, as described in subsection II.B of this thesis, directors should generally be free to recommend to shareholders the best individuals to serve on the board and rules should not preclude them from doing so. If having independent directors on a board is a good way to promote independence, it is not the only way to do so and imposing a majority of independent directors should be weighed against the potential costs of losing board members who may contribute through their experience or otherwise.

Section 102(2) of the *CBCA* already ensures the presence of unrelated directors. It states that the board of directors of a corporation may be composed of one or more directors, but if the corporation has offered securities to the public, the board must be composed of at least three directors, at least two of whom are not officers or employees of the corporation or its affiliates.⁶³⁴ The federal legislator should think of changing that definition, in order to come closer to the definition of independence described in the previous subsection of this thesis. As we have seen throughout this thesis, many factors may preclude a board from acting independently, only one of which is being an employee or officer of the corporation. Section 102(2) of the *CBCA* should take into account other factors that increase the control or influence of management or of a significant shareholder over the board of directors.

One may question the rationale for having a mandatory requirement such as section 102(2) of the *CBCA*. However, as explained above, both theoretical and

⁶³³ See subsection II.A.1(c) of this thesis.

⁶³⁴ Sutherland, H., note 17, at 383; and Welling, B., *supra* note 122, at 310 and 311.

empirical reasons call for having a minimum number of independent directors on the board. It is only when the level of independent directors exceeds the majority of directors that the cost/benefit analysis may be less persuasive. In addition, it must be realized that having a minimum number of independent directors is a prerequisite for other independence practices (for instance it is impossible to have an independent chair or “*in camera*” meetings without at least a few independent members). Without a minimum number of independent directors, prophylactic and curative measures based on independence could not be put in place, which may increase agency costs and the chance of potential breaches by directors to their fiduciary duties.

In short, we would not suggest any change to the current recommendation of the CSA with respect to a majority of independent directors on a board.

(ii) *The special case of controlled corporations*

The question of board independence requires special consideration when it relates to corporations controlled by a significant shareholder. In such a case, the significant shareholder may have a considerable influence on the actions of the board of directors. Where a significant shareholder owns an important fraction of the equity of a corporation (and thus incurs costs because of the non-diversification of his or her assets) and exercises control over agency costs, it may seem legitimate and beneficial that such a shareholder choose a majority of directors, who may come from his or her relatives, friends or business associates. On the other hand, however, if the significant shareholder controls the board, that may cause opportunities for misappropriation in the shareholder's favour.

It has been suggested that one way to resolve the dilemma between the importance of independent directors and the right of significant shareholders to elect whoever they want, is to ensure that the number of directors who are not related to the corporation, senior management or the significant shareholder, always reflects the

proportion of equity held by shareholders, other than the significant shareholder, in the corporation.⁶³⁵ This solution could be acceptable from a legitimacy point of view since it respects the right of owners to appoint representatives in proportion of their shareholding in the corporation, while at the same time recognizing the importance of minority holders. Hence, in a corporation with many classes of voting shares, some of which may be multi-voting and others subordinate, the number of seats to be allocated to the significant shareholder would be calculated as a proportion of its equity ownership as opposed to its voting power. This solution, however, would be difficult to implement considering that ownership changes over time.

A better solution would be to amend the definition of independence described in previous subsections of this thesis so that the board takes into account the relationships between a director and the significant shareholder of a corporation when considering if the director is independent from the corporation. Hence, an individual related to the significant shareholder could still be considered independent by the board of directors of the corporation but any relationship with the significant shareholder would have to be disclosed. As in the case of widely held corporations, having directors that are not related to the significant shareholder seems essential to allow the board to put in place independence practices.⁶³⁶ These practices are particularly important, in the case of a controlled corporation, as they act as safeguards to prevent intershareholder opportunism.⁶³⁷

We would thus recommend that the relationship with significant shareholders be taken into account when considering which directors are independent. Otherwise, we would not suggest other changes to section 3.1 of National Instrument 58-201.

⁶³⁵ Joint Committee on Corporate Governance, *supra* note 6, at 24; and Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 25 and 26.

⁶³⁶ See Caisse de dépôt et placement du Québec, *supra* note 362, at 3.

⁶³⁷ Roe, M.J., *supra* note 42, at 6.

(b) Composition of board committees

One of the major features of an active monitoring board is the existence of committees that perform crucial monitoring functions.⁶³⁸ The most common committees are the audit, the nominating and the compensation committees.⁶³⁹ As mentioned above, sensitive matters dealt with by those committees require a certain level of independence. However, as we will see below, the number of independent directors on committees should not be imposed by law but should instead be left to the discretion of corporate boards.

(i) Independence of the audit committee

In September 1998, Arthur Levitt, who was Chairman of the SEC at the time, highlighted the importance of independent audit committees, stating that “qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest”.⁶⁴⁰

In Canada, subsection 171(1) of the *CBCA* stipulates that the audit committee should comprise a majority of directors who are neither officers nor employees of the corporation or its affiliates. This requirement stems from a recommendation of a 1988 Commission which reported to The Canadian Institute of Chartered Accountants with suggestions for improving the role of auditors and the flow of financial information to directors and shareholders of Canadian public corporations. The report of the Commission recommended that all public corporations be required by law to have an audit committee composed entirely of independent directors.⁶⁴¹

⁶³⁸ Gordon, J.N., *supra* note 2, at 11.

⁶³⁹ Those are the only committees mentioned in Multilateral Instrument 52-110 and National Policy 58-201, in Canada, and in section 303A of the NYSE Company Manual, in the U.S.

⁶⁴⁰ Gordon, J.N., *supra* note 2, at 11

⁶⁴¹ Canadian Institute of Chartered Accountants, *Report of the Commission to Study the Public's Expectations of Audits* (Toronto, CICA, 1988); referred to in Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 15.

Under Multilateral Instrument 52-110, all members of the audit committee must now be independent. In accordance with the framework described in subsection II.B of this thesis and current empirical research described in subsection II.A.1(d) of the thesis, it is argued that the composition of the audit committee should be decided by the board of directors, which at the end will be responsible for the discharge of the responsibilities delegated to such committee.

Of course, having committees composed solely of independent directors is a practice that would help to insulate directors from the influence of management. However, there might be good reasons why an audit committee member should be selected among the non-independent directors. For instance, such person may be the most competent or experienced with respect to accounting and auditing matters. In such a case, the board should be free to choose that candidate to sit on the audit committee. One may argue that the presence of even one non-independent director on the audit committee could be enough to prevent thorough investigations of management decisions. However, in most cases, other safeguards could help protect the independence of the committee. For instance, *in camera* meetings, regularly scheduled, may allow independent members of the committee to discuss sensitive issues without the presence of non independent directors and members of management. In fact, *in camera* meetings are arguably much more important than having a committee composed solely of independent directors if members of management typically attend committee meetings as “guests”.

As mentioned in the empirical studies described in subsection II.A.1(d) of this thesis, there is no strong evidence that an audit committee composed only of independent directors will enhance corporate performance or create more value for shareholders. Until such correlation is established, directors should be free to determine the composition of the audit committee and be ready to assume the consequences of their decisions in the case of a claim asserting that they have breached their fiduciary duties. In practice, that means that Multilateral Instrument 52-110 should be amended to remove

the obligation that the audit committee be composed solely of independent directors, subject to disclosing which members are not independent.

(ii) Independence of the nominating committee

Turning to the composition of other committees of the board, subsection 3.10 of National Policy 58-201 recommends that nominating committees be composed entirely of independent directors.⁶⁴² Since that policy only constitutes a guideline, boards are free to decide what should be the optimal composition of the committee, depending on the strengths and weaknesses of each board member. In all cases, the composition of the nominating committee must be disclosed in the proxy circular pursuant to section 6(b) of Form 58-101F1.

Some authors have found a positive correlation between the use of a nominating committee and the independence of the board of directors.⁶⁴³ It was argued that in practice, the existence of such a committee assists independent directors in removing from the chief executive officer the power to choose board members. Altering the appointment process to have independent directors nominated exclusively by other independent directors was found to help in severing the ties that bind directors to management.⁶⁴⁴ Just like a virtuous ascending spiral, the board and its committees should select truly independent directors, who will promote and maintain a climate of independence, which will foster more independence.⁶⁴⁵

As will be explained further in subsection II.C.4 of this thesis, the nominating committee should be involved in the evaluation of the board, its committees, board and

⁶⁴² National Policy 58-201 constitutes guidelines and therefore is not mandatory while subsection 303A(4)(a) of the NYSE Company Manual is not mandatory for Foreign Private Issuers, including Canadian corporations listed on the NYSE, subject to applicable disclosure.

⁶⁴³ Bender, M., *supra* note 17, at 1-20.

⁶⁴⁴ Brudney, V., "The Independent Director – Heavenly City or Potemkin Village?" (1982) 95 Harv. L. Rev. 597, at 621.

⁶⁴⁵ Ontario Teachers' Pension Plan, *supra* note 362, at 10; and Caisse de dépôt et placement du Québec, *supra* note 362, at 3.

committee chairs and individual directors. In order to be credible, boards must ensure that director nomination and evaluation processes are independent of management's influence or authority.⁶⁴⁶

In light of the foregoing, having a nominating committee composed solely of independent directors may be a best practice and the benefits of having only independent directors on the committee should be considered carefully by the board before appointing a non-independent director. The provisions of National Policy 58-201 related to the independence of such committee should thus be maintained as guidelines. Just like for audit committees, there would however be disadvantages in requiring that a nominating committee be composed entirely of independent members. For instance, a non-independent board member could be an expert in governance or have significant experience in the evaluation or remuneration of board members and therefore be the most qualified person to serve on the committee. A requirement to have independent members only should not be imposed unless the benefits of that measure have clearly been established. As seen above, there are other ways to ensure the independence of a committee. Although the nominating and corporate governance committee is often considered as the appropriate committee to perform certain tasks for which independent members would be an advantage,⁶⁴⁷ such tasks can also be delegated to other committees, which could be composed solely of independent directors, such as the compensation and human resources committee.⁶⁴⁸ In such a case, of course, investors should be informed of the composition and responsibilities of each committee through the mandatory disclosure described in subsection II.C.1(c) and II.C.3(a) of this thesis.

⁶⁴⁶ National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Director Professionalism* (Washington: National Association of Corporate Directors, 1996), at 16.

⁶⁴⁷ The Business Roundtable, *supra* note 247, at 17.

⁶⁴⁸ See subsection 303A(4) of the NYSE Company Manual.

(iii) Independence of the compensation committee

Subsection 3.15 of National Policy 58-201 states that the compensation committee should also be composed entirely of independent directors.⁶⁴⁹ The composition of the compensation committee has been the topic of much attention due in great part to the fact that this committee is usually responsible for determining the remuneration of senior management.⁶⁵⁰

The benefits of having a compensation committee composed only of independent directors have been contested. As found by Professors Bhagat and Black, there is little evidence that independent directors could do a better job than inside directors in establishing chief executive officer compensation.⁶⁵¹ After all, chief executive officer compensation “exploded over the same period during which independent directors became dominant on large firm boards – a trend that has continued despite the recent trend toward supermajority-independent boards and independent compensation committees”.⁶⁵² Such increases in chief executive officer compensation may well be the consequence of what has been called the “managerial power effect”, which can be defined as the ability of executives to influence their own compensation schemes. According to this concept, compensation arrangements approved by boards often deviate from optimal contracting because directors are captive of or subject to the influence of management, sympathetic to management or simply ineffectual in overseeing compensation. As a result, executives can receive pay in excess of the level that would be optimal for shareholders.⁶⁵³

⁶⁴⁹ Multilateral Policy 58-201 constitutes guidelines and therefore is not mandatory while subsection 303A(4)(a) of the NYSE Company Manual is not mandatory for Foreign Private Issuers, including Canadian corporations listed on the NYSE, subject to applicable disclosure. See Canadian Coalition for Good Governance, *supra* note 362, at 19.

⁶⁵⁰ Ontario Teachers' Pension Plan, *supra* note 362, at 14; and Caisse de dépôt et placement du Québec, *supra* note 362, at 3.

⁶⁵¹ Bhagat, S. & Black, B., *supra* note 390, at 12 and 13.

⁶⁵² *Ibid.*, at 4.

⁶⁵³ Bebchuk, L.A., Fried, J.M. & Walker, D.I., *supra* note 102, at 753.

Even if the approval of executive compensation was under the responsibility of a committee composed solely of independent directors, several reasons would exist to be skeptical that the process of setting executive compensation would approximate the arm's length ideal.⁶⁵⁴ Management influence, board dynamics and information disparities between management and the board of directors are only a few of these reasons.⁶⁵⁵ However, an argument can be made that the appropriate answer to such skepticism is further independence.

As described in subsection II.A.2(c)(ii) of this thesis when reviewing the Repap decision, the use of an independent committee, which can hire independent advisors, has been endorsed by the courts as a reasonable way to determine fair compensation for the chief executive officer. The answer to the influence of management in the compensation process is perhaps to add other independence practices to the process. For instance, *in camera* meetings of independent members of the committee and access by committee members to compensation advisors that are selected and paid by the committee and have no relationships with the corporation could help reduce the influence of management over their compensation.⁶⁵⁶

In order to help investors assess the benefits of such additional independence measures, disclosure of same is essential. As suggested in subsection II.C.1(d) of this thesis, disclosure of general and specific independence practices should thus be mandatory.

(iv) Special committees

In certain circumstances, boards of directors may form special committees composed solely of independent directors to deal with particular situations. National Policy 58-201 should be amended to recognize and encourage such practice. Special

⁶⁵⁴ *Ibid.*, at 766.

⁶⁵⁵ *Ibid.*, at 766 to 774.

⁶⁵⁶ Ontario Teachers' Pension Plan, *supra* note 362, at 14.

committees are most commonly established for the purpose of reviewing certain types of transactions that raise issues of real or apparent conflicts of interest.⁶⁵⁷ Resorting to independent committees may help alleviate such conflicts.⁶⁵⁸ This approach was endorsed by the Ontario Court of Appeal in *Maple Leaf Foods Inc. v. Schneider Corp.*,⁶⁵⁹ a case in which a special committee was created to advise the board of a target corporation in the context of a takeover bid:

A common method used to alleviate concerns that a conflict of interest exists between directors, who may be major shareholders, and the interests of a minority or non-voting group of shareholders, is the creation of a special committee from among the independent members of a board who do not have a conflict. The purpose of a special committee is to advise the directors and to make a recommendation as to what the Board should do. It appears that under the law of Delaware, where a Board acts on the recommendation of a special committee, the decision will be accorded respect under the business judgement rule, provided that the special committee has discharged its role independently, in good faith, and with the understanding that in a situation where a change of control transaction is contemplated, the special committee can only agree to a transaction that is fair in the sense of being the best available in the circumstances [...]⁶⁶⁰

As stated by the Court, a special committee is a procedural device used to ensure the fair treatment of shareholders, to assist a board of directors in discharging its fiduciary duties of loyalty and care and to make transactions less vulnerable to legal attack by disgruntled shareholders and others. A special committee is also intended to ensure that the interests of minority shareholders are not unfairly disregarded:

The *raison d'être* of a special committee independent of management and the controlling shareholder is to protect the interests of minority shareholders and to bring a measure of objectivity to the assessment of bids [...] the appointment of a special committee is intended to ensure that the interests of those the oppression remedy is intended to protect are not unfairly disregarded or prejudiced. It is clearly in the interests of a

⁶⁵⁷ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 187, at par. 117.

⁶⁵⁸ *Westfair Foods v. Watt*, (1990) 48 B.L.R. 43, at 72.

⁶⁵⁹ *Supra* note 263.

⁶⁶⁰ *Ibid.*, at 192.

corporation, and of all shareholders, for alternatives to an unsolicited takeover offer to be explored. It might give the shareholders a higher price for their shares. The creation of a special committee was part of a process undertaken by the Board to obtain the best transaction available in the circumstances.⁶⁶¹

National Policy 58-201 should therefore be amended to encourage the use of such committees and National Instrument 58-101 should include a requirement to disclose such use by boards of directors.

(c) Other independence practices

The presence of a majority of independent directors on a board of directors, as well as committees composed entirely of independent members, are the traditional ways of installing a climate of creative tension between the board and management. However, these methods should be complemented by other practices such as the adoption of additional independence criteria, policies for identifying conflicts of interest, policies for discouraging such conflicts, the presence of an independent chair and the use of independent advisors. Subsection II.C.1 of this thesis explained the importance of disclosing such practices. This subsection will now review their intrinsic benefits.

(i) Additional independence criteria

As mentioned in subsection II.A of this thesis, the adoption, by a board, of a definition of independence which includes criteria that are more demanding than the regulatory definition, allows the board to determine, in advance, the potential reasons for considering an individual as being not independent. The main advantages of such criteria are that they permit adjustments to the particular circumstances of each corporation and ensure that certain factors which could have an impact on the independence of board members are considered.

⁶⁶¹*Ibid.*, at 195 and 198.

As previously stated in this thesis, independence criteria should always take into account the regulatory definition of independence against which disclosure will have to be made. It would be confusing for a board to adopt a totally different set of factors that preclude independence. As a best practice, boards should adopt additional criteria relevant to their particular circumstances. National Policy 58-201 should thus be amended to mention the adoption of additional independence criteria particular to each corporation as a corporate governance guideline.

(ii) Policies related to the identification of conflicts of interests

As mentioned in subsection II.A of this thesis, policies for identifying conflicts of interest may assist in putting in place a climate of independence. In order to identify potential situations of conflicts of interest and ensure that these situations are disclosed in accordance with corporate laws, corporations should require directors to provide information about their affiliations at least annually.⁶⁶²

Such measures might include the circulation of conflict of interest questionnaires, which could be sent to directors at the same time as questionnaires requiring the information necessary to prepare a corporation's management proxy circular. In addition, if during the course of the year the corporation is involved in a significant transaction, it should specifically inquire as to the existence of any interest, by any director, in the transaction.⁶⁶³ Examples of such policies should thus be described in National Policy 58-201 and issuers should be encouraged to adopt them.

(iii) Policies discouraging conflicts of interest

To complement policies for identifying conflicts of interest, corporate boards should adopt policies that discourage such conflicts. All corporations should have

⁶⁶² Priest, M. & Nathan, H.R., *supra* note 3, at 198.

⁶⁶³ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 3, at 42.

policies and guidelines to protect their assets and restrict access to, and disclosure of, material non-public information.⁶⁶⁴ Such policies do not have to be adopted on a stand alone basis. They can be part of the code of business conduct which applies to directors and management. However, directors and management must be informed, in all cases, of the consequences of an act of misappropriation and of the seriousness with which the board will enforce any right of the corporation in connection therewith.

Conflict of interest policies have a paramount importance in corporations controlled by a significant shareholder. Indeed, in addition to reminding directors of their fiduciary duties, they can set high standards to ensure that directors are free from any undue influence of the controlling shareholder. The adoption of such policy will provide comfort to minority shareholders and guidance to directors. They are particularly important in Canada, where many corporations are controlled by significant shareholders⁶⁶⁵ and where investors might potentially discount the value of the shares of such corporations in order to account for the risk of self-interested conduct by the controlling shareholder.

National Policy 58-201 already refers to codes of ethics. Such policy should be amended to describe other policies discouraging conflicts of interests.

(iv) Independent board chair

It has been suggested that one of the principal measures of independence within a corporation is whether or not the chair of the board is also a member of management.⁶⁶⁶ In December 1994, the Dey Report recognized that a board chair who is not a member of

⁶⁶⁴ Bender, M., *supra* note 17, at 17-36.

⁶⁶⁵ See Parizeau, R. *supra* note 362.

⁶⁶⁶ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 41; See also Canadian Coalition for Good Governance, *supra* note 362, at 12; Ontario Teachers' Pension Plan, *supra* note 362, at 18; and See Caisse de dépôt et placement du Québec, *supra* note 362, at 4.

management was a good way to ensure that the board of a corporation could function independently of management:

We propose as our next guideline that every board should have in place appropriate structures and procedures to ensure that the board can function independently of management. An appropriate structure would be to (i) appoint a chair of the board who is not a member of management with responsibility to ensure that the board discharges its responsibilities or (ii) adopt alternate means such as assigning this responsibility to a committee of the board, such as the governance committee, or to a director, sometimes referred to as the “lead director”. The chair, or the committee or other director assigned the responsibility, is responsible for managing the process of the board and for ensuring that the board discharges the responsibilities we have previously defined for it. Appropriate procedures may involve the board meeting on a regular basis without management present or may involve expressly assigning the responsibility for administering the board’s relationship to management to a committee of the board.⁶⁶⁷

This recommendation was adopted by the TSX as part of the former TSX Guidelines and, subsequently, the CSA adopted subsection 3.2 of National Policy 58-201, which now states that:

The chair of the board should be an independent director. Where this is not appropriate, an independent director should be appointed to act as “lead director”. However, either an independent chair or an independent lead director should act as the effective leader of the board and ensure that the board’s agenda will enable it to successfully carry out its duties.

Separating the office of chief executive officer from the office of board chair was already encouraged in the report of the Canadian Standing Senate Committee on Banking, Trade and Commerce (hereinafter the “Kirby Report”), which was created to examine and report upon the state of the financial system in Canada. Indeed, the committee recommended that:

⁶⁶⁷ *Ibid.*

There is clearly a fine line between asking penetrating questions and embarrassing a CEO. Given the existence of social norms of behaviour, is it reasonable to expect that directors will pursue problem areas in depth in front of a chairman who is also the CEO? In a healthy company this is obviously not a problem, but what happens if danger signs appear? Will there be a delay in the recognition of emerging problems, which can lead to serious difficulties for the board later on? At what point will directors be willing to engage in discussion in the absence of the CEO/chairman? [...]

The Committee strongly recommends that publicly traded *CBCA* corporations separate the positions of chairman of the board and chief executive officer.⁶⁶⁸

The Kirby Report quoted William G. Bowen in support of this recommendation:

A chairman/CEO wears two hats at the same time and you just can't do that and look good in both roles... He/she is in a delicate position between the CEO and the board letting the CEO make necessary reports and recommendations, supporting the CEO, and sometimes even protecting the CEO. But at the same time, he/she must make certain that suggestions/challenges, even criticisms are heard and considered. In my view no one can do all that and be the CEO as well. I know; I tried it. If the chairman is also the CEO, he/she makes the agenda, conducts the meeting, presents management's recommendations, controls the discussion, and asks for support of his/her own recommendations. When one does all that and in addition usually picks his/her fellow board members, you have in my opinion a dictatorship. It may be benign and it may even be enlightened, but it is nonetheless a dictatorship. In my view, any chairman/CEO inevitably wears primarily his/her CEO hat and only occasionally takes on the far more neutral and impartial role of chairman of the Board. [...]

