***THE ROLE OF THE CORPORATE DIRECTOR:***
***MORE THAN JUST 'MAKING IT' IN THE CORPORATE WORLD***

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> ***Corporation**, n. An ingenious device for obtaining individual profit without individual responsibility.*
>
> Ambrose Bierce, *The Devil's Dictionary*

## I. Introduction

Ambrose Bierce's 100 year old derogatory comment about corporate accountability, or rather the lack thereof, may seem somewhat prophetic with the benefit of all but the most recent hindsight. Yet, Bierce, a self-proclaimed cynic and popular columnist of the late nineteenth century, was, in fact, sharing a widely held sentiment of the time. Rooted in a bloody British experience[1], 19th century anti-corporate sentiment was heightened considerably by the US Supreme Court's controversial decision to grant corporations the same rights as living persons under the Fourteenth Amendment to the Constitution[2]. This, in turn, sparked grave concerns about the transformation of the traditional jointly owned and managed business, most common in North America, to the manager-operated but shareholder-owned structure of the corporation; and in particular, daunting concerns about who would be held accountable for the actions of the latter. As we noted in an earlier paper for McGill University's Meredith Memorial Lectures, the Lord Chancellor once asked 'did you ever expect a corporation to have a conscience, when it has no soul to be damned, and no body to be kicked?'[3] The comments of the Lord Chancellor ring even more loudly today.

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[1] For an excellent review of the introduction of the corporate entity to colonial America see Ted Nace's *Gangs of New York: The Rise of Corporate Power and the Disabling of Democracy,* Berrett-Koehler Publishers Inc., 2003, available online at www.gangsofamerica.com.

[2] *Santa Clara County v. Southern Pacific Railroad Company*, 118 U.S. 396 (1886). The Fourteenth Amendment provides for 'Rights Guaranteed Privileges and Immunities of Citizenship, Due Process and Equal Protection'.

[3] Groia and Adams, 'Searching for a Soul to Damn and a Body to Kick: The Liability of Corporate Officers and Directors' in *Meredith Memorial Lectures 1990* ( Cowansville, Quebec: Les Éditions Yvon Blais Inc., 1990) at p.127. As cited by J.C. Coffee Jr., 'No Soul to Damn, No Body to Kick: An Unscandalized Inquiry into the Problem of Corporate Punishment' (1981) 79 *Michigan L.Rev.* 386 at 386.

As it turned out, these concerns foreshadowed many of the major corporate legal issues for the better part of the next century; the corporation thrived in its unique position as a legal ‘person’ while the persons who acted as the directing mind and will of the corporation all too often enjoyed unparalleled freedom from many of the personal responsibilities and consequences normally associated with commercial activity. In the interim, the ties that bound corporations and government together (so feared by America’s founding father’s) strengthened, rendering the corporation a most formidable force in the North American marketplace.

It is within this context that the modern day evolving role of directors and officers, both within the corporation, and in the capital markets at large, must be considered. Clearly there are many stakeholders who play a role in defining the modern corporation – customers, shareholders, employees, creditors, management, auditors and regulators just to name a few. Yet, in the fallout from Enron and the continued falling out of Parmalat, it is the conduct of Directors that has received some of the most scathing criticisms and as a result it is also Directors who have been burdened by the lion’s share of corporate governance reforms intended to address both real, and imagined, shortcomings in corporate, securities and administrative law.

This paper will try to provide a general review of the many changes and proposed changes to the role of corporate directors in public companies, and to shed some light on how these changes will likely impact director liability and corporate accountability in the future. We hope to show, very simply, that these approaches are both ill conceived and somewhat misguided.  Corporate malfeasance and non-feasance is as much a part of the capital markets and corporate life as is the balance sheet, share pricing, and the right of

most shareholders to vote. Although it is a gross over-simplification to suggest that effective boards with active independent directors can always avoid difficulties, it is much easier to find dysfunctional boards behind many of the recent corporate disasters (Enron, Tyco, HealthSouth and Parmalat are only a few). In our respectful view, what is needed is a new, three-pronged, approach:

1. Government and regulators should spend less time passing new rules and regulations and more time effectively policing and prosecuting under the already well developed and, we would argue, over-inclusive existing legal framework;

2. Shareholders need to change their sense of corporate expectations from the unrealistic demands of the 1990s for ever increasing quarterly profits to a longer-term sustainable corporate earnings mandate; and

3. Directors, particularly independent or non-executive directors, need to do the job they were hired for; effectively managing management with a view to the best interests of all the shareholders and other corporate stakeholders.

