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CORPORATE GOVERNANCE: A PRACTICAL AND EFFECTIVE RESPONSE TO THE CHALLENGES RAISED

by

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Abstract

This thesis seeks to address corporate governance from both a practical as well as an academic perspective. It searches for solutions to *self-interest* and agency costs, problems that it is posited are innate to the anthropomorphism of the corporation and to the separation of management and ownership of widely held, publicly traded, corporations.

Practically, this dissertation is anchored in experience, garnered from empirical research, based on in depth and general surveys, as well as detailed interviews. It examines the workings of corporations, including their boards of directors, of gatekeepers, of checks and balances and of shareholders and the relative importance and rationale for the roles that they play. Based on the academic and empirical efforts it is posited that *self-interest* and the *funneling syndrome,* (a process whereby information required for decision making is constrained and managed by those in control), almost always predetermines the outcome of the corporate formal decision making process involving the board of directors. This facilitates abuse. When it occurs and there appears to be no accountability, confidence essential to the capital markets, quite understandably, suffers.

A hypothesis is advanced to explain the complexity of a potential failure of corporate governance through a relatively simple formula. It draws conclusions as to what is required to help address the challenges raised by the breakdown in effective corporate governance and to help instill greater investor confidence. A self-assessment mechanism to help quantify how effectively a corporation is dealing with corporate governance, both on an absolute basis (comparing itself year over year) and on a relative basis (compared to one's peers) is proffered. This tool of more effective corporate governance, seeks to identify the causes for breakdowns in corporate governance and to assist a board of directors in dealing more proactively with this challenge.

Résumé

Cette thèse se consacre à l'analyse la question de la gouvernance d'entreprise sous un angle à la fois pratique et académique. Elle cherche des solutions aux problèmes de l'intérêt personnel et des coûts d'encadrement, lesquels, il est soumis, sont inhérents à l'anthropomorphisme de la corporation et à la séparation existant entre propriété et gestion dans le cas des compagnies publiques à grand nombre d'actionnaires.

Le fondement pratique de cette thèse est ancré dans l'expérience, et provient de recherches empiriques reposant sur des enquêtes générales et en profondeur. Cette thèse examine le fonctionnement des corporations, y inclus leur conseil de direction, les « gardiens », les freins et contrepoids, les actionnaires, et le rôle particulier de chacun de ceux-ci. Il est proposé, sur la base de recherches académiques et empiriques, que l'intérêt personnel et le « syndrome de l'entonnoir » (selon lequel l'information nécessaire à la prise de décision est contrainte et gérée par ceux qui contrôlent la corporation) détermine presque toujours à l'avance le résultat du processus formel de prise de décision du conseil de direction de la corporation, ce qui encourage les abus. Lorsque ceux-ci se produisent et que personne ne semble être responsable, il est compréhensible que la confiance nécessaire au fonctionnement des marchés financiers en souffre.

Pour expliquer la complexité d'un échec potentiel de gouvernance d'entreprise, une hypothèse est proposée par le biais d'une formule relativement simple. Des conclusions sont tirées quant à ce qui est requis pour répondre aux défis qui surgissent à cause des ruptures d'efficacité dans la gouvernance d'entreprise, et pour encourager la confiance des investisseurs. Un mécanisme d'autoévaluation est proposé. Celui-ci permet de quantifier le degré d'efficacité avec lequel une corporation s'occupe de questions de gouvernance, à la fois de manière absolue (en mesurant sa propre performance année après année), et de manière relative (en se comparant avec ses pairs). Cet outil pour une gouvernance d'entreprise plus efficace cherche à identifier les causes de ratage dans la gouvernance et à assister le conseil de direction dans la poursuite de solutions proactives.

Acknowledgements

Life is a journey and all whom one encounters along the way impact one's direction. Each of the following played a key role in this endeavor and should share in any of its success; however I alone bear responsibility for any of its shortcomings.

To my parents, who instilled in me a love of learning and a desire to pursue my dreams, I am forever indebted in more ways than words can ever express.

To my wife whom I grow to love more with every passing day (if that is possible given the feelings that I already have for her), I attribute most of the recognition for whatever I have managed to achieve (and not only in this effort). She puts up with more than I would ever have accepted if the tables were reversed. Meeting and falling in love with her, almost four decades ago, was clearly the best thing that ever happened to me. Without her unequivocal support as a wife, confidante, friend, and mother (and sometimes pseudo father) to our children, much of what I have sought to achieve in life, including this endeavor, would have been nothing more than an "impossible dream".

To my children, Richard and his wife Dr. Aviva Lowe, Kenneth and his wife Dr. Marion Cummings and Michelle, who have put up with a dad that was more absent than present (even when physically in attendance and you all know to what I am alluding to) and who have supported me, unequivocally, in all that I have ever pursued (in ways that each and every one of you knows), I am blessed by having you as my children.

To all from the world of business, the professions and academia, who notwithstanding personal time constraints, gave so unselfishly of your time, anonymously sharing personal experiences, insights and observations (and seeking no recognition for your important contribution), I salute each and every one of you. I only hope that I have managed to do justice to your expenditures of time and effort.

To all the other anonymous contributors, respondents to the surveys, as well as those who otherwise assisted (and to any whom I may have inadvertently omitted), your assistance was and is greatly appreciated.

Last, and perhaps most importantly in terms of this effort, I would like to publicly acknowledge a debt of gratitude to Roderick A. Macdonald, the Scott Professor of Constitutional and Public Law at the Faculty of Law at McGill University. Rod was much more than a supervisor; he was an inspiration. His love of the law, of learning, of teaching and of opening my mind to new thoughts, ideas and challenges, was at the very least humbling; it made me appreciate how relatively little one really knows and how much more there was to learn. It was also without doubt one of the primary lasting benefits of this effort. Notwithstanding Rod's heavy academic obligations, (while still finding time to be available to all students and colleagues), and his participation in other activities, (including acting as a legal expert and consultant in Canada and throughout the world), he was always available (albeit frequently by email). How he found the time to be able to respond to almost any query within twenty-four hours could form the basis for a study on "effective time management". While a supervisor at the outset, I now consider Rod to be a friend and an inspiration; if ever I was to become more engaged in academia (which I now consider a real possibility) Rod would be my role model. Rod exemplifies what I always believed a university professor should be. He is the model that others should strive to emulate. I feel fortunate in having had his support, guidance and mentoring in this effort.

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Introduction

As a lawyer, a chartered accountant, former chief legal officer of one of Canada's largest corporations and a corporate director, I find the failure of corporate governance to protect the interests of a corporation's constituents while those in control appear to benefit troubling. Notwithstanding the rhetoric (for example, that management seeks to align its interests with those of shareholders), there appears to be a misalignment between the objectives of those in control of a widely held, publicly traded corporation (namely, management and the board of directors) and those of the shareholders. Although this could be viewed as the exception as opposed to the rule, it seems to be a recurring theme. The failure of boards of directors, comprised as they usually are of individuals with ostensibly impeccable credentials, competence and integrity, to help safeguard the interests of the corporation's constituents, strikes me as a paradox. Engaging in a search for the causes of and possible responses to address this enigma sparked my interest and is the genesis of this dissertation.

This research endeavor has both practical and academic objectives. From a practical perspective, it needs to be recognized that capital markets, which serve as a source of funding to drive economic growth and prosperity, require investor confidence. In trying to discover what can engender greater investor confidence, I seek to reassess the different academic theories and other proposals advanced to help address these recurring concerns. I begin by questioning whose interests a corporation should be serving, those in control, the shareholders or others. To pursue an understanding of how it is believed that investor confidence can best be achieved, I seek to ascertain whether suggested approaches are working and if not, why not, and to see if alternatives can be derived and proffered. Being able to ascertain why ostensible checks and balances that were designed to help ensure and support investor confidence fail and what one can do to minimize (but never to remove) the risk of failure is, I believe, a necessary pre-condition to helping re-establish a stronger base for more effective corporate governance and concomitant investor confidence. Understanding the problem and seeking to help reduce the risk that

those in control will benefit while the providers of capital lose their investment, is the practical problem at the core of this undertaking.

In pursuing this project, I sought to harness my personal background and experience, more than thirty years of involvement in business, including as a member of numerous boards of directors of for-profit corporations. While this gave me access to people within the business community, my objective was not to attempt to do an *exposé* on how corporations operate. Rather, I hoped to apply my practical experience to a scholarly research initiative. I sought to combine what I had learned through experience over the years, with what I could discover through research, both academic and empirical. To help advance my learning process I felt that the structure, assistance and guidance provided by an institution of higher learning would be most beneficial. Pursuing a doctorate in laws enabled me to achieve a dual objective.

First, I was able to expand my appreciation of corporate governance and related issues beyond the limitations of "practical experience". Important as practical experience may be, it is also restrictive in that it is constrained to specific issues and events. Being able to explore the views and rationales of others and to test them against what happens in the "real world" provided what I believed would be a unique and exciting opportunity.

The second reason for the approach that was adopted can be categorized as "pragmatic opportunism". Working to pursue a doctorate at a recognized institution of higher learning provided instant credibility. Engaging in "empirical research" and asking individuals who are otherwise very proactively engaged and often "time challenged" to volunteer their time, thoughts and opinions for a "commercial activity" would at best be a challenge. It would be hard to justify or to rationalize such use of their extremely valuable time. Absent being engaged in an academic endeavor (the results of which might also be useful to academia and the business community), accessing such individuals would require using (or abusing) friendships, something that raises ethical issues. However, seeking to advance the frontiers of education through research and study

facilitated gaining access, even to individuals whom I had rarely and often had never met previously.[1]

To translate my ambition and objectives into a written dissertation, I adopted the following structure.

Chapter 1 introduces and positions the concept of corporate governance, the challenges that it seeks to address and the policy questions that it raises. It also describes briefly the empirical work that I am undertaking (to anchor this study in commercial reality). It further outlines the current legal framework as a base of reference, and based upon anecdotal experience, initial field work and preliminary readings and research, advances certain research hypotheses that are to be tested by the work that is to be undertaken. It concludes with a brief description of the challenges engendered by this effort.

The next step, Chapter 2, consists of a "review of the scholarly literature". It canvasses and reviews the nature of a corporation, its anthropomorphism and related academic issues. These include whose interests should be protected, suggested solutions (be it market efficiency, regulation or an expanded role for institutional investors), the challenges raised by these approaches and notes that many of the challenges raised more than three-score and ten years ago[2] continue to confront us.

Chapter 3 seeks to frame the issues faced in seeking to achieve more effective corporate governance. It focuses on the primary areas: conflict of interests, the challenges raised by the business judgment rule, board capture, compensation and *self-interest* in dealing with material information, and ends with the challenges faced when *self-interest* conflicts with other interests.

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[1] It is to be noted that only one person turned down a request for an interview. Barring time conflicts (either of the individual or of the author) all others agreed to be interviewed. All interviews were held on a confidential, not for personal attribution, basis.

[2] See generally Adolf Augustus Berle & Gardiner Coit Means, *The Modern corporation and Private Property*, 4th edition (New Brunswick, N.J.: Transaction Publishers, 2002), originally published in 1932.

The next chapter, Chapter 4, critically analyzes the effectiveness of the checks and balances (the gatekeepers) used to help safeguard the interests of investors. It highlights a tautology, that no one is immune from the impact of *self-interest.*

Chapter 5 focuses on the control of the corporation, addresses the role of independent directors and the impact of changes in control of a corporation, and suggests that when it comes to control, there is a lack of accountability to the shareholders. Furthermore, it postulates that barring exceptional circumstances (such as a takeover or a loss of confidence in the chief executive officer (CEO)), the CEO is in fact (if not in law) in control of the corporation.

In Chapter 6, I develop and explain two key ideas that are central to understanding the current challenge, the *funneling syndrome*[3] and *self-interest.* Understanding how these two factors contribute to the deterioration of effective corporate governance is a pre-condition to determining ways to address them more effectively.

Chapter 7 focuses on two basic challenges that continue to confront scholars whose field of research is corporate governance. First, whose interests should corporate governance be endeavoring to protect? Second, how can this be achieved most effectively?

Chapter 8 addresses the empirical data – anecdotal experience, survey research, interviews and fieldwork that were undertaken – to complement the academic initiative. It reports on the respective findings. It concludes by advancing a hypothesis that attempts to explain the complexity of a potential failure in corporate governance, through a relatively simple formula.

Based on the research undertaken, Chapter 9 seeks to postulate tools and a rationale to address what I claim are at the core of the breakdown in corporate governance, namely the notions of *self-interest* and the *funneling syndrome* as explained in Chapter 6.

Chapter 10 seeks to draw conclusions as to what is required to address the challenges raised by the breakdown in effective corporate governance. It provides a mechanism to self-assess (as to whether a corporation is improving in its attempts at ensuring that the challenges faced are being addressed) on both an "absolute basis" (by comparing oneself year over year) and on a "relative basis", (by comparing oneself to one's peers). It also recognizes that steps taken by corporations were to supplement shortcomings in the legislative process, as if one believed that existing legislation addressed all areas of potential abuse, the need for any additional intervention would well be a moot point.