In practical terms, the presence of a non-CEO chairman provides a structure whereby the board itself has a clearly understood role in nominating board members, appointing board committees, setting agendas and, if need be, selecting independent advisors to the board. These seemingly innocent-sounding powers [...] can be very important. Finally, the presence of a separate chairman facilitates the regular review of the

⁶⁶⁸ Standing Senate Committee on Banking, Trade and Commerce, *supra* note 89, at 33 and 39.

performance of the CEO and avoids any risk that a CEO might preside at a discussion of his own future.⁶⁶⁹

For the Canadian Standing Senate Committee on Banking, Trade and Commerce, the separate chairman/chief executive officer model appeared to increase the likelihood of a genuine “second opinion”. Splitting the two also clarifies the principle that the chief executive officer reports to the board and not the other way around.⁶⁷⁰ In Canada, where more corporations are controlled by a significant shareholder than in the U.S.,⁶⁷¹ the importance of an independent chair may be even greater because the chair then not only acts as a conduit for channeling concerns of directors with respect to management but also concerns regarding the influence and power of the significant shareholder.

Where a board does not choose to separate the board chair and the chief executive officer positions, or when it is in transition to a structure where the positions will be separated, National Policy 58-201 states that a “lead director” position should be established.⁶⁷² The main reason for having an independent board leader is to ensure the thoughtful execution of independent functions. Strong leadership from an outside director within the board can also assist a board in developing a culture of independence.⁶⁷³

In the U.S., the practice of having an independent director serving as board chair is not widely adopted⁶⁷⁴ and many observers believe that American corporations are well served by a structure in which the chief executive officer also acts as board chair.⁶⁷⁵ In 2002, approximately 75% to 80% of the S&P 500 corporations in the U.S. combined the

⁶⁶⁹ Bowen, W.G., *Inside the Boardroom* (New York: John Wiley and Sons, 1994), at 83, 84 and 86; quoted in Standing Senate Committee on Banking, Trade and Commerce, *ibid.*, at 33 and 34.

⁶⁷⁰ Standing Senate Committee on Banking, Trade and Commerce, *ibid.*, at 34.

⁶⁷¹ See Parizeau, R. *supra* note 38.

⁶⁷² See section 3.2 of National Policy 58-201; see also Conference Board, *supra* note 79, at 21; Ontario Teachers’ Pension Plan, *supra* note 362, at 18; and See Caisse de dépôt et placement du Québec, *supra* note 362, at 4.

⁶⁷³ Joint Committee on Corporate Governance, *supra* note 6, at 13.

⁶⁷⁴ American Bar Association, Section of Business Law, *supra* note 618, at 1592.

⁶⁷⁵ The Business Roundtable, *supra* note 247, at 11.

roles of board chair and chief executive officer in one person, whereas approximately 70% to 75% of the TSX 300 corporations in Canada separated the roles.⁶⁷⁶

Some of the reasons often mentioned in support of combining the roles of board chair and chief executive officer include the following:

- Dividing the offices of board chair and chief executive officer could dilute the power of the chief executive officer to provide effective leadership to the corporation;⁶⁷⁷
- It could create a potential rivalry between the chief executive officer and the board chair, leading to compromise rather than crisp decisiveness;⁶⁷⁸
- If the positions are separated, there may not be sufficient accountability with respect to all aspects of the corporation. There may not be sufficient delineation of the authority and responsibilities for each office so that the officeholders and all stakeholders of a corporation understand the respective roles of the board chair and the chief executive officer and no gaps are created between the two offices;⁶⁷⁹
- The board chair may be overly protective of the chief executive officer and shield the chief executive officer from being held accountable by the board for poor performance;⁶⁸⁰
- Having two public spokespersons may lead to confusion.⁶⁸¹

⁶⁷⁶ Dimma, W.A., *supra* note 75, at 73.

⁶⁷⁷ Lorsch, J.W. & Lipton, M., "On the Edge: The Lead Director" (1993) Jan.-Feb. Harv. Bus. Rev. 76, at 79.

⁶⁷⁸ *Ibid.*, at 79.

⁶⁷⁹ Bender, M., *supra* note 17, at 1-9; and Lorsch, J.W. & Lipton, M., *ibid.*

⁶⁸⁰ Bender, M., *ibid.*, at 1-9; and Lorsch, J.W. & Lipton, M., *ibid.*

⁶⁸¹ Lorsch, J.W. & Lipton, M., *ibid.*

As explained in subsection II.A of this thesis, having an independent board, however, also has many advantages. Because we are not aware of any empirical study that would demonstrate that the advantages of having an independent board chair always exceed the above mentioned potential disadvantages, it would be prudent to keep flexibility in this regard. Hence, the wording of National Instrument 58-101 and National Policy 58-201, which allow a board to choose an independent or a non-independent board member, subject to appropriate disclosure, is appropriate.

(v) *In camera meetings*

As mentioned throughout this subsection, *in camera* meetings are essential to allow directors to discuss sensitive issues without the inhibitory presence of management or non independent directors. As a best practice, *in camera* meetings should be held at every meeting of the board and of each of its committees and should be chaired by an independent director, who would then report any concern of directors to the board chair or the committee chair (if they are not independent), and to the full board.

Section 3.3 of National Policy 58-201 currently states that “The independent directors should hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance”. Because of the importance of *in camera* meetings in creating a dynamics of empowerment, as discussed in subsection II.A of this thesis, National Policy 58-201 should be amended to encourage corporations to hold *in camera* meetings at every board and committee meetings.

(vi) *Independent advisors*

The above mentioned practices are good ways, for directors, to maintain a proper level of independence. To ensure a higher degree of independence, the board and its committees should also have access to independent advisors, at the corporation’s expense, when required.

As explained in subsection II.A of this thesis, in many circumstances, reliance by a board or its committees upon the written advice of an expert can be an important element considered by a tribunal in deciding whether the procedures adopted by a board in accordance with such opinion allow directors to comply with their duties.⁶⁸² Subsection 123(5) of the *CBCA* specifically relieves directors from certain liabilities if they rely in good faith upon financial statements presented by an officer of the corporation or a written report of the auditor or a person whose profession lends credibility to a statement made by the professional person (such as a lawyer, accountant or appraiser).⁶⁸³

In the U.S., the impact of certain court decisions which imposed monetary liability on directors, have produced very noticeable changes in board behaviour, including the use of third-party advisors to give expert opinions to the board on various corporate matters.⁶⁸⁴ The hiring of independent advisors is particularly useful in situations of conflicts of interest. Combined with independent committees, it may help directors to prove that they have satisfied their obligations.⁶⁸⁵

Board committees, just like the board itself, are often well advised to hire independent advisors. For instance, when assessing the integrity of a corporation's financial statements, directors sitting on the audit committee may feel the need to consult independent auditors and counsel.⁶⁸⁶ Audit committee members may also need the assistance of experts to investigate certain audit and accounting issues. As mentioned in the Treadway Report:

⁶⁸² Priest, M. & Nathan, H.R., *supra* note 3, at 47 and 197.

⁶⁸³ See II.A.2 of this thesis for an analysis of subsection 123(5) of the *CBCA*.

⁶⁸⁴ Elson, C.M. & Thompson, R.B., *supra* note 255.

⁶⁸⁵ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 187, at par. 117.

⁶⁸⁶ *In Re Standard Trustco Ltd.*, *supra* note 199, at 286.

Audit Committees should have the discretion to institute investigations of improprieties or suspected improprieties, including the standing authority to retain special counsel or experts.⁶⁸⁷

On this matter, section 4.1 of Multilateral Instrument 52-110, which is mandatory for audit committees of reporting issuers already states that:

4.1 An audit committee must have the authority

- (a) to engage independent counsel and other advisors as it determines necessary to carry out its duties,
- (b) to set and pay the compensation for any advisors employed by the audit committee, and
- (c) to communicate directly with the internal and external auditors.

Although there are good reasons to require that audit committees be allowed to have access to independent advisors, there is no empirical research establishing a correlation between such practice and improved corporate performance. In fact, one may imagine that a corporation may prefer not to allow such access, particularly in the case of the audit committee. Since that committee is generally responsible for reviewing the internal controls of the corporation, the use of independent advisors could be very costly if they follow a methodology similar to the one developed in the implementation of section 404 of *SOX*. Consistent with the other recommendations in this subsection, we would thus leave some flexibility to the board so that it may decide if such access should be guaranteed as part of board and committee charters and if limits (such as the prior approval of the board chair) should be imposed. Therefore, we would amend Multilateral Instrument 52-110 to remove the requirement to grant access to these advisors and add a guideline encouraging corporations to allow such access.

⁶⁸⁷ National Commission on Fraudulent Financial Reporting, *Report of the National Commission on Fraudulent Financial Reporting* (Washington: National Commission on Fraudulent Financial Reporting, 1987), at 43.

Pursuant to section 3.11 of National Policy 58-201, which is not mandatory but is a guideline of the CSA, a nominating committee should be given authority to engage and compensate any outside advisor that it determines to be necessary to permit it to carry out its duties. Section 3.16 of National Policy 58-201 provides the same language for compensation committees. As a best practice, all committees should be allowed to hire independent advisors if they need to and the guideline set forth in section 3.11 of National Policy 58-201 should be amended accordingly. Like all best practices mentioned in National Policy 58-201, such guideline may be adopted by a corporation on a voluntary basis, but the disclosure of the policy regarding the access to such advisors should be mandatory.

Whether experts are hired by the board or a board committee, one must consider that in certain circumstances, particularly when independent advice is sought, less deference will be given to the opinion of advisors if the advisors themselves are seen as suffering from disabling conflicts.⁶⁸⁸ Consequently, it is important to ensure the independence of advisors prior to hiring them.

Although the retention of independent advisors may contribute to ensuring a certain level of independence and help establish a due diligence defence, the use of such advisors does not relieve directors of their obligation to actually exercise reasonable diligence when assessing a transaction.⁶⁸⁹ Corporate directors must always be cautious to fulfill their duty of care, and there is no better way to fulfill such duty than through active monitoring practices, as the next subsection of this thesis will discuss.

3. DISCLOSURE OF ACTIVE MONITORING PRACTICES AGAINST A MANDATORY TEMPLATE

As explained in subsection II.C.1 of this thesis, under our proposed framework, we would suggest that National Instrument 58-101 be amended to follow a categorization based on independence and active monitoring. This subsection reviews the disclosure

⁶⁸⁸ *Kahn v. Tremont*, 694 A.2d 422 (Del. Ch. 1997); and Strine, L.E., *supra* note 61, at 1398.

requirements relating to active monitoring contained in Multilateral Instrument 52-110 and National Instrument 58-101 and suggests changes to improve these instruments.

As will be explained in this subsection, board and committee charters, as well as the position descriptions of the board chair, the committee chairs and the chief executive officer, should be disclosed. Policies related to the assessment of the board, its committees and individual directors, as well as orientation and continuing education programs should also be made public. However, the content of those charters, position descriptions and policies, should be voluntary.

(a) Board and committee charters

Section 2 of Form 58-101F1, requires issuers to disclose the text of the board's written charter and if the board does not have a written charter, to disclose how the board delineates its role and responsibilities. Similarly, section 6(c) and 7(c) of Form 58-101 state that if the board has appointed a nominating and a compensation committee, their responsibilities, powers and operations should be disclosed. Section 8 of Form 58-101 also provides that if the board has put in place standing committees other than the audit, compensation and nominating committees, these committees and their functions should be identified. Instruction note 2 to Form 58-101F1 states that disclosure regarding board committees made under section 8 may include the existence and summary content of any committee charter. With respect to audit committees, section 2.3(1) of Multilateral Instrument 52-110 requires issuers to adopt a written charter setting out the mandate and responsibilities of the audit committee.

As explained in subsection II.B of this thesis, disclosure of board practices is important because it permits comparability between corporations and reduces information costs for investors. In addition, disclosing board and committee responsibilities and processes to be followed increases the standards of conduct for

⁶⁸⁹ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, *supra* note 187, at par. 126.

directors, which should reduce agency costs⁶⁹⁰ and assist directors in the discharge of their fiduciary duties.⁶⁹¹

Under the current rules described in National Instrument 58-101, boards and committees (other than the audit committee)⁶⁹² are not required to adopt or disclose written charters. Instead, they may choose to disclose the responsibilities and powers of the board and its committees generally. We believe that National Instrument 58-101 should be amended to require that charters be adopted for the board and its committees and that such charters be made public.⁶⁹³

Such amendment is not trivial because of the content of those charters. Indeed, such charters usually describe in detail what are the responsibilities, the composition, the methods of operation and the reporting procedures of the board and its committees. As mentioned in subsection II.B of the thesis, the disclosure of such content will help investors assess the practices of the corporation.

Another advantage of requiring that the charters be made public is that such requirement will put pressure on directors to determine what should be the responsibilities of the board and its committees, which is an important exercise in itself.⁶⁹⁴ The identification of such responsibilities will help directors develop methods of operation with management, including formal levels of intervention in the affairs of the corporation. Such identification will likely empower the board and its committees and allow directors to play a more active role in supervising management and corporate initiatives.⁶⁹⁵

One may argue that small issuers should not have to disclose their charters because it would impose unnecessary costs on them (*i.e.*, the costs of developing a

⁶⁹⁰ See subsection II.A.2(b) of this thesis.

⁶⁹¹ See subsection II.A.2(c) of this thesis.

⁶⁹² Disclosure of the audit committee charter is mandatory under section 1 of Form 52-110F1.

⁶⁹³ See Canadian Coalition for Good Governance, *supra* note 362, at 22.

⁶⁹⁴ For examples of board and committee charters, see Dorval, T., *Governance of Publicly Listed Corporations* (Toronto: LexisNexis, 2005), at 171 to 192.

formal structure describing the distribution of responsibilities). We would argue that a lack of structure could be even more costly because of the potential risks of mismanagement caused by the fact that certain tasks may not be assigned (nor discharged). In addition, our proposed model would provide enough flexibility to allow boards of directors to decide the content of the charters. Indeed, a board of directors would have the flexibility to delegate more or less responsibilities to its committees and to management, depending on how it wants to allocate corporate resources and who it considers to be in the best position to discharge the duties. National Instrument 58-101 should consequently be amended to require that charters be adopted and disclosed for the board and each committee.

(b) Directors

(i) Availability

In order to be in a position to exercise active monitoring, directors must have the time to prepare for meetings, be present at such meetings and be available, occasionally, for assisting management on an *ad hoc* basis. There is a strong probability that directors will not be able to do what is expected from them if they are involved in too many other ventures.

In order for investors to be able to assess if a director will be in a position to discharge his or her duties correctly, the other occupations of such director should generally be made public. In National Instrument 51-102 – *Continuous Disclosure Obligations* (“National Instrument 51-102”) of the CSA,⁶⁹⁶ item 7.1(d) of Form 51-102F5 already requires that the principal occupation, business or employment of each proposed director be disclosed in the management proxy circular of a corporation. In

⁶⁹⁵ See also subsection I.A.2(b) of this thesis.

⁶⁹⁶ (2004) 27 O.S.C.B. 3439 and (2005) 28 O.S.C.B. 4975. National Instrument 51-102 has been implemented in all Canadian provinces and territories.

addition, section 1(d) of Form 58-101F1 requires that if a director is presently a director of any other reporting issuer, that fact be disclosed.

Amendements should be made to Form 58-101F1 in order to require that all important directorships (as opposed to directorships of public issuers only) of candidates for election at a shareholder meeting be disclosed. Indeed, many private corporations are very important in size and revenues and may require a significant amount of time and energy from a director. Shareholders of a corporation should be aware of other significant time commitments of the directors.⁶⁹⁷

In order to help investors assessing the availability of corporate directors, section 1(g) of Form 58-101F1 requires that the attendance record of each director to all board meetings held in the past year be disclosed. In practice, many corporations also provide attendance records for committees of the board.⁶⁹⁸ Form 58-101F1 should be amended to require the disclosure of committee attendance records in all cases, with the objective of better signaling to shareholders the efforts devoted by directors to the affairs of the corporation.⁶⁹⁹

(ii) Relevant education and experience

Active monitoring by board members is certainly more difficult (or at least not as efficient) if directors do not have the level of education or experience required to discharge their duties. In order to help shareholders assess the competence of corporate directors, the education and experience of directors should be disclosed.

Section 3 of Form 52-110F1, which relates to audit committees, already requires corporations to describe the education and experience of each audit committee member

⁶⁹⁷ See Canadian Coalition for Good Governance, *supra* note 362, at 8; and Ontario Teachers' Pension Plan, *supra* note 362, at 10.

⁶⁹⁸ See for instance the management proxy circulars of SNC-Lavalin Group inc., RONA inc, and Canadian National Railway Company, available on sedar at: www.sedar.com (date accessed: March 3, 2007).

relevant to the performance of his or her responsibilities as an audit committee member, particularly with respect to understanding and assessing accounting principles used by the corporation, preparing, auditing, analyzing or evaluating financial statements and understanding internal controls and procedures for financial reporting. Form 58-101F1 should be amended to require that the relevant education and experience of directors be disclosed generally.⁷⁰⁰ When a director has a specific expertise relevant to his or her work on a committee of the corporation, disclosure of that fact should also be made.⁷⁰¹

(iii) Orientation and continuing education

In order to maintain and improve the skills of directors in creating value for shareholders, corporations often put in place orientation and continuing education programs for directors.⁷⁰² Section 4 of Form 58-101F1 requires corporations to describe what measures the board takes to orient new directors and to provide continuing education to them. If the corporation does not provide continuing education, the corporation should describe how the board ensures that its directors maintain the skills and knowledge necessary to meet their obligations as directors. Such disclosure requirement is helpful in showing to investors what the corporation does to keep its board informed and Form 58-101F1 should remain unchanged in this respect.

(c) Critical responsibilities of the board and its committees

Form 58-101F1 requires disclosure with respect to responsibilities of the board that the CSA consider important. In the case of the audit committee, as mentioned

⁶⁹⁹ This is recommended by The Globe & Mail, *supra* note 599, item 21.

⁷⁰⁰ Canadian Coalition for Good Governance, *supra* note 362 at 22; see also Caisse de dépôt et placement du Québec, *supra* note 362, at 4.

⁷⁰¹ See for instance the management proxy circular of SNC-Lavalin Group inc., available on sedar at: www.sedar.com (date accessed: March 3, 2007).

⁷⁰² For an example of simple directors' orientation and continuing education policy, see Dorval, T., *supra* note 693, at 201 and 202.

above, such disclosure is not made in the same way. Instead, Multilateral Instrument 52-110 requires that specific responsibilities be included in the charter of the committee and that the charter be disclosed, making it easy to identify any divergence from the prescribed conduct.

The following subsections will review the content of Form 58-101 with respect to the most important tasks of the board and its committees. It will then suggest certain amendments to be made thereto and propose that Multilateral Instrument 52-110 be abandoned and that a similar framework for responsibilities generally entrusted to audit committees be included in Form 58-101F1. These recommendations are in addition to our suggestion that charters of the board and its committees be disclosed, mentioned in subsection II.C.3(a) of this thesis.

(i) *Ethical business conduct*

Subsection 5(a) of Form 58-101F1 states that corporations must disclose whether or not the board has adopted a written code of conduct for its directors, officers and employees, how to obtain a copy of the code, how the board monitors compliance with the code and any material change report filed in the last year describing a departure from the code by a director or executive officer. Section 2.3 of National Policy 58-101 requires that the code and any amendment thereto be filed on the Canadian System for Electronic Document Analysis & Retrieval ("SEDAR"). Subsections 5(b) and (c) of Form 58-101F1 also require corporations to disclose any steps the board takes to encourage and promote a culture of ethical business conduct. Such disclosure items should remain unchanged, since it provides investors with relevant information to assess the procedures in place to foster ethical conduct.

(ii) Nomination and corporate governance

Section 6 of Form 58-101F1 states that corporations must describe the process by which the board identifies new candidates for board nomination. The existence of a nominating committee composed solely of independent directors and the responsibilities of such committees must also be disclosed. If the board does not have a nominating committee composed entirely of independent directors, the board must describe the steps the board takes to encourage an objective nomination process.

The requirement to describe the responsibilities of the nominating committee would become irrelevant if the charter of the committee had to be disclosed, as recommended above. When considering the disclosure of specific responsibilities, section 6 of Form 58-101F1 should be amended to add a requirement to disclose the existence of a responsibility for overseeing the corporate governance practices of the board. Such requirement could be put elsewhere in Form 58-101F1 but having it under section 6 would be convenient because it is often a responsibility of the nominating committee.

As for board assessment, a responsibility often delegated to the nominating committee, section 9 of Form 58-101F1 requires corporations to disclose whether or not the board, its committees and individual directors are regularly assessed with respect to their effectiveness and contribution. When such assessments are conducted, a description of the process must be provided. When not conducted, a description must be provided as to how the board satisfies itself that the board, its committees and individual directors are performing effectively.

This requirement is a good way to help investors assess the involvement of the board in reviewing its performance.⁷⁰³ However, it should also cover the disclosure relating to the assessment of the board chair and committee chairs. Furthermore, since the assessment of the board and its directors is often a responsibility of the nominating

⁷⁰³ Ontario Teachers' Pension Plan, *supra* note 362, at 10.

committee, we would recommend regrouping such disclosure with the disclosure items related to other tasks of the committee, under section 6 of Form 58-101F1. Hence Form 58-101F1 should be amended to require the disclosure of any responsibility for overseeing corporate governance practices and the mechanisms to assess board and committee chairs.

(iii) Compensation and human resources

Section 7 of Form 58-101F1 requires the corporation to describe the process by which the board determines the compensation of directors and officers. It also requires the disclosure of whether or not the board has a compensation committee composed entirely of independent directors and if it is not the case, to describe what steps the board takes to ensure an objective process for determining such compensation.⁷⁰⁴

As discussed above, instead of disclosing the general responsibilities of the compensation committee, National Instrument 58-101 should require the disclosure of the committee charter. With respect to particular responsibilities, section 7 of Form 58-101F1 should also be changed to add a requirement to disclose the responsibilities of the committee relating to human resources. Currently, nothing in Form 58-101F1 relates to the human resources practices of the board other than executive compensation. This is rather surprising. Because retaining and motivating employees will likely be important for the success of most corporations⁷⁰⁵ and that the disclosure of processes related thereto should be of interest to investors, we would recommend that section 7 be changed to add a disclosure requirement related thereto.

⁷⁰⁴ See Canadian Coalition for Good Governance, *supra* note 362, at 22.

⁷⁰⁵ See Pfeffer, J., *Competitive Advantage Through People- Unleashing the Power of the Work Force* (Cambridge: Harvard Business School Press, 1994); and Horwitz, F.M., Teng Heng, C. & Quazi, H.A., "Finders, keepers? Attracting, motivating and retaining knowledge workers" (2003) 13 Hum. Res. Man. J. 23.