## II. Traditional Duties of the Corporate Director

### *Fiduciary Duty and Duty of Care*

The modern corporate director is a creature of statute. By the end of the twentieth century the statutory duties, obligations and liabilities of directors had evolved into a complex melange of corporate and securities laws, bankruptcy, income tax, occupational health, and environmental protection rules and regulations. At last count there were well over 100 statutes that imposed one form or another of liability or responsibility on an Ontario director. However, long before the duties and obligations of directors were prescribed by statute, their role was considered to be akin to that of the trustee. At its core the responsibility of the director is a fiduciary one owed first and foremost to its primary beneficiary – the corporation. There are, however, important distinctions between the role of the trustee and that of the corporate director. While the similarities account for much

of the historical development of the role of a director and his or her liabilities, the duties and obligations of the modern director vis-à-vis the corporation are clearly distinguishable from those of the trustee.

Unlike the trustee, who holds the legal ownership of the trust property and makes decisions with respect to that property with a view to the best interests of its beneficiaries, directors are not, in most cases, the legal owners of the corporation. Furthermore, while the fiduciary duty of the director, often referred to as a duty of loyalty, requires the director to act honestly and in good faith with a view to the best interests of the corporation, there is an understanding that in most cases the best interests of the corporation will be one and the same as those of the shareholders – sustainable profitability.

In addition to this fiduciary duty, the director also has a duty of care requiring her to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. In Canada, these dual core duties – fiduciary duty and duty of care – are statutorily prescribed in the various corporate statutes. For example, section 122 of the *Canada Business Corporations Act* (CBCA) provides:

> **Duty of care of directors and officers –**
> **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 reasonably prudent person would exercise in comparable circumstances.[4]

The duties to act in 'good faith', 'in the best interests of the corporation' and to exercise

the care of a 'reasonably prudent person' are important legal concepts. Each is the subject of constant interpretation and reinterpretation by the courts and each is worthy of a paper all its own. For this paper it is sufficient that we appreciate the seriousness, complexity and evolving nature of these core obligations.

It should be noted, however, that the harshness of these duties has traditionally been mitigated by the deference of the courts to decisions made by directors in the course of business, known as the Business Judgment Rule (BJR). In *CW Shareholdings Inc. v. WIC Western International Communications Inc.* Justice Blair defined the BJR as follows:

> This rule is an extension of the fundamental principle that the business and affairs of a corporation are managed by or under the direction of its board of directors. It operates to shield from court interference business decisions which have been made honestly, prudently, in good faith and on reasonable grounds. In such cases the board's decision will not be subject to microscopic examination and the court will be reluctant to interfere and to usurp the board of director's function in managing the corporation.[5]

This historical deference by both courts and legislatures seems to be rapidly lessening; because recent corporate governance reforms have placed directors in a form of corporate straight-jacket and because Courts have shown a much greater interest in having a deciding role at the boardroom table.

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[4] See also s. 134 OBCA, Standard of Care, etc., of directors, etc.
[5] 39 O.R. (3d) 755.

## III. The Reform Movement

Given the flurry of recent commentary about corporate governance practices, one might be forgiven for thinking that, pre-Enron, there were few requirements; statutory, regulatory, or otherwise, governing the corporate governance practices of a public corporation. However, even before Enron, the complex network of duties and obligations of corporate directors, contained in the various statutes, imposed liability on directors for breaches of specific obligations owed either to the corporation or to other participants in the capital markets. They did not purport to dictate to the corporation or its directors what was best for the corporation or how best to manage the relationships within the body corporate. Rather they established broad procedural requirements to provide wide boundaries for corporate decisions. For example, the corporate statutes mandate the election and removal of directors, the terms of their engagement, their qualifications[6] and they require directors to "manage, or supervise the management of, the business and affairs of the corporation."[7]

This laissez-faire approach to corporate behaviour was a natural consequence of the belief that the persons in control of a corporation should know what was best for the corporation. But did they? As the final decade of the century broke bringing a bear market with it, market participants began to reconsider the accuracy of this assumption

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[6] Admittedly, these are few. For example, s. 105(1) CBCA sets out the **Qualifications of directors** as follows:

> **105.** (1) The following persons are disqualified from being a director of a corporation:
> (*a*) anyone who is less than eighteen years of age;
> (*b*) anyone who is of unsound mind and has been so found by a court in Canada or elsewhere;
> (*c*) a person who is not an individual; or
> (*d*) a person who has the status of bankrupt.