Chapter 11 summarizes the key ideas of the thesis. It concludes by reporting on the fourteen research hypotheses set out in Chapter 1. It also highlights ancillary and related issues that could not be pursued, given the focus of this effort. It notes that a failure to address the potential for abuse and ensure accountability merely serves to provide the scope for the untrammeled pursuit of *self-interest* and *the funneling syndrome* the means, unless constrained, to achieve it.

If I were to state the principal purpose of this dissertation, it would be that confidence, essential for the effectiveness of our capital markets, is often betrayed by a breakdown in effective corporate governance. The enablers that facilitate this potential for abuse are unconstrained *self-interest, the funneling syndrome* and a lack of meaningful *accountability.* As a result the interests of those who are to act, ostensibly to create value for the investors (the shareholders), often benefit personally at the expense of those whose interests they should be protecting. Why this takes place and what can be done to enable this to be dealt with more effectively (although, unfortunately, never to prevent its recurrence) is the research focus of this thesis.

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[3] This concept suggests that information required for decision-making by a board of directors is controlled by the CEO. This is discussed in detail in Chapter 6.

Chapter 1

Corporate Governance

1.1. INTRODUCTION

In its broadest context, governance[4] can be defined as the *rules, concepts and processes* that regulate interactions to achieve desired ends. Thus, governance can apply to social, political and economic relationships. The genesis of rules is not uniform as they may originate from ethics and morals and be anchored in religion, with non-secular sanctions for a failure to comply. They may be reflected in voluntary embodiments such as codes of conduct having non-legal sanctions. They may be man-made and reflected in agreements (both oral and written) between parties,[5] or may be established by legal authorities[6] with administrative or penal sanctions for non-compliance. Or they may be embodied in what seem like rules of nature, which suggests a natural evolution[7] without unnatural external intervention. Irrespective of their source, these *rules* have one thing in common: they try to assist in achieving a desired end and have repercussions for a failure to comply. These *rules, concepts and processes*, for purposes of this thesis, are understood as *"the tools of governance"*.

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[4] See generally Lester M. Salamon, ed., *The Tools of Governance: A Guide to the New Governance* (Oxford: Oxford University Press, 2002). Salamon notes a theme supported in this thesis, that new governance "builds on a rich history of past thinking, changing emphasis, and incorporating new elements, but hardly replacing all that has gone before." "The result, however", he suggests, "is a new synthesis, a new paradigm, that brings prevailing realities into better focus and consequently makes more sense out of some of the central dynamics at work." *Ibid.* at 9.

[5] Historically, for example, listing standards were reflected in listing agreements and were negotiated between the issuer (the corporation) and the exchange. On this topic, see generally Roberta S. Karmel, "The Future of Corporate Governance Listing Requirements" (2001) 54 SMU L. Rev. 325.

[6] See *Securities and Exchange Act of 1934*, 15 U.S.C. §78a (2004), online: <http://www.law.uc.edu/CCL/34Act>, setting up the Securities and Exchange Commission (SEC). Regarding the SEC generally, see online: SEC <http://www.sec.gov>. In Ontario, see *Securities Act*, R.S.O. 1990, c. S-5, online: Ontario Statutes and Regulations <http://www.e-laws.gov.on.ca/DBLaws/Statutes/English/90s05_e.htm#P671_38847> [*OSA*], setting up the Ontario Securities Commission (OSC). Regarding the OSC generally, see online: Ontario Securities Commission <http://www.osc.gov.on.ca>.

[7] See generally Charles Darwin, *On the Origin of Species by Means of Natural Selection*, ed. by Joseph Carroll (Peterborough, Ont.: Broadview Press, 2003), originally published in 1859.

Barring anarchy, it is submitted that all human relationships are subjected to *governance*, be they *natural* (given), the "laws of nature", or *artificial* (contracted), "externally imposed". Business relationships are no different. They embody a broad spectrum of commercial activities; these can be and are achieved through a variety of vehicles, including sole proprietorships, partnerships, limited partnerships, corporations, trusts and even other instrumentalities.[8] They are also accomplished in a number of manners, including by acting personally or through others. Determining how to ensure that business operates in an optimum manner and what we mean by that have been and continue to be challenges facing not only business but also the academic communities, as well as society more generally; views on this subject continue to diverge.

One of the core fundamental points of debate concerns the relationship between owners and managers of businesses. Where ownership and control are vested in the same individual, agency costs[9] are minimized, as the objectives of the owner and the manager are aligned. However, where ownership or control are, in fact or in law, divided (so that both no longer totally reside within the same person), it is necessary if one wishes to minimize agency costs to seek to ensure that the division does not lead to a divergence of interest. Achieving and maintaining a reasonable alignment in a common interest should, it is postulated, be a key goal of modern corporate governance and law.

Governance as it applies to a corporation, what I refer to in this thesis as *corporate governance*, has both an external and an internal dimension. Externally, it is the social and economic goals. Why do we have corporations?[10] And why do we have rules like limited liability for corporations? These rules about ultimate goals and objectives are not directly considered here. Rather, the focus is on internal corporate governance with a view to enhancing investor confidence.

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[8] See generally William A. Klein & John C. Coffee, Jr., *Business Organization and Finance: Legal and Economic Principles*, 8th ed. (New York: Foundation Press, 2002).

[9] For a description of such agency costs as "the combination of monitoring, bonding and residual costs", see Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991) at 10 [Easterbrook & Fischel, *Economic Structure*].

[10] See generally Joel Bakan, *The corporation: The Pathological Pursuit of Power* (New York: Free Press, 2004).

Corporate governance for the purposes of this thesis can therefore be understood to mean the *rules, concepts and processes,* derived from and predicated on principles, subject to which a corporation ought to be managed.[11] Interest in corporate governance tends to be pushed to the forefront whenever we are faced with spectacular business failures.[12] However, the challenge is not the corporate failures in and of themselves (as our economic system encourages risk and rewards,[13] which suggests the prospect of not only gain but also failure), but also the manner in which these corporate failures come to pass. It could be argued that the "supposed checks and balances" of traditional corporate law, reinforced by more recent initiatives,[14] should have protected the interests of shareholders. However, the supposed protection of the owners (shareholders) against the alleged "greed and avarice" of business managers appears to have failed. In what seems

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[11] Robert A.G. Monks & Nell Minow, *Corporate Governance*, 2d ed. (Cambridge, Mass.: Blackwell Business, 1995) at 1, defines corporate governance as the "relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) shareowners, (2) management (led by the CEO) and (3) the board of directors." The California Public Employees' Retirement System (CalPERS) explicitly adopts this definition in CalPERS, "Corporate Governance: Core Principles & Guidelines" (Sacramento, Calif., 13 April 1998) at 2, online: CalPERS <http://www.calpers-governance.org/principles/domestic/us/downloads/us-corpgov-principles.pdf>. See also this report generally for CalPERS' views on US corporate governance principles. The Cadbury Report defined corporate governance in the following terms: "Corporate governance is the system by which businesses are directed and controlled." See Committee on the Financial Aspects of Corporate Governance, "Report of the Committee on the Financial Aspects of Corporate Governance", Adrian Cadbury (Chairman) (London: Gee, 1992), ¶2.5, online: World Bank: Corporate Governance Best Practices <http://www.worldbank.org/html/fpd/privatesector/cg/codes.htm> ["Cadbury Report"]. For CalPERS' discussion of the Cadbury Report's definition of corporate governance, see generally CalPERS, "United Kingdom Market Principles", online: <http://www.calpers-governance.org/principles/international/uk/page01.asp>. For other definitions of corporate governance, see online: Encycogov.com <http://www.encycogov.com/WhatIsGorpGov.asp>.

[12] Recall Bre-X Minerals, Cinar corporation, Livent Inc., Castor Holdings, and YBM Magnex, to cite a few that are well-known and have received broad media coverage in Canada; and Enron, WorldCom, Tyco, and Adelphia Cable, to name but a few in the United States.

[13] On this issue, see e.g. Terry Carroll & Mark Webb, *The Risk Factor: How to Make Risk Management Work for You in Strategic Planning and Enterprise* (Harrogate, U.K.: Take That, 2001).

[14] For example, the following initiatives were undertaken in Canada in an attempt to help address the challenges raised: Toronto Stock Exchange, Report of the Committee on Corporate Governance in Canada, *Where were the Directors? Guidelines for Improved Corporate Governance in Canada* (Toronto: TSE Publications, December 1994) [*Dey Report*]; Toronto Stock Exchange, Interim Report of the Committee on Corporate Disclosure, *Toward Improved Disclosure: A Search for Balance in Corporate Disclosure* (Toronto: TSE Publications, December 1995) [*Fleming Report*]; Toronto Stock Exchange, Final Report of the Committee on Corporate Disclosure, *Responsible Corporate Disclosure: A Search for Balance*, (Toronto: TSE Publications, March 1997) [*Allen Report*]; Chartered Accountants of Canada, Toronto Stock Exchange, Canadian Venture Exchange, Final Report of the Joint Committee on Corporate Governance, "Beyond Compliance: Building a Corporate Culture" (November 2001), online: Joint Committee on Corporate Governance <http://www.jointcomgov.com/index.cfm/ci_id/8113/la_id/1.htm> ["Saucier Report"].

to be a perennial problem, shareholders have seen their investments evaporate, but the captains of "their ships of commerce", the CEOs of the corporations "who were expected to go down with their ships", escape not only unscathed but with great personal profit from their misadventure.[15] This perceived inequity, buttressed by reported cases of alleged fraud,[16] has once again cast a cloud over stock markets and appears to have shaken the confidence of the investing public (the potential shareholders), which must be upheld if capital markets are to thrive.[17]

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[15] Numerous illustrations exist. For particular examples, see online: CNN/Money Special Report, "Corporate Corruption", online: <http://money.cnn.com/news/specials/corruption> ["Corporate Corruption"]. However, the following are indicative of the challenges facing the re-establishment of investor confidence in financial markets. One involves allegations by investors that Lord Black of Hollinger International Inc. and others had been improperly awarded slightly less than $300 million in fees. See Stephanie Kirchgaessner & Adrian Michaels, "SEC Launches its Own Probe into Payments at Hollinger" *Financial Times* (2 November 2003) 23. To appreciate the impact on potential investors, it is to be noted that a search on LexisNexis for this one event from 10 November to 20 November 2003 revealed that it was covered in more than 233 newspapers. A second, randomly selected one involves a report that the founder and former CEO of Security Trust Company, N.A., its former president and the individual in charge of supervising the company's trading operations and relationships with clients were charged with grand larceny and fraud. See SEC, News Release, "SEC Charges Security Trust Company, N.A. and Three Former Executives for Facilitating Fraudulent Mutual Fund Late Trading and Market Timing Schemes" (25 November 2003), online: SEC <http://www.sec.gov/news/press/2003-164.htm>; SEC, News Release, "SEC Charges Dallas Investment Complex and Three of Its Officers with Defrauding Hundreds of Mutual Funds in Market Timing and Late Trading Scheme" (4 December 2003), online: SEC <http://www.sec.gov/news/press/2003-164.htm>. A third example is with respect to reported scandals involving major actors in the mutual fund industry, such as Fred Alger, Janus Capital Management, AXA Financial, Morgan Stanley, and Marsh & McLennan. See e.g. Michael P. Bruno, "Mutual Funds Beget Scandals" *ISS Institutional Shareholder Service SCAS Alert* (December 2003), online: ISS Institutional Shareholder Service, online: <http://www.issproxy.com/articles/2003archived/archived118.asp>. A fourth example involves governance challenges facing stock exchanges, such as a lawsuit by CalPERS against the New York Stock Exchange. See CalPERS, News Release, "CalPERS Sues NYSE and Specialist Firms in Landmark Federal Lawsuit" (16 December 2003), online: CalPERS <http://www.calpers.ca.gov/index.jsp?bc=/about/press/archived/pr-2003/dec/landmark.xml>. In this action, CalPERS also asked the Court to consolidate other securities class action lawsuits where specialists were also alleged to have engaged in wide-range manipulation, self dealing, deception and misleading conduct in violation of NYSE and SEC rules, as well as the Securities and Exchange Act, allegedly resulting in millions of dollars of losses to the investors in question. It was also alleged, against the NYSE, that as a body integral to helping ensure and apply more effective corporate governance, it deliberately failed to oversee, regulate and supervise its securities exchange, and discipline its members and specialists for the blatant violation of the NYSE rules.

[16] As in the cases of Bre-X, Cinar, Livent, Castor Holdings and YBM Magnex in Canada, and Adelphia, Dynegy, Enron, HealthSouth, ImClone, former Credit Suisse investment banker Frank Quattrone, Qwest, Rite Aid, Tyco and WorldCom in the United States. On this topic, see "Scandals from A to W" *The Wall Street Journal* (30 March 2004) C1. The case of Maxwell Holdings instantiates these problems in the United Kingdom. See also "Corporate Corruption", *supra* note 15.