(d) Position descriptions for the board chair and the chairs of each board committee

Subsection 3(a) of Form 58-101F1 requires corporations to disclose whether or not their board has developed written position descriptions for their chair and the chair of each board committee. If the board has not developed such descriptions, the corporation must describe how the board delineates the role and responsibilities of each such position.⁷⁰⁶

The adoption and disclosure of written positions for board and committee chairs should be mandatory, for the same reasons as board and committee mandates.⁷⁰⁷ It would certainly be interesting for an investor to know how the chairs of the board and of each committee are involved in the affairs of the corporation. In addition, such disclosure would likely improve active monitoring.⁷⁰⁸ Incidentally, an active chair will also likely reduce the costs of mismanagement and potentially those of misappropriation by other board members and executives, because of his or her increased leadership.

In addition, as with the disclosure of board and committee charters, the preparation of position descriptions will be a good exercise in itself. It will focus attention on what should be the prerogatives of board and committee chairs and should further empower them. National Instrument 58-101 should thus be amended to require that such position descriptions be created and disclosed.

(e) Position description for the chief executive officer

Subsection 3(b) of Form 58-101F1 is similar to 3(a) but relates to the written position description of the chief executive officer. Again, the corporation must disclose if its board has developed a written position description for the chief executive officer

⁷⁰⁶ For examples of position descriptions for the board chair and committee chairs, see Dorval, T., *supra* note 693, at 193 to 196.

⁷⁰⁷ Canadian Coalition for Good Governance, *supra* note 362, at 22.

and if not, it must describe how the board delineates the role and responsibilities of the chief executive officer.⁷⁰⁹

Just like for the board chair and committee chairs, the disclosure of the position description of the chief executive officer should help investors in identifying which decisions are delegated to management. Such charter and the working plans prepared by management in connection therewith can also act as a checklist to ensure that management has discharged all duties delegated to it.⁷¹⁰

The development and adoption of a position description for the chief executive officer is in itself a potential way for the board to reduce agency costs and discharge its fiduciary duties. Indeed, such position description should help the board monitor and assess the chief executive officer against specific tasks and make him or her more accountable. By making him or her more accountable, the board potentially reduces costs of misappropriation and mismanagement. Hence, we would not propose any change to subsection 3(b) of Form 58-101F1.

(f) Other improvements to be made to Form 58-101F1

(i) *The role of the board with respect to strategy*

Section 3.4 (b) of National Policy 58-201 states that the written charter of the board should explicitly acknowledge responsibility of the board for adopting a strategic planning process and approving a strategic plan which takes into account the opportunities and risks of the business. However, Form 58-101F1 does not touch upon the role of the board with respect to corporate strategy. Because strategy is at the heart of

⁷⁰⁸ See the discussion on increased potential liability under securities legislation such as Part XXIII.1 the *OSA* in subsection II.A.2(b) of this thesis.

⁷⁰⁹ For an example of position description for the president and chief executive officer, see Dorval, T., *supra* note 693, at 197 to 199.

⁷¹⁰ This may be important to prove that fiduciary duties have been duly discharged. See subsection II.A.2(c) of this thesis.

the board and management's actions, Form 58-101F1 should at the very least require that corporations disclose generally the processes for developing corporate strategy, as well as the respective responsibilities of the board and management in connection therewith. Such requirement should not include the disclosure of the strategy itself, as such disclosure may be confidential and its disclosure may reduce the competitive advantage of the corporation *vis-à-vis* private corporations which do not have to make such disclosure. However, the disclosure of the strategic planning process would assist investors in assessing if enough attention is devoted to that important topic.

(ii) *Risk identification and management*

Section 3.4(c) of National Policy 58-201 states that the identification of the principal risks of a corporation's business and the implementation of appropriate systems to manage these risks should be a responsibility included in the board's written charter. Section 3.4(f) states that the board should also be responsible for overseeing the issuer's internal control and management information systems. However, again, no disclosure is required regarding those important items. Form 58-101F1 should be amended to require a general description of risk identification and management processes, as well as internal control and management information systems.

The annual information form, a document that must be filed by reporting issuers pursuant to National Instrument 51-102, already requires that the principal business risks of a business be disclosed. In order to help investors assess what a corporation does to identify and mitigate these risks, it would certainly be a good idea to require some disclosure on corporate systems related thereto.

That being stated, it must be recognized that risks only constitute one side of a coin. The other side, which may be as important, is the identification and management of opportunities. Indeed, the loss or failure to recognize certain opportunities may be as detrimental to shareholders as the lack of mechanisms to manage risks. Therefore, in

amending Form 58-101F1, we would also include a requirement to disclose the systems in place within a corporation to identify and manage opportunities.

(iii) Succession planning

Section 6 of Form 58-101F1 states that corporations must describe the process by which the board identifies new candidates for board nomination but nothing of this nature exists for senior management. Because management spends much more time than board members on the businesses of the corporation and may have a more important impact on its results, the disclosure of the selection process for choosing members of management would seem to be at least as important as the one for choosing directors. We would therefore amend Form 58-101F1 to add a requirement to disclose management succession processes.

(iv) Receiving feedback from stakeholders

Section 3.4(i) of National Policy 58-201 mentions that the written charter of the board should set out measures for receiving feedback from stakeholders. Such measures should also be an item of disclosure. Such a requirement could potentially help directors reduce agency costs because it would allow third parties to signal misappropriations and mismanagement by employees of the corporation, which otherwise would take time to be reported or would not be reported at all. We would therefore amend National Instrument 58-101 to require that disclosure be made regarding the processes in place at the corporation for receiving feedback from stakeholders.

(v) Expectations of directors

Section 3.4(ii) of National Policy 58-201 provides that the written charter of the board should mention expectations and responsibilities of directors, including basic duties and responsibilities with respect to attendance at board meetings and advance

review of meeting materials. Assuming that the board charter is disclosed, the expectations of directors would also be made public at the same time. Such disclosure would have the benefit of instructing investors as to the level of involvement required from directors.⁷¹¹ If too low, such expectations could signal that the board may be complacent and agency costs may run free. If very high, that would raise the bar in terms of liability and encourage more involvement by directors, which could translate in potential reduction of agency costs and a better discharge of their fiduciary duties.

(g) Amendments to be made to Multilateral Instrument 52-110

It would certainly be difficult to prove empirically that the set of responsibilities that have been imposed on audit committees by Multilateral Instrument 52-110 should in all cases be discharged by the audit committee instead of the full board, another committee or management. As explained in subsections II.B and II.C.1 of this thesis, we submit that until empirical studies are conclusive on that matter, the general content of board and committee charters should be left to the board to decide, but charters should be disclosed so that shareholders may be informed of how the board has chosen to discharge its responsibilities.

Form 58-101F1 is a good compromise in that sense. As seen above, it requires corporations to disclose what their board does with respect to certain tasks without requiring that such tasks be performed by specific committees. Multilateral Instrument 52-110 should be amended to remove the obligations imposed on audit committees and such obligations should instead be identified as best practices and added as items of disclosure under Form 58-101F1. Such obligations can be divided in two groups. Those related to accounting and financial reporting and those related to the oversight of internal and external auditors.

⁷¹¹ Caisse de dépôt et placement du Québec, *supra* note 362, at 4.

(i) Accounting and financial reporting

Section 2.3(5) and (6) of Multilateral Instrument 52-110 provide that an audit committee must review a corporation's financial statements, management discussion and analysis⁷¹² and earnings press releases before they are disclosed and that it must be satisfied that adequate procedures are in place for the review of the corporation's public disclosure of financial information extracted from such financial statements.

As mentioned in subsection II.A of this thesis, empirical studies are not conclusive on the correlation between entrusting to an audit committee composed solely of independent directors the review of financial statements and the chances of restatements of such financial statements. Unless empirical studies can show that such responsibility can not be performed by the whole board, the board should have the flexibility to retain that function. However, in all cases, proper disclosure should be made as to the process in place at the board or committee level to oversee accounting and financial reporting.

(ii) Oversight of internal and external auditors

One of the recommendations of the Saucier Report was that audit committees periodically review the need for an internal audit function and, on the basis of that review, determine whether such a function should be instituted.⁷¹³ National Instrument 58-101 should be amended to require that corporations disclose if they have an internal auditor and if not, what the corporation does to reduce the possibility of financial irregularities. In the U.S., section 303A(7) of the NYSE Company Manual now requires listed corporations to put in place an internal audit function.⁷¹⁴ In accordance with our

⁷¹² The management disclosure and analysis is defined, in Form 51-102F1 of National Instrument 51-102, as a narrative explanation, through the eyes of management, of how the corporation performed during the period covered by the financial statements, and of the corporation's financial condition and future prospects.

⁷¹³ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 31.

⁷¹⁴ Not mandatory for Foreign Private Issuers, subject to appropriate disclosure.

proposed template, we would not make it a requirement in Canada but disclosure of the existence or not of the function should be mandatory.

With respect to external auditors, Multilateral Instrument 52-110 requires corporations to establish a special link between the external auditors and the audit committee. It requires that the audit committee be responsible for recommending to the board of directors the external auditors and their compensation. It also requires that the audit committee be responsible for overseeing their work, pre-approve all non-audit services to be provided by them to the corporation and review and approve the corporation's hiring policies regarding employees of the present and former external auditors.

Unless there is an empirical justification for requiring that the audit committee be responsible for the above mentioned responsibilities, the board should have the flexibility to perform them directly, subject to appropriate disclosure. In fact, instead of requiring that the audit committee oversee those tasks, it would probably be more helpful for investors to know which processes are in place to ensure that these tasks are being performed. Multilateral Instrument 52-110 should thus be abandoned and National Instrument 58-101 should be amended so that boards are free to discharge their duties as they wish but an explanation must be provided as to the process they chose to put in place.

The disclosure should still be made in respect thereto. In fact, disclosure items should include the processes in place for: (i) recommending the external auditors to the shareholders, (ii) determining how external auditors are compensated and how their performance is evaluated, (iii) determining how disagreements between management and the external auditors regarding financial reporting are resolved, and (iv) pre-approving audit and non-audit services performed by external auditors. Disclosure regarding the corporation's policies with respect to hiring employees of the present and former external auditors of the issuer would also be of interest for shareholders as it would demonstrate the safeguards in place to preserve the independence of external auditors.

This subsection of the thesis should not be interpreted as meaning that most of the tasks currently performed by audit committees should be performed by the board or another committee. Instead, it suggests that the board should have the flexibility to perform those duties directly or to delegate them differently if it believes it is better for the corporation. For instance, if board members were to choose to entrust the responsibility for reviewing corporate financial statements to a committee distinct from the audit committee and composed solely of independent directors, it should have the flexibility to do so. In most cases, however, the current practice of having the audit committee perform that task will be a convenient and efficient practice.

4. VOLUNTARY BOARD PRACTICES RELATED TO ACTIVE MONITORING

In this subsection, we will propose certain amendments to be made to Canadian securities regulations in order to approach the optimal regime described in subsection II.B.3 of this thesis. We will also provide many recommendations to improve the guidelines described in National Policy 58-201, based on the active monitoring principles described in subsection II.A(2) of this thesis.

As explained in the proposed template developed in subsection II.C.3 of this thesis, the disclosure of board and committee charters should be mandatory. The content of those charters, however, should be voluntary. This does not mean that guidelines should not describe recommended practices, but a mandatory approach such as the one of Multilateral Instrument 52-110 with respect to the composition and responsibilities of the audit committees should be avoided. It is the board of directors, and not regulators, who should have the prerogative to decide how its duties will be discharged. At the end, it is the personal liability of directors which may be at stake. If a board considers that its duties can be discharged in a better way than what is suggested, the board should be allowed to diverge from the recommended conduct, subject to appropriate disclosure of what the board decides to do.

Although closer to an optimal framework than Multilateral Instrument 52-110, National Instrument 58-101 and National Policy 58-201 could still be improved. In the previous section, the disclosure requirements included in National Instrument 58-101 relating to active monitoring were discussed and amendments were suggested regarding how to increase their effectiveness. This section will assess and propose ways to improve the active monitoring guidelines contained in National Policy 58-201.

(a) Content of the board charter

As described in subsection II.A.2 of this thesis, an active monitoring board should assume many responsibilities. Such responsibilities may be discharged directly by the board or delegated to one of its committees. However, board members are ultimately responsible for matters delegated to committees. This subsection will describe and comment on general board functions and the next subsections will describe functions that are traditionally delegated to board committees. This subsection categorizes board responsibilities under two broad categories. The first one relates to the leadership function of the board and includes corporate strategy and the appointing of executive management. The second relates to the oversight function and includes the monitoring of corporate controls and the supervision of management.⁷¹⁵

(i) Leadership function

Experimental psychologists and economists have found that group decision-making is generally superior to decision-making by individuals. Indeed, numerous studies have shown that group decisions are not only superior to decisions of the average member of a group, but also to those made by the very best individuals.⁷¹⁶ This insight

⁷¹⁵ See Ontario Teachers' Pension Plan, *supra* note 362, classifies these responsibilities in three categories: (i) determining direction and strategy, (ii) exercising control, and (iii) evaluating performance and succession planning. We believe such last category is implicitly included in the two others.

⁷¹⁶ Forbes, D.P. & Milliken, F.J., "Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-making Groups" (1999) 24 Acad. Mgmt. Rev. 489, at 500 and 501; and

may explain in part why modern organizational theory increasingly posits that the contribution of a board to the definition of strategy and the choice of executive management is integral to the success of a corporation.⁷¹⁷

- (1) The board should be involved in the development and implementation of corporate strategy

Corporate strategy is the foundation on which all corporate policies should stand and is at the heart of the board leadership function. The CSA recognize the importance of corporate strategy. Subsection 3.4(b) of National Policy 58-201 states that boards should assume responsibility for “adopting a strategic planning process and approving, on at least an annual basis, a strategic plan which takes into account, among other things, the opportunities and risks of the business.”

Although the text of such provision is a step in the right direction, we would enhance the participation of the board by suggesting that it be more involved in overseeing the development and implementation of corporate strategy. In order to be efficient in monitoring the affairs of the corporation, it seems logical that the board of directors of a corporation should understand the corporation’s strategic plans from their inception through their execution by management.⁷¹⁸ The board should also regularly monitor the implementation of the strategic plan to determine whether it is being implemented effectively and whether changes are needed thereto.⁷¹⁹ In practice, a corporation’s chief executive officer and senior management will often prepare the first draft of the corporate strategic plan, present it to the board and implement it once adopted by the board.⁷²⁰

Shaw, M.E., “A Comparison of Individuals and Small Groups in the Rational Solution of Complex Problems” (1932) 44 Am. J. Psychol. 491, at 492 and 493; referred to in Bainbridge, S.M., *supra* note 34, at 12.

⁷¹⁷ Millstein, I., *supra* note 437, at 1433 and 1434.

⁷¹⁸ See Canadian Coalition for Good Governance, *supra* note 362, at 18.

⁷¹⁹ The Business Roundtable, *supra* note 247, at 4; and Dimma, W.A., *supra* note 75, at 15.

⁷²⁰ The Business Roundtable, *ibid.*, at 7; and Millstein, I., *supra* note 437, at 1434.

A board's responsibility with respect to strategic planning should go beyond the adoption of the corporate strategy. The board should also contribute to the development of a strategic direction through the adoption of ancillary corporate policies that take into account the corporate strategy.⁷²¹ In order to adapt to the evolving business environment, corporate strategy and corporate policies must be revisited regularly and the board must be vigilant in keeping apprised of changes, unexpected risks and new opportunities.⁷²² Boards should expect periodic updates regarding changes that impact strategic plans or the continued validity of underlying assumptions.⁷²³ Therefore, National Policy 58-201 should be amended to suggest, as a best practice, that the board be involved in overseeing the development and implementation of corporate strategy. As mentioned in subsection II.C.3 of this thesis, National Instrument 58-101 should however require general disclosure on the strategic planning process of each corporation.

(2) The board should be responsible for appointing executive management

An important way for a board of directors to set the right "tone at the top", is to ensure that management is composed of the right people. Hence, the second responsibility related to the board leadership function consists of appointing the chief executive officer and approving his or her choices for senior management.⁷²⁴

Section 121 of the *CBCA* provides that subject to the provisions of "the articles, the by-laws or any unanimous shareholder agreement, [...] the directors may designate

⁷²¹ Joint Committee on Corporate Governance, *supra* note 6, at 23.

⁷²² Priest, M. & Nathan, H.R., *supra* note 3, at 4. As mentioned by Priest and Nathan, The Canadian Institute of Chartered Accountants, in its Submission to the Toronto Stock Exchange Committee on Corporate Governance in Canada, on November 4, 1993, observed that "The most significant risks to the viability or survival of a company often result from the unanticipated consequences of strategic decisions, such as entry into new markets and other responses to competitive conditions. The board needs to be continually updated on changes in the company's environment and other strategic issues, so that it can deal promptly with actions proposed by management to address new opportunities and threats".

⁷²³ Canadian Institute of Chartered Accountants, *supra* note 351, at 4.

⁷²⁴ Joint Committee on Corporate Governance, *supra* note 6, at 20; see also Canadian Coalition for Good Governance, *supra* note 362, at 17.

the offices of the corporation, appoint as officers persons of full capacity, specify their duties and delegate to them powers to manage the business and affairs of the corporation [...]”.⁷²⁵ Subsection 3.4(d) of National Policy 58-201 states that the charter of a board should state that the board is responsible for overseeing management “succession planning (including appointing, training and monitoring senior management)”.

The *CBCA* does not require a corporation to have officers of any specific type or designation.⁷²⁶ Consequently, the board has an important discretion in appointing the individuals that it thinks are of the highest calibre to the positions it determines.⁷²⁷ Since senior management is responsible for the day-to-day management of the corporation and for the implementation of corporate policies, it is important that board members be convinced that senior managers discharge their responsibilities in an ethical and competent manner. Subsection 3.4(a) of National Policy 58-101 states that the board charter should provide that the board is responsible for, “to the extent feasible, satisfying itself as to the integrity of the chief executive officer and other executive officers and that the chief executive officer and other executive officers create a culture of integrity throughout the organization”. The selection and nomination of well-qualified, honest individuals is paramount in the discharge by the board of its own obligations.

As will be shown below, the compensation and human resources committee also has an important role to play in the selection and assessment of corporate managers as well as in the approval of compensation policies for such managers.⁷²⁸ We would not make any change to National Policy 58-201 with respect to the appointment of executive management. It appropriately defines the role of the committee, but allows each corporation to decide how to fulfill it, subject to disclosure.

⁷²⁵ Sutherland, H., *supra* note 17, at 400.

⁷²⁶ McGuinness, K.P., *supra* note 17, at 799.

⁷²⁷ *Ibid.*, at 20.

⁷²⁸ See subsection II.C.3(b)(iii) of this text.

(ii) Oversight function

The oversight function of the board can be divided in two: the monitoring of corporate controls and the supervision of management. We would suggest that National Policy 58-201 be amended to clarify which practices relate to each of those two categories. This would enhance clarity because each practice would be easily associated with the objective it is expected to reach.

(1) Monitoring of corporate controls

An important responsibility of the board consists of monitoring corporate controls. This includes overseeing the management of corporate risks and opportunities as well as information controls and corporate disclosure practices. Pursuant to subsection 3.4(c) of National Policy 58-201, the charter of a board should state that the board assumes the responsibility for “the identification of the principal risks of the issuer’s business, and ensuring the implementation of appropriate systems to manage these risks”. This subsection is very important. However, its scope should be broadened. As mentioned in subsection II.C.3 of this thesis, we would amend subsection 3.4(c) of National Policy 58-201 to also include identification and management of opportunities.

Pursuant to subsection 3.4(f) of National Policy 58-201, a board charter should include, among a board’s responsibilities, the responsibility for overseeing “the issuer’s internal control and management information systems.” A good reporting system is essential to the decision-making process of a board. It will assist the corporation in complying with applicable disclosure obligations and avoid claims for misrepresentations. In order to enable the effective disclosure of material information to shareholders, other stakeholders and the public in general, a corporation should adopt a comprehensive communication policy. Subsection 3.4(e) of National Policy 58-201 provides that a board charter should state, as one of the duties of the board, the responsibility for “adopting a communication policy for the issuer”. In Canada, National

Policy 51-201- *Disclosure Standards*⁷²⁹ (“National Policy 51-201”) describes what should be included in such a policy. National Policy 51-201 aims at avoiding misrepresentations and eliminating selective disclosure (which can be defined as the practice of disclosing potentially material information to a small group of individuals prior to full dissemination of the information to the marketplace).⁷³⁰

A good communications policy should include comprehensive procedures to prevent leaks of confidential information and to prevent trading on the basis of material non-public information.⁷³¹ Such a policy should also accommodate feedback from interested parties, which should be factored into the corporation’s business decisions.⁷³² With such feedback, and with the information gathered through the corporation’s internal information systems, boards should be in a good position to assess corporate risks and opportunities and the effectiveness of corporate controls.

Since National Policy 58-201 already includes guidelines regarding the monitoring of corporate controls and the adoption of a communication policy, we would not suggest any amendment thereto. As mentioned in subsection II.C.3 of this thesis, National Instrument 58-101 should however require the disclosure of the audit committee charter.

(2) Supervision of management

As explained in subsection I.B.3 of this thesis, boards of directors of publicly listed corporations can delegate most of their day-to-day responsibilities to management, but they always remain responsible for monitoring the management team and for adopting disciplinary measures when appropriate.⁷³³ Subsection 3.4(d) of National Policy 58-201 states that a board charter should specify that the board is responsible for

⁷²⁹ 25 OSCB 4492.

⁷³⁰ Ellis, M.V., at 15-65 and 15-66.

⁷³¹ *Ibid.*, at 15-52.

⁷³² Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 18.

⁷³³ See section II.B.2 of this thesis.

monitoring senior management. Because of the importance of the matter, more emphasis should be put, in National Policy 58-201, on how the board discharges that responsibility.

National Policy 58-201 should suggest that the board set in advance goals and objectives against which management's performance can be measured⁷³⁴ and performance indicators to provide monitoring benchmarks.⁷³⁵ Under the current section 3.5 of National Policy 58-201, it is suggested that the board develop or approve the corporate goals and objectives for the chief executive officer but it does not refer to benchmarks. It seems to us that referring to benchmarks would help to ensure that the assessment of management's performance is linked to the specific performance of the corporation (as opposed to the performance of the industry in which the corporation evolves).⁷³⁶ Hence, when all corporations in a particular industry have great results, management's performance would only be considered as superior if the corporation's performance is higher than the performance of its competitors (or those benchmarked, as applicable). Similarly, if management keeps the corporation afloat in times when competitors are in serious financial problems due to an economic downturn in that particular industry, the work of management would then better be recognized.

Therefore, we would recommend that National Policy 58-201 be amended to include a best practice guideline to the effect that boards should set in advance goals and objectives against which management can be assessed. This would complement the current requirement in National Instrument 58-101 to describe the process by which the board determines the compensation of management.

The compensation and human resources committee has an important role to play in assisting the board in the monitoring of senior management. The next subsection will describe the role of such committee, as well as the roles of other committees of the board.

⁷³⁴ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 18.

⁷³⁵ Joint Committee on Corporate Governance, *supra* note 6, at 20.