[7] s. 102 CBCA; s.115 OBCA.

and by 1994 mandatory corporate governance guidelines and disclosure requirements, that significantly narrowed the boundaries of corporate discretion, were on the horizon.

## A. Toronto Stock Exchange Corporate Governance Guidelines: Just a Suggestion

The advent of the corporate governance movement in Canada is most often traced back to the 1994 Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada (the 'Dey Report'). Aptly titled '*Where Were the Directors? Guidelines for Improved Corporate Governance in Canada*' this report resulted in the inclusion of corporate governance guidelines in the Toronto Stock Exchange Company Manual and a mandatory requirement for listed companies incorporated in Canada to disclose, on an annual basis, its approach to corporate governance.[8] This 'Statement of Corporate Governance Practices' is required to be included in the company's annual report or information circular.

Based on the recommendations of the Committee, the Toronto Stock Exchange also set out a comprehensive set of 'guidelines for effective corporate governance'[9]. These include recommendations that corporate directors:

- adopt a strategic planning process and succession planning for senior management;
- constitute the board with a majority of unrelated directors[10];
- create a committee composed exclusively of outside directors[11] with a majority of unrelated directors to propose new nominees to the board and

[8] Part IV, Maintaining a Listing – General Requirements, s. 473.
[9] Ibid, s.474.
[10] Defined as a director who is independent of management and is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation.
[11] An outside director is a non-executive director, i.e. not a member of management such as the chief executive officer or the chief financial officer.

assess existing directors on an ongoing basis;

- review the adequacy and form of director compensation with a view to ensuring that the compensation realistically reflects the responsibilities and risk involved in being an effective director; and

- compose the audit committee solely of outside directors who should be responsible for overseeing management's reporting on internal controls.

These were, however, only guidelines. So that even those corporations that are required to disclose their corporate governance practices are under no obligation to implement any of the suggested guidelines. This was in keeping with the traditional Canadian principles-based approach to corporate governance. In addition, the guidelines, largely a quick-fix response to a public incensed by a declining market, were merely structural and reactive, providing little more than the then-current indicia of how to perform directoral duties in good faith.

We will look at this approach in more detail when we review the current Canadian effort to enhance corporate governance.

## B. Corporate Governance Reforms in the US

### *The Blue Ribbon Report*

Just as the custodians of the Canadian capital markets turned their thoughts to corporate governance, their US counterparts were engaging in a similar exercise. In 1999 the Blue Ribbon Committee, sponsored by the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD), released its report, '*Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*'. Dealing specifically with audit committees, the intended purpose of the Report was to effect

‘pragmatic, progressive changes in the functions and expectations placed on corporate boards, audit committees, senior and financial management, the internal auditor and the outside auditors regarding financial reporting and the oversight process.’[12]

For our purposes, the significant recommendations of the Committee were twofold: director independence and financial literacy of directors. In respect of the former, the Committee recommended that both the NYSE and NASD adopt the following definition of independence for the purposes of service on the audit committees for companies with a market capitalization over $200 million:

> Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation.[13]

The Report also provided examples of relationships that would not be independent. These included, among other things, directors employed by the corporation or its affiliates for the current year or any of the preceding five years (including any one who had a family member who was employed as an executive officer of the corporation) and any director receiving compensation from the corporation or its affiliates other than in their capacity as a member of the board.

As proposed, directors who could not meet these independence requirements would be permitted to sit on the audit committee so long as the board determined that it was in the best interests of both the corporation and its shareholders. However, the nature of the

[12] Letter from the Chairmen of the Blue Ribbon Committee.
[13] Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, Recommendation 1, p. 10.

relationship and the reasons for having a related director on the committee would have to be disclosed.

In addition to the recommendations for independent directors, the Committee also made recommendations with respect to the financial literacy of directors. In particular, they suggested that the audit committee be comprised of no less than three directors all of whom are financially literate[14] or become financially literate within a reasonable period of time after being appointed. In addition, the Committee recommended that at least one of the members of the audit committee 'have accounting or related financial management expertise'.[15]

Interestingly, while the Report was intended to deal specifically with the role of directors on the audit committee the Blue Ribbon Committee clearly approached their task with a view to the broader concerns about board membership generally. Hence, its comment that "board membership is no longer just a reward for 'making it' in corporate America; being a director today requires the appropriate attitude and capabilities, and it demands time and attention."[16] Unfortunately, corporate America wasn't yet ready to heed this call to revamp the role of the director. In any event, WorldCom and Enron were just around the corner.