[17] See "Poll: Investors Optimistic About '04 Market Outlook" (9 November 2003), online: San Diego Union-Tribune <http://www.signonsandiego.com/news/business/20031109-9999_1b9poll.html>, which reported that "[a]nother survey released last week showed that some of America's wealthiest people have developed a lack of trust in publicly traded companies, corporate financial statements and independent

The policy questions that therefore need to be addressed are the following:

> *Have the tools of governance failed to serve and to protect the interests of the shareholders, the purported owners of widely held, publicly listed or publicly traded corporations, without any controlling or major shareholder (defined herein as "corporation" and which are the focus of this dissertation)? Have they concomitantly served the interests of the managers? If so, (a) why has this taken place; and (b) what can be done to address and to resolve this problem?*[18]

1.2. EMPIRICAL RESEARCH

In an attempt to deal with these questions, I have sought to anchor this thesis in empirical research.[19] Therefore, before engaging in academic study, preliminary fieldwork was initiated.

The first step was to develop the following matrix.[20] The objective was to have individuals, sophisticated and knowledgeable about business, locate the "Interest Groups" (indicated on the right hand side of the matrix in Table 1), to reflect their views regarding the degree to which each was subjected to "checks and balances"[21] to curtail abuse[22] and in a position to affect important decisions.[23]

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auditors. The survey by wealth management firm United States Trust Co. of the most affluent 1 percent of Americans showed that the growing number of corporate scandals has badly shaken their investing confidence. Seventy-nine percent of those polled 'question the reliability' of corporate financial statements and do not trust equity analysts, 67 percent do not trust corporate management, and 65 percent do not trust independent auditors." While similar information is not readily available for Canada, there is no reason to expect views to differ substantially. See "*Governance for Federally Incorporated Companies: Proposals for Amendments to the Canada Business corporations Act*" (Ottawa: Industry Canada, 2004), online: <http://strategis.ic.gc.ca/epic/internet/incilp-pdci.nsf/en/h_c100730e.html>, where it is noted that "many leading world economies have reviewed , or are in the process of reviewing, their corporate governance standards, all with a view of raising the bar to *enhance investor confidence* and better guard against corporate wrongdoing." [Emphasis added].

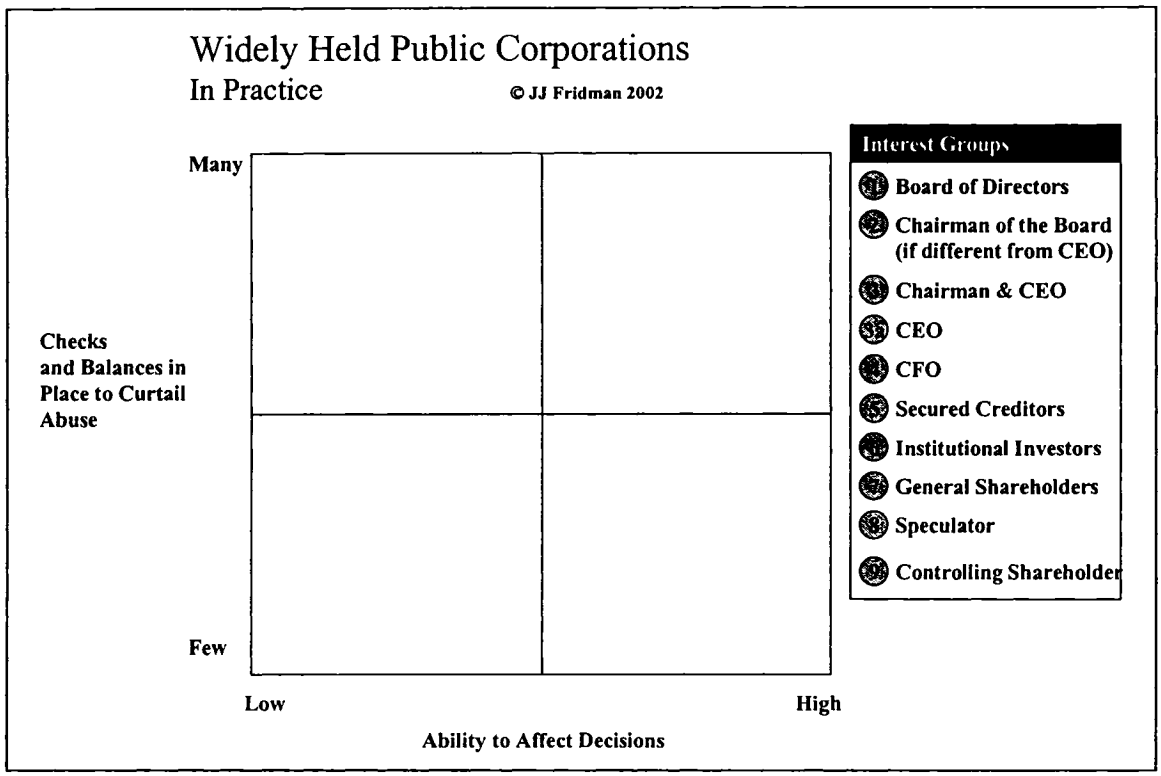
[18] For the NYSE's reference to the alignment of the interests of management with those of shareholders, see New York Stock Exchange, "Report of the NYSE Corporate Accountability and Listing Standards Committee" (New York: New York Stock Exchange, 2002) at A-62, online: New York Stock Exchange <http://www.nyse.com/pdfs/corp_govreport.pdf>.

[19] Easterbrook & Fischel, *Economic Structure, supra* note 9 at 5, suggest that "[t]he best structure cannot be derived from theory; it must be developed by experience." The approach used in conducting the interviews and surveys was "experientially based" (without pretense to statistical validity, other than the research coordinated with *CA Magazine* relating to Canadian chartered accountants, which was statistically based), and used the "snowballing technique".

[20] The rationale for this matrix and the factors influencing its design will be discussed in Chapter 8, below.

[21] Or, as it is referred to in administrative law literature, a process of "confining, structuring and checking discretion." See generally Kenneth Culp Davis, *Discretionary Justice: A Preliminary Inquiry* (Urbana, Ill.:

Table 1



To assist in conducting a meaningful analysis of personal perceptions of corporate governance raised by the principal research questions of the thesis, **the second step** was composed of developing a detailed questionnaire.[24] It was based on a review of the issues that had surfaced in the media and in studies such as TSE Reports,[25] the Cadbury Report[26] and suggested "Best Practices"[27] and was modified based on input received during the initial interviews. The questionnaire was geared towards a focus group of

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University of Illinois Press, 1973), particularly c. III, "Confining Discretion", at 52 *et seq.*; c. IV, "Structuring Discretion", at 97 *et seq.*; c. V, "Checking Discretion", at 142 *et seq.*

[22] The term "abuse" is defined for our purposes as seeking to advance personal, as opposed to, and sometimes at the expense of, corporate interests.

[23] The concept of "being in a position to affect important decisions" is defined for the purposes of this matrix as "having a significant impact on, or being a deciding factor in decisions, whether or not this ability was exercised."

[24] It is attached hereto as Appendix A, and is discussed in Chapter 8, below.

[25] See *supra* note 14, particularly the Dey Report.

[26] "Cadbury Report", *supra* note 11.

[27] Such as in Conference Board, "Final Report of the Commission on Public Trust and Private Enterprise" (New York: Conference Board, 2003), online: Conference Board <http://www.conference-board.org/pdf_free/758.pdf>, particularly Part 2, "Corporate Governance", & Part 3, "Audit and Accounting".

individuals ostensibly well versed in business. This group included people who were chairmen and/or CEOs, lawyers from public and private practice, accountants, financial community representatives and investors, as well as academics. These individuals were often interviewed in person, although a limited number of the questionnaires were responded to through correspondence. The questionnaire sought to ascertain the views of the insiders on many of the contemporary corporate governance issues. An attempt was made to focus the questions on the key constituents (players) in corporate governance, (from the board of directors [including the chairman of the board] to management [focusing on the CEO], to the shareholders, as well as the gatekeepers, including the external auditors, the regulators, government, investment community, analysts and the media).[28] Moreover, in attempting to assess the perceptions of how the interests of shareholders and management were aligned, the questionnaire also focused on matters relating to compensation, including more specifically "stock option grants". Lastly, disclosure, liability and new legislative initiatives were also canvassed.

The questionnaire and related personal interviews sought to assess the perceived effectiveness, independence and accountability of those constituents playing a key role in the governance of a *large widely held, publicly traded corporation.*

The third step was to develop a general questionnaire, to seek comparative information from a number of selected groups.[29] This brief survey[30] sought to obtain five categories of information.

First, *general information* was sought about the respondent; an attempt was made to ascertain whether the person was an actual or potential investor in the stock market and the individual's self-assessment of his (her) own level of understanding of corporate governance. Second, emphasis was placed on *corporate oversight*; an attempt was made

[28] Those who are purported to help minimize agency costs by their vigilance and reaction to management's actions. See Chapter 4, Section 4.2., below.
[29] A copy of the questionnaire is attached as Appendix B, below.
[30] It was initially limited to 21 questions, but was increased to 23 at the request of the CICA. See Chapter 8, below.

to obtain the "beliefs" of the respondents, about "Management, Boards of Directors, External Auditors, Regulators and the Media". Third, *views* on specific matters, namely compensation and stock options, were sought. Fourth, general *attitudes* towards CEOs, stock markets and corporate governance were canvassed. Finally, *demographic* information was sought to assist in future, more in-depth analyses of the results.

Using the data garnered from the surveys, a correlation was to be looked for among the interview results obtained from the surveys of the *DSI* group, graduates of the McGill Faculty of Law and Canadian chartered accountants. The objective was to ascertain whether there was a match or a mismatch in the answers to the questions received from these groups and if so, the extent thereof.

The overall objective of this information-gathering exercise was to do a "micro" review of corporate governance (from within looking out, using personal, "anecdotal", as well as "interview" data) tested against a "macro" perspective (from the outside looking in).

Contemporaneously with the "micro-macro review", an assessment of the *scholarly literature* as well as the *current checks and balances (the current legal framework)* was undertaken to see if and how answered those concerns that surfaced from the empirical research.

1.3. THE CURRENT LEGAL FRAMEWORK

Given the innate conflicts that may exist between the interests of a corporation and those working for it, checks and balances (also referred to as internal controls in the accounting literature[31]) are generally put into place to help ensure that rules, concepts and processes (whether they originate in law or in internal corporate practices) of the corporation are

[31] See e.g. Walter T. Harrison & Charles T. Horngren, *Financial Accounting*, 4th ed. (Upper Saddle River, N.J.: Prentice Hall, 2004) at 712, where internal control is defined as the "[o]rganizational plan and all the related measures adopted by an entity to safeguard assets, encourage adherence to company policies, promote operational efficiency, and ensure accurate and reliable accounting records."

complied with. However, the more senior the manager,[32] the greater the scope of individual authority and the more limited the checks and balances appear to be. Nevertheless, checks and balances must still apply to all who purport to act on behalf of others, including managers and directors. Intervention is necessary to help ensure that the interests of shareholders and those ostensibly working to create value for them are appropriately aligned. There appears to be a general consensus, within both the business and academic communities, that alignment should be achieved; that much does not appear to be in dispute. However, the manner in which this should be achieved optimally has been and continues to be at the core of the debate over effective corporate governance.

Positions on this subject, both legal (as embodied in applicable legislative enactments) and academic, appear to be a function of two perspectives or orientations. One suggests that structural checks and balances are required. This would include the Berle and Means[33] school of thought, which would advocate public intervention to protect the interests of the "owners" (the shareholders) from the threats of the "self-serving" non-owners (managers and directors).

The other, embodying agency defection, focuses on agency costs and suggests that while checks and balances are required to minimize agency costs, imposing additional artificial, bureaucratic, external intervention and costs, all borne directly or indirectly by shareholders, does not achieve the desired objectives. Supporters of this thesis would appear to suggest that that the market is the best check and balance.[34]

Before critically reviewing and analyzing these alternative approaches,[35] an attempt will be made to focus on existing checks and balances. To assist in this analysis, the parties or individuals responsible for assuring checks and balances have been denominated into

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[32] Unless the context clearly indicates otherwise, the term "managers" should be taken to focus primarily on corporate officers.
[33] See Berle & Means, *supra* note 2.
[34] See generally Michael C. Jensen, "Some Anomalous Evidence Regarding Market Efficiency" (1978) 6 J. Fin. Econ. 95.

three subcategories or tiers; these have been labeled as first-tier (or primary checks and balances), second-tier (or secondary checks and balances) and third-tier (or tertiary checks and balances).

First-tier or "primary" checks and balances include those parties that have inside information (or access thereto) and the authority to ensure that corporate governance is complied with both on an *ex ante* and on an *ex post* basis. First-tier parties have the ability to be proactive (given their access to inside information), as well as reactive (given that they are or should be amongst the first to become aware that corporate governance has not been complied with).