⁷³⁶ See Canadian Coalition for Good Governance, *supra* note 362, at 12 and 17.

(b) Content of board committee charters

Virtually all boards of directors of publicly listed corporations operate using several committees to assist them.⁷³⁷ The number of committees and their structure will vary from one corporation to another, depending upon the size of the corporation and of its board, the composition of the board and the business and needs of the corporation.⁷³⁸

The three committees that generally perform most key functions in monitoring management of publicly-held corporations are the audit committee, the nominating committee and the compensation committee.⁷³⁹ In Canada, under section 171 of the *CBCA*, public corporations are required to have an audit committee⁷⁴⁰ and the nominating and compensation committees are recommended by National Policy 58-201.⁷⁴¹

As mentioned in subsection II.A of this thesis, there are two main advantages to the use of committees by a board. First, it allows the board to deal with a large number of issues, some of which may be very complex. It allows for attention to be given to certain areas that the board acting only as a unit would not have the time to consider.⁷⁴² Funneling specific matters to committee members who can analyze such matters in depth helps to avoid overloading the full board.⁷⁴³ Second, committees composed of independent directors are often in a better position than the full board to provide independent advice and analysis in areas where directors who are not independent may have real or perceived conflicts of interest.⁷⁴⁴

⁷³⁷ Section 115 of the *CBCA* provides that directors of a corporation may appoint committees of directors and delegate certain powers to such committees. The Business Roundtable, *supra* note 247, at 11.

⁷³⁸ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 8, at 2.

⁷³⁹ *Ibid.*, chap. 8, at 1.

⁷⁴⁰ See also Canadian Securities Administrators Multilateral Instrument 52-110; and Priest, M. & Nathan, H.R., *supra* note 3, at 95.

⁷⁴¹ See sections 3.10 and 3.15 of National Policy 58-201.

⁷⁴² Priest, M. & Nathan, H.R., *supra* note 3, at 35; and The Business Roundtable, *supra* note 247, at 21.

⁷⁴³ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 8, at 5.

⁷⁴⁴ Priest, M. & Nathan, H.R., *supra* note 3, at 92.

Acknowledging the almost universal use of board committees by publicly listed corporations, the following subsections propose certain amendments to National Policy 58-201 to include guidelines on board committee responsibilities generally, to be followed by guidelines on responsibilities of the audit committee, the nominating and corporate governance committee and the compensation and human resources committee, the three traditional board committees.

(i) Board committee responsibilities generally

Because the board remains ultimately responsible for the discharge of the responsibilities delegated to its committees, a good reporting process should be in place so that the board remains informed of how these responsibilities are being discharged. Hence, National Policy 58-201 should suggest, as a best practice, that committee charters describe the process in place at the corporation for keeping the board informed of the activities of the committee. This process could consist in written or oral reports by the committee chair.⁷⁴⁵ However, in all cases, the process should be formalized so that directors who do not sit on the committee may request such reports.

With a view to improve committee efficiency, National Policy 58-201 should also be amended to state that committees, like the board, should meet regularly, with adequate notice, written agendas and documentation provided to members in advance.⁷⁴⁶ For committee members to be efficient in actively monitoring the affairs of the corporation, they should meet frequently enough and have the time to review the material before the committee meetings.

Suggested amendments to the current guidelines contained in National Policy 58-201 regarding responsibilities to be delegated to board committees are described below. As a preliminary comment and to enhance clarity, it is recommended that National Policy

⁷⁴⁵ The Business Roundtable, *supra* note 247, at 12.

⁷⁴⁶ Priest, M. & Nathan, H.R., *supra* note 3, at 94.

58-201 describe the responsibilities of each committee under a heading corresponding to the name of such committee.

(ii) Audit committee

Under section 2.1 of Multilateral Instrument 52-110, every issuer must have an audit committee that complies with the requirements of that instrument. In 1994, the Dey Report recommended that the roles and responsibilities of the audit committee be specifically defined so as to provide appropriate guidance to audit committee members on their duties.⁷⁴⁷ Later, the Saucier Report recommended that each audit committee adopt a formal written charter, approved by the full board, setting out the scope of the committee's responsibilities. It also suggested that the charter be disclosed to shareholders, and that a regular assessment of the effectiveness of the committee against its charter be conducted and reported to the full board.⁷⁴⁸ But these reports never suggested that specific responsibilities be mandatory for all audit committees.

The mandatory approach is instead similar to the one described in *SOX*, the SEC rules implementing the provisions of *SOX* and the NYSE Company Manual,⁷⁴⁹ which were adopted in a time of crisis, in order to restore confidence in U.S. financial markets.⁷⁵⁰ As explained in subsection II.B of the thesis, without convincing evidence of the merits of the mandatory regime for the audit committees, we would change the approach and be consistent with the general approach described in National Instrument 58-101 and National Policy 58-201, which are more in line with the hybrid regime proposed in this thesis. We would thus recommend that the content of the audit committee charter be voluntary, but that its disclosure be mandatory.

⁷⁴⁷ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 43.

⁷⁴⁸ Joint Committee on Corporate Governance, *supra* note 6, at 29.

⁷⁴⁹ See sections 303A(7) of the NYSE Company Manual, sections 204 and 301 of the *Sarbanes-Oxley Act*, SEC rule 33-8183 and section 2.3 of Multilateral Instrument 52-110.

⁷⁵⁰ Clark, R.C., *supra* note 492; Romano, R., *supra* note 405.

Caution is required when drafting the charter of the audit committee or of any other committee of the board, for increased involvement in operational matters may jeopardize the committee's independence from management, and committee members may not possess the requisite competence or have the time to perform ever-expanding tasks.⁷⁵¹ The following subsections of this thesis will analyze the responsibilities most often entrusted to an audit committee of a publicly-listed corporation. These responsibilities can be grouped in two categories: (i) oversight of financial reporting, corporate controls and risk management and (ii) oversight of internal and external auditors. Most of the guidelines proposed below are currently mandatory under Multilateral Instrument 52-110. Our comments related thereto would apply even if they were voluntary standards described in National Policy 58-201. As a general, preliminary comment, we would propose that National Policy 58-201 include headings, such as those of the subsections below, to enhance clarity.

(1) Oversight of financial reporting, internal controls and risk management

- *Oversight of financial reporting*

Corporate and securities laws in Canada require public corporations to file continuous disclosure documents with regulatory authorities and to mail some of these documents, such as the annual financial statements and the management discussion and analysis report, to their shareholders.⁷⁵² These documents are also widely distributed to market analysts and investors in general. Since these documents include a lot of information on the financial health of the corporation, which might affect the corporation's stock price, and that management's compensation is often related to stock price, management could be tempted to engage in "earnings management" in how it discloses. "Earnings management" covers a broad range of activities, from the lawful to the unlawful, which all share the common characteristic of enabling corporate

⁷⁵¹ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 8, at 11.

management to intentionally affect the corporation's earnings.⁷⁵³ If relatively small changes in earnings, or the growth of earnings, have a significant impact on the stock price, and if management receives a significant portion of its compensation through stock options, the temptation is obvious.⁷⁵⁴ It is the responsibility of management, under the oversight of the board, to produce financial statements that fairly present the financial condition and results of operations of the corporation, to make the timely disclosure investors need to permit them to assess the financial and business soundness and risks of the corporation, and of course to avoid earnings management in how and what is disclosed.⁷⁵⁵

Section 171 of the *CBCA* states that audit committees must review the annual financial statements of corporations. Similarly, National Instrument 51-102 requires boards to review financial statements but allows boards to delegate this task to audit committees with regard to interim financial statements.⁷⁵⁶ In addition, pursuant to subsections 2.3(5) and (6) of Multilateral Instrument 52-110:

2.3(5) An audit committee must review the issuer's financial statements, MD&A and annual and interim earnings press releases before the issuer publicly discloses this information.

(6) An audit committee must be satisfied that adequate procedures are in place for the review of the issuer's public disclosure of financial information extracted or derived from the issuer's financial statements, other than the public disclosure referred to in subsection (5), and must periodically assess the adequacy of those procedures.

As explained above, the *CBCA* and securities regulations should not require that certain functions be performed by a particular committee, unless the benefits of such requirement are clearly proven, which is currently not the case. That is not to say that delegating these responsibilities to the audit committee does not constitute a best

⁷⁵² See Multilateral Instrument 51-102.

⁷⁵³ Coffee, J.C., *supra* note 18, at 17 and 18.

⁷⁵⁴ Gordon, J.N., *supra* note 336, at 14.

⁷⁵⁵ The Business Roundtable, *supra* note 247, at iv.

⁷⁵⁶ Section 4.5 of National Instrument 51-102.

practice. On the contrary. As a best practice, the board, through the audit committee, should make sure that it understands the financial statements, including: (i) why the accounting principles critical to the corporation's business were chosen; (ii) what key judgments and estimates were made by management; and (iii) how the choice of principles, and the making of such judgments and estimates, impact the reported financial results of the corporation.⁷⁵⁷ It is the responsibility of directors to make the appropriate inquiries in order to satisfy themselves about the integrity of the annual and interim financial statements. As stated in *In Re Standard Trustco Ltd.*:⁷⁵⁸

In our view, in the circumstances, it was incumbent upon all of the respondent directors to make a number of inquiries directly of various people to obtain the necessary information and advice in order to satisfy themselves about the integrity of the interim financial statements before they made the decision to approve and issue the financial statements. We agree that the directors ought to have consulted the auditor and counsel. At the very least, the directors ought to have given management specific direction on the inquiries that were to be made of the outside lawyer and the auditor and insisted that management report back to the board with the results of the inquiries so that the board could then consider the advice and exercise their judgement on whether to issue the financial statements or make additional disclosure or make further inquiries. Given the seriousness of the issue at hand, the directors should not have felt that they could rely on advice provided by the outside lawyer and auditor to management, when the directors did not even hear or consider the advice prior to exercising their judgement with respect to the financial statements.⁷⁵⁹

The review by the audit committee, with the assistance of independent advisors if required, of the financial statements, ensures the other directors that a reasonable process is in place and that through the audit committee they duly discharge their duty of care toward the corporation. Subsections 2.3(5) and (6) of Multilateral Instrument 52-110 should thus be reformulated as guidelines in National Policy 58-201. As mentioned in subsection II.C.3 of this thesis, disclosure should however be made with respect to the process in place to oversee accounting and financial reporting.

⁷⁵⁷ The Business Roundtable, *supra* note 247, at 5.

- *Oversight of internal controls*

Implicit in the integrity of financial statements and in the effective discharge of the responsibilities of a board and its committees is the oversight of internal controls.⁷⁶⁰ However, Multilateral Instrument 52-110 does not currently include any responsibilities relating to the monitoring of the effectiveness of internal controls, a task often delegated to the audit committee.

“Control” has been described by the Canadian Institute of Chartered Accountants as comprising all the elements of an organization (including its resources, systems, processes, culture, structure and tasks) that, taken together, support people in the achievement of the organization’s objectives. Control is “effective” to the extent that it provides reasonable assurance that the organization will achieve its objectives reliably.⁷⁶¹ Control supports the reliable achievement of corporate objectives and, as such, an assessment of control is necessarily an assessment of how the organization is managed.⁷⁶²

As for the expression “internal control”, it can be defined as “a process, effected by a corporation’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (i) effectiveness and efficiency of operations; (ii) reliability of financial reporting; and (iii) compliance with applicable laws and regulations”.⁷⁶³

As recommended by the Dey Report, the duties of the audit committee should generally include oversight responsibilities for management reporting on internal

⁷⁵⁸ *Supra* note 199.

⁷⁵⁹ *Ibid.*, at 286 and 287.

⁷⁶⁰ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 18.

⁷⁶¹ Canadian Institute of Chartered Accountants, *supra* note 351, at 2.

⁷⁶² *Ibid.*

⁷⁶³ Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework* (Jersey City: July 1994), at 3.

controls.⁷⁶⁴ The audit committee should ensure that the internal control systems convey all relevant information to the directors by requesting management to report regularly to the audit committee on that matter.⁷⁶⁵ National Policy 58-201 should thus be amended to include a best practice guideline regarding the oversight by the audit committee of the effectiveness of corporate internal controls.

- *Oversight of risk management*

Directors, through the audit committee, should also make sure that risks and opportunities are well managed. Efficient management of risks and opportunities will reduce the likelihood that directors of a corporation be found liable for failure to fulfill their responsibilities or comply with the law.⁷⁶⁶ In order to adequately oversee management in the monitoring of internal controls, an audit committee should understand the corporation's risk profile and oversee the corporation's risk assessment and management practices.⁷⁶⁷ With appropriate identification and management systems, directors should expect periodic briefings or reports on specific operational risks by members of management responsible for key functions such as finance, operations, internal audit, human resources, legal, environmental protection, research and development and so on.⁷⁶⁸ Directors should also expect briefings related to the opportunities identified and pursued (and not pursued) by the corporation, including new product lines, potential geographical markets, new methods of operations and new technologies.

As required by subsection 2.3(7) of the Canadian Multilateral Instrument 52-110, which is similar to section 301 of *SOX*, an audit committee should also "establish procedures for: (i) the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls or auditing matters; and (ii) the

⁷⁶⁴ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 45.

⁷⁶⁵ Priest, M. & Nathan, H.R., *supra* note 3, at 98; The Business Roundtable, *supra* note 247, at 15.

⁷⁶⁶ Priest, M. & Nathan, H.R., *ibid.*, at 188.

⁷⁶⁷ The Business Roundtable, *supra* note 247, at 13.

confidential, anonymous submission by employees of the corporation of concerns regarding questionable accounting or auditing matters”. Such procedures are very useful as they often provide valuable information to the audit committee in the testing of corporate controls and risk management.

Hence, we would integrate, as part of National Policy 58-201, a best practice guideline to the effect that the audit committee charter should include a responsibility for overseeing the identification and management of corporate risks and opportunities. We would also include a guideline similar to the current subsection 2.3(7) of Multilateral Instrument 52-110 to encourage the adoption of a process for the reporting of complaints and concerns related to accounting and auditing matters. As mentioned in subsection II.C.3 of this thesis, National Instrument 58-101 should however require the disclosure of systems to identify and manage corporate risks and opportunities.

(2) Oversight of internal and external auditors

- *Oversight of internal auditors*

Multilateral Instrument 52-110 currently focuses on the relationship between the audit committee and a corporation’s external auditors. It does not mention internal auditors. We would amend National Policy 58-201 in order to include certain guidelines relating to internal auditors. The expression “internal auditor” refers to a member of management responsible for internal auditing. “Internal auditing” can be defined as an activity within the corporation “which brings a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes”.⁷⁶⁹

As mentioned in the Treadway Report, internal auditors are beneficial to a corporation since they can help it to meet its responsibilities and reduce the incidence of

⁷⁶⁸ Canadian Institute of Chartered Accountants, *supra* note 351, at 6.

financial irregularities.⁷⁷⁰ As a best practice, when a corporation chooses to appoint internal auditors, the audit committee should be satisfied that they have adequate resources to perform their responsibilities, and ensure that the chief internal auditor has direct and open communication with the committee.⁷⁷¹

The audit committee charter should state that the audit committee oversees the corporation's internal audit function, which includes the review of reports submitted by the internal audit staff, and that the audit committee should review the appointment and replacement of the chief internal auditor.⁷⁷² The corporation should also set forth in writing the scope of responsibilities of the internal auditors⁷⁷³ and the scope of these responsibilities as well as any change in role or function of the internal auditors should be the subject of regular review by the audit committee.⁷⁷⁴ Furthermore, public corporations should ensure that their internal auditors are free to perform their functions in an objective manner, without interference, and are able to report findings to the appropriate people for corrective action.⁷⁷⁵

Internal auditors should not be mandatory as many small corporations may not have the size to afford such a position. Unless empirical research demonstrates that imposing internal auditors is beneficial to all corporations, the flexibility of a guideline is the best approach. Hence, we would recommend the amendment of National Policy 58-201 to include guidelines related to internal auditors. Such guidelines should suggest that the audit committee charter state that the audit committee oversees the corporation's internal audit function and the mandate of the internal auditors, and that the audit committee should review the appointment and replacement of the chief internal auditor. It should also state that the chief internal auditor reports directly to the audit committee.

⁷⁶⁹ Institute of Internal Auditors, *The Professional Practices Framework* (New York: The IIA Research Foundation, 2004), at 1.

⁷⁷⁰ National Commission on Fraudulent Financial Reporting, *supra* note 686, at 6.

⁷⁷¹ Section 2.2 of Multilateral Instrument 52-110 and Joint Committee on Corporate Governance, *supra* note 6, at 31.

⁷⁷² The Business Roundtable, *supra* note 247, at 15.

⁷⁷³ National Commission on Fraudulent Financial Reporting, *supra* note 686, at 37.

⁷⁷⁴ *Ibid.*

⁷⁷⁵ *Ibid.*, at 38.

As explained in subsection II.C.3 of this thesis, this would be subject to the disclosure by the corporation, under National Instrument 58-101, of whether or not it has an internal audit function.

- *Oversight of external auditors*

The oversight of external auditors is often considered as one of the most important roles of the audit committee. Such role is not explicitly described in the *CBCA*, which nevertheless sets the basis on which securities regulations may stand to require that such responsibility be included in the audit committee charter. Hence, under section 155 of the *CBCA*, the directors of a corporation must place before the shareholders at every annual meeting the comparative financial statements and the report of the external auditors. Under subsection 169(1) of the *CBCA*, the external auditors “shall make the examination that is in their opinion necessary to enable them to report [...] on the financial statements” of the corporation. As for section 171 of the *CBCA*, it states that external auditors should attend meetings of the audit committee and can even call a meeting of the committee.

Subsections 2.3(2), (3) and (4) of Multilateral Instrument 52-110 currently describe the mandatory responsibilities of the audit committee with respect to the external auditors:

2.3 [...] (2) An audit committee must recommend to the board of directors:

- (a) the external auditor to be nominated for the purpose of preparing or issuing an auditor’s report or performing other audit, review or attest services for the issuer; and
 - (b) the compensation of the external auditor.
- (3) An audit committee must be directly responsible for overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor’s report or performing other audit, review or attest services for the

issuer, including the resolution of disagreements between management and the external auditor regarding financial reporting.

- (4) An audit committee must pre-approve all non-audit services to be provided to the issuer or its subsidiary entities by the issuer's external auditor.

We would recommend to include in National Policy 58-201 a guideline to the effect that the responsibilities now described in Multilateral Instrument 52-110 be integrated in the audit committee charter. In addition, National Policy 58-201 should suggest that the audit committee charter mention that the committee is responsible for reviewing and discussing with the external auditors the corporation's critical accounting policies and the quality of accounting judgments and estimates made by management.⁷⁷⁶

Subsection 2.3(2) of Multilateral Instrument 52-110 states that the audit committee must recommend the external auditors to the board of directors. In recommending external auditors, National Policy 58-201 should go further to suggest that the audit committee consider the impact of any non-audit services provided to the corporation on their independence.⁷⁷⁷ In addition, an audit committee should review annually the written statement of the external auditors outlining all relationships between the auditors and the corporation and engage in a dialogue with the auditors with respect to any relationships or services that may impact their objectivity and independence.⁷⁷⁸

It may be challenging for an audit firm to remain totally independent when the auditing revenues that the firm receives from a corporation are modest in proportion to other kind of revenues received from it.⁷⁷⁹ As stated by Professor Coffee, "The batter ought to worry about the umpire who is selling life-insurance to the pitcher".⁷⁸⁰ For this

⁷⁷⁶ *Ibid.*, at 14.

⁷⁷⁷ *Ibid.*

⁷⁷⁸ New York Stock Exchange & National Association of Securities Dealers, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (New York, 1999), at 14.

⁷⁷⁹ *Ibid.*, at 14 and 15.

⁷⁸⁰ Referred to in Gordon, J.N., *supra* note 336, at 6; see Coffee, J.C., *supra* note 752.

reason, *SOX* prohibits the same accounting firm from providing audit and certain non-audit services to public corporations. The prohibited services are: (i) bookkeeping or other services related to the accounting records or financial statements; (ii) financial information systems design and implementation; (iii) appraisal or valuation services, fairness opinions or contribution-in-kind reports; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions and human resources functions; (vii) broker-dealer, investment advisor or investment banking services; and (viii) legal services or other expert services unrelated to an audit.⁷⁸¹ Similar prohibitions now exist in the codes of conduct that Canadian auditors must follow in order to keep their professional qualification.⁷⁸² Hence, there is no need to list such prohibited services in National Policy 58-201.

As a complement to its responsibility of appointing the external auditors, the audit committee is also responsible for reviewing the reasonableness of proposed audit fees. Section 162 of the *CBCA* provides that if the shareholders have not set the remuneration of the auditor (which is rarely the case in public corporations), then the directors may do so. Multilateral Instrument 52-110 states that the audit committee must recommend to the board of directors the compensation of the external auditors. National Policy 58-201 should suggest that the responsibility for recommending the compensation of external auditors be included in the charter of the audit committee.

With respect to non-prohibited services, subsection 2.3(4) of Multilateral Instrument 52-110 states that the audit committee must pre-approve all non-audit services to be provided to the issuer by the issuer's external auditor. This is consistent with the goal of ensuring the independence of external auditors and we would therefore also maintain such item as a best practice to be included in National Policy 58-201.

With respect to the assessment of external auditors, as seen above, subsection 2.3(3) of Multilateral Instrument 52-110 provides that the audit committee must "be

⁷⁸¹ See sections 201 of the *Sarbanes-Oxley* Act and SEC rule 33-8183.

directly responsible for overseeing the work of the external auditor [...]”. In order to allow the audit committee to perform this function efficiently, National Policy 58-201 should recommend that the charter of the audit committee state that the external auditors report directly to the audit committee.⁷⁸³

In short, National Policy 58-201 should include guidelines to the effect that audit committee responsibilities now mandatory under Multilateral Instrument 52-110 be integrated in audit committee charters as best practice guidelines. In addition, it should recommend that such charters include the responsibilities to review and discuss with the external auditors the corporation’s critical accounting policies and the quality of accounting judgments and estimates made by management, and to consider the impact of any non-audit services provided to the corporation when recommending the external auditors to the board. Such charter should also specifically suggest that external auditors report directly to the audit committee.⁷⁸⁴ Pursuant to our recommendations set forth in subsection II.C.3 of this thesis, the audit committee charter should have to be disclosed.

(iii) *Nominating and corporate governance committee*

The two other committees of the board mentioned in National Policy 58-201, are the nominating committee (often called the “nominating and corporate governance committee”) and the compensation committee (often called the “compensation and human resources committee”). Special attention will be paid, in this subsection, to the usual responsibilities of the nominating and corporate governance committee, whereas the next subsection will focus on the compensation and human resources committee. The responsibilities of the nominating and corporate governance committee may be

⁷⁸² See section 204.4 of the rules of professional conduct of the Canadian chartered accountants available at www.cica.ca (date accessed: 3 March 2007).