[14] Defined at p. 6 as the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement and cash flow statement.
[15] Ibid, Recommendation 3, p. 12. 'Expertise' is defined at p. 26 of the Report as past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a CEO or other senior officer with financial oversight responsibilities.
[16] Ibid, Overview and Recommendations, p.6.

**Corporate Governance Reform: The Real Deal**

In hindsight, the shortcomings highlighted by the Blue Ribbon Committee in 1999 (and their effort to reveal the seriousness of the ramifications if those shortcomings continued unchecked) were right on the mark. Although the NYSE revised its listing requirements in response to the Report, the provisions were still extremely broad, allowing companies considerable leeway in constituting their audit committees. In the result, in the period between the Report and the corporate fiascos that gave rise to the corporate governance initiative, very little had changed in the boardroom or in the audit committees.

***Sarbanes-Oxley Act of 2002 (SOX)***

The US response to the series of corporate meltdowns that began with the downfall of Enron and were rounded out by comparable failures at Worldcom, Tyco, Adelphia, Global Crossing and ImClone, has been rapid and comprehensive. Intended to bolster public confidence in the capital markets, *Sarbanes-Oxley* is arguably the single most important legislative initiative to address corporate governance concerns in US (and possibly Canadian) history. From the creation of a Public Company Accounting Oversight Board (PCAOB), to its provisions for auditor independence and enhanced financial disclosure, the legislation leaves almost no aspect of corporate life untouched. For our purposes the significant changes brought about by the Act are those in Title III: Corporate Responsibility and Title IV: Enhanced Financial Disclosure.

*Corporate Responsibility: Addressing the Perception of Shirking*

The confines of this paper do not allow a thorough review of all of the ‘corporate

responsibility' changes that impact directors. There are, however, a few key provisions relating to the audit committee, certification of financial statements and the impact of financial restatements on directors that we should consider.

In respect of the audit committee, the Act requires each member of the audit committee to be a member of the board of directors, but otherwise independent, and confers upon the audit committee responsibility for the appointment, compensation and oversight of any public accounting firm employed to perform audit services.[17] In order to be independent the Act provides that a director 'may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee – (a) accept any consulting, advisory or other compensatory fee from the issuer; or (b) be an affiliated person of the issuer or any subsidiary thereof.'[18]

Given the recommendations of the Blue Ribbon Committee in 1999, the independence requirement is no surprise and is not especially controversial. The same cannot be said of *SOX*'s introduction of CEO/CFO certification of financial statements into the corporate governance regime. Section 302 of *SOX* instructed the SEC to promulgate rules requiring the CEO and CFO to certify, in each annual or quarterly report filed or submitted pursuant to ss.13(a) or 15(d) of the *Securities Exchange Act of 1934,* that:

- The signing officer has reviewed the report;
- The report does not contain untrue statements or material omissions;
- The financial statements fairly present, in all material respects the financial conditions and results of operations of the issuer;
- Such officers are responsible for internal controls designed to ensure that they receive material information regarding the issuer and consolidated subsidiaries;
- The internal controls have been reviewed for their effectiveness within

[17] *Sarbanes-Oxley* s. 301 amending s. 10A of the *Securities Exchange Act* of 1934.
[18] Ibid, adds subsection (m)(3)(B).

90 days prior to the report;

- All deficiencies in the design or operation of internal controls have been disclosed to the auditor and the audit committee; and
- Any significant changes to the internal controls.

Pursuant to *SOX* the SEC adopted its Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports. Effective August 29, 2002, the provision makes no distinction between domestic and foreign issuers and, hence by its terms, clearly applies to foreign private issuers.[19]

The Certification requirements are controversial for many reasons, not the least of which is the role it asks the director to play – remember the executive directors are supposed to be running the business. Instead they are becoming corporate investigators. There is also a concern that a pattern of what has been referred to as 'regulation by personal certification', will develop whereby directors will incur more and more responsibility by certification (while others who should bear the responsibility are given an out). These suspicions are buttressed by the recent movement in the US for CEO certification of tax returns for which *Sarbanes-Oxley* provided the impetus. Surprisingly, s.1001, entitled 'Sense of the Senate Regarding the Signing of Corporate Tax Returns by Chief Executive Officers' states that the sense of the Senate is that corporate tax returns should be signed by the Chief Executive Officer. US corporate lawyer Michael O'Sullivan has referred to this extension of CEO certification, rather colloquially, as akin to strapping the CEO to the front bumper.[20] Most directors would probably agree.