Second-tier or "secondary" checks and balances include those parties that generally do not (or at least should not) have access to inside information but monitor, as a profession or vocation, what is publicly available (and what they can obtain from any and all sources). They are not insiders and thus do not have access to the information pool that is available to the "first tier" or the "primary" actors.

Third-tier or "residual" parties are all those not falling within the first two categories but who for personal or other reasons tend to seek to "oversee" and "monitor" the activities of players in the business world.

One can engage in a debate as to who falls within which tier. This would, however, miss the point of the exercise. The critical issue is not the categorization but that checks and balances designed to work sometimes fail. One must try to understand why they fail and whether the failure is endemic or systemic. It was in order to arrive at such an understanding that aggregating checks and balances using "common attributes" was undertaken. Only by clearly understanding what the system is striving to achieve and why it appears to fail (if in fact, as some believe, it is failing) can one attempt to build a new or modified model (or structure) that will seek to address identified (and agreed to)

[35] This will be dealt with in the examination of the scholarly literature, in Chapter 2, below.

deficiencies. One must then attempt to test the effectiveness of the suggested revisions against the known weaknesses of the incumbent structure.

Having focused on the "question" and undertaken a "three-step approach" to begin this review of corporate governance while briefly addressing the existing checks and balances, I sought to refocus on the "Statement of Thesis". I concluded as follows:

Corporate governance must seek to ensure that obligations and interests of management are, in law and in fact, aligned with the rights and the interests of the shareholders and that management is always held accountable in an effective manner, if the interests of the shareholders, the purported owners of the corporation, are to be protected from abuse and shareholder confidence sustained.

However, given the title of this thesis, ***Corporate Governance: A Practical and Effective Response to the Challenges Raised***, this needs to be accomplished practically. This means that effective corporate governance should be achieved in a manner that does not sacrifice the efficiency of the corporation, as an engine of economic growth, risk taking and prosperity and that one is able to ensure and enforce *accountability.* Consequently, *"interests"* need to be defined in a quantifiable and measurable manner.

1.4. STATEMENT OF RESEARCH HYPOTHESES

In order to move forward in a focused manner, the following research hypotheses dealing with *corporations* (based on anecdotal experience, initial field work and preliminary readings and research) were advanced.

First, there is no direct correlation between the *rights* of shareholders and the *obligations* of management. As a result, in many cases they can and will conflict.

Second, checks and balances ostensibly designed to help protect the interests of shareholders can, and in fact are often neutralized by the *funneling syndrome.*[36]

Third, shareholders are constrained from becoming involved in the day-to-day activities of a corporation. However, an opening for *greater shareholder intervention* exists and may need to be considered as a potential response to the need for more effective checks and balances.

Fourth, *anthropomorphism* (that is, the attribution to a corporation, a legal fiction, the capacity, the powers and the privileges of a natural person[37]) has resulted in the attribution of legal rights to the "corporation" and concomitant greater control to management (as the corporation can only act through others) at the expense of the rights of shareholders.

Fifth, the interests of shareholders and management cannot be aligned unless a "proxy" for such "common interests", easily understood, quantifiable, measurable and subject to "independent challenge and determination" with the ability to ensure accountability, can be implemented.

Sixth, profit maximization, both short- and long-term, with share appreciation (beyond the "norm for the market"; that is, a positive deviation from the market over time) may be a more effective way of aligning the interests of management and the shareholders as it is easily understood, is easily measurable (or should be) and checks and balances (with appropriate sanctions) can be put into place to help ensure that it works effectively.

Seventh, management *self-interest* (known amongst economists as the problem of agency[38]), unless subjected to meaningful checks and balances, has been and will continue to push the limits of personal gratification, including the introduction of new

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[36] The process is described and analyzed in Chapter 6, below.

[37] See e.g. *Canada Business corporations Act*, R.S.C. 1985, c. C-44, s. 15(1) [*CBCA*], which states that "[a] corporation has the capacity and subject to this Act, the rights, powers and privileges of a natural person".

methods or vehicles, such as mutual funds and investment trusts, that will further expand the rights of management at the expense of the rights of the investor.

Eighth, to the extent that *"interests"* need to be protected or otherwise taken into account (that is, not only the interests of shareholders but also of others such as employees, creditors or environmentalists), guidelines, codes, best practices or other "voluntary" actions are ineffective in achieving the desired or required results.

Ninth, should the research hypotheses prove to be correct, effective checks and balances would appear to be required to be *imposed by statute* to address the identified challenges associated with the governance of corporations.

Tenth, *principles* should serve as the guide to what is expected from corporate governance (as opposed to limiting intervention to specific *rules* that the unscrupulous can seek to "legally" if not "ethically" circumvent or to recommended non-mandatory guidelines that have no teeth).

Eleventh, *more effective and meaningful sanctions* should be introduced that result in the individual, as opposed to the corporation, being held accountable. An inability to transfer responsibility to the corporation or to third parties should help to ensure compliance.
Twelfth, *corporate governance* should be recognized for what it is, a *means to an end and not an end unto itself.* Corporate governance should assist in achieving measurable objectives (including reducing the risk of abuse) and the results of the objective should be capable of being quantified and rationally explained.

Thirteenth, while one cannot legislate *competence, integrity or accountability (CIA)*, they *can be imposed by legislation.* Minimum levels of acceptable corporate governance and accountability established by legally imposed *"mandatory principles of conduct" (as*

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[38] See Easterbrook & Fischel, *Economic Structure, supra* note 9.

opposed to "voluntary codes of conduct") should form the foundation for the *basic tools of governance* for corporations.

Fourteenth, the ability to jurisdiction shop (that is, to incorporate or transfer a corporation to a jurisdiction it is believed would help protect the position of management and the board of directors at the expense of shareholders), requires that "minimum legislatively imposed mandatory principles" be imposed at a *common point.*

1.5. CONCLUSION – THE CHALLENGE

Confidence is an essential and critical pillar supporting the effective operation of our capital markets.[39] Recent reported failures of governance are suggested to be at the core of its erosion. This pillar, if not crumbling, appears at best to have been badly weakened. Despite what might be suggested or inferred anecdotally however, breakdowns in corporate governance are not all that exceptional. Misbehavior has always been with us.[40] One needs only to refer to the Savings and Loan scandals of the 1980's in the U.S.[41] for a reminder that these problems are perennial. Too often however our responses have been

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[39] The importance of confidence has been the focus of numerous articles. See e.g. Nanette Byrnes, "Five Ways to Avoid More Enrons" *Business Week* (18 February 2002) 36 (ProQuest); Daniel Kadlec, "Eight Remedies" *Time* 159:24 (17 June 2002) 51 (ProQuest); Mary Ellen Lloyd "Questioning the Books: Krispy Kreme Takes Steps to Increase Investor Confidence" *Wall Street Journal* (8 March 2002) A4 (ProQuest); Burton G. Malkiel "The Market Can Police Itself" *Wall Street Journal* (28 June 2002) A10 (ProQuest), who states the opinion of a leading economist, that "investing is an act of faith.... There is no doubt that this faith has been shattered and is urgently in need of repair"; "Getting Investors to Trust Again," Editorial, *Business Week* (4 March 2002) 120 (ProQuest); "The Tyco Market," Editorial, *Wall Street Journal* (4 June 2002) A20 (ProQuest), which suggests that "anyone who still doubts that markets operate on trust might want to inspect yesterday's carnage on Wall Street" (cited in Lynn A. Stout, "The Ninth Annual Abraham L. Pomerantz Lecture. The Investor Confidence Game" (2002) 68 Brook. L. Rev. 407, note 3); Frank Partnoy, "Why Markets Crash and What Law Can Do About It" (2000) 61 U. Pitt. L. Rev. 741 at 764, noting that "trust plays a key role in the formation and function of capital markets" but that "trust is an important consideration not often recognized by those considering the role of law in financial markets" (cited in Stout, *supra* note 409, note 4). President George W. Bush recently added his voice to the swelling chorus. See Jeanne Cummings, "Bush to Seek Tougher Penalties in Assault on Corporate Fraud" *Wall Street Journal* (9 July 2002) A1 (ProQuest), who quotes the President as saying that "the free enterprise system ... requires trust. We've had some destroy the trust of the American people, and we need to do something about it" (cited in Stout, *supra* note 409, note 3).

[40] For a case in point, see Christopher Reed, "The Damn'd South Sea" *Harvard Magazine* (May-June 1999), online: Harvard Magazine <http://www.harvard-magazine.com/issues/mj99/damnd.html>, which recounts the story of the South Sea Bubble, a speculative investment dating back to 1720, as well as the challenges faced by investors at that time.

[41] See FDIC, "The S&L Crisis: A Chrono-Bibliography", online: Federal Insurance Deposit corporation <http://www.fdic.gov/bank/historical/s&l/>.

ad hoc, designed to address the particular problem and to "restore confidence" in a particular sector.[42] Many fine minds (in business, academe, government, and regulatory agencies) have puzzled through these problems.[43] Part of the challenge is that these are occasionally "interest-group driven".[44] To deal effectively with these challenges, research and analysis is essential. However, research has to be framed not in an "ideal-type" view of the world of corporate governance, but in the practices and experiences that we confront today. In that light, what is required is "empirical research". We need to know what is actually going on, not just on the basis of speculation, economic models of behavior or anecdotal evidence. This is the task that was undertaken through empirical research,[45] in the outlined three-step approach. The next phase was to develop[46] and test[47] practical and realistic solutions that could address root causes, not just symptoms. The last phase was to report on the results of the recommendations and to attempt to reach conclusions based on the work undertaken.[48] We clearly need proposals that can be made to work, and that can actually set measurable and enforceable standards. One may once again attempt a quick fix, and successfully create the appearance that more effective corporate governance is being introduced. However, over time such short-sighted actions will not withstand the strains of an existing business structure that will seek to push corporate governance to its limit in the pursuit of *self-interest* at the expense of the corporation's shareholders and other investors. While bull markets and related shareholder euphoria may operate to mask such concerns,[49] failure to deal effectively with the underlying causes will ensure recidivism.

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[42] For a history of the response to the savings and loan scandals, see *ibid.*

[43] Such as Adolphe A. Berle, Gardiner C. Means, John C. Coffee, Frank Easterbrook, Daniel R Fischel, Robert A.G. Monk, Neil Minow, Michael C. Jensen, Ronald J. Daniels, .Janis Sarra, Senator E. Leo Kolber and David Brown, Chairman of the Ontario Securities Commission, to name but a few

[44] See e.g. the submissions presented before the Canadian Senate, Standing Committee on Banking, Trade and Commerce, "Navigating Through 'The Perfect Storm': Safeguards to Restore Investor Confidence" (June 2003) at 72-76, online: The Conference Board of Canada <http://www.conferenceboard.ca/GCSR/links/pdfs/Senate_Comm_Report_Jun03.pdf>.

[45] Addressed in Chapter 8, below.

[46] Addressed in Chapter 9, below.

[47] Addressed in Chapter 10, below.

[48] Addressed in Chapter 11, below.

[49] However, it is posited that it merely conceals the dangers and removes them from public view, but does not address them.

Chapter 2

Review of the Literature (Tempered by Anecdotal Experience)

2.1. INTRODUCTION

The "corporation", like nature and everything else around us, is in an ongoing process of transition. Evolution may entail dramatic, little or no change or even a reversion in certain respects to the *status quo ante,* based on conditions both internally and externally. The evolving entity may or may not continue to possess the characteristics of its predecessors.[50] What was true in the 1800s when a corporation may have been an association of individuals, where each individual may have known the others and where all understood the rules of the game, would not appear to have been the general case of corporations in the early 1900s[51] and is clearly not the case of the widely held, public international corporations of today. The corporation evolved from the point where individuals were initially perceived to have a right in property (when "contractually" individuals got together to achieve a business purpose and both owned and managed the corporation) to being established by founding shareholders, who introduced other participants. Providers of seed capital (to help advance an innovative idea), venture capitalists (to enable the idea to be moved forward to a pre-initial public offering stage) or promoters, who would help sell equity to the public, of the entity that had been created pursuant to a statute (a private act or an enactment of general application with related attributes, rights and powers), were introduced and the nature of the corporation changed. Furthermore, as business enterprise gave rise with the passage of time to widely held, increasingly complex, international business corporations with professional management whose shares were publicly traded on numerous stock exchanges and whose activities, including production, distribution and consumption, were carried on in multiple

[50] See Jonathan Barron Baskin & Paul J. Miranti, *A History of Corporate Finance* (Cambridge, U.K.: Cambridge University Press, 1997).
[51] See generally Berle & Means, *supra* note 2.

jurisdictions and subjected to varying rules of law as well as to divergent cultures,[52] they continued to evolve.