⁷⁸³ The Business Roundtable, *supra* note 247, at 13.

⁷⁸⁴ See subsection 4.1(c) of Multilateral Instrument 52-110.

divided in two main functions: a nominating function and a corporate governance function.

(1) Nominating function

Traditionally, the primary function of a nominating committee was to recommend candidates for election as directors.⁷⁸⁵ Today, nominating committees are often also responsible for reviewing and making recommendations concerning the organization and size of the board, the structure of board committees, qualifications for membership on particular committees and director compensation, and assessing the effectiveness of the board, its committees and the contribution of individual directors.⁷⁸⁶

- *Nomination of new directors*

Sections 3.12 to 3.14 of National Policy 58-201 suggest a process to be followed by the board and the nominating and corporate governance committee with respect to the nomination of new directors:

3.12 Prior to nominating or appointing individuals as directors, the board should adopt a process involving the following steps:

(A) Consider what competencies and skills the board, as a whole, should possess. In doing so, the board should recognize that the particular competencies and skills required for one issuer may not be the same as those required for another.

(B) Assess what competencies and skills each existing director possesses. It is unlikely that any one director will have all the competencies and skills required by the board. Instead, the board should be considered as a group, with each individual making his or her own contribution.

⁷⁸⁵ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 8, at 13; and American Bar Association, Section of Business Law, *supra* note 618, at 1608. Canadian Coalition for Good Governance, *supra* note 362 at 7 suggests that the most important corporate governance requirement is the quality of directors. See also Ontario Teachers' Pension Plan, *supra* note 362, at 10.

⁷⁸⁶ Brodsky, E. & Adamski, M.P., *ibid.*

Attention should also be paid to the personality and other qualities of each director, as these may ultimately determine the boardroom dynamic.

The board should also consider the appropriate size of the board, with a view to facilitating effective decision-making.

In carrying out each of these functions, the board should consider the advice and input of the nominating committee.

3.13 The nominating committee should be responsible for identifying individuals qualified to become new board members and recommending to the board the new director nominees for the next annual meeting of shareholders.

3.14 In making its recommendations, the nominating committee should consider:

- (a) the competencies and skills that the board considers to be necessary for the board, as a whole, to possess;
- (b) the competencies and skills that the board considers each existing director to possess; and
- (c) the competencies and skills each new nominee will bring to the boardroom.

The nominating committee should also consider whether or not each new nominee can devote sufficient time and resources to his or her duties as a board member.

As a general comment, we would recommend that the style of those provisions be changed to encourage corporations to include those responsibilities as part of a publicly disclosed corporate policy. This would be consistent with our arguments relating to the adoption and disclosure of policies discussed in subsections II.A and II.B of this thesis, pursuant to which such adoption and disclosure would decrease the risks of mismanagement and assist directors in the discharge of their duty of care.

With respect to specific improvements to be made to National Policy 58-201 relating to the nomination of new directors, section 3.14 currently focusses on the “competencies and skills” of existing directors and nominees. We would recommend

that section 3.14 be broadened to also cover the experience of individuals. From our point of view, for a board to be efficient in discharging its duty of care and in reducing the risks of mismanagement, the board should monitor closely the mix of competencies, skills and experience of directors and continuously assess whether it has the necessary tools to perform its oversight function effectively.⁷⁸⁷ The board should be composed of people who are competent and know how to manage a corporation, who know the corporation's industry and who know and are known in the corporation's principal markets.⁷⁸⁸

In recommending board composition, members of the nominating and corporate governance committee should also remember that some directors should be "independent". Although obvious for the informed reader, it could be a good idea to add a sentence to that effect, as a reminder, in section 3.14 of National Policy 58-201.

National Policy 58-201 only relates to the composition of the board. Considering the importance of committees in assisting the board to discharge its duties, we would recommend that the nominating and corporate governance committee charter include a responsibility for recommending committee membership to the board.⁷⁸⁹ The nominating and corporate governance committee should establish criteria for committee composition and consider rotation of committee members.⁷⁹⁰ Similarly, the committee should recommend the board chair and chairs for every board committee, to be approved by the board.⁷⁹¹

Hence, National Policy 58-201 should be amended to suggest that the process for identifying board members be included in a publicly disclosed corporate policy. It should also recognize that the experience and business relationships of board candidates should be considered in the nominating process of the nominating and corporate

⁷⁸⁷ *Ibid.*

⁷⁸⁸ Dimma, W.A., *supra* note 75, at 13.

⁷⁸⁹ *Ibid.*, at 12.

⁷⁹⁰ *Ibid.*, at 17.

⁷⁹¹ *Ibid.*, at 12. See also Ontario Teachers' Pension Plan, *supra* note 362, at 10.

governance committee and that the charter of the committee should include a responsibility to recommend committee composition as well as candidates to become board chair and committee chairs.

- *Board assessment*

Subsection 3.18 of National Policy 58-201 states that:

3.18 The board, its committees and each individual director should be regularly assessed regarding his, her or its effectiveness and contribution. An assessment should consider

(a) in the case of the board or a board committee, its mandate or charter, and

(b) in the case of an individual director, the applicable position description(s), as well as the competencies and skills each individual director is expected to bring to the board.

Again, we would first recommend that National Policy 58-201 be amended to suggest that such process be included in a publicly disclosed corporate policy.⁷⁹² Because the nominating and corporate governance committee is often responsible for assessing the effectiveness of the board of directors, board committees and individual directors on an ongoing basis,⁷⁹³ National Policy 58-201 should also be amended so that section 3.18 is included under the nominating and corporate governance heading. It is now under an independent section of National Policy 58-201.

To improve the current text of National Policy 58-201, it should be extended to cover the assessment of the board chair as well as committee chairs. Practical guidelines could also be provided to mention that board and committee performance assessments may include an evaluation of the structure, composition, methods of operation and

⁷⁹² Ontario Teachers' Pension Plan, *supra* note 362, at 10; and Caisse de dépôt et placement du Québec, *supra* note 362, at 4.

effectiveness of the board and its committees, board and committee meeting agenda, frequency and length of meetings, adequacy of information flow and quality of discussions.⁷⁹⁴

With respect to individual directors' performance assessment, it can be done through directors' self-assessment, directors' peer review, or both. In individual self-assessments, directors may review the use of their time and skills, their knowledge of the corporation and its industry and their general level of preparation and contribution.⁷⁹⁵ The peer review may consider the value and use of various directors' skill sets and interpersonal styles, as well as individual preparedness and availability.⁷⁹⁶ Guidance could be added to National Policy 58-201 to that effect.

It has been said that if directors rate one another, damage could be done to the cohesive sense of equality that is so crucial to effective boards.⁷⁹⁷ However, peer evaluation, when done properly, may be an efficient way for a board to identify under-performing directors and a powerful tool to motivate directors to focus on how to add value.⁷⁹⁸ If consistent negative assessments are made with respect to a given director, corrective action must be taken. Otherwise, the other directors could potentially be liable in case of a breach of fiduciary duties caused by such director. More importantly, board functioning may be impaired.

The nominating and corporate governance committee is well placed to coordinate the assessment process.⁷⁹⁹ However, in many corporations, the independent board chair is also involved in the process. He or she may meet with each director individually to

⁷⁹³ See also section 303A(4) of the NYSE Company Manual; Sonnenfeld, J.A., *supra* note 448, at 113; and Conference Board, *supra* note 79, at 10.

⁷⁹⁴ Dimma, W.A., *supra* note 75, at 52; see also Conger, J.A., Finegold, D. & Lawler, E.E., "Appraising Boardroom Performance" (1998) Harv. Bus. Rev. 136; and Lorsch, J.W., *supra* note 335, at 116 and 117.

⁷⁹⁵ Sonnenfeld, J.A., *supra* note 448, at 113.

⁷⁹⁶ *Ibid.* See also See Canadian Coalition for Good Governance, *supra* note 362, at 16.

⁷⁹⁷ Dimma, W.A., *supra* note 75, at 55.

⁷⁹⁸ See the Board Shareholder Confidence Index developed by the Clarkson Centre for Business Ethics & Board Effectiveness of the Joseph L. Rotman School of Management available at: <http://www.rotman.utoronto.ca/ccbe/criteria.htm> (date accessed: 3 March 2007); McFarland, J., *supra* note 530 and The Strategic Counsel, *supra* note 458., at 12.

discuss the director's evaluation.⁸⁰⁰ Hence, the guidelines described in National Policy 58-201 should mention the potential involvement of the board chair.

In short, National Policy 58-201 should be amended to recommend that the oversight of the assessment of the board, board committees, board and committee chairs and individual directors be one of the responsibilities described in the charter of the nominating and corporate governance committee and that the method for doing so be disclosed in a corporate policy. Guidelines respecting how this assessment could be made and the potential involvement of the board chair could also be included in National Policy 58-201.

- *Directors' compensation*

Concurrent with board assessment, the nominating and corporate governance committee should review the adequacy and form of directors' compensation, making sure that such compensation realistically reflects the responsibilities and risks of their position. *Prima facie*, directors of a corporation do not have an absolute right to be paid for their services to the corporation and are in a conflict of interest when fixing their own remuneration.⁸⁰¹ However, section 120 of the *CBCA* specifically allows them to participate in decisions regarding their remuneration, subject to the provisions of the articles, by-laws or any unanimous shareholder agreement.⁸⁰²

National Policy 58-201 only mentions briefly, in subsection 3.17(b), that the compensation committee (not the nominating and corporate governance committee) should be responsible for making recommendations to the board with respect to director compensation. Because it is the role of the nominating and corporate governance committee to assess the board, its committees and individual directors, it would only seem logical that such committee make recommendations as to directors' compensation.

⁷⁹⁹ See Canadian Coalition for Good Governance, *supra* note 362, at 15.

⁸⁰⁰ *Ibid.*, at 18 and 19.

⁸⁰¹ Wegenast, F.W., *supra* note 120, at 400; and Sutherland, H., *supra* note 17, at 450.

Hence, we would amend National Policy 58-201 to recommend that the charter of the nominating and corporate governance committee include that responsibility as a best practice.

Furthermore, taking into consideration the importance of compensation as an incentive mechanism, the wording of National Policy 58-201 should be expanded to provide more guidance on that topic. For instance, the committee should be responsible for making recommendations to the board on the components of the remuneration.⁸⁰³ As well, it should be responsible for recommending the remuneration to be paid to individual directors, committee chairs and the board chair. A corporation may vary the remuneration of directors and discriminate between directors.⁸⁰⁴ Directors that are employees of the corporation generally do not receive any compensation for serving on the board.⁸⁰⁵ In contrast, because board and committee chairs and members of certain committees make a greater commitment of time than other board members, additional compensation may be justified for these directors.⁸⁰⁶

The remuneration of directors often reflects the responsibility and commitment that goes with board membership. If compensation is minimal, directors may not show the commitment that would be expected from them. On the other hand, if the remuneration is excessive, this might affect the independence of directors.⁸⁰⁷

Thus, National Policy 58-201 should be amended to provide that the nominating and corporate governance committee charter should include, as part of the responsibilities of the committee, that of recommending director compensation to the board. It should also include some guidelines relating thereto. Pursuant to our

⁸⁰² Sutherland, H., *ibid.*, at 451 and 452.

⁸⁰³ Canadian Coalition for Good Governance, *supra* note 362, at 9 suggests that directors should have a significant investment in the corporation on the board of which they sit. Compensation mechanisms such as restricted share units or deferred share units can allow directors to obtain such investment. See also Ontario Teachers' Pension Plan, *supra* note 362, at 25; and Caisse de dépôt et placement du Québec, *supra* note 362, at 7.

⁸⁰⁴ *Ibid.*, at 451.

⁸⁰⁵ American Bar Association, Section of Business Law, *supra* note 618, at 1593.

⁸⁰⁶ Strine, L.E., *supra* note 61, at 1397.

recommendations in subsection II.C.3 of this thesis, the charter should have to be disclosed.

(2) Corporate governance function

As mentioned above, nominating committees now play a leadership role in shaping the corporate governance policies of corporations and are involved in the continuous education of board members.⁸⁰⁸ National Policy 58-201 should be amended to better recognize these roles as discussed below.

- *Corporate governance*

National Instrument 58-101 provides that a corporation must disclose its corporate governance practices in its management information circular or, if the corporation does not send a circular to its security holders, in its annual information form.⁸⁰⁹ The nominating and corporate governance committee often plays a central role in reviewing these policies and guidelines and making recommendations regarding them for adoption by the board. National Policy 58-201 should suggest that this function be described in the charter of the committee.

As seen above, an important role of the board is to ensure a “tone at the top” and a corporate culture that promotes ethical values and practices within the organization.⁸¹⁰ As part of its responsibility for elaborating the corporate governance guidelines of a corporation, the nominating and corporate governance committee is often responsible for the adoption and the review of a corporation’s code of business conduct.⁸¹¹ Subsection 3.8 of National Policy 58-201 states that such a code should govern the behaviour of the

⁸⁰⁷ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 33.

⁸⁰⁸ The Business Roundtable, *supra* note 247, at 17.

⁸⁰⁹ See section 2.1 of Multilateral Instrument 58-101.

⁸¹⁰ See subsection II.C.4(a) of this thesis; see also Conference Board, *supra* note 79, at 11.

corporation's directors, officers and employees, and should address certain prescribed topics. This section should be placed under the corporate governance committee heading in National Policy 58-201 and it should be recommended that such responsibility be included in the committee charter.

National Policy 58-201 should thus be amended to recommend that the nominating and corporate governance committee charter include a responsibility for overseeing the corporate governance practices of the corporation as well as for adopting and reviewing its code of business conduct and ethics.

- *Directors' orientation and education*

The creation and monitoring of orientation and education programs is contemplated by subsections 3.6 and 3.7 of National Policy 58-201⁸¹²:

3.6 The board should ensure that all new directors receive a comprehensive orientation. All new directors should fully understand the role of the board and its committees, as well as the contribution individual directors are expected to make (including, in particular, the commitment of time and resources that the issuer expects from its directors). All new directors should also understand the nature and operation of the issuer's business.

3.7 The board should provide continuing education opportunities for all directors, so that individuals may maintain or enhance their skills and abilities as directors, as well as to ensure their knowledge and understanding of the issuer's business remains current.

Because of the role played by the nominating and corporate governance committee in reviewing corporate governance practices of the corporation, these provisions should be placed under the heading related to such committee. National

⁸¹¹ Both the Canadian and U.S. rules describe how the code should be disclosed and state that any change or waiver to the code should be disclosed. See section 2.3 of Multilateral Instrument 58-101, subsection 303A(10) of the NYSE Company Manual and SEC rule 33-8177.

⁸¹² See also subsections 303A(9) of the NYSE Company Manual.

Policy 58-201 should also mention it as part of the responsibilities to be described in the charter of the nominating and corporate governance committee.

No matter their level of experience, new directors need information on the corporation's practices and procedures.⁸¹³ At the very least, an orientation program should cover the role of the directors and how the board and its committees operate.⁸¹⁴ As a best practice, orientation programs should also provide new directors with information about the corporation's structure, history, strategy, operations, facilities and management, as well as on the corporation's industry and competitors.⁸¹⁵ These programs should also allow directors to become familiar with the laws and regulations that apply to the corporation as well as their specific statutory responsibilities and their exposure to liability.⁸¹⁶ Guidelines on these best practices should be added to National Policy 58-201.

Learning is a journey, not a destination⁸¹⁷ and, as such, continuing educational programs are also very important. These programs should flesh out the basics covered in the orientation program and delve into different aspects of the corporation's operations. Some of these programs may take the form of one- or two-day seminars, held annually, with presentations from management or qualified experts in fields in which the corporation operates.⁸¹⁸ External courses or seminars are also a good way to educate directors on their responsibilities, on how to become or remain effective directors and on issues of corporate governance generally.⁸¹⁹ Again, adding some guidance in National Policy 58-201 regarding best practices in this regard would be helpful.

In short, National Policy 58-201 should recommend that the nominating and corporate governance committee charter include a responsibility for adopting and

⁸¹³ Bender, M., *supra* note 17, at 17-30.

⁸¹⁴ *Ibid.*, at 17-32.

⁸¹⁵ *Ibid.*, at 17-30 and 17-31.

⁸¹⁶ *Ibid.*, at 17-33.

⁸¹⁷ Dimma, W.A., *supra* note 75, at 30.

⁸¹⁸ Bender, M., *supra* note 17, at 17-32.

reviewing directors' orientation and continuous orientation programs and that some guidance be provided with respect to the content of those programs.

(iv) Compensation and human resources committee

The third "critical board committee" mentioned in National Policy 58-201⁸²⁰ is the compensation committee (often called compensation and human resources committee). As suggested in the name of the committee, the responsibilities of the compensation and human resources committee can be divided in two main functions: compensation and human resources. A description of those two functions is presented below.

(1) Compensation Function

Subsection 3.17 of National Policy 58-201 states that the compensation committee should be responsible for the chief executive officer's performance assessment and executive compensation:⁸²¹

3.17 The compensation committee should be responsible for:

- (a) reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO's performance in light of those corporate goals and objectives, and determining (or making recommendations to the board with respect to) the CEO's compensation level based on this evaluation;
- (b) making recommendations to the board with respect to non-chief executive officer compensation, incentive-compensation plans and equity-based plans; and

⁸¹⁹ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 31; in Canada, the Institute of Corporate Directors provides such courses and seminars to directors.

⁸²⁰ See section 3.15 of National Policy 58-201.

⁸²¹ See also subsections 2.2(15) (16) and (17) of National Policy 58-201 and subsection 303A(5) of the NYSE Company Manual.

(c) reviewing executive compensation disclosure before the issuer publicly discloses this information.

Certain improvements could be made to these provisions. As discussed with respect to the nominating and corporate governance committee, we would first recommend that National Policy 58-201 be amended to suggest that the responsibilities described in its current provisions relating to executive compensation be part of the compensation and human resources committee charter.

With respect to the specific wording of subsection 3.17 of National Policy 58-201, it currently provides that the compensation committee should approve or develop the corporate goals and objectives that the chief executive officer is responsible for meeting, assess the chief executive officer against these goals and objectives and report the results to the board. We would suggest that other members of senior management, just like the chief executive officer, be evaluated against their corporate goals and objectives and compensated according to their ability to reach those goals and objectives. We would also recommend, as a best practice, that the compensation and human resources committee should review the performance of the chief executive officer and other managers at least annually.⁸²² Currently, National Policy 58-201 is silent on the frequency of such reviews.

In addition to the responsibilities regarding executive and compensation, National Policy 58-201 should also be amended to recognize the responsibility of the compensation and human resources committee for overseeing the corporation's overall compensation programs.⁸²³ Because the committee already focuses on the practices of the corporation related to executive compensation, it only seems to make sense that it also assists the board in considering matters relating to employee compensation and expense policies, fringe benefits, conditions of employment, and share purchase and

⁸²² The Business Roundtable, *supra* note 247, at 24; and Veasey, E.N., *supra* note 79, at 403.

⁸²³ The Business Roundtable, *ibid.*, at 18.

share option plans.⁸²⁴ The committee should help the board in evaluating the overall compensation structure of the corporation and to determine if it has appropriate incentives in place for management and employees at all levels.⁸²⁵

In sum, National Policy 58-201 should be amended to recommend that the responsibilities currently mentioned therein be included in compensation and human resources committee charters and that the review of the performance of the chief executive officer and other managers and recommendations on their compensation be made at least annually. National Policy 58-201 should also recommend that such committee charters include a responsibility for overseeing the corporation's overall compensation practices. As mentioned in subsection II.C.3 of this thesis, National Instrument 58-101 should require the disclosure of such charters.

(2) Human resources function

Monitoring management succession planning is an important task of the compensation and human resources committee and National Policy 58-201 should cover that topic. A provision should thus be added to the policy, under the human resource and compensation committee heading, to describe that function and recommend that it be a responsibility integrated into the compensation and human resources committee charter.

As mentioned in subsection II.C.3 of this thesis, a good transition in management can be crucial to a corporation's continuing ability to succeed.⁸²⁶ The board of directors, through its compensation and human resources committee, should be able to identify and periodically update the qualities and characteristics required for its chief executive officer and for other members of management.⁸²⁷

⁸²⁴ Institute of Corporate Directors, *supra* note 343, at 50; Bender, M., *supra* note 17, at 1-22; and Priest, M. & Nathan, H.R., *supra* note 3, at 100.

⁸²⁵ Institute of Corporate Directors, *ibid.*, at 18.

⁸²⁶ Priest, M. & Nathan, H.R., *supra* note 3, at 100.

⁸²⁷ The Business Roundtable, *supra* note 247, at 24.

The committee should also periodically monitor and review the development and progression of potential manager candidates.⁸²⁸ Apart from planning for the retirement of key management people, it is necessary to be prepared for the possibility of their unexpected absence, incapacity or death.⁸²⁹ The committee, working with the chief executive officer, should track the succession issue regularly, regardless of whether any change is imminent.⁸³⁰ The committee should also be willing to recommend to the board of directors the change of failing senior management members in a timely fashion when necessary. National Policy 58-201 should include guidance on the monitoring of succession planning.

National Policy 58-201 should also recognize that the compensation and human resources committee is often responsible for reviewing policies regarding employee matters in general. As a best practice, this committee should take reasonable steps to ensure that management has put in place hiring policies, training policies and compensation structures so that the corporation can attract, motivate and retain the quality of personnel required to meet its business objectives. As mentioned in subsection II.C.3 of this thesis, the disclosure of the responsibilities of the committee relating to human resources should however be mandatory.

Together with the nominating and corporate governance committee, compensation and human resources committee should also promote ethical behaviours and recommend “whistleblower” policies to protect employees against any retaliation from their employer for reporting potential or actual violations to applicable laws, regulations or to the corporation’s code of business conduct. Again, National Policy 58-201 should be amended to recommend that the compensation and human resources charter include a responsibility for overseeing policies regarding employee matters in general and include some guidance with respect to whistleblowing procedures. The process required to be put in place by audit committees to allow employees and third

⁸²⁸ *Ibid.*

⁸²⁹ Priest, M. & Nathan, H.R., *supra* note 3, at 100.

⁸³⁰ Dimma, W.A., *supra* note 75, at 77.

parties to submit their concerns regarding accounting or auditing matters, pursuant to section 301 of *SOX* and subsection 2.3(7) of Multilateral Instrument 52-110, could be used as a model for such whistleblowing procedures.⁸³¹

In short, National Policy 58-201 should be amended to suggest that compensation and human resources committee charters include responsibilities for monitoring management succession planning and for overseeing employee matters in general. Guidance should also be provided on those topics. In accordance with our recommendations described in subsection II.C.3 of this thesis, the charter of the committee should have to be disclosed.