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[19] The extraterritorial nature of *Sarbanes-Oxley* has been the source of much comment and criticism. As Howard Davies, Chairman of the Financial Services Authority in the UK, stated 'with their usual generosity of spirit, the Americans have ensured that a number of its provisions apply to overseas companies as well as to their own.'

[20] *'Strapping the CEO to the Front Bumper'*, Corp Law Blog, October 3, 2003 at www.corplawblog.com.

The final corporate responsibility initiative of interest pursuant to *Sarbanes-Oxley* is the requirement that CEO's and CFO's forfeit any bonus or other incentive-based or equity-based compensation received if the company is required to make an accounting restatement due to the material non-compliance of an issuer.[21] It should be noted that the SEC has the discretion to exempt any person from the applicability of this section 'as it deems necessary and appropriate.'

*Financial Disclosure*

*Sarbanes-Oxley* contains a number of financial disclosure provisions, two of which are of particular significance to the role of the director. The first of these is the prohibition of personal loans extended by a corporation to its executives and directors.[22] The second is the requirement for senior directors, among others, to disclose changes in securities ownership or securities-based swap agreements within two business days.[23]

***New York Stock Exchange***

In an effort to improve corporate governance and to be in sync with the changes brought about by *Sarbanes-Oxley* the NYSE made a proposal in August 2002, to the SEC, requesting the SEC's approval of material amendments to the NYSE's rules. In November 2003, after a lengthy period of comment and debate, the NYSE Listed

[21] *Sarbanes-Oxley* s. 304.
[22] Ibid, s.402 amending s. 13 *SEA* of 1934.
[23] Ibid, s.403 amending s.16 *SEA* of 1934.

Company Manual was amended to incorporate these proposed changes. Many of these changes are significant to directors, including increased board independence, the establishment of nominating/corporate governance committees and compensation committees, and annual CEO certification.

*Independence*

Pursuant to new rule 303A listed companies must have a majority of independent directors. The Rules provide a detailed description of what is required to be an independent director in what it describes as 'Independence Tests'. The tests are:

- No director qualifies as 'independent' unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). Companies must disclose these determinations;

- A director who is an employee, or whose immediate family member is an executive officer, of the company is not independent until three years after the end of such employment relationship;

- A director who receives, or whose immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service), is not independent until three years after he or she ceases to receive more than $100,000 per year in such compensation;

- A director who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the company is not 'independent' until three years after the end of the affiliation or the employment or auditing relationship;

- A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee is not 'independent' until three years after the end of such service or the employment relationship; and

- A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues, is not 'independent' until three years after falling below such threshold.

*Committees*

The new listing requirements also establish a number of committees, two of which deserve special attention. The first of these is the nominating/corporate governance committee who's duties are prescribed in terms of a minimum expectation that they identify individuals qualified to become board members, consistent with criteria approved by the board; select, or recommend that the board select, the director nominees for the next annual meeting of shareholders; develop and recommend to the board a set of corporate governance principles applicable to the corporation; and oversee the evaluation of the board and management.[24] In addition, the committee must undertake an annual performance evaluation of the committee.

In addition to the nominating committee, the manual also mandates that a compensation committee be established.[25] Again, the obligations of the committee are expressed in terms of a minimum expectation that it review and approve the corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives, and determine and approve the CEO's compensation level based on this evaluation. The compensation committee is also expected to produce the reports on executive compensation required by the SEC.

[24] Rule 303A.04 NYSE Listed Company Manual.

The commentary to the rule provides that in determining the long-term incentive component of CEO compensation, the committee should consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company's CEO in past years.[26]

Both committees must be comprised entirely of independent directors.

## C. Canadian Corporate Governance Reform

It has been suggested that the Canadian reaction to the corporate failures of recent years has been more measured than that of our neighbours to the south. This is due, at least in part, to the fact that Canada's corporate failures, and we certainly have had our own corporate governance issues to be sure (think Bre-X and YBM), followed upon those of the US. Hence, we had the benefit of witnessing the US experience. On the downside, it is arguable that the proximity to the US markets and the extraterritorial nature of their reforms has constrained the Canadian response. This is particularly evident in light of the new corporate governance guidelines proposed by the Ontario Securities Commission, and the extent to which those guidelines are a marked departure from the traditional Canadian principles-based approach to corporate governance.