The anthropomorphism of the corporation[53] (that is, in law viewing it as a "person" as opposed to a vehicle of commerce), with in effect the rights, to the extent feasible under the law, of a natural person, is an evolution that it could be suggested is revolutionary. Furthermore, with shareholders, many of whom may now be transient (speculative and short term in a highly liquid financial market), it can be submitted that a new creation has evolved. It can be suggested that notwithstanding its roots, a corporation is no longer anchored as it was in the past in pure rights of property or in contract. Rather, it is arguable that a corporation is nothing more than a creature of statute, an "innominative creation" that continues to be termed a "corporation". The rights of shareholders and of other constituents are no more or less than what the law, or practice, determines them to be. Being a shareholder, it can be postulated, is clearly no longer the same as being a holder of traditional property rights in a business,[54] although the ownership of a share, the piece of paper, continues to constitute traditional property rights in "the share".[55] Furthermore, it can be argued that a CEO in fact controls the corporation[56] and that a board of directors is no more than an advisory, counseling, monitoring and decision-

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[52] See generally Charles W. L. Hill, *International Business: Competing in the Global Marketplace*, 3d ed. (Boston: Irwin/McGraw-Hill, 2000).

[53] As is the case under statutes of incorporation in Canada. See e.g. *CBCA*, *supra* note 37. The same is true in the United States. See e.g. Delaware's *General corporation Law*, Del. Code Ann. tit. 8 [*DGCL*]. See also generally Gregory A. Mark, "The Personification of the Business corporation in American Law" (1987) U. Chicago L. Rev. 1441; Meir Dan-Cohen, "Freedoms of Collective Speech: A Theory of Protected Communications by Organizations, Communities, and the State" (1991) 79 Cal. L. Rev. 1229 [Dan-Cohen, "Freedoms"].

[54] See *Atco v. Calgary Power*, [1982] 2 S.C.R. 557 at 561, 140 D.L.R. (3d) 193.

[55] See *Sparling v. Québec (Caisse de dépôt & de placement)*, [1988] 2 S.C.R. 1015 at 1025, [1988] S.C.J. No. 95.

[56] See Alan Greenspan, Address (Speech delivered at the Stern School of Business, New York University, 26 March 2002), online: The Federal Reserve Board <http://www.federalreserve.gov/boarddocs/speeches/2002/200203262/default.htm>, in which Chairman Greespan noted:

> [I]t has increasingly fallen on corporate officers, especially the chief executive officer, to guide the business.... Indeed the boards of directors appointed by the shareholders are in the overwhelming majority of cases chosen from the slate proposed by the CEO. The CEO sets the business strategy of the organization and strongly influences the choice of accounting practices that measure the ongoing degree of success or failure of that strategy. Outside auditors are generally chosen by the CEO or by an audit committee of CEO-chosen directors. Shareholders usually perfunctorily affirm such choices.

making body that only intervenes under exceptional circumstances, such as the unplanned departure or the death of a CEO or when other external events force a board of directors to react. How one views a corporation may well be determinative of how one seeks to deal with corporate governance and how one addresses the issues raised by the separation of ownership and management.

2.2. ISSUES ARISING FROM A SEPARATION OF OWNERSHIP AND CONTROL

While some of the issues arising from the separation of ownership and management (*i.e.*, control) have been addressed over the years, including the establishment by statute of a regulatory body (or bodies) to work to help protect the interests of investors (such as state regulatory bodies, and the Securities and Exchange Commission (SEC)[57] at the federal level in the United States and provincial counterparts such as the Ontario Securities Commission (OSC) in Canada)[58] and others have been rationalized or explained away by new corporate theories, many still remain to be resolved. For example, the description by Berle and Means, where they note that in a corporation, management can become self-perpetuating through its control of the proxy machinery[59] continues to be an unresolved matter. The introduction of takeover bids, where third parties may seek to intervene to purchase an under-performing, publicly traded corporation (under a thesis that would appear to be primarily prescriptive and normative rather than descriptive and empirical,[60] that postulates that the issues raised by the separation of ownership and control are addressed and resolved by the efficient operation of the stock market[61]) may be advanced to attempt to address concerns raised by the separation of ownership and control. As well, the growing role of institutional investors[62] or other self-appointed gatekeepers[63] can be

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[57] See *supra* note 6.
[58] *Ibid.*
[59] Berle & Means, *supra* note 2 at 6.
[60] See Ron Harris, "The Encounters of Economic History and Legal History" (2003) 21 L.H.R. 297.
[61] The efficient market theory posits that the price at which a stock trades incorporates and reflects all material information released by a corporation, such that the market price accurately reflects all relevant public information. See Eugene F. Fama, "Efficient Capital Markets: A Review of Theory and Empirical Work" (1970) 25 J. Fin. 383; Ronald J. Gilson & Reinier H. Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Va. L. Rev. 549 at 554-56 [Gilson & Kraakman, "Mechanisms"].
[62] For instance, the Canadian Coalition for Good Governance (CCGG) lists 27 institutions amongst its members. The CCGG brings together investors with $500 billion in assets under management, including approximately $350 billion invested in Canadian publicly traded companies. The CCGG defines its mission

pointed to as another illustration of how externalities attempt to operate to help address the challenges raised.

Notwithstanding inroads and attempts at an explanation if not a rationalization of the nature of the corporation, its evolution has seen the continued expansion of the power and the authority of management at the expense of shareholders. Enabling as opposed to constraining corporate charters, "blank check" authority to issue shares (including multiple-voting shares) and the creation of "staggered and classified boards" and "poison pills" that permit incumbent management to delay if not to frustrate takeovers, appears to suggest continuing support for a maximization of the power and control of management. Public choice (the lack of incentives for rational individuals to expend resources for the common good when their personal benefit is less than the anticipated expenditure)[64] serves to help explain what generally appears to be the doubtful cognition and lack of volition on the part of shareholders (holding a relatively small number of shares). This inaction on the part of the supposed owners, the shareholders, continues to enable those in control of corporations to ensure that their parochial interests, *ceteris paribus* (that is, *all other things being equal,* to borrow a phrase frequently used by economists) can be pursued in a relatively unconstrained manner. A cost-benefit analysis of those in control of a corporation (that is, no personal cost as corporate resources are used but clearly potential personal benefits) supports the continued use of corporate funds to pursue and enshrine their interests.

As well, the integrity and accountability, if not the competence, of gatekeepers is currently under attack. Their ability to obtain, assess and disseminate accurate corporate information in a meaningful and believable manner is suspect. Until issues of credibility

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in the following terms: "to represent Canadian institutional shareholders through the promotion of best corporate governance practices and to align the interests of boards and management with those of the shareholder". See online: CCGG <http://www.ccgg.ca/web/website.nsf/web/ccgghome> [*CCGG*]. See also generally Robert C. Clark, "The Four Stages of Capitalism" (1981) 94 Harvard L. Rev. 561.

[63] The term is defined as "those on whom the public relies to help ensure the accuracy of information made available to them given the supposed 'reputations' they would stand to lose if they failed to deal honestly with the public". See Chapter 4, Section 4.2., below.

[64] Mancur Olson, *The Logic of Collective Action: Public Goods and The Theory of Groups* (Cambridge, Mass.: Harvard University Press, 1965).

are addressed and resolved and *CIA*[65] are re-established, these unresolved issues will continue to mitigate against the effectiveness of gatekeepers as an instrument of public policy and as a check and balance on the actions of management.

2.2.1. Market Efficiency

A contemporary thesis advanced by the "Neo-Classical School"[66] rests on the efficient capital markets hypothesis (that is, "market efficiency"[67]). It postulates that markets that are efficient can rapidly, if not almost concurrently, absorb and react to information, with the result being that the price of securities are in effect the same at almost any point in time for all investors. Advanced by its proponents as the least costly and most efficient means of protecting investors, it argues against increased external intervention. Market efficiency would appear to constitute the theoretical underpinning of both the Canadian and American regulatory disclosure policies, notwithstanding serious issues that can be raised questioning its efficacy.

Market efficiency is information-dependent. As a result, information control and dissemination, accurate or inaccurate, positive or negative, impacts market reaction. Information required to feed the market can be sourced both directly from a corporation and indirectly from third parties, including analysts, suppliers and customers. It can also be obtained both publicly, given the legally imposed requirements to disclose information, and privately, one-on-one or through restricted group sessions. As well, there are costs associated with validating and processing information and, as recent events have demonstrated, substantial economic penalties for the failure to do so effectively.[68] Accordingly, to suggest, as the *market efficiency* hypotheses does, that all investors, actual and potential, are uniformly informed in a costless manner appears to

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[65] The reference to "CIA" was the product of a discussion about corporate governance, several years ago, between the author and C.V. Allen, a distinguished (now retired) chief legal officer of an internationally renowned corporation.

[66] "Neo-classical economists assumed a clear distinction between markets and nonmarket settings. They were interested in markets, not in institutions. Markets were considered the natural state of things. They were presumed to have always been there". Harris, *supra* note 60 at 300.

[67] Jensen, for instance, states his belief that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis". Jensen, *supra* note 34 at 95.

engage in a theoretical world of *ceteris paribus* and to ignore practical realities and anecdotal experience.[69]

As recent events have demonstrated, *market efficiency*, being information-dependent, is not immune to human intervention, manipulation and abuse.[70] Even prior to what appeared to be a collapse of corporate integrity on the altar of CEO greed and avarice, an American court questioned the efficacy of market efficiency. In *Smith v. Van Gorkom*,[71] a seminal case on directors' obligations (which concluded that the directors had not met their fiduciary obligations in approving a proposed merger), the Court, dealing with the efficiency of the market, noted that "[u]sing market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious premise, as the defendants' own evidence demonstrates."[72]

Contemporary events further challenge the theory of the efficiency of the markets. Enron[73] and WorldCom,[74] two of the world's most acclaimed corporations, filed for

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[68] John Crudele, "Spitzer Fiddled While Investors Got Burned" *New York Post* (24 December 2002) O23.

[69] See Gilson & Kraakman, "Mechanisms", *supra* note 61.

[70] The following comment was volunteered by a McGill Faculty of Law graduate, now a partner in a law firm when responding to the *PS*:

> I have come to the conclusion (belatedly) that the stock market cannot reflect the economic reality of listed companies. This is because of the price manipulation that occurs, especially in the way of late-in-the-day trades instigated in many cases by insiders. Admitting my naiveté, I was surprised to learn that there exists a whole industry openly dedicated to 'building' the price of stocks. In their zeal to perform their mandate, it is no surprise that such firms might be tempted to boost artificially a stock price by engaging in an out-of whack small transaction ten minutes before the close of the market in order to show a higher closing price than the true market would warrant. I am sure that such practices are but the tip of the iceberg in the lexicon of shady dealing, but it shakes my confidence in the institution to its very foundations.

The *PS* is addressed in Chapter 8, below.

[71] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) [*Van Gorkom*].

[72] *Ibid.* at 875-76.

[73] See e.g William H. Miller, "Vision Vanquisher (Enron CEO Kenneth L. Lay)" *Industry Week* 247:10 (18 May 1998) 36 (ProQuest), a feature cover story on Enron executive Ken Lay and his vision. Miller reports that "[o]ne who doesn't think Enron has set the bar too high for itself is Ronald Barone, New York-based analyst for Paine Webber Inc. 'Enron has been on the leading edge of change and innovation,' he observes. 'And Ken Lay is the No. 1 energy visionary in the country. I am vastly impressed with the management and capabilities of this company'."

[74] Gregory Zuckerman, "WorldCom Makes History with $6.1 Billion Sale of Eagerly Awaited, Strongly Demanded Bonds" *Wall Street Journal* (1998) 1. The esteem in which WorldCom was held is reflected in this article, which noted that strong demand allowed WorldCom Inc. to achieve a record $6.1 billion, bond sale, topping Norfolk Southern's May 1997 $4.3 billion record, despite weak market for corporate issues.

bankruptcy in the wake of revelations of overstated earnings and off-balance sheet frauds.[75] Irregularities involving "pillars of the business community", those who were held up as examples for others to emulate, shook the financial markets. As well, restatements of audited reported earnings and the escalation in their pace served to attack if not to erode the efficient market hypothesis. "Earnings restatement of publicly traded corporations (in the US) averaged 43 per year from 1990 to 1997 and then increased to 92 in 1997, 102 in 1998, then soared to 174 in 1999, 201 on 2000 and 225 in 2002. Moreover, not only did the number of earnings restatement increase over this period, but so also did the amounts involved".[76] During the period 1997 to June 2002, one in ten of all publicly listed corporations in the United States announced at least one restatement.[77] When added to the mutual fund scandals, the charges leveled against the Wall Street firms, that they had abused their positions of trust for personal gain at the expense of their clients, and the failure of the regulator (the New York Stock Exchange, a key gatekeeper, that appeared to have failed to itself practice effectively and transparently what it was entrusted to apply and to monitor in others[78]), confidence in the efficiency of the market seemed to reach new lows. The fact that by early in the summer of 2002, the "efficient market" had lost $7 trillion in value[79] merely indicated the inefficiency of the market that had permitted problems to remain hidden (at least in the short term). What had been advanced as the optimum approach to the protection of shareholder interests and could be rationalized and defended in a rising bull market, appeared in the recent past and more currently to be suffering from serious shortcomings. However, effective in a world of *ceteris paribus* economics, the efficient market hypothesis may well, absent external

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[75] See e.g. John R. Emshwiller & Rebecca Smith, "Murky Waters: A Primer on Enron Partnerships" *Wall Street Journal* (21 January 2002) C1. The article examines Enron corporation's use of partnerships, limited-liability companies and other affiliates, and alleges Enron often told investors little or nothing about them. The article also suggests that those partnerships enabled Enron to hide hundreds of millions of dollars of losses and debt from public view.