(v) *Other committees of the board*

In addition to the above mentioned committees, many boards of directors also choose to create other committees such as an environment and safety committee or an executive committee. It is also a good practice, when required by the circumstances, to establish additional committees to examine special problems or opportunities in greater depth than would otherwise be feasible.⁸³²

An environment and safety committee can devote the attention needed to oversee the corporate programs, procedures and guidelines put in place to comply with environmental, security and health and safety regulations. It can be responsible for overseeing employee training standards and should receive a copy of any report regarding complaints, investigations or proceedings by governmental authorities on environmental, security and health and safety matters.

Many boards of directors also delegate extensive responsibilities to executive committees, so that board authority can be exercised between board meetings.⁸³³ The

⁸³¹ See subsection II.C.4(b)(ii) of this thesis.

⁸³² Section 2.2 of Multilateral Instrument 52-110 and The Business Roundtable, *supra* note 247, at 12.

⁸³³ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 8, at 6.

historical model of an executive committee that comprises the real decision-makers within a board and excludes all other directors has virtually disappeared. This trend should be applauded because this model tends to create two classes of directors.⁸³⁴ Although an executive committee is an efficient mechanism for dealing with matters that require emergency actions between meetings of the board of directors, care should be taken to prevent the executive committee from usurping the functions of the board. Thus, directors who are not members of the executive committee should be kept informed of all decisions made by the committee so that they can review those decisions.⁸³⁵ In all cases, directors should make sure that such a committee, just like any other committee of the board, keeps accurate and complete minutes of its actions and reports regularly and promptly to the full board, which, in turn, should record the receipt and consideration of such report.⁸³⁶

Because the use of those committees is less common than the use of audit, nominating and corporate governance, and compensation and human resources committees, we would not suggest that guidelines relating thereto be included in National Policy 58-201 but would suggest instead that a general comment be added to the effect that it is a good practice for corporations to appoint additional committees to deal with matters that are of particular importance to them. In accordance with our proposed framework and as stated in subsection II.C.3 of this thesis, disclosure of the charters of such committees should be mandatory.

SUMMARY

This subsection of the thesis reviewed the current rules and guidelines of the CSA and suggested amendments thereto, taking into account: i) the independence vs. active monitoring categorization made in subsection II.A of the thesis; and ii) the proposed

⁸³⁴ Toronto Stock Exchange Committee on Corporate Governance in Canada, *supra* note 4, at 43; and Dimma, W.A., *supra* note 75, at 13.

⁸³⁵ Brodsky, E. & Adamski, M.P., *supra* note 173, chap. 8, at 7.

⁸³⁶ Bender, M., *supra* note 17, at 1-23.

hybrid (mandatory/voluntary) framework described in subsection II.B thereof. A very simple Categorization/Implementation Matrix was used to help visualize our proposed bidimensional approach to corporate governance.

As a preliminary comment, it was recommended that the mandatory provisions of Multilateral Instrument 52-110 regarding disclosure of audit committee composition and responsibilities be transferred in National Instrument 58-101 and that the other provisions be made voluntary and mentioned in National Policy 58-201 as suggested guidelines.

With respect to mandatory disclosure on board independence, we reviewed the existing criteria for the selection of independent directors mentioned in Multilateral Instrument 52-110 and suggested that the provisions relating thereto be amended so that the current presumptions precluding independence be only factors that a board should consider when determining if a director is independent, subject to full disclosure with respect to the prescribed relationships. Other factors to be considered and against which disclosure should be made were also suggested.

It was also recommended that National Instrument 58-101 be amended to require the disclosure of independence practices such as *in camera* meetings, policies for identifying conflicts of interest, independent board and committee chairs and access to independent advisors.

A review of the guidelines regarding independence, contained in National Policy 58-201, was also undertaken. Although the merits of having independent board and committees were recognized, it was suggested that corporations should always be allowed to choose the optimal composition of the board and of each committee, subject to disclosure. Certain amendments to the best practices recommended in National Policy 58-201 were suggested to encourage corporations to adopt independence practices such as independence criteria, policies related to the identification of conflicts of interest and policies discouraging such conflicts, independent board chairs, *in camera* meetings and the access to independent advisors.

This subsection also explained why National Instrument 58-101 should be amended to require more disclosure of active monitoring practices. As mentioned, the disclosure of board and committee charters should be mandatory in order to assist investors in assessing the methods of operation of the board and to increase the standards of conduct of directors, which should decrease agency costs and assist directors in their discharge of their fiduciary duties. It was also explained that the disclosure of board and committee attendance records as well as the education and experience of each director would help investors assess the efforts and the individual qualities of directors.

It was furthermore suggested that the position descriptions of the board chair, committee chairs and the chief executive officer be disclosed. Such disclosure would again assist investors in understanding how the corporation is managed and would motivate the chairs and the chief executive to properly discharge all responsibilities entrusted to them. Among other elements of disclosure in National Instrument 58-201, we recommended that more be said on the role of the board with respect to strategy, risk identification and management, and succession planning, as well as on methods for receiving feedback from stakeholders.

Finally, National Policy 58-201 was reviewed and it was suggested that it be amended to recommend that certain responsibilities be included in board and committee charters and that guidance be given with respect to the most important functions of the board and its committees. Board functions were divided into leadership and oversight functions and it was suggested that to enhance clarity, National Policy 58-201 include a similar categorization.

The responsibilities to be delegated to the “three critical board committees” were reviewed and proposals for amendments were made with respect to each function. Hence, it was suggested that the audit committee be responsible for the oversight of financial reporting, corporate controls and risk management, as well as for the oversight of internal and external auditors. The nominating and corporate governance committee should be responsible for recommending candidates for election as directors and for

assessing the board, board committees, board and committee chairs and individual directors, and should also play a leadership role in shaping corporate governance policies. As for the compensation and human resources committee, it should recommend compensation practices to the board and oversee management succession planning and performance evaluation.

We mentioned that other committees are often created by a board to help it discharge its fiduciary duties, such as an environment and safety or an executive committee, but because those committees are not widely used, it was recommended that a very simple and general comment be added to National Policy 58-201 to the effect that it is a good practice for corporations to appoint additional committees where needed. In accordance with our proposed framework and as stated in subsection II.C.3 of this thesis, disclosure of the charters of such committees should be mandatory.

CONCLUSION

In this thesis, we have demonstrated how good corporate governance practices can be used to reduce agency costs and assist directors in the discharge of their fiduciary duties. The first part of the thesis explained the nature of the challenges that agency costs and compliance with fiduciary duties represent for directors. In section A of part I, agency costs resulting from the dispersal of ownership were described. Agency costs were categorized into two categories: misappropriation and mismanagement costs. The costs of misappropriation result from a misallocation of corporate assets to the personal advantage of an agent, whereas the costs of mismanagement exist when agents neglect the business of the corporation.

Section B of part I described the fiduciary duties of directors. Pursuant to these duties, directors must act honestly and in good faith, in the best interests of the corporation (the duty of loyalty) and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (the duty of care). Statutory exceptions apply to the duty of loyalty and the duty of care, and the duty of care is also limited by the business judgment rule.

Section C of part I then explained how the duty of loyalty and the duty of care constitute imperfect attempts to decrease costs of misappropriation and of mismanagement. It was shown that the efficiency of these legal duties is undermined by lacks of incentives to enforce them and by procedural limits. Consequently, prophylactic and curative measures, within a corporation, are required to reduce agency problems and help directors in the discharge of their fiduciary duties.

Part II of the thesis proposed solutions to the challenges described in part I. It was explained that such solutions were based on independence and active monitoring practices. Section A of part II described the concept of independence. It was explained that the essential elements of board independence include true outsiders who can create a

climate of creative tension in the boardroom. It was shown that independence best practices include the presence of independent directors on a board and its committees, policies to identify and sanction wrongful conduct, the appointment of an independent board chair, *in camera* meetings and policies allowing directors to consult independent advisors.

In principle, an independent board will be a powerful tool to complement the duty of loyalty in decreasing agency costs and in assisting directors avoid potential liability. Empirical studies, however, call for prudence in the implementation of mandatory independence practices, as corporations with super-majority of independent directors are not necessarily always associated with better performance.

Section B of part II then described the concept of active monitoring, which refers to the active supervision of management and corporate initiatives by the board of directors, directly or through the use of board committees. Active monitoring was shown to empower the board through the adoption of board and committee charters and position descriptions for board and committee chairs and for the chief executive officer. Policies related to the assessment of the board and orientation and continuous education programs for directors were shown to reduce the risks of mismanagement.

It was also explained that active monitoring practices can assist directors in the discharge of their duty of care. It was submitted that active monitoring does so by helping directors in defining appropriate norms of conduct. Other advantages of active monitoring practices are that they can allow directors to benefit from statutory defenses and are essential to complement other protective measures. Empirical research is very scarce on the effects of active monitoring on corporate performance. Accordingly, regulators should be cautious in making specific active monitoring practices mandatory for all corporations.

Section C of part II discussed in detail the question of whether or not best practices regarding independence and active monitoring should be imposed on issuers (a mandatory regime) or be left to the discretion of boards of directors (a voluntary regime). The costs and benefits of both mandatory and voluntary regimes were identified and it was found that a hybrid regime could allow corporations to benefit from the most important advantages of the mandatory and the voluntary regimes, while avoiding their most important disadvantages. A hybrid regime provides boards with the freedom to determine which practices to follow, but at the same time requires corporate disclosure of practices followed against a mandatory template. It allows flexibility for corporations to adopt practices most consistent with their particular circumstances, including their size, sectors of activity and ownership structure, but at the same time encourages corporations to follow best practices.

It was explained that the current Canadian regime possesses many attributes of the hybrid regime, but could still be improved. A matrix was used to show how, in practice, the independence vs. active monitoring categorization can be combined with the hybrid framework to provide a roadmap for how to implement optimal prophylactic and curative measures to decrease agency costs and assist directors in discharging their fiduciary duties.

As preliminary comments, it was recommended that the mandatory provisions of Multilateral Instrument 52-110, regarding disclosure of audit committee composition and responsibilities, be transferred to National Instrument 58-101 and that other provisions of Multilateral Instrument 52-110 become voluntary and be moved into National Policy 58-201 as guidelines. Existing criteria for the selection of independent directors mentioned in Multilateral Instrument 52-110 were then reviewed and it was suggested that they be amended so that the current presumptions precluding independence become factors that a board should consider when determining if a director is independent, subject to full disclosure with respect to prescribed relationships. Other factors to be considered were also suggested and it was recommended that National Instrument 58-101 be amended to require the disclosure of independence practices such as *in camera* meetings, policies for

identifying conflicts of interest, independent board and committee chairs and access to independent advisors.

The guidelines on independence contained in National Policy 58-201 were also reviewed. Although we recognize the merits of having a board composed of a majority of independent directors and having committees composed solely of independent directors, it was suggested that each corporation should always be allowed to choose the optimal composition for its board and for each committee, subject to disclosure.

With respect to active monitoring practices, it was proposed that National Instrument 58-101 be amended to require the disclosure of board and committee charters and position descriptions of the board chair, committee chairs and the chief executive officer. Recommendations were also made to improve the disclosure related to other active monitoring practices.

Finally, National Policy 58-201 was reviewed and it was suggested that it be amended to recommend that certain responsibilities be included in board and committee charters and that guidance be provided with respect to the most important functions of the board and its committees.

We believe that in order to be followed, best practices need to be set in an easy and understandable way. In order to do that, a simple categorization is needed. What has been described in this thesis is a framework to assess the importance of the two pillars of corporate governance around which all rules, standards and practices should revolve, that is independence and active monitoring.

Throughout the thesis, it was demonstrated that independence and active monitoring are paramount to ensure that directors will discharge their duties in the best interests of the shareholders. Best practices, if followed by directors, should help reduce agency costs and protect directors against liability. However, imposing rules that are not adapted to corporate needs may be inefficient and even detrimental to corporations.

Therefore, corporations must be allowed to choose whether and to what extent to conform to identified best practices. President Abraham Lincoln once said that “Important principles may and must be flexible”.⁸³⁷ As described throughout this thesis, corporate governance is a good example of an area where such statement takes all its importance.

⁸³⁷ Bachelder, L., *Abraham Lincoln – Wisdom and Wit* (New York: Peter Pauper Press Inc., 1998), at 6.

APPENDIX A

MULTILATERAL INSTRUMENT 52-110 – AUDIT COMMITTEES

PART 1 – DEFINITIONS AND APPLICATION

1.1 Definitions – In this Instrument,

“accounting principles” has the meaning ascribed to it in National Instrument 52-107 *Acceptable Accounting Principles, Auditing Standards and Reporting Currency*;

“AIF” has the meaning ascribed to it in National Instrument 51-102;

“asset-backed security” has the meaning ascribed to it in National Instrument 51-102;

“audit committee” means a committee (or an equivalent body) established by and among the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer, and, if no such committee exists, the entire board of directors of the issuer;

“audit services” means the professional services rendered by the issuer’s external auditor for the audit and review of the issuer’s financial statements or services that are normally provided by the external auditor in connection with statutory and regulatory filings or engagements;

“credit support issuer” has the meaning ascribed to it in section 13.4 of National Instrument 51-102;

“designated foreign issuer” has the meaning ascribed to it in National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*;

“exchangeable security issuer” has the meaning ascribed to it in section 13.3 of National Instrument 51-102;

“executive officer” of an entity means an individual who is:

- (a) a chair of the entity;
- (b) a vice-chair of the entity;
- (c) the president of the entity;
- (d) a vice-president of the entity in charge of a principal business unit, division or function including sales, finance or production;
- (e) an officer of the entity or any of its subsidiary entities who performs a policy-making function in respect of the entity; or
- (f) any other individual who performs a policy-making function in respect of the entity;

“foreign private issuer” means an issuer that is a foreign private issuer within the meaning of Rule 405 under the 1934 Act;

“immediate family member” means an individual’s spouse, parent, child, sibling, mother or father-in-law, son or daughter-in-law, brother or sister-in-law, and anyone (other than an employee of either the individual or the individual’s immediate family member) who shares the individual’s home;

“investment fund” has the meaning ascribed to it in National Instrument 51-102;

“marketplace” has the meaning ascribed to it in National Instrument 21-101 *Marketplace Operation*;

“MD&A” has the meaning ascribed to it in National Instrument 51-102;

“National Instrument 51-102” means National Instrument 51-102 *Continuous Disclosure Obligations*;

“non-audit services” means services other than audit services;

“SEC foreign issuer” has the meaning ascribed to it in National Instrument 71-102 *Continuous Disclosure and Other Exemptions Relating to Foreign Issuers*;

“U.S. marketplace” means an exchange registered as a ‘national securities exchange’ under section 6 of the 1934 Act, or the Nasdaq Stock Market;

“venture issuer” means an issuer that, at the end of its most recently completed financial year, does not have any of its securities listed or quoted on the Toronto Stock Exchange, a U.S. marketplace or a marketplace outside of Canada and the United States of America.

1.2 Application – This Instrument applies to all reporting issuers other than:

- (a) investment funds;
- (b) issuers of asset-backed securities;
- (c) designated foreign issuers;
- (d) SEC foreign issuers;
- (e) issuers that are subsidiary entities, if
 - (i) the subsidiary entity does not have equity securities (other than non-convertible, non-participating preferred securities) trading on a marketplace, and
 - (ii) the parent of the subsidiary entity is
 - (A) subject to the requirements of this Instrument, or
 - (B) an issuer that (1) has securities listed or quoted on a U.S. marketplace, and (2) is in compliance with the requirements of that U.S. marketplace applicable to issuers, other than foreign private issuers, regarding the role and composition of audit committees;
- (f) exchangeable security issuers, if the exchangeable security issuer qualifies for the relief contemplated by, and is in compliance with the requirements and conditions set out in, section 13.3 of National Instrument 51-102; and

- (g) credit support issuers, if the credit support issuer qualifies for the relief contemplated by, and is in compliance with the requirements and conditions set out in, section 13.4 of National Instrument 51-102.

1.3 Meaning of Affiliated Entity, Subsidiary Entity and Control –

- (1) For the purposes of this Instrument, a person or company is considered to be an affiliated entity of another person or company if
 - (a) one of them controls or is controlled by the other or if both persons or companies are controlled by the same person or company, or
 - (b) the person is an individual who is
 - (i) both a director and an employee of an affiliated entity, or
 - (ii) an executive officer, general partner or managing member of an affiliated entity.
- (2) For the purposes of this Instrument, a person or company is considered to be a subsidiary entity of another person or company if
 - (a) it is controlled by,
 - (i) that other, or
 - (ii) that other and one or more persons or companies each of which is controlled by that other, or
 - (iii) two or more persons or companies, each of which is controlled by that other; or
 - (b) it is a subsidiary entity of a person or company that is the other's subsidiary entity.
- (3) For the purpose of this Instrument, "control" means the direct or indirect power to direct or cause the direction of the management and policies of a person or company, whether through ownership of voting securities or otherwise.
- (4) Despite subsection (1), an individual will not be considered to control an issuer for the purposes of this Instrument if the individual:
 - (a) owns, directly or indirectly, ten per cent or less of any class of voting securities of the issuer; and
 - (b) is not an executive officer of the issuer.

1.4 Meaning of Independence –

- (1) An audit committee member is independent if he or she has no direct or indirect material relationship with the issuer.
- (2) For the purposes of subsection (1), a "material relationship" is a relationship which could, in the view of the issuer's board of directors, be reasonably expected to interfere with the exercise of a member's independent judgement.

- (3) Despite subsection (2), the following individuals are considered to have a material relationship with an issuer:
- (a) an individual who is, or has been within the last three years, an employee or executive officer of the issuer;
 - (b) an individual whose immediate family member is, or has been within the last three years, an executive officer of the issuer;
 - (c) an individual who:
 - (i) is a partner of a firm that is the issuer's internal or external auditor,
 - (ii) is an employee of that firm, or
 - (iii) was within the last three years a partner or employee of that firm and personally worked on the issuer's audit within that time;
 - (d) an individual whose spouse, minor child or stepchild, or child or stepchild who shares a home with the individual:
 - (i) is a partner of a firm that is the issuer's internal or external auditor,
 - (ii) is an employee of that firm and participates in its audit, assurance or tax compliance (but not tax planning) practice, or
 - (iii) was within the last three years a partner or employee of that firm and personally worked on the issuer's audit within that time;
 - (e) an individual who, or whose immediate family member, is or has been within the last three years, an executive officer of an entity if any of the issuer's current executive officers serves or served at that same time on the entity's compensation committee; and
 - (f) an individual who received, or whose immediate family member who is employed as an executive officer of the issuer received, more than \$75,000 in direct compensation from the issuer during any 12 month period within the last three years.
- (4) Despite subsection (3), an individual will not be considered to have a material relationship with the issuer solely because
- (a) he or she had a relationship identified in subsection (3) if that relationship ended before March 30, 2004; or
 - (b) he or she had a relationship identified in subsection (3) by virtue of subsection (8) if that relationship ended before June 30, 2005.
- (5) For the purposes of clauses (3)(c) and (3)(d), a partner does not include a fixed income partner whose interest in the firm that is the internal or external auditor is limited to the receipt of fixed amounts of compensation (including deferred compensation) for prior service with that firm if the compensation is not contingent in any way on continued service.

- (6) For the purposes of clause (3)(f), direct compensation does not include:
 - (a) remuneration for acting as a member of the board of directors or of any board committee of the issuer, and
 - (b) the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer if the compensation is not contingent in any way on continued service.
- (7) Despite subsection (3), an individual will not be considered to have a material relationship with the issuer solely because the individual or his or her immediate family member
 - (a) has previously acted as an interim chief executive officer of the issuer, or
 - (b) acts, or has previously acted, as a chair or vice-chair of the board of directors or of any board committee of the issuer on a part-time basis.
- (8) For the purpose of section 1.4, an issuer includes a subsidiary entity of the issuer and a parent of the issuer

1.5 Additional Independence Requirements –

- (1) Despite any determination made under section 1.4, an individual who
 - (a) accepts, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or any subsidiary entity of the issuer, other than as remuneration for acting in his or her capacity as a member of the board of directors or any board committee, or as a part-time chair or vice-chair of the board or any board committee; or
 - (b) is an affiliated entity of the issuer or any of its subsidiary entities,is considered to have a material relationship with the issuer.
- (2) For the purposes of subsection (1), the indirect acceptance by an individual of any consulting, advisory or other compensatory fee includes acceptance of a fee by
 - (a) an individual's spouse, minor child or stepchild, or a child or stepchild who shares the individual's home; or
 - (b) an entity in which such individual is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary entity of the issuer.
- (3) For the purposes of subsection (1), compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the issuer if the compensation is not contingent in any way on continued service.

- 1.6 Meaning of Financial Literacy – For the purposes of this Instrument, an individual is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements.

PART 2 – AUDIT COMMITTEE RESPONSIBILITIES

- 2.1 Audit Committee – Every issuer must have an audit committee that complies with the requirements of the Instrument.
- 2.2 Relationship with External Auditors – Every issuer must require its external auditor to report directly to the audit committee.
- 2.3 Audit Committee Responsibilities –
- (1) An audit committee must have a written charter that sets out its mandate and responsibilities.
 - (2) An audit committee must recommend to the board of directors:
 - (a) the external auditor to be nominated for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer; and
 - (b) the compensation of the external auditor.
 - (3) An audit committee must be directly responsible for overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer, including the resolution of disagreements between management and the external auditor regarding financial reporting.
 - (4) An audit committee must pre-approve all non-audit services to be provided to the issuer or its subsidiary entities by the issuer's external auditor.
 - (5) An audit committee must review the issuer's financial statements, MD&A and annual and interim earnings press releases before the issuer publicly discloses this information.
 - (6) An audit committee must be satisfied that adequate procedures are in place for the review of the issuer's public disclosure of financial information extracted or derived from the issuer's financial statements, other than the public disclosure referred to in subsection (5), and must periodically assess the adequacy of those procedures.
 - (7) An audit committee must establish procedures for:
 - (a) the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and
 - (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

- (8) An audit committee must review and approve the issuer's hiring policies regarding partners, employees and former partners and employees of the present and former external auditor of the issuer.
- 2.4 *De Minimis* Non-Audit Services – An audit committee satisfies the pre-approval requirement in subsection 2.3(4) if:
- (a) the aggregate amount of all the non-audit services that were not pre-approved is reasonably expected to constitute no more than five per cent of the total amount of fees paid by the issuer and its subsidiary entities to the issuer's external auditor during the fiscal year in which the services are provided;
 - (b) the issuer or the subsidiary entity of the issuer, as the case may be, did not recognize the services as non-audit services at the time of the engagement; and
 - (c) the services are promptly brought to the attention of the audit committee of the issuer and approved, prior to the completion of the audit, by the audit committee or by one or more of its members to whom authority to grant such approvals has been delegated by the audit committee.
- 2.5 Delegation of Pre-Approval Function –
- (1) An audit committee may delegate to one or more independent members the authority to pre-approve non-audit services in satisfaction of the requirement in subsection 2.3(4).
 - (2) The pre-approval of non-audit services by any member to whom authority has been delegated pursuant to subsection (1) must be presented to the audit committee at its first scheduled meeting following such pre-approval.
- 2.6 Pre-Approval Policies and Procedures – An audit committee satisfies the pre-approval requirement in subsection 2.3(4) if it adopts specific policies and procedures for the engagement of the non-audit services, if:
- (a) the pre-approval policies and procedures are detailed as to the particular service;
 - (b) the audit committee is informed of each non-audit service; and
 - (c) the procedures do not include delegation of the audit committee's responsibilities to management.