A brief review of the rules versus principles debate will provide some insight into the extent to which Canada is following in the steps of the US.

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[25] Rule 303A.05 NYSE Listed Company Manual.
[26] Commentary to Rule 303A.05, Compensation Committee, NYSE Listed Company Manual.

***Principles or Rules?***

As we discovered when we looked at the Toronto Stock Exchange Corporate Governance Guidelines introduced in 1995, Canada's corporate governance model has been a principles-based approach. Having established guidelines for good corporate governance practices, corporations are left to implement those practices in the spirit of the guidelines. The furthest the Toronto Stock Exchange was prepared to go was mandatory disclosure of compliance with a required explanation for non-compliance. This has not been the approach in the US. To the contrary, the US has traditionally favoured mandatory compliance with detailed legislation and listing requirements. This trend has only been increased post-Enron. The bottom line is if Canada wants to keep in step with US corporate governance reforms, we likely will have to adhere to a rules-based approach, thereby reducing (and some might suggest abolishing) the discretion that has historically existed in the Canadian boardroom.

Clearly arguments can be made for both approaches to corporate governance reform. On the one hand, the arguments most often made in favour of the rules-based approach are certainty (knowing the role they are filling and the decisions they will have to make) and enhanced management accountability (for instance, certification by CEO's and CFO's provides as much security for other members of the board as it does for the investing public). On the other hand, advocates of the principles-based approach insist that many of the concerns about what is going on in the boardroom are really just concerns about the people sitting at the boardroom table – and rules don't do much for addressing human frailty. It has also been suggested that "an excess of rules and regulations can easily suffocate the very spirit of innovation and risk-taking that makes markets so successful in

driving human progress."[27]

A careful review of the new and proposed rules suggests the rules versus principles debate has been settled (at least in Ontario) in favour of the former.

***Keeping the Promise for a Strong Economy Act (Budget Measures)***

In Ontario the legislative response to *Sarbanes-Oxley* began with Bill 198. Given royal assent in December 2002, the *Keeping the Promise for a Strong Economy Act (Budget Measures)* impacted the role of the director in two fundamental respects: Firstly, it amended Part XXII of the *Securities Act* (Ontario) to make directors and officers liable for corporate non-compliance with Ontario securities law by deeming the director, officer, or the person who "authorized, permitted or acquiesced in the non-compliance … to also have not complied with Ontario securities law."[28]

Secondly, the Act gave the Ontario Securities Commission (OSC) new rulemaking powers to change its rules to hold corporate executives accountable for the internal control of their companies.[29] This provision has not been without controversy. If we look at the corporate governance reforms in the US, the legislature took the onus and provided a script for the desired amendments to the *Securities and Exchange Act of 1934*. Here,

[27] Comment of the Canadian Council of Chief Executives (CCCE), *'Canadian Chief Executives Commit to Leadership in Improving Corporate Governance'*, September 26, 2002.
[28] *Securities Act* (Ontario), s. 129.2.
[29] Section 187 *Keeping the Promise*, amended s. 143 of the *Securities Act* to allow the Commission to make rules in respect of defining auditing standards for attesting to and reporting on reporting issuer's internal controls, requiring reporting issuers to appoint audit committees and their responsibilities, and requiring CEO's and CFO's to provide certification of the reporting issuer's internal controls and disclosure controls and procedures, among other things.

instead of legislating the changes, the legislature has delegated its legislative power to the OSC. The heightened role of the OSC in recent corporate governance initiatives suggests they intend to use it.

***Toronto Stock Exchange Corporate Governance Policy: Too Little Too Late?***

Before we discuss the recent OSC corporate governance proposals it is necessary to take a brief look at the now-defunct TSX Proposed New Disclosure Requirement and Amended Guidelines. In July 2000 the Toronto Stock Exchange, the TSX Venture Exchange and the Canadian Institute of Chartered Accountants mandated the Joint Committee on Corporate Governance to review the state of corporate governance practices in Canada. Its final report (the 'Saucier Report'), issued in November 2001, contained 15 recommendations many of which suggested changes to the existing TSX Corporate Governance Guidelines we looked at earlier.

The response of the Toronto Stock Exchange to the Committee's recommendations is telling – while the TSX was willing to implement many of the changes to the guidelines, including the role of the board in adopting a strategic process and the introduction of financial literacy and accounting expertise requirements for audit committee members, it reiterated its belief that 'issuers must have the flexibility to develop its own approach to corporate governance'. This continued commitment to the principles-based approach subjected the TSX to a considerable amount of criticism at a time when the capital markets were reeling from corporate scandals on both sides of the border. Nevertheless, in July 2002, with *Sarbanes-Oxley* and Bill 198 looming on the horizon, the OSC approved the Amended Guidelines.