[76] John C. Coffee, Jr., "Understanding Enron: 'It's About the Gatekeepers, Stupid'" (2002) 57 Bus. Law. 1403 [Coffee, "Understanding Enron"].

[77] Comparable statistics were not readily available in Canada. However, based on anecdotal information, there is no reason to believe that the position in Canada is any better.

[78] See e.g. "NYSE Braces for Possibility of SEC Charges" *Wall Street Journal* (30 March 2004) C1, which reports that that the NYSE "failed to adequately police its elite trading firms, known as specialist firms.... The five largest NYSE specialists, without admitting or denying the allegations, consented to civil charges that they traded for their own accounts at inappropriate times between 1998 and 2002, shortchanging investors by about $155 million."

intervention, fall far short in the real world, where the rights of the individual, including ownership rights, cannot be left to the vagaries of the market alone.

2.2.2. External Checks and Balances

In terms of checks and balances, the contemporary focus on external factors, such as regulators and the efficiency of the market or gatekeepers, appear to have fallen short of achieving the desired objectives. A refocus on "internal structure" and more specifically on the challenges raised by the *funneling syndrome* that could help make those responsible for corporations more accountable may be required. The use of independent verification, based on original as opposed to secondary sources of data, and greater accountability to the end users, especially by those responsible for "first-tier" or "primary checks and balances", may need to be effectively implemented. The ability to access source data, reach independent, rational decisions and help to ensure that "quality data" is released into the market, efficiently and transparently, to enable greater functional market reliability and integrity, may be pivotal to assisting in more effective governance of corporations.

2.2.3. The Funneling Syndrome

The *funneling syndrome,* the explicit recognition that all material information, as it ascends to the highest level of authority for decision-making purposes within a corporation, is funneled through and controlled by the CEO (or the Chairman and CEO where these functions are still combined) or his (her) delegate, constrains effective checks and balances. While this process can be viewed as nothing more than "quality control" and as being integral to effective corporate management, it can nevertheless also lead to abuse, not only in terms of data and results but more importantly in terms of decision making. Unless those with statutory access to source data to enable them to independently determine *CIA* can bypass the *funneling syndrome*, the implementation of checks and balances that underpin more effective corporate governance will be difficult, if not impossible, to achieve.

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[79] See Crudele, *supra* note 68

2.2.4. Alignment of Interests

Lip service is paid to seeking to align the interests of management with those of shareholders (that is, the "owners" of the business). However, that may be truer in theory than in practice. As will be addressed herein, rhetoric appears to be inconsistent with reality, and confidence must therefore suffer. It is interesting to note that Marcelo Mackinlay, an executive search consultant and former Chairman of the Institute of Corporate Directors in Canada, appears to share this view. He was quoted in the *Globe and Mail* as stating that "the business community has spouted platitudes while responding timidly to the enormous loss of confidence among ordinary investors" and that he believes "that investors will not come back without meaningful change, a view that is not apparently shared by many of his colleagues in the business community, who believe that investors will come back as they always have".[80]

The perception of the pursuit by management of personal as opposed to shareholder interests appears to be fueled by reported actions relating to executives, not by mere rhetoric. A case in point, focused on by Berle and Means as well as by contemporary critics[81] are options granted to acquire shares of a corporation by those (usually officers) working for the corporation. While options were relatively new at the time of the work by Berle and Means, these commentators chose to question the legal basis and certain inherent problems of this mechanism.[82] Still, options met a need and therefore continued to flourish. When the wealth creation capability of options for management was married by the opportunities created by the *funneling syndrome*, the potential for abuse was innate given *self-interest* and the lack of effective checks and balances. Furthermore, failure to prevent insiders from speculating (that is, from exercising options at one point in time and then immediately thereafter disposing of the shares acquired with these options so as to avoid any "holding risk"[83]), supported by generally accepted accounting principles

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[80] Janet McFarland, "Investors Won't Come Back Without Evidence of Change" *The Globe and Mail* (14 May 2003) B2.

[81] Linda J. Barris, "The Overcompensation Problem: A Collective Approach to Controlling Executive Pay" (1992) 68 Indus. L.J. 59.

[82] Berle & Means, *supra* note 2 at 164 *et seq.*

[83] The US "short swing profit rule", in *Securities and Exchange Act of 1934*, *supra* note 6, s. 16(b), requires directors and officers of an issuer, as well as a shareholder owning more than 10% of the shares of the

ignoring and failing to reflect the "costs" of options in the financial statements of corporations, served at best to camouflage and at worst to hide the true impact of options on investors. The efficient market, supported by rhetoric, appeared to view these actions as aligning the interests of management with investors. For example, Murray J Weidham and Mark Jensen have suggested that "[g]ranting key executives options to purchase the stock.... provides them with a powerful incentive to maximize share performance. Bonuses in the form of stock ensure that the recipients, at least to some degree, will start to think like shareholders".[84] However, contemporary revelations are not so charitable. Stock options can motivate actions that distort the allegedly efficient market, often for the personal gain of the short-term investor (speculator) and officer option holders, as opposed to seeking to maximize long-term shareholder value. Nevertheless, the myth of stock options operating to align shareholder and management interests continues to be perpetuated.

2.3. TRADITIONAL PROPERTY PERSPECTIVE: SEPARATION OF OWNERSHIP AND CONTROL

When ownership and control were vested in the same individual(s), the incentives and rewards for active monitoring and control justified a proactive role for the owner(s). However, with the rise of small investors in corporations, the paradigm shifted. Public choice recognized that there were few if any incentives for monitoring by such investors.[85] Those in control who could act at the expense and with the support of the resources of the corporation and with the incentive to do so moved to preserve and, in many cases, to enhance their own parochial interests.[86]

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issuer, to turn over to the issuer, as a penalty, any profits made by the purchaser by the purchase or resale of any profits made by the purchaser by the purchase or sale of securities of the issuer within any period of less than six months. Further, of the *Securities and Exchange Act of 1934*, *ibid.*, s. 21A(e), provides for a bounty paid "to the person or persons who provide information leading to the imposition of such penalty." Having anti-speculative rules such as the US "short swing profit rules" that appeared to be designed to avoid "insider speculation" to not apply in such instances, opened the door to abuse.

[84] Berle & Means, *supra* note 2 at xiii.

[85] See Daniel A. Farber & Philip P. Frickey, *Law and Public Choice: A Critical Introduction* (Chicago: University of Chicago Press, 1991); Dennis C. Mueller, *Public Choice II* (Cambridge, U.K.: Cambridge University Press, 1989); Olson, *supra* note 63.

Widely dispersed shareholders owning relatively few shares, as well as the free-rider principle had in the past and continues in the present to act as an impediment to effective shareholder monitoring. The free-rider principle suggests that "unless there is coercion or some other special device to make individuals act in their common interest, rational, self-interested individuals will not act to achieve their common or group interests."[87] Therefore, absent meaningful internal or external checks and balances, or a combination thereof, the potential for greater slack, self-dealing and inflated agency costs[88] (that is, the added expense incurred by having stand-ins act for and on behalf of owners) increases. As noted by Adam Smith in his 1776 *An Inquiry into The Wealth of Nations*, "managers of other people's money than their own, cannot well be expected that they should watch over it with the same anxious vigilance with which partners in a private copartnery watch over their own."[89] Contemporary authors have made similar observations, namely that with the division of ownership and control, "[it] is inevitable that a substantial amount of undesirable slack or self-dealing will occur".[90] Therefore, given the work of Berle and Means and the related legal scholarship subsequent thereto, at least one thing is unequivocally clear: the dialectical nature of the challenges created by the separation of ownership and control and the inherent risk of increased agency costs are now well identified and recognized. However, despite attempts at identifying prophylactic solutions by governments, regulators and self-regulatory organizations (SROs) as well as the writings within academe, the consensus as to the optimum response thereto continues to be less than clear.

2.4. NEXUS OF CONTRACTS

An alternative new wave of scholarship, referred to as the *nexus of contracts,* challenged the work of Berle and Means and sought to explain and rationalize the workings of the

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[86] William J. Carney, "The Production of Corporate Law" (1998) 71 S. Cal. L. Rev. 715.
[87] Olson, *supra* note 63 at 2.
[88] Melvin A. Eisenberg "The Structure of corporation Law" (1989) 89 Colum. L. Rev. 1461 at 1471-74.
[89] Adam Smith, *An Inquiry into the Nature and Cause of the Wealth of Nations*, 4th ed. by Edwin Cannan (London: Methuen, 1922) at 233.
[90] Frank H. Easterbrook & Daniel R. Fischel, "Contractual Freedom in Corporate Law: Articles & Comments; the Corporate Contract" (1989) 89 Colum. L. Rev. 1416 at 1421 [Easterbrook & Fischel, "Contractual Freedom"].

corporation. Predicated on the writings of Knight[91] and Coase,[92] it did not gain academic prominence until the work of Jensen and Meckling in the 1970s.[93] The corporation, under this thesis, contracted with each of the participants by negotiation with those capable or willing to do so, such as providers of financing (banks) and other suppliers of goods and services, or by a contract of adhesion for those unwilling or unable to negotiate, such as shareholders. This scholarship therefore viewed the corporation as including a variety of contributors, participants and claimants and sought to focus on and rationalize the obligations of management to each of those stakeholders.[94]

Anthropomorphism under the *nexus of contracts* appears to have attributed rights, obligations and the capacity to contract, not to the agents, but to the corporation in its "personal" capacity.[95] Management, under this paradigm, did not act on behalf of the shareholders under a theory of agency, but acted pursuant to a contract that included "default rules" (the articles of incorporation), which applied unless contractually modified or excluded. Under this thesis, the decoupling of ownership and control appears to be almost complete, given the right jurisdiction of incorporation,[96] to which corporations could transfer. With strong management, as well as jurisdictions that provided enabling corporate law and limited default rules predicated on contractual freedom,[97] the divorce of ownership and control, if not complete, at least had the two constituents, the shareholders and management, "living separate and apart" in accordance

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[91] See generally Frank H. Knight, *Risk, Uncertainty and Profit* (London: London School of Economics and Political Science, 1933).

[92] Ronald H. Coase, "The Nature of the Firm" (1937) Economica 386, in Richard A. Posner & Kenneth E. Scott, *Economics of corporation Law and Securities Regulation* (Boston: Little, Brown, 1980) 3.

[93] Ian Ayres, "Review: Making a Difference: The Contractual Contributions of Easterbrook and Fischel" (1992) 59 U. Chicago L. Rev. 1391; Michael C. Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 J. Fin. Econ. 305.

[94] See "Symposium: Corporate Malaise – Stakeholder Statutes: Cause or Cure?" (1991) 21 Stetson L. Rev. 1; "The Corporate Stakeholder Conference" (1991) 43 U.T.L.J. 297; Lawrence E. Mitchell, ed., *Progressive Corporate Law* (Boulder, Colo.: Westview Press, 1995).

[95] Meir Dan-Cohen, *Rights, Persons and Organizations: A Legal Theory for Bureaucratic Society* (Los Angeles: University of California Press, 1986) [Dan-Cohen, *Rights*]; Dan-Cohen, "Freedoms", *supra* note 53.

[96] William L. Cary, "Federalism and Corporate Law: Reflections Upon Delaware" (1974) 83 Yale L.J. 663; Robert Daines, "The Incorporation Choices of IPO Firms" (2002) 77 N.Y.U.L. Rev. 1559.

[97] Henry N. Butler & Larry E. Ribstein, "Opting out of Fiducuary Duties: A Response to the Anti-Contractarians" (1990) 65 Wash. L. Rev. 1.

with the terms of a "separation contract of adhesion" (the articles of incorporation and bylaws).