PART 3 – COMPOSITION OF THE AUDIT COMMITTEE

3.1 Composition –

- (1) An audit committee must be composed of a minimum of three members.
- (2) Every audit committee member must be a director of the issuer.
- (3) Subject to sections 3.2, 3.3, 3.4, 3.5 and 3.6, every audit committee member must be independent.
- (4) Subject to sections 3.5 and 3.8, every audit committee member must be financially literate.

3.2 Initial Public Offerings –

- (1) Subject to section 3.9, if an issuer has filed a prospectus to qualify the distribution of securities that constitutes its initial public offering, subsection 3.1(3) does not apply for a period of up to 90 days commencing on the date of the receipt for the prospectus, provided that one member of the audit committee is independent.
- (2) Subject to section 3.9, if an issuer has filed a prospectus to qualify the distribution of securities that constitutes its initial public offering, subsection 3.1(3) does not apply for a period of up to one year commencing on the date of the receipt for the prospectus, provided that a majority of the audit committee members are independent.

3.3 Controlled Companies –

- (1) An audit committee member that sits on the board of directors of an affiliated entity is exempt from the requirement in subsection 3.1(3) if the member, except for being a director (or member of a board committee) of the issuer and the affiliated entity, is otherwise independent of the issuer and the affiliated entity.
- (2) Subject to section 3.7, an audit committee member is exempt from the requirement in subsection 3.1(3) if:
 - (a) the member would be independent of the issuer but for the relationship described in paragraph 1.5(1)(b) or as a result of subsection 1.4(8);
 - (b) the member is not an executive officer, general partner or managing member of a person or company that
 - (i) is an affiliated entity of the issuer, and
 - (ii) has its securities trading on a marketplace;
 - (c) the member is not an immediate family member of an executive officer, general partner or managing member referred to in paragraph (b), above;
 - (d) the member does not act as the chair of the audit committee; and
 - (e) the board determines in its reasonable judgement that
 - (i) the member is able to exercise the impartial judgement necessary for the member to fulfill his or her responsibilities as an audit committee member, and
 - (ii) the appointment of the member is required by the best interests of the issuer and its shareholders.

3.4 Events Outside Control of Member – Subject to section 3.9, if an audit committee member ceases to be independent for reasons outside the member's reasonable control, the member is exempt from the requirement in subsection 3.1(3) for a period ending on the later of:

- (a) the next annual meeting of the issuer, and
- (b) the date that is six months from the occurrence of the event which caused the member to not be independent.

- 3.5 Death, Disability or Resignation of Member – Subject to section 3.9, if the death, disability or resignation of an audit committee member has resulted in a vacancy on the audit committee that the board of directors is required to fill, an audit committee member appointed to fill such vacancy is exempt from the requirements in subsections 3.1(3) and (4) for a period ending on the later of:
- (a) the next annual meeting of the issuer, and
 - (b) the date that is six months from the day the vacancy was created.
- 3.6 Temporary Exemption for Limited and Exceptional Circumstances – Subject to section 3.7, an audit committee member is exempt from the requirement in subsection 3.1(3) if:
- (a) the member is not an individual described in subsection 1.5(1);
 - (b) the member is not an employee or officer of the issuer, or an immediate family member of an employee or officer of the issuer;
 - (c) the board, under exceptional and limited circumstances, determines in its reasonable judgement that
 - (i) the member is able to exercise the impartial judgement necessary for the member to fulfill his or her responsibilities as an audit committee member, and
 - (ii) the appointment of the member is required by the best interests of the issuer and its shareholders;
 - (d) the member does not act as chair of the audit committee; and
 - (e) the member does not rely upon this exemption for a period of more than two years.
- 3.7 Majority Independent – The exemptions in subsection 3.3(2) and section 3.6 are not available to a member unless a majority of the audit committee members would be independent.
- 3.8 Acquisition of Financial Literacy – Subject to section 3.9, an audit committee member who is not financially literate may be appointed to the audit committee provided that the member becomes financially literate within a reasonable period of time following his or her appointment.
- 3.9 Restriction on Use of Certain Exemptions – The exemptions in sections 3.2, 3.4, 3.5 and 3.8 are not available to a member unless the issuer's board of directors has determined that the reliance on the exemption will not materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of this Instrument.

PART 4 – AUTHORITY OF THE AUDIT COMMITTEE

- 4.1 Authority – An audit committee must have the authority
- (a) to engage independent counsel and other advisors as it determines necessary to carry out its duties,
 - (b) to set and pay the compensation for any advisors employed by the audit committee, and
 - (c) to communicate directly with the internal and external auditors.

PART 5 – REPORTING OBLIGATIONS

- 5.1 Required Disclosure – Every issuer must include in its AIF the disclosure required by Form 52-110F1.
- 5.2 Management Information Circular – If management of an issuer solicits proxies from the security holders of the issuer for the purpose of electing directors to the issuer's board of directors, the issuer must include in its management information circular a cross-reference to the sections in the issuer's AIF that contain the information required by section 5.1.

PART 6 – VENTURE ISSUERS

- 6.1 Venture Issuers – Venture issuers are exempt from the requirements of Parts 3 (*Composition of the Audit Committee*) and 5 (*Reporting Obligations*).
- 6.2 Required Disclosure –
- (1) Subject to subsection (2), if management of a venture issuer solicits proxies from the security holders of the venture issuer for the purpose of electing directors to its board of directors, the venture issuer must include in its management information circular the disclosure required by Form 52-110F2.
 - (2) A venture issuer that is not required to send a management information circular to its security holders must provide the disclosure required by Form 52-110F2 in its AIF or annual MD&A.

PART 7 – U.S. LISTED ISSUERS

- 7.1 U.S. Listed Issuers – An issuer that has securities listed or quoted on a U.S. marketplace is exempt from the requirements of Parts 2 (*Audit Committee Responsibilities*), 3 (*Composition of the Audit Committee*), 4 (*Authority of the Audit Committee*), and 5 (*Reporting Obligations*), if:
- (a) the issuer is in compliance with the requirements of that U.S. marketplace applicable to issuers, other than foreign private issuers, regarding the role and composition of audit committees; and
 - (b) if the issuer is incorporated, continued or otherwise organized in a jurisdiction in Canada, the issuer includes in its AIF the disclosure (if any) required by paragraph 7 of Form 52-110F1.

PART 8 – EXEMPTIONS

- 8.1 Exemptions –
- (1) The securities regulatory authority or regulator may grant an exemption from this rule, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.
 - (2) Despite subsection (1), in Ontario, only the regulator may grant such an exemption.

PART 9 – EFFECTIVE DATE

9.1 Effective Date --

- (1) This Instrument comes into force on March 30, 2004.
- (2) Despite subsection (1), this Instrument applies to an issuer commencing on the earlier of:
 - (a) the first annual meeting of the issuer after July 1, 2004, and
 - (b) July 1, 2005.

FORM 52-110F1 – AUDIT COMMITTEE INFORMATION REQUIRED IN AN AIF

1. The Audit Committee's Charter

Disclose the text of the audit committee's charter.

2. Composition of the Audit Committee

Disclose the name of each audit committee member and state whether or not the member is (i) independent and (ii) financially literate.

3. Relevant Education and Experience

Describe the education and experience of each audit committee member that is relevant to the performance of his or her responsibilities as an audit committee member and, in particular, disclose any education or experience that would provide the member with:

- (a) an understanding of the accounting principles used by the issuer to prepare its financial statements;
- (b) the ability to assess the general application of such accounting principles in connection with the accounting for estimates, accruals and reserves;
- (c) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the issuer's financial statements, or experience actively supervising one or more individuals engaged in such activities; and
- (d) an understanding of internal controls and procedures for financial reporting.

4. Reliance on Certain Exemptions

If, at any time since the commencement of the issuer's most recently completed financial year, the issuer has relied on

- (a) the exemption in section 2.4 (*De Minimis Non-audit Services*),
- (b) the exemption in section 3.2 (*Initial Public Offerings*),
- (c) the exemption in section 3.4 (*Events Outside Control of Member*),

- (d) the exemption in section 3.5 (Death, Disability or Resignation of Audit Committee Member) or
- (e) an exemption from this Instrument, in whole or in part, granted under Part 8 (*Exemptions*),

state that fact.

5. Reliance on the Exemption in Subsection 3.3(2) or Section 3.6

If, at any time since the commencement of the issuer's most recently completed financial year, the issuer has relied upon the exemption in subsection 3.3(2) (*Controlled Companies*) or section 3.6 (*Temporary Exemption for Limited and Exceptional Circumstances*), state that fact and disclose

- (a) the name of the member, and
- (b) the rationale for appointing the member to the audit committee.

6. Reliance on Section 3.8

If, at any time since the commencement of the issuer's most recently completed financial year, the issuer has relied upon section 3.8 (*Acquisition of Financial Literacy*), state that fact and disclose

- (a) the name of the member,
- (b) that the member is not financially literate, and
- (c) the date by which the member expects to become financially literate.

7. Audit Committee Oversight

If, at any time since the commencement of the issuer's most recently completed financial year, a recommendation of the audit committee to nominate or compensate an external auditor was not adopted by the board of directors, state that fact and explain why.

8. Pre-Approval Policies and Procedures

If the audit committee has adopted specific policies and procedures for the engagement of non-audit services, describe those policies and procedures.

9. External Auditor Service Fees (By Category)

- (a) Disclose, under the caption "Audit Fees", the aggregate fees billed by the issuer's external auditor in each of the last two fiscal years for audit services.
- (b) Disclose, under the caption "Audit-Related Fees", the aggregate fees billed in each of the last two fiscal years for assurance and related services by the issuer's external auditor that are reasonably related to the performance of the audit or review of the issuer's financial statements and are not reported under clause (a) above. Include a description of the nature of the services comprising the fees disclosed under this category.
- (c) Disclose, under the caption "Tax Fees", the aggregate fees billed in each of the last two fiscal years for professional services rendered by the issuer's external auditor for tax compliance, tax advice, and tax planning. Include a description of the nature of the services comprising the fees disclosed under this category.

- (d) Disclose, under the caption “All Other Fees”, the aggregate fees billed in each of the last two fiscal years for products and services provided by the issuer’s external auditor, other than the services reported under clauses (a) (b) and (c), above. Include a description of the nature of the services comprising the fees disclosed under this category.

INSTRUCTION

The fees required to be disclosed by this paragraph 9 relate only to services provided to the issuer or its subsidiary entities by the issuer’s external auditor.

FORM 52-110F2 – DISCLOSURE BY VENTURE ISSUERS

1. The Audit Committee’s Charter

Disclose the text of the audit committee’s charter.

2. Composition of the Audit Committee

Disclose the name of each audit committee member and state whether or not the member is (i) independent and (ii) financially literate.

3. Relevant Education and Experience

Describe the education and experience of each audit committee member that is relevant to the performance of his or her responsibilities as an audit committee member and, in particular, disclose any education or experience that would provide the member with:

- (a) an understanding of the accounting principles used by the issuer to prepare its financial statements;
- (b) the ability to assess the general application of such accounting principles in connection with the accounting for estimates, accruals and reserves;
- (c) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the issuer’s financial statements, or experience actively supervising one or more individuals engaged in such activities; and
- (d) an understanding of internal controls and procedures for financial reporting.

4. Audit Committee Oversight

If, at any time since the commencement of the issuer’s most recently completed financial year, a recommendation of the audit committee to nominate or compensate an external auditor was not adopted by the board of directors, state that fact and explain why.

5. Reliance on Certain Exemptions

If, at any time since the commencement of the issuer’s most recently completed financial year, the issuer has relied on

- (a) the exemption in section 2.4 (*De Minimis Non-audit Services*), or
- (b) an exemption from this Instrument, in whole or in part, granted under Part 8 (*Exemptions*),

state that fact.

6. Pre-Approval Policies and Procedures

If the audit committee has adopted specific policies and procedures for the engagement of non-audit services, describe those policies and procedures.

7. External Auditor Service Fees (By Category)

- (a) Disclose, under the caption "Audit Fees", the aggregate fees billed by the issuer's external auditor in each of the last two fiscal years for audit fees.
- (b) Disclose, under the caption "Audit-Related Fees", the aggregate fees billed in each of the last two fiscal years for assurance and related services by the issuer's external auditor that are reasonably related to the performance of the audit or review of the issuer's financial statements and are not reported under clause (a) above. Include a description of the nature of the services comprising the fees disclosed under this category.
- (c) Disclose, under the caption "Tax Fees", the aggregate fees billed in each of the last two fiscal years for professional services rendered by the issuer's external auditor for tax compliance, tax advice, and tax planning. Include a description of the nature of the services comprising the fees disclosed under this category.
- (d) Disclose, under the caption "All Other Fees", the aggregate fees billed in each of the last two fiscal years for products and services provided by the issuer's external auditor, other than the services reported under clauses (a) (b) and (c), above. Include a description of the nature of the services comprising the fees disclosed under this category.

INSTRUCTION

The fees required to be disclosed by this paragraph 7 relate only to services provided to the issuer or its subsidiary entities by the issuer's external auditor.

8. Exemption

Disclose that the issuer is relying upon the exemption in section 6.1 of the Instrument.

COMPANION POLICY 52-110CP – TO MULTILATERAL INSTRUMENT 52-110

AUDIT COMMITTEES

PART 1 – GENERAL

- 1.1 Purpose – Multilateral Instrument 52-110 *Audit Committees* (the Instrument) is a rule in each of Québec, Alberta, Manitoba, Ontario, Nova Scotia and Newfoundland and Labrador, a Commission regulation in Saskatchewan and Nunavut, a policy in New Brunswick, Prince Edward Island and the Yukon Territory, and a code in the Northwest Territories. We, the securities regulatory authorities in each of the foregoing jurisdictions (the Jurisdictions), have implemented the Instrument to encourage reporting issuers to establish and maintain strong, effective and independent audit committees. We believe that such audit committees enhance the quality of financial disclosure made by reporting issuers, and ultimately foster increased investor confidence in Canada's capital markets.

This companion policy (the Policy) provides information regarding the interpretation and application of the Instrument.

- 1.2 Application to Non-Corporate Entities – The Instrument applies to both corporate and non-corporate entities. Where the Instrument or this Policy refers to a particular corporate characteristic, such as a board of directors, the reference should be read to also include any equivalent characteristic of a non-corporate entity. For example, in the case of a limited partnership, the directors of the general partner who are independent of the limited partnership (including the general partner) should form an audit committee which fulfils these responsibilities.

Income trust issuers should apply the Instrument in a manner which recognizes that certain functions of a corporate issuer, its board and its management may be performed by any or all of the trustees, the board or management of a subsidiary of the trust, or the board, management or employees of a management company. For this purpose, references to “the issuer” refer to both the trust and any underlying entities, including the operating entity.

If the structure of an issuer will not permit it to comply with the Instrument, the issuer should seek exemptive relief.

- 1.3 Management Companies – The definition of “executive officer” includes any individual who performs a policy-making function in respect of the entity in question. We consider this aspect of the definition to include an individual who, although not employed by the entity in question, nevertheless performs a policy-making function in respect of that entity, whether through another person or company or otherwise.
- 1.4 Audit Committee Procedures – The Instrument establishes requirements for the responsibilities, composition and authority of audit committees. Nothing in the Instrument is intended to restrict the ability of the board of directors or the audit committee to establish the committee’s quorum or procedures, or to restrict the committee’s ability to invite additional parties to attend audit committee meetings.

PART 2 – THE ROLE OF THE AUDIT COMMITTEE

- 2.1 The Role of the Audit Committee – An audit committee is a committee of a board of directors to which the board delegates its responsibility for oversight of the financial reporting process. Traditionally, the audit committee has performed a number of roles, including

- helping directors meet their responsibilities,
- providing better communication between directors and the external auditors,
- enhancing the independence of the external auditor,
- increasing the credibility and objectivity of financial reports, and
- strengthening the role of the directors by facilitating in-depth discussions among directors, management and the external auditor.

The Instrument requires that the audit committee also be responsible for managing, on behalf of the shareholders, the relationship between the issuer and the external auditors. In particular, it provides that an audit committee must have responsibility for:

- (a) overseeing the work of the external auditors engaged for the purpose of preparing or issuing an auditor’s report or related work; and
- (b) recommending to the board of directors the nomination and compensation of the external auditors.

Although under corporate law an issuer's external auditors are responsible to the shareholders, in practice, shareholders have often been too dispersed to effectively exercise meaningful oversight of the external auditors. As a result, management has typically assumed this oversight role. However, the auditing process may be compromised if the external auditors view their main responsibility as serving management rather than the shareholders. By assigning these responsibilities to an independent audit committee, the Instrument ensures that the external audit will be conducted independently of the issuer's management.

- 2.2 Relationship between External Auditors and Shareholders – Subsection 2.3(3) of the Instrument provides that an audit committee must be directly responsible for overseeing the work of the external auditors engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer, including the resolution of disagreements between management and the external auditors regarding financial reporting. Notwithstanding this responsibility, the external auditors are retained by, and are ultimately accountable to, the shareholders. As a result, subsection 2.3(3) does not detract from the external auditors' right and responsibility to also provide their views directly to the shareholders if they disagree with an approach being taken by the audit committee.
- 2.3 Public Disclosure of Financial Information – Issuers are reminded that, in our view, the extraction of information from financial statements that have not previously been reviewed by the audit committee and the release of that information into the marketplace is inconsistent with the issuer's obligation to have its audit committee review the financial statements. See also National Policy 51-201 *Disclosure Standards*.

PART 3 – INDEPENDENCE

- 3.1 Meaning of Independence – The Instrument generally requires every member of an audit committee to be independent. Subsection 1.4(1) of the Instrument defines independence to mean the absence of any direct or indirect material relationship between the director and the issuer. In our view, this may include a commercial, charitable, industrial, banking, consulting, legal, accounting or familial relationship, or any other relationship that the board considers to be material. Although shareholding alone may not interfere with the exercise of a director's independent judgement, we believe that other relationships between an issuer and a shareholder may constitute material relationships with the issuer, and should be considered by the board when determining a director's independence. However, only those relationships which could, in the view of the issuer's board of directors, be reasonably expected to interfere with the exercise of a member's independent judgement should be considered material relationships within the meaning of section 1.4.

Subsection 1.4(3) and section 1.5 of the Instrument describe those individuals that we believe have a relationship with an issuer that would reasonably be expected to interfere with the exercise of the individual's independent judgement. Consequently, these individuals are not considered independent for the purposes of the Instrument and are therefore precluded from serving on the issuer's audit committee. Directors and their counsel should therefore consider the nature of the relationships outlined in subsection 1.4(3) and section 1.5 as guidance in applying the general independence requirement set out in subsection 1.4(1).

- 3.2 Derivation of Definition – In the United States, listed issuers must comply with the audit committee requirements contained in SEC rules as well as the director independence and audit committee requirements of the applicable securities exchange or market. The definition of independence included in the Instrument has therefore been derived from both the applicable SEC rules and the corporate governance rules issued by the New York Stock Exchange. The portion of the definition of independence that parallels the NYSE rules is found in section 1.4 of the Instrument. Section 1.5 of the Instrument contains additional rules regarding audit committee

member independence that were derived from the applicable SEC rules. To be independent for the purposes of the Instrument, a director must satisfy the requirements in both sections 1.4 and 1.5.

- 3.3 Safe Harbour – Subsection 1.3(1) of the Instrument provides, in part, that a person or company is an affiliated entity of another entity if the person or company controls the other entity. Subsection 1.3(4), however, provides that an individual will not be considered to control an issuer if the individual:

- (a) owns, directly or indirectly, ten per cent or less of any class of voting equity securities of the issuer; and
- (b) is not an executive officer of the issuer.

Subsection 1.3(4) is intended only to identify those individuals who are not considered to control an issuer. The provision is not intended to suggest that an individual who owns more than ten percent of an issuer's voting equity securities automatically controls an issuer. Instead, an individual who owns more than ten percent of an issuer's voting equity securities should examine all relevant facts and circumstances to determine if he or she controls the issuer and is therefore an affiliated entity within the meaning of subsection 1.3(1).

- 3.4 Remuneration of Chair of Board, Etc. – Subsection 1.4(6) of the Instrument provides that, for the purpose of the prescribed relationship described in clause 1.4(3)(f), direct compensation does not include remuneration for acting as a member of the board of directors or of any board committee of the issuer. In our view, remuneration for acting as a member of the board also includes remuneration for acting as the chair of the board or of any committee of the board.

PART 4 – FINANCIAL LITERACY, FINANCIAL EDUCATION AND EXPERIENCE

- 4.1 Financial Literacy – For the purposes of the Instrument, an individual is financially literate if he or she has the ability to read and understand a set of financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of the issues that can reasonably be expected to be raised by the issuer's financial statements. In our view, it is not necessary for a member to have a comprehensive knowledge of GAAP and GAAS to be considered financially literate.
- 4.2 Financial Education and Experience –
- (1) Item 3 of Forms 52-110F1 and 52-110F2 require an issuer to disclose any education or experience of an audit committee member that would provide the member with, among other things, an understanding of the accounting principles used by the issuer to prepare its financial statements. The level of understanding that is requisite is influenced by the complexity of the business being carried on. For example, if the issuer is a complex financial institution, a greater degree of education and experience is necessary than would be the case for an audit committee member of an issuer with a more simple business.
 - (2) Item 3 of Forms 52-110F1 and 52-110F2 also require an issuer to disclose any experience that the member has, among other things, actively supervising persons engaged in preparing, auditing, analyzing or evaluating certain types of financial statements. The phrase active supervision means more than the mere existence of a traditional hierarchical reporting relationship between supervisor and those being supervised. An individual engaged in active supervision participates in, and contributes to, the process of addressing (albeit at a supervisory level) the same general types of issues regarding preparation, auditing, analysis or evaluation of financial statements as

those addressed by the individual or individuals being supervised. The supervisor should also have experience that has contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised. An executive officer should not be presumed to qualify. An executive officer with considerable operations involvement, but little financial or accounting involvement, likely would not be exercising the necessary active supervision. Active participation in, and contribution to, the process, albeit at a supervisory level, of addressing financial and accounting issues that demonstrate a general expertise in the area would be necessary.