In the result, however, the Amended Guidelines were never implemented. The enactment of *Sarbanes-Oxley* prompted the OSC to ask the TSX to reconsider its approach and to consider making the Amended Guidelines look less like guidelines and more like rules. In response the TSX made a subsequent proposal for Amended Guidelines. Then, in June 2003 the OSC published for comment new measures of its own. Finally, in September 2003 the OSC announced that it would take over responsibility for monitoring governance standards from the TSX.

***The OSC and Corporate Governance: A Tough Love Approach to Corporate Governance?***

In June 2003 the OSC, in connection with the Canadian Securities Administrators (CSA), published for comment proposed *Multilateral Instrument 52-108 – Auditor Oversight (MI 52-108)*, *Multilateral Instrument 52-109 – Certification of Disclosure in Companies' Annual and Interim Filings (MI 52-109)* and *Multilateral Instrument 52-110 – Audit Committees (52-110)*. MI 52-108 came into force as a National Instrument on March 30, 2004 while MI 52-109 and MI 52-110 came into force as Multilateral Instruments on the same date.[30] For our purposes, it is the audit committee and certification requirements that are the most significant – but all of these measures when taken together represent a breathtaking incursion into matters of corporate law by a regulator that only a few years ago advocated that those matters were best left for courts and legislatures.

[30] Because they were not adopted by the British Columbia Securities Commission.

*Audit Committee*

The new audit committee requirements are essentially the same as those adopted in the US by *Sarbanes-Oxley*. Pursuant to s.2.1 every issuer must have an audit committee responsible for overseeing the external auditor, approving any non-audit services provided by the external auditor, and reviewing the issuer's financial statements, MD&A and annual and interim earnings press releases before the issuer publicly discloses such information.[31]

The audit committee must be composed of at least three directors all of whom are independent and financially literate.[32] At first blush this appears to be a rather onerous requirement, however, there are generous exceptions for Initial Public Offerings (IPO's) and Controlled Companies. In addition, where a committee member ceases to be independent for reasons beyond the control of the issuer that member will be temporarily exempt from the independence requirement.

'Independence' is defined in terms of the materiality of the relationship. Specifically, a director will be independent when she has no direct or indirect material relationship with the issuer. A material relationship is a relationship that could, in the view of the issuer's board of directors, reasonably interfere with the exercise of the member's independent judgment.[33] A list of individuals who are considered to have a material relationship with an issuer is included in the section. These include the usual suspects – employees and

[31] s.2.3, Part 2, MI 52-110.
[32] s.3.1, Part 3, MI 52-110. 'Financial Literacy' is defined as the ability to read and understand a set of financial statements that present a breadth and level of complexity of the 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: s.1.5, Part 1, MI 52-110.
[33] s.1.4, Part 1, MI 52-110.

CEO's, family members of CEO's, individuals affiliated with the external auditor, and persons who receive more than $75,000 per year in direct compensation from the issuer, other than as remuneration for acting in their capacity as a board and/or board committee member.[34]

*CEO/CFO Certification*

The certification requirements are the same as those adopted by the SEC pursuant to *Sarbanes-Oxley*. Here, the certification regime will require CEO's and CFO's to personally certify – each and every time a company makes its annual or interim filings – that:

- The signing officer has reviewed the report;
- The report does not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made;
- The report fairly presents in all material respects the financial condition, results of operations and cash flows of the issuer;
- Such officers are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer; and
- Such officers have caused the issuer to disclose any change in the issuer's internal controls over financial reporting.[35]

Not surprisingly, British Columbia (regrettably the last bastion for the principles-based approach to corporate governance) declined to adopt the certification and audit committee requirements.

***Corporate Governance Standards – Another Kick at the Can***

[34] By way of contrast the NYSE Listed Company Manual threshold for direct compensation is $100,000.

On January 16, 2004 the OSC finally published its proposed Policy for Effective Corporation Governance. In developing the policy the Commission operated under the belief that the Canadian approach to corporate governance must:

- 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 developments in the US and around the world; and
- Recognize that corporate governance is in a constant state of evolution.[36]

Clearly, the 'Canadian approach' to corporate governance has come a long way since the TSX corporate governance guidelines. Nevertheless, these proposed corporate governance standards, like its predecessor, are only guidelines. The recommendations, 18 in all, include board composition (majority of independent directors), the desirability of a written code of conduct and ethics, the creation of a nomination committee for selecting new directors, and the creation of a compensation committee to ensure directors and management are adequately and appropriately compensated.