The shareholders of corporations, albeit at best holders of residual rights and ranking as claimants against the corporation after all other parties, could, it has been suggested under the *nexus of contracts*, be delegated to the status of merely another contracting party.[98] Because under the *nexus of contracts* approach the contract would dictate the terms of the relationship (except where the law would override [as is the case in contracts generally where for example issues of public morals and good order cannot be overridden by contract]), the terms of the purported contact would prevail. Under this approach, the parties were free to incorporate and contract by act of commission (with full knowledge) or omission (by adhesion). As a result, barring mandatory legal requirements, freedom of contract, including maximum flexibility to delete traditional shareholder checks and balances, could prevail.[99]

It is worth noting that if one accepts the notion of the *nexus of contracts,* then in all cases other than that of the shareholder, the supposed contracts are for a term certain and determinative.[100] Furthermore, other than the shareholder, who is a "*sine qua non*", that is, "imperative" for the very existence of a corporation (without a shareholder the for-profit corporation cannot exist), the other parties are merely "ancillary". The parties (other than the shareholder) are merely facilitative (non-essential but clearly beneficial to the value creation of a corporation). The contract with the shareholder is, in effect, a contract of creation (and ownership of what has been created, albeit at the extreme it may be naked ownership as the *"usus"* and the *"fructus"* can in effect be carved off by the "rules of governance" that apply, leaving only the *"onus" or the naked ownership*). Share ownership represents the result (that is, "the creation of the corporation"). Barring a sale (or other disposition) or an abandonment of the investment by the shareholder, the "shareholder contract" is in perpetuity. This places a shareholder in a unique position.

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[98] Margaret M. Blair & Lynn A. Stout, "Team Production in Business Organizations: An Introduction" (1999) 24 Iowa J. Corp. L. 743 [Blair & Stout, "Team Production"].
[99] See generally Butler & Ribstein, *supra* note 97.

Irrespective of the approach that one takes to the concept of the corporation, one must conclude that a shareholder in not merely another contracting party to a corporation, but rather is an "owner"[101] with property rights, rights of ownership, which can, do and should differ from the rights of the other constituents.

Given the foregoing, the novelty of the *nexus of contracts* appears to be not in its descriptive nature but in its implications. It facilitates the rationalization of the continued erosion of shareholder rights, a view that is by no means novel, advocating other purposes for a corporation in addition to its profit-making function.[102] A corporation however should act to maximize shareholder (owner) value; it should therefore contract with all where it is mutually beneficial to do so and should seek to ensure that those "contracting with the firm" help to maximize shareholder returns. Notwithstanding the foregoing focused, "single-purpose" objective, that does not seek to minimize the importance nor the significance of all contributions that are essential to the overall success of a corporation. However, under the *nexus of contracts*, the function of the board of directors appears not to be *mono-* but rather *multi*-purpose.[103] The board of directors is required to consider "the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state [or the province] and nation, community and societal considerations and the long-term and short-term interests of the corporation and its shareholders, including the possibility that these interests may best be served by the continued independence of the corporation" (as is the case in certain jurisdictions).[104] Given the breadth of what is to be taken into account by a board of directors in what can be characterized as an "egalitarian philosophical approach", *ex post* accountability would at best be specious. If optimal contracting to maximize value for the shareholders is to be

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[100] See generally Brian R. Cheffins, *Company Law* (Oxford: Clarendon Press, 1997).

[101] Journal of Management and Governance [Electronic journal articles are available in portable document format, while PDF abstracts are in HTML format] (Kluwer Academic Publishers, 1997); available from <http://www.kluweronline/com/issn/1385-3457/contents> (access restricted to McGill users).

[102] E. Merrick Dodd, "For Whom Are Corporate Managers Trustees?" (1932) 45 Harv. L. Rev. 1145.

[103] See generally Blair & Stout, "Team Production", *supra* note 98; Margaret M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Washington, D.C.: Brookings Institution Press, 1995) [Blair, *Ownership and Control*].

the criteria used in assessing the role of all constituents, and given that the foregoing analysis suggests that shareholders are in fact and in law owners,[105] then this alternative approach would appear to be designed to protect sub-optimal contracting parties at the expense of ownership rights.[106]

It would therefore appear that the *nexus of contracts* not only recognizes and rationalizes but also, advertently or otherwise, allows for the entrenchment of the pursuit of what would appear to be conflicting interests. Given the number of divergent considerations that the board of directors (and their designees, the officers) would have to seek to reconcile, little overall guidance or direction could be provided. No single objective would be specified against which to assess performance. Rather, decisions could be rationalized in the context of all the factors that the board would be entitled to consider, on a *pari passu* basis. This could operate to camouflage results; the effectiveness of any intended checks and balances would be negatively impacted. If one were to accept the foregoing, this would result in *ex ante* contracting in the absence of *ex post* observation, verification and accountability,[107] and such an approach could operate to vitiate accountability.

It is recognized that the attractiveness of the *nexus of contracts* is that it operates to explain the workings of a corporation in terms that one can easily understand and relate to. However, even if it appears rational, it is at best facile. It could, would and should be endorsed and rationalized by those who support seeing management as moving towards absolute power and control within a corporation. It assists and operates to enshrine maximum management discretion, with very little or at best reduced accountability. At

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[104] See generally Robert W. Hamilton, *corporation Finance*, 2d ed. (St. Paul, Minn.: West Publishing Group, 1989). See also Jay A. Conger *et al.*, *Corporate Boards: New Strategies for Adding Value at the Top* (San Francisco: Jossey-Bass, 2001).

[105] Louis D. Alessi, "Private Property and Dispersion of Ownership in Large corporations" (1973) 28 J. Fin. 839, cited in Posner & Scott, *supra* note 97 at 30.

[106] See Hamilton, *supra* note 104.

[107] Luca Anderlini & Leonardo Felli, "Incomplete Written Contracts: Indescribable States of Nature" (1994) 109 Q.J. Econ. 1085.

the same time, given the dialectical nature of the management-shareholder relationship, it contributes to the continued erosion or, at the extreme, elimination of shareholder rights.

2.5. INSTITUTIONAL GUARDIANS

In an attempt to address identified weaknesses in corporate governance, a third approach appears to be surfacing, that is the use of "institutional shareholders" as guardians to help ensure effective corporate governance.[108] This view is gaining increasing momentum in light of highly visible actions taken by certain institutions with substantial shareholdings, such as Omers[109] and Teachers[110] in Canada and Calpers[111] in the United States. Furthermore, the growing concentration of shareholdings in the hands of institutions[112] is focusing increasing attention (including by publications like *The Economist*[113]) on this growing constituency as a source of an additional potential external check and balance on management. However, such suggested use may well be "foreign" to the Anglo-American tradition that sought to protect against abuses by a controlling block. This approach seeks to support the use of specific "control blocks" (*de jure* or *de facto*) in the hands of an "individual" (institution) or "control group" (institutions) or achieved through structural mechanisms (such as coalitions) to help accomplish specified objectives. To the extent that such a group is analogous to a controlling shareholder/owner, its detailed review is outside the scope of this thesis, as the focus of this research is on widely held, publicly traded corporations. However, the rise of large institutional investors has raised speculation as to whether these shareholders can serve as

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[108] See generally Bernard S. Black, "Agents Watching Agents: The Promise of Institutional Investor Voice" (1992) 39 UCLA L. Rev. 811; Ronald J. Gilson & Reinier H. Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 Stan. L. Rev. 863.

[109] See online: OMERS <http://www.omers.ca/>.

[110] See online: Ontario Teachers' Pension Plan <http://www.otpp.com/web/website.nsf/web/home>.

[111] *Supra* note 11.

[112] It totals 49% in the United States, which is four times as much as forty years ago, according to *The Economist*. "Open the Club: Corporate Governance" *The Economist* 367:8320 (19 April 2003) 11 (ProQuest) ["Open the Club"]. Comparable Canadian statistics were not readily available, although the CCGG has indicated that it brings together investors with $500 billion in assets under management, including approximately $350 billion invested in Canadian publicly traded companies. See *CCGG*, *supra* note 62.

[113] "Open the Club", *ibid.*

an instrument to help advance effective corporate governance.[114] Coalitions to improve corporate governance (such as the Council of Institutional Investors,[115] founded in 1985 in the United States, and the Canadian Coalition for Good Governance,[116] organized in 2002 in Canada, which include "motivated investors") appear to be attempts at addressing the challenges faced by investors. These groups seem to have coalesced in response to threats to their interests, including high-profile business failures, to refocus on the weaknesses in corporate governance. However, reaching conclusions as to their effectiveness appears to be premature. While they may well prove to be helpful,[117] they should not be viewed as the panacea to address and resolve the challenges faced. Given the character, temperament and integrity of certain of the leaders of these coalitions, they may act altruistically and assist in the improvement of how corporations are governed. Nevertheless, they will continuously face the challenges raised by the public choice, free-rider concerns and self-interest (personal or of the group(s) that they represent). As a result, while they may serve as an additional gatekeeper, it is nevertheless suggested that they suffer from the inherent weaknesses associated therewith, namely *self-interest.*

A transition towards the use of institutional investors as a "first-tier" as opposed to "second-tier" check and balance, if successful, might prove to be a move not towards a reincarnation of the *status quo ante* of other jurisdictions, rather than a system that is unique. It may result in the introduction of an additional "first-tier" gatekeeper with an economic interest to act and to bypass the *funneling syndrome*, as opposed to waiting to react; this clearly may prove to be beneficial. However, the challenges associated with the free-rider principles as well as the innate conflict that may motivate the advancement

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[114] See Jayne W. Barnard, "Institutional Investors and the New Corporate Governance" (1991) N.C.L. Rev. 1135.

[115] Online: CII <http://www.cii.org/>. The Council of Institutional Investors' site notes that it is an organization of large public labor funds and corporate pension funds founded in 1985 in response to controversial takeover activities that threatened the financial interests of pension fund beneficiaries and has over 130 pension fund members whose assets exceed $2 trillion, and more than 125 honorary international participants and educational sustainers. It describes itself as a significant recognized voice for institutional shareholder interests.

[116] See generally *CCGG*, *supra* note 62.

[117] In extreme cases, institutions have intervened notwithstanding the free-rider issue. See *UPM-Kymmene corporation v. UPM Kymmene Miramichi Inc.*, [2004] O.J. No. 636 (QL), aff'g [2002] O.J. No. 2412 (Sup. Ct.).

of personal as opposed to public interests is a challenge to the continued efficiency of this additional potential "first-tier" gatekeeper. At worst, this could create powerful united shareholdings with the ability to self-deal. These challenges associated with controlling shareholders could result in attempts to revert to relying on large holdings (which traditionally were and in many cases still are by individuals, wealthy families, banks or structures, such as small share-holdings with multiple votes, cross holdings, informal relationships or formal ones) to help manage and control a corporation with all the traditional challenges.[118]

Risks faced by seeking to rely on institutional investors include those that are often innate to controlling shareholders. By proactively engaging in monitoring the activities of a corporation,[119] the institution could in effect become an "insider". This may at best constrain their flexibility in how they deal with their investment and at worst raise the prospect of obtaining and trading on inside information. As well, public choice and free-rider concerns would apply. Should an institution expend resources that benefit not only their constituents but also more significantly others, but that are paid for only by the institution? Alternatively, if the institution were to parlay its "special position" into a means of maximizing value for its constituents at the expense of other investors (that is, potential free riders), then the anticipated check and balance feature and the hypothesized public benefit might be minimized or at worst lost.

Other practical considerations will also impact the approach of institutional investors. Do they wish to confront management and risk being ostracized by the business community, or seek to work with management and enjoy the benefits that cooperation usually brings?

Information, knowledge and the power to challenge management also creates the potential to enjoy "special arrangements". One way to seek to address the free-rider challenges is for the monitoring institution to seek to cut a special deal with the

[118] See generally William W. Bratton & Joseph A. McCahery, "Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference" (1999) 38 Colum. J. Transnat'l L. 213.
[119] As, for example, has been suggested in the "Cadbury Report", *supra* note 11.

corporation in question, so that it (and its constituents) can reap the benefits of its actions. This can be achieved in either a confrontational or a cooperative manner. Confrontation can lead to greenmail (that is, a corporation buying back its shares from the institution at a premium, to silence the party). Alternatively, by working to sometimes ostensibly help entrench management, an institution can invest in a corporation at the outset of the monitoring through a financial instrument that enables the institution to capitalize on its actions (while minimizing any downside). Such an opportunity is not difficult to structure, especially when it is done cooperatively with management. Warren Buffet's Berkshire Hathaway (Berkshire) Corporation managed to achieve such an arrangement. It invested $700 million in Salomon Brothers in 1987 by buying a special issue of preferred stock with a nine per cent yield convertible into common shares at Berkshire's option.[120] This enabled Berkshire to achieve a reasonable rate of return pending an improvement in the affairs of the corporation and an increase in the value of the common shares and minimized its downside (as the conversion to common shares was at its option). This was not an isolated example. Gillette, US Air and Champlain International, to cite but three other examples, also benefitted from the support of Warren Buffet's Berkshire Corporation, albeit not for altruistic reasons. Apparently, eight to twelve percent of the voting power of these corporations was transferred through the sale of preferred stock on terms that were sufficiently attractive to warrant Berkshire's intervention.[121]

This approach at least recognized and sought to address the free-rider challenge. As well it served to highlight a tautology that *self-interest* as opposed to public motivation generally is the necessary ingredient to encourage intervention. Accordingly, the use of institutions to assist in monitoring may well be helpful and superficially, it appears to be. However, it should not be portrayed as the panacea to the challenges in corporate

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[120] Margaret M. Blair & Lynn A. Stout, "Corporate Accountability: Director Accountability and the Mediating Role of the Corporate Board" (2001) 79 Wash. U. L.Q. 403; Robert Kleinman *et al.*, "Are There Payoffs for Patient Corporate Investors?" *Mergers and Acquisitions* 28:5 (March-April 1994) 34 (ProQuest).