PART 5 – NON-AUDIT SERVICES

5.1 Pre-Approval of Non-Audit Services – Section 2.6 of the Instrument allows an audit committee to satisfy, in certain circumstances, the pre-approval requirements in subsection 2.3(4) by adopting specific policies and procedures for the engagement of non-audit services. The following guidance should be noted in the development and application of such policies and procedures:

- Monetary limits should not be the only basis for the pre-approval policies and procedures. The establishment of monetary limits will not, alone, constitute policies that are detailed as to the particular services to be provided and will not, alone, ensure that the audit committee will be informed about each service.
- The use of broad, categorical approvals (*e.g.* tax compliance services) will not meet the requirement that the policies must be detailed as to the particular services to be provided.
- The appropriate level of detail for the pre-approval policies will differ depending upon the facts and circumstances of the issuer. The pre-approval policies must be designed to ensure that the audit committee knows precisely what services it is being asked to pre-approve so that it can make a well-reasoned assessment of the impact of the service on the auditor's independence. Furthermore, because the Instrument requires that the policies cannot result in a delegation of the audit committee's responsibility to management, the pre-approval policies must be sufficiently detailed as to particular services so that a member of management will not be called upon to determine whether a proposed service fits within the policy.

PART 6 – DISCLOSURE OBLIGATIONS

6.1 Incorporation by Reference – National Instrument 51-102 permits disclosure required to be included in an issuer's AIF or information circular to be incorporated by reference, provided that the referenced document has already been filed with the applicable securities regulatory authorities.⁸³⁸ Any disclosure required by the Instrument to be included in an issuer's AIF or management information circular may also be incorporated by reference, provided that the procedures set out in National Instrument 51-102 are followed.

⁸³⁸

See Part 1, paragraph (f) of Form 51-102F2 (*Annual Information Form*) and Part 1, paragraph (c) of Form 51-102F5 (*Information Circular*).

APPENDIX B

NATIONAL INSTRUMENT 58-101 DISCLOSURE OF CORPORATE GOVERNANCE PRACTICES

PART 1 – PART 1 DEFINITIONS AND APPLICATION

1.1 Definitions – In this Instrument,

“AIF” has the same meaning as in National Instrument 51-102 Continuous Disclosure Obligations;

“CEO” means a chief executive officer;

“code” means a code of business conduct and ethics;

“executive officer” has the same meaning as in National Instrument 51-102;

“marketplace” has the same meaning as in National Instrument 21-101 Marketplace Operation;

“MD&A” has the same meaning as in National Instrument 51-102;

“MI 52-110” means Multilateral Instrument 52-110 Audit Committees, as enacted or adopted by the securities regulatory authority in each jurisdiction in Canada except British Columbia;

“SEDAR” has the same meaning as in National Instrument 13-101 System for Electronic Document Analysis and Retrieval (SEDAR);

“significant security holder” means, in relation to an issuer, a security holder that owns or controls 10% or more of any class of the issuer’s voting securities, or

is able to affect materially the control of the issuer, whether alone or by acting in concert with others;

“subsidiary entity” has the meaning set out in MI 52-110;

“U.S. marketplace” means an exchange registered as of the effective date of this Instrument as a “national securities exchange” under section 6 of the 1934 Act, or the Nasdaq Stock Market; and

“venture issuer” means an issuer that, at the end of its most recently completed financial year, does not have any of its securities listed or quoted on the Toronto Stock Exchange, a U.S. marketplace, or a marketplace outside of Canada and the United States of America.

1.2 Meaning of Independence –

- (1) In a jurisdiction other than British Columbia, a director is independent if he or she would be independent within the meaning of section 1.4 of MI 52-110.
- (2) In British Columbia, a director is independent if
 - (a) a reasonable person with knowledge of all the relevant circumstances would conclude that the director is independent of management of the issuer and of any significant security holder, or
 - (b) the issuer is a reporting issuer in a jurisdiction other than British Columbia, and the director is independent under subsection (1).

1.3 Application – This Instrument applies to a reporting issuer other than:

- (a) an investment fund or issuer of asset-backed securities, as defined in National Instrument 51-102;
- (b) a designated foreign issuer or SEC foreign issuer, as defined in National Instrument 71-102 Continuous Disclosure and Other Exemptions Relating to Foreign Issuers;
- (c) a credit support issuer or exchangeable security issuer that is exempt under sections 13.2 and 13.3 of National Instrument 51-102, as applicable; and
- (d) an issuer that is a subsidiary entity, if
 - (i) the issuer does not have equity securities, other than non-convertible, non-participating preferred securities, trading on a marketplace, and
 - (ii) the person or company that owns the issuer is
 - (A) subject to the requirements of this Instrument, or
 - (B) an issuer that has securities listed or quoted on a U.S. marketplace, and is in compliance with the corporate governance disclosure requirements of that U.S. marketplace.

PART 2 – DISCLOSURE AND FILING REQUIREMENTS

2.1 Required Disclosure –

- (1) If management of an issuer, other than a venture issuer, solicits a proxy from a security holder of the issuer for the purpose of electing directors to the issuer's board of directors, the issuer must include in its management information circular the disclosure required by Form 58-101F1.
- (2) An issuer, other than a venture issuer, that does not send a management information circular to its security holders must provide the disclosure required by Form 58-101F1 in its AIF.

2.2 Venture Issuers –

- (1) If management of a venture issuer solicits a proxy from a security holder of the venture issuer for the purpose of electing directors to the issuer's board of directors, the venture issuer must include in its management information circular the disclosure required by Form 58-101F2.
- (2) A venture issuer that does not send a management information circular to its security holders must provide the disclosure required by Form 58-101F2 in its AIF or annual MD&A.

- 2.3 Filing of Code – If an issuer has adopted or amended a written code, the issuer must file a copy of the code or amendment on SEDAR no later than the date on which the issuer's next financial statements must be filed, unless a copy of the code or amendment has been previously filed.

PART 3 – EXEMPTIONS AND EFFECTIVE DATE

3.1 Exemptions –

- (1) The securities regulatory authority or regulator may grant an exemption from this rule, in whole or in part, subject to any conditions or restrictions imposed in the exemption.
- (2) Despite subsection (1), in Ontario, only the regulator may grant an exemption.

3.2 Effective Date –

- (1) This Instrument comes into force on June 30, 2005.
- (2) Despite subsection (1), sections 2.1 and 2.2 only apply to management information circulars, AIFs and annual MD&A, as the case may be, which are filed following an issuer's financial year ending on or after June 30, 2005.

FORM 58-101F1 – CORPORATE GOVERNANCE DISCLOSURE

1. Board of Directors –

- (a) Disclose the identity of directors who are independent.
- (b) Disclose the identity of directors who are not independent, and describe the basis for that determination.
- (c) Disclose whether or not a majority of directors are independent. If a majority of directors are not independent, describe what the board of directors (the **board**) does to facilitate its exercise of independent judgement in carrying out its responsibilities.
- (d) If a director is presently a director of any other issuer that is a reporting issuer (or the equivalent) in a jurisdiction or a foreign jurisdiction, identify both the director and the other issuer.
- (e) Disclose whether or not the independent directors hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance. If the independent directors hold such meetings, disclose the number of meetings held since the beginning of the issuer's most recently completed financial year. If the independent directors do not hold such meetings, describe what the board does to facilitate open and candid discussion among its independent directors.
- (f) Disclose whether or not the chair of the board is an independent director. If the board has a chair or lead director who is an independent director, disclose the identity of the independent chair or lead director, and describe his or her role and responsibilities. If the board has neither a chair that is independent nor a lead director that is independent, describe what the board does to provide leadership for its independent directors.
- (g) Disclose the attendance record of each director for all board meetings held since the beginning of the issuer's most recently completed financial year.

2. **Board Mandate – *Disclose the text of the board’s written mandate. If the board does not have a written mandate, describe how the board delineates its role and responsibilities.***
3. **Position Descriptions –**
 - (a) Disclose whether or not the board has developed written position descriptions for the chair and the chair of each board committee. If the board has not developed written position descriptions for the chair and/or the chair of each board committee, briefly describe how the board delineates the role and responsibilities of each such position.
 - (b) Disclose whether or not the board and CEO have developed a written position description for the CEO. If the board and CEO have not developed such a position description, briefly describe how the board delineates the role and responsibilities of the CEO.
4. **Orientation and Continuing Education –**
 - (a) Briefly describe what measures the board takes to orient new directors regarding
 - (ii) the role of the board, its committees and its directors, and
 - (iii) the nature and operation of the issuer’s business.
 - (b) Briefly describe what measures, if any, the board takes to provide continuing education for its directors. If the board does not provide continuing education, describe how the board ensures that its directors maintain the skill and knowledge necessary to meet their obligations as directors.
5. **Ethical Business Conduct –**
 - (a) Disclose whether or not the board has adopted a written code for the directors, officers and employees. If the board has adopted a written code:
 - (iv) disclose how a person or company may obtain a copy of the code;
 - (v) describe how the board monitors compliance with its code, or if the board does not monitor compliance, explain whether and how the board satisfies itself regarding compliance with its code; and
 - (vi) provide a cross-reference to any material change report filed since the beginning of the issuer’s most recently completed financial year that pertains to any conduct of a director or executive officer that constitutes a departure from the code.
 - (b) Describe any steps the board takes to ensure directors exercise independent judgement in considering transactions and agreements in respect of which a director or executive officer has a material interest.
 - (c) Describe any other steps the board takes to encourage and promote a culture of ethical business conduct.
6. **Nomination of Directors –**
 - (a) Describe the process by which the board identifies new candidates for board nomination.

- (b) Disclose whether or not the board has a nominating committee composed entirely of independent directors. If the board does not have a nominating committee composed entirely of independent directors, describe what steps the board takes to encourage an objective nomination process.
- (c) If the board has a nominating committee, describe the responsibilities, powers and operation of the nominating committee.

7. Compensation –

- (a) Describe the process by which the board determines the compensation for the issuer's directors and officers.
- (b) Disclose whether or not the board has a compensation committee composed entirely of independent directors. If the board does not have a compensation committee composed entirely of independent directors, describe what steps the board takes to ensure an objective process for determining such compensation.
- (c) If the board has a compensation committee, describe the responsibilities, powers and operation of the compensation committee.
- (d) If a compensation consultant or advisor has, at any time since the beginning of the issuer's most recently completed financial year, been retained to assist in determining compensation for any of the issuer's directors and officers, disclose the identity of the consultant or advisor and briefly summarize the mandate for which they have been retained. If the consultant or advisor has been retained to perform any other work for the issuer, state that fact and briefly describe the nature of the work.

8. Other Board Committees – *If the board has standing committees other than the audit, compensation and nominating committees, identify the committees and describe their function.*

9. Assessments – *Disclose whether or not the board, its committees and individual directors are regularly assessed with respect to their effectiveness and contribution. If assessments are regularly conducted, describe the process used for the assessments. If assessments are not regularly conducted, describe how the board satisfies itself that the board, its committees, and its individual directors are performing effectively.*

INSTRUCTION:

- (1) *This Form applies to both corporate and non-corporate entities. Reference to a particular corporate characteristic, such as a board, includes any equivalent characteristic of a non-corporate entity.*

Income trust issuers must provide disclosure in a manner which recognizes that certain functions of a corporate issuer, its board and its management may be performed by any or all of the trustees, the board or management of a subsidiary of the trust, or the board, management or employees of a management company. In the case of an income trust, references to "the issuer" refer to both the trust and any underlying entities, including the operating entity.

- (2) *If the disclosure required by Item 1 is included in a management information circular distributed to security holders of the issuer for the purpose of electing directors to the issuer's board of directors, provide disclosure regarding the existing directors and any proposed directors.*

- (3) *Disclosure regarding board committees made under Item 8 of this Form may include the existence and summary content of any committee charter.*

FORM 58-101F2 – CORPORATE GOVERNANCE DISCLOSURE (VENTURE ISSUERS)

1. **Board of Directors – Disclose how the board of directors (the board) facilitates its exercise of independent supervision over management, including**
 - (i) the identity of directors that are independent, and
 - (ii) the identity of directors who are not independent, and the basis for that determination.
2. **Directorships – *If a director is presently a director of any other issuer that is a reporting issuer (or the equivalent) in a jurisdiction or a foreign jurisdiction, identify both the director and the other issuer.***
3. **Orientation and Continuing Education – *Describe what steps, if any, the board takes to orient new board members, and describe any measures the board takes to provide continuing education for directors.***
4. **Ethical Business Conduct – *Describe what steps, if any, the board takes to encourage and promote a culture of ethical business conduct.***
5. **Nomination of Directors – *Disclose what steps, if any, are taken to identify new candidates for board nomination, including:***
 - (i) who identifies new candidates, and
 - (ii) the process of identifying new candidates.
6. **Compensation – *Disclose what steps, if any, are taken to determine compensation for the directors and CEO, including:***
 - (i) who determines compensation, and
 - (ii) the process of determining compensation.
7. ***Other Board Committees – If the board has standing committees other than the audit, compensation and nominating committees, identify the committees and describe their function.***
8. **Assessments – *Disclose what steps, if any, that the board takes to satisfy itself that the board, its committees, and its individual directors are performing effectively.***

INSTRUCTION:

- (1) This form applies to both corporate and non-corporate entities. Reference to a particular corporate characteristic, such as a board, includes any equivalent characteristic of a non-corporate entity.

Income trust issuers must provide disclosure in a manner which recognizes that certain functions of a corporate issuer, its board and its management may be performed by any or all of the trustees, the board or management of a subsidiary of the trust, or the board, management or employees of a management company. In the case of an income trust, references to “the issuer” refer to both the trust and any underlying entities, including the operating entity.

- (2) *If the disclosure required by Items 1 and 2 is included in a management information circular distributed to security holders of the issuer for the purpose of electing directors to the issuer's board of directors, provide disclosure regarding the existing directors and any proposed directors.*
- (3) *Disclosure regarding board committees made under Item 7 of this Form may include the existence and summary content of any committee charter.*

APPENDIX C

NATIONAL POLICY 58-201

CORPORATE GOVERNANCE GUIDELINES

PART 1 – PURPOSE AND APPLICATION

- 1.1 Purpose of this Policy – This Policy provides guidance on corporate governance practices which have been formulated to:

- achieve a balance between providing protection to investors and fostering fair and efficient capital markets and confidence in capital markets;
- be sensitive to the realities of the greater numbers of small companies and controlled companies in the Canadian corporate landscape;
- take into account the impact of corporate governance developments in the U.S. and around the world; and
- recognize that corporate governance is evolving.

The guidelines in this Policy are not intended to be prescriptive. We encourage issuers to consider the guidelines in developing their own corporate governance practices.

We do, however, understand that some parties have concerns about how this Policy and National Instrument 58-101 *Disclosure of Corporate Governance Practices* affect controlled companies. Accordingly, we intend, over the next year, to carefully consider these concerns in the context of a study to examine the governance of controlled companies. We will consult market participants in conducting the study. After completing the study, we will consider whether to change how this Policy and National Instrument 58-101 treat controlled companies.

- 1.2 Application – This Policy applies to all reporting issuers, other than investment funds. Consequently, it applies to both corporate and non-corporate entities. Reference to a particular corporate characteristic, such as a board of directors (the board), includes any equivalent characteristic of a non-corporate entity. For example, in the case of a limited partnership, we recommend that a majority of the directors of the general partner should be independent of the limited partnership (including the general partner).

Income trust issuers should, in applying these guidelines, recognize that certain functions of a corporate issuer, its board and its management may be performed by any or all of the trustees, the board or management of a subsidiary of the trust, or the board, management or employees of a management company. For this purpose, references to "the issuer" refer to both the trust and any underlying entities, including the operating entity.

PART 2 – MEANING OF INDEPENDENCE

- 2.1 Meaning of Independence – For the purposes of this Policy, a director is independent if he or she would be independent for the purposes of National Instrument 58-101 *Disclosure of Corporate Governance Practices*.

PART 3 – CORPORATE GOVERNANCE GUIDELINES

Composition of the Board

- 3.1 The board should have a majority of independent directors.
- 3.2 The chair of the board should be an independent director. Where this is not appropriate, an independent director should be appointed to act as "lead director". However, either an independent chair or an independent lead director should act as the effective leader of the board and ensure that the board's agenda will enable it to successfully carry out its duties.

Meetings of Independent Directors

- 3.3 The independent directors should hold regularly scheduled meetings at which non-independent directors and members of management are not in attendance.

Board Mandate

- 3.4 The board should adopt a written mandate in which it explicitly acknowledges responsibility for the stewardship of the issuer, including responsibility for:
- (a) to the extent feasible, satisfying itself as to the integrity of the chief executive officer (the CEO) and other executive officers and that the CEO and other executive officers create a culture of integrity throughout the organization;
 - (b) adopting a strategic planning process and approving, on at least an annual basis, a strategic plan which takes into account, among other things, the opportunities and risks of the business;
 - (c) the identification of the principal risks of the issuer's business, and ensuring the implementation of appropriate systems to manage these risks;
 - (d) succession planning (including appointing, training and monitoring senior management);
 - (e) adopting a communication policy for the issuer;
 - (f) the issuer's internal control and management information systems; and
 - (g) developing the issuer's approach to corporate governance, including developing a set of corporate governance principles and guidelines that are specifically applicable to the issuer.⁸³⁹

The written mandate of the board should also set out:

- (i) measures for receiving feedback from stakeholders (e.g., the board may wish to establish a process to permit stakeholders to directly contact the independent directors), and
- (ii) expectations and responsibilities of directors, including basic duties and responsibilities with respect to attendance at board meetings and advance review of meeting materials.

⁸³⁹

Issuers may consider appointing a corporate governance committee to consider these issues. A corporate governance committee should have a majority of independent directors, with the remaining members being "non-management" directors.

In developing an effective communication policy for the issuer, issuers should refer to the guidance set out in National Policy 51-201 *Disclosure Standards*.

For purposes of this Policy, "executive officer" has the same meaning as in National Instrument 51-102 *Continuous Disclosure Obligations*.

Position Descriptions

- 3.5 The board should develop clear position descriptions for the chair of the board and the chair of each board committee. In addition, the board, together with the CEO, should develop a clear position description for the CEO, which includes delineating management's responsibilities. The board should also develop or approve the corporate goals and objectives that the CEO is responsible for meeting.

Orientation and Continuing Education

- 3.6 The board should ensure that all new directors receive a comprehensive orientation. All new directors should fully understand the role of the board and its committees, as well as the contribution individual directors are expected to make (including, in particular, the commitment of time and resources that the issuer expects from its directors). All new directors should also understand the nature and operation of the issuer's business.
- 3.7 The board should provide continuing education opportunities for all directors, so that individuals may maintain or enhance their skills and abilities as directors, as well as to ensure their knowledge and understanding of the issuer's business remains current.

Code of Business Conduct and Ethics

- 3.8 The board should adopt a written code of business conduct and ethics (a code). The code should be applicable to directors, officers and employees of the issuer. The code should constitute written standards that are reasonably designed to promote integrity and to deter wrongdoing. In particular, it should address the following issues:
- (a) conflicts of interest, including transactions and agreements in respect of which a director or executive officer has a material interest;
 - (b) protection and proper use of corporate assets and opportunities;
 - (c) confidentiality of corporate information;
 - (d) fair dealing with the issuer's security holders, customers, suppliers, competitors and employees;
 - (e) compliance with laws, rules and regulations; and
 - (f) reporting of any illegal or unethical behaviour.
- 3.9 The board should be responsible for monitoring compliance with the code. Any waivers from the code that are granted for the benefit of the issuer's directors or executive officers should be granted by the board (or a board committee) only.

Although issuers must exercise their own judgement in making materiality determinations, the Canadian securities regulatory authorities consider that conduct by a director or executive officer which constitutes a material departure from the code will likely constitute a "material change" within the meaning of National Instrument 51-102 *Continuous Disclosure Obligations*. National

Instrument 51-102 requires every material change report to include a full description of the material change. Where a material departure from the code constitutes a material change to the issuer, we expect that the material change report will disclose, among other things:

- the date of the departure(s),
- the party(ies) involved in the departure(s),
- the reason why the board has or has not sanctioned the departure(s), and
- any measures the board has taken to address or remedy the departure(s).

Nomination of Directors

- 3.10 The board should appoint a nominating committee composed entirely of independent directors.
- 3.11 The nominating committee should have a written charter that clearly establishes the committee's purpose, responsibilities, member qualifications, member appointment and removal, structure and operations (including any authority to delegate to individual members and subcommittees), and manner of reporting to the board. In addition, the nominating committee should be given authority to engage and compensate any outside advisor that it determines to be necessary to permit it to carry out its duties. If an issuer is legally required by contract or otherwise to provide third parties with the right to nominate directors, the selection and nomination of those directors need not involve the approval of an independent nominating committee.
- 3.12 Prior to nominating or appointing individuals as directors, the board should adopt a process involving the following steps:
- (A) Consider what competencies and skills the board, as a whole, should possess. In doing so, the board should recognize that the particular competencies and skills required for one issuer may not be the same as those required for another.
 - (B) Assess what competencies and skills each existing director possesses. It is unlikely that any one director will have all the competencies and skills required by the board. Instead, the board should be considered as a group, with each individual making his or her own contribution. Attention should also be paid to the personality and other qualities of each director, as these may ultimately determine the boardroom dynamic.
- The board should also consider the appropriate size of the board, with a view to facilitating effective decision-making.
- In carrying out each of these functions, the board should consider the advice and input of the nominating committee.
- 3.13 The nominating committee should be responsible for identifying individuals qualified to become new board members and recommending to the board the new director nominees for the next annual meeting of shareholders.
- 3.14 In making its recommendations, the nominating committee should consider:
- (a) the competencies and skills that the board considers to be necessary for the board, as a whole, to possess;
 - (b) the competencies and skills that the board considers each existing director to possess; and

- (c) the competencies and skills each new nominee will bring to the boardroom.

The nominating committee should also consider whether or not each new nominee can devote sufficient time and resources to his or her duties as a board member.

Compensation

- 3.15 The board should appoint a compensation committee composed entirely of independent directors.
- 3.16 The compensation committee should have a written charter that establishes the committee's purpose, responsibilities, member qualifications, member appointment and removal, structure and operations (including any authority to delegate to individual members or subcommittees), and the manner of reporting to the board. In addition, the compensation committee should be given authority to engage and compensate any outside advisor that it determines to be necessary to permit it to carry out its duties.
- 3.17 The compensation committee should be responsible for:
 - (a) reviewing and approving corporate goals and objectives relevant to CEO compensation, evaluating the CEO's performance in light of those corporate goals and objectives, and determining (or making recommendations to the board with respect to) the CEO's compensation level based on this evaluation;
 - (b) making recommendations to the board with respect to non-CEO officer and director compensation, incentive-compensation plans and equity-based plans; and
 - (c) reviewing executive compensation disclosure before the issuer publicly discloses this information.

Regular Board Assessments

- 3.18 The board, its committees and each individual director should be regularly assessed regarding his, her or its effectiveness and contribution. An assessment should consider
 - (a) in the case of the board or a board committee, its mandate or charter, and
 - (b) in the case of an individual director, the applicable position description(s), as well as the competencies and skills each individual director is expected to bring to the board.

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