## IV. The Evolving Role of the Independent Director

A recent article in the *Economist* (March 20, 2004) entitled "Where's all the Fun Gone" made the following comments about corporate governance and the boardroom:

> *As recent power struggles at Shell and Hollinger International have amply shown, well-organised and determined non-executive directors can be a powerful force to improve corporate governance by reining in over-mighty chief executives. In most rich countries, efforts are under way to make that force more*

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[35] Forms 52-109F1 – Certification of Annual Filings and 52-109F2 – Certification of Interim Filings

[36] Request for Comments, Proposed Multilateral Policy 58-201 Effective Corporate Governance, (2004) 27 OSCB 967.

> *reliable. Better governance, it is argued, comes from making non-executive directors more independent and giving them more work to do. But actually, that is only part of the answer – and has its drawbacks. Much the most important change is to find ways of encouraging non-executive directors to behave independently. And that, perhaps surprisingly, turns out to be easier than it sounds.*

There is no doubt that the corporate governance reforms outlined above go a long way to trying to redefine the role of a director in a public corporation by imposing a more tightly established set of rules, narrowing the scope of a director's discretion and giving less than full faith and credit to the exercise of business judgment. This is occasioned by the fact that, irrespective of what the role of the director was supposed to be, historically there has been a perception that the role was less than significant, even 'decorative'[37]. In the post-Enron boardroom a 'parsley' stance is clearly not going to fly.

We sense that the reforms described above have resulted in both structural and substantive changes in how modern boards do their work. Meetings are now longer and better documented, tougher questions are being asked, law firms, accounting firms and consulting groups are all vying for mandates to assist directors in performing their roles, and some directors are going to director boot camp to learn how to perform their jobs more effectively.

In our view, however, the reforms are only part of the answer. Directors today have a much healthier concern about directoral liability. There was a time when, absent fraud or self-dealing, directors were seldom sued successfully. That is no longer true.

[37] The source of this well-known description of corporate directors appears to be a statement made by Irving Olds during his time as Chairman of the Board of Bethlehem Steel. Apparently, when asked about his position Mr. Olds replied to the effect that in his capacity as Chairman he was roughly the equivalent of parsley on a platter of fish. This is often quoted as "Directors are like parsley on fish, decorative but useless".

Furthermore, the financial constraints of directors and officers liability insurance is causing many sleepless nights in the bedrooms of Canadian board members.

We also note that the composition of Boards is changing with more independent directors being appointed and more management directors being removed. This change brings with it a certain amount of risk. Unless independent directors immerse themselves in the history, business and future of their corporation, Board decisions will certainly be independent but they may not be terribly well informed. This trend is perhaps less well pronounced in Canada than it is in the United States because we have a large group of family-controlled public companies where management will continue to play a much larger role.

Most importantly, however, we believe that the values of directors have significantly changed. This arises in part because those who will now serve on a board are not usually from the old class of retired, marqué directors. It is also in part because of the pressures of the marketplace as a whole. The loss of personal goodwill arising from a corporate collapse is arguably as much of a deterrent as anything a court or regulator might actually *do* to a director found to have engaged in corporate malfeasance or non-feasance.

**Conclusion**

The last question we need to be asking is what does the future have in store for directors and their liabilities. Beyond the fiduciary duty to the corporation and the various statutory provisions described above are the tort cases where directors can be held personally liable for their acts on behalf of the corporation. If the recent trend is any

indication, we will likely continue to see the protections afforded by the business judgment rule and by acting in good faith and in the best interests of the corporation whittled away by the courts. We also do not expect to see legislators and regulators stop at the latest round of reforms as the public's appetite for more rules and regulations remains strong, even though we would argue that this approach is, in all likelihood, unnecessary.

We remain, however, guardedly optimistic. In our view, the most effective way to reduce corporate malfeasance is probably already underway. It will arise from boards carrying out their mandates with more enthusiastic due diligence; from the dismantling of the few remaining corporate dinosaurs such as Parmalat; and most importantly, from a more activist, but more realistic, shareholder class. To paraphrase the famous dictum of Pierre Elliott Trudeau – that the government has no business in the bedrooms of the nation – perhaps it is also true that the government has no real place in its boardrooms either.