[121] Jennifer Arlen & Eric Talley, "Precommitment and Managerial Incentives: Unregulable Defenses and the Perils of Shareholder Choice" (2003) 152 U. Pa. L. Rev. 577 [Arlen & Talley, "Precommitment and Managerial Incentives"]; Edward Rock, "Controlling the Dark Side of Rational Investing" (1994) 15 Cardozo L. Rev. 987.

governance confronting the business community. As is often feared in the case of a controlling shareholder acting on its own, rather than in the corporation's best interests, a concomitant concern could well apply in the case of institutions. The one that may gain disproportionately or solely from the institutional effort (absent checks, balances and transparency) may well be the monitoring institution.

The foregoing overview of academic approaches to deal with the challenges generated by a separation of ownership and control necessitates an understanding of, agreement on and assessment of the underlying factor or factors contributing thereto. Such an exercise is a *sine qua non*, if one is to pursue addressing this matter from a practical perspective. A framing of the issues, an understanding of the role of checks and balances, its information dependency as well as the putative role of gatekeepers, the role of *self-interest* and the areas of conflict and their convergence at what has been termed the *funneling syndrome* are necessary pre-conditions to assessing and attempting to appreciate why many of the challenges identified more than three-score and ten years ago continue to haunt us.

2.6. CONCLUSION

There may have been "improvements" to corporate governance over the years, but the fact that concerns raised by Berle and Means[122] over seventy years ago are still relevant today points to the relatively limited success in addressing and resolving many of the issues that they had raised. Inertia triggered by the resources, focus of purpose and *self-interest* of those in or closely aligned with the ones in control may well be one critical reason for where we are today. As well, the ability of corporations, notwithstanding the challenges outlined herein, to deliver rates of return over time that have been deemed acceptable to the investing public, even in the face of added agency costs and corporate failures, is clearly another. Short-term market forces as they apply to a corporation appear to continue to be directly impacted, if not indirectly controlled, by those in *de facto* charge of the enterprise, and clearly not by the shareholders who finance it, or the regulators who are mandated to act in the public interest. What must therefore be

[122] See generally Berle & Means, *supra* note 2.

recognized is that inertia, what is perceived to be in the *self-interest* of those who control a corporation, will continue to constrain voluntary action.

The issue facing "pragmatic academics" continues to be how one seeks to ensure that the corporation, an engine (if not the engine) of economic prosperity, continues to perform in an optimum manner. "Continues" has intentionally been used as, based on anecdotal and reported materials, we are all aware that corporations have their weaknesses; they have nevertheless served us relatively well. The challenge therefore is to attempt to focus on the source of potential problems in a corporation and to seek to identify what can be done to reduce (but never to eliminate) the risk in a practical and realistic manner. Based on history, we may end up with some tinkering. However, we would have to consider the practical aspects so as to ensure that the cure is not worse than the "weaknesses" that one is trying to address.

An evaluation and understanding of the role of key constituents that were traditionally perceived to have helped address the challenges raised by the separation of ownership and control may assist in identifying inherent weaknesses. Furthermore, it may advance the quest for alternative or perhaps complementary methodologies, from a practical and perhaps even more effective manner.

Chapter 3

The Framing of the Issues (Roles and Accountability of Directors and Officers)

3.1. INTRODUCTION

The genesis of the problem and the solution to more effective corporate governance may require one to focus on a common source, *self-interest*. As was noted by Adam Smith,[123] Easterbrooke and Fischel[124] and Berle and Means,[125] *self interest* was long regarded as the "best guarantee of economic efficiency". However, with the separation of ownership and control and with management (or large block holders, including institutional investors) as the *nexus* of "power and expanding control" (at the expense of small shareholders of publicly traded corporations), the issues faced continue to be common. How does one seek to ensure that *self-interest*[126] does not prevail over the interests that corporate governance should be seeking to protect, and how is this to be done most effectively? How does one ensure that trust is not abused?

For all who would honor their fiduciary[127] obligations, additional checks and balances merely serve to increase the cost of carrying on business. The challenge is therefore to search for tools of corporate governance that do not merely increase bureaucracy and agency costs and detract from efficiency. Such tools should serve as "risk of abuse mitigators" (RAMs),[128] (that is, enablers to help protect corporate interests[129] and provide

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[123] Smith, *supra* note 89.

[124] Frank H. Easterbrook & Daniel R. Fischel, "Takeover Bids, Defensive Tactics, and Shareholders' Welfare" (1981) 36 Bus. Law. 1733 [Easterbrook & Fischel, "Takeover Bids"].

[125] Berle & Means, *supra* note 2.

[126] Whether it is the interest of a substantial block-holder or that of a controlling shareholder.

[127] *Black's Law Dictionary*, rev. 4th ed. (St. Paul, Minn.: West Publishing Co., 1968) at 753 [*Black's Law Dictionary*], defines it to include "a person holding ... a character analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor that it requires", which should be applicable to the relationship of directors to shareholders.

[128] This is covered in greater detail in Chapter 9, below.

[129] Which it can be argued, and has been suggested to me, the PCOAB is endeavoring to do. See online: Public Company Accounting Oversight Board <http://www.pcaobus.org> [*PCOAB*]. See also <http://www.cica.ca/index.cfm/ci_id/7796/la_id/1.htm>, announcing the establishment of the PCAOB, which it has been suggested is "designed to restore investor confidence and protect the public interest".

an environment that fosters real long-term economic prosperity for corporations). As well, it should allow for fair as opposed to disproportionate or speculative returns for those who manage the business. To seek to address these challenges, one must endeavor to better appreciate the competing *self-interests* of owners and managers.

3.2. PRIMARY AREAS OF CONFLICT OF INTERESTS (FIDUCIARY OBLIGATIONS: DUTY OF COMPETENCE AND DUTY OF LOYALTY)

The obligations of directors (a source of first-tier or primary checks and balances), namely those of competence and loyalty, may be stated simply in theory and in law.[130] However, the reality is not quite so simple. Directors, just like managers, are not immune to being impacted personally by *self-interest.* Tools of more effective governance must recognize and be responsive to this challenge in a primary gatekeeper.

It has been suggested by Easterbrook and Fischel that the fiduciary obligation (of directors and officers) is an alternative to attempting to address that which cannot be easily defined, to the avoidance of extra monitoring and to "[replacing] prior supervision with deterrence, much as criminal law uses penalties for bank robbery rather than pat-down searches of everyone entering banks".[131] However, it would be a tautology to note that notwithstanding the comments of Easterbrook and Fischel, criminal law does not rely solely on penalties. Minimizing the opportunity to break the law, *ex ante,* is more important than applying sanctions *ex post.* The same should be applicable in the case of corporate governance.

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[130] For example, with respect to the duty of competence, *CBCA*, *supra* note 37, s. 122, requires directors to exercise the care, due diligence and skill that a reasonably prudent person would exercise in comparable circumstances. With respect to the obligation of loyalty, directors in exercising their powers and in discharging their duties are required by the same statute to act honestly and in good faith with a view to the best interests of the corporation. *Ibid.*, s. 122(1)(a). See also generally Harry Sutherland *et al.*, *Company Law of Canada*, 6th ed. (Scarborough, Ont.: Carswell, 1993). Comparable legislative enactments exist in the provincial jurisdictions in Canada (see e.g. *Ontario Business corporations Act*, R.S.O. 1990, c. B.16, s. 134; *Quebec Companies Act*, R.S.Q., c. C-38, ss. 123.83-123.84), as well as in the state jurisdictions in the United States (see e.g. *DGCL*, *supra* note 53, s. 141.

[131] Easterbrook & Fischel, *Economic Structure*, *supra* note 9 at 92.

Fiduciary obligations, as currently constituted and applied, appear capable of being monitored on an *ex post* (as opposed to an *ex ante*) basis. However, incentives for shareholders of corporations to intervene after the fact for a breach of these duties, and their chances of success in the very unlikely event that they initiate actions on their own, are very limited.[132] They are therefore required to rely on the gatekeepers, the primary one being the board of directors. However, the board of directors of a corporation is generally disinclined to align itself with the concerns of shareholders.

Two contributing factors help explain such board passivity. The first is its responsibility for managing the business and affairs of the corporation, which out of necessity, it achieves through the officers that it appoints. As a result (barring very exceptional circumstances), it naturally aligns with management, its delegates. As well, the business judgment rule[133] further reinforces that relationship, as the properly documented actions of directors are insulated from legal exposure to shareholders and others. The second is board-capture, a process whereby management in fact (all other things being equal) controls the board of directors through the proactive use of the *funneling syndrome*; the board therefore generally "approves" management's "recommendations" as a matter of course (as opposed to after a thorough review and understanding), notwithstanding that, as a matter of law, final decision-making authority rests with the board of directors.[134] Both these factors directly affect more effective corporate governance.

3.2.1. Business Judgment Rule

The business judgment rule helps explain why it is rational and in a director's *self-interest* to align with management. This rule assumes that control is in the hands of the board of directors. As well, under this rule, there is an operating presumption that in making a business decision, the directors of a corporation have acted on an informed basis, in good faith and in the honest belief that the actions taken were in the best

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[132] Public choice and free rider concerns, as well as costs (both financial and personal), militate against the initiation of legal proceedings by individual or small shareholders (other than through class action suits, the cost and risk of which is borne by others).

[133] Discussed in Chapter 3, Section 3.2.1., below.

[134] See *CBCA*, *supra* note 37, s. 102(1).

interests of the corporation. Thus, anyone (including shareholders) attacking a board decision as being made on an uninformed basis must rebut the presumption that the board of directors' business judgment was an honest and informed one.[135] Furthermore, provided that the directors have acted honestly and reasonably, the court generally takes the position that it ought not to substitute its own business judgment for that of the board of directors.[136] In essence, as long as they have maintained a properly documented paper trail, *the business judgment rule* serves to permit directors to insulate themselves from liability for shirking.[137] Indeed, barring conflicts of interests or self-dealing, the

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[135] The business judgment rule is described by Blair J. in *CW Shareholdings Inc. v. WIC Western International Communications Ltd.*, 39 O.R. (3d) 755 at 774, 160 D.L.R. (4th) 131, as follows:

> In assessing whether or not directors have met their fiduciary and statutory obligations, as outlined earlier in these reasons, Canadian courts have generally approached the subject on the basis of what has become known as the "business judgment rule". 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 intervention business decisions which have been made honestly prudently, in good faith and on reasonable grounds. In such cases, the board's decisions will not be subject to microscopic examination and the Court will be reluctant to interfere and to usurp the board of directors' function in managing the corporation.

See however *Corporacion Americana de Equipamientos Urbanos S.L. v. Olifas Marketing Group Inc.*, 66 O.R. (3d) 352 at 357, [2003] O.J. No. 3368, where the Business Judgment Rule was held not to be a defense, the court noting:

> Under s. 122 of the CBCA, directors have a duty, amongst other things, to act honestly and in good faith with a view towards the best interests of the corporation and to comply with the CBCA. According to the Applicants, the December 1994 transaction breached both the CBCA (s. 194) and the Shareholders' Agreement and, as such, is not captured by the Business Judgment Rule. It is difficult to imagine that any decision which run[s] contrary to both the CBCA and the Shareholders' Agreement could nevertheless be said to be honest, and in good faith. Accordingly, I must find that the Respondent cannot rely on the Business Judgment Rule as support for its argument.

See also *Main v. Delcan Group Inc.*, [1999] O.J. No. 1961 (QL), 47 B.L.R. (2d) 200, para. 35, where Lederman J., stated:

> The court in *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* (1998), 39 O.R. (3d) 755 (Gen. Div.), was of the view that judicial non-interference is limited to business decisions that are made honestly, prudently, in good faith and on reasonable grounds. The Applicants argue that such was not the case here. The lack of sufficient notice given by the company, the failure to give the Applicants a straight answer when questioned about the 1994 shareholder bonus, and the use of the shareholder bonus to help finance the purchase all evidence the lack of honesty and good faith in this decision.

[136] *Brant Investments Ltd. v. KeepRite Inc.*, 3 O.R. (3d) 289 (C.A.) at 301, [1991] O.J. No. 683, aff'g [1987] O.J. No. 574, 60 O.R. (2d) 737 (H.C.).

[137] James P. Holdcroft & Jonathan R. Mercy, "Corporate Governance: Flexibility in Determining the Role of the Board of Directors in the Age of Information" (1997) 19 Cardozo L. Rev. 291.

likelihood of finding that directors breached their duty of care in Canada would appear to be highly unlikely.[138]

It is also important to recognize that under current Canadian law, directors are not viewed as agents of the shareholders.[139] As a result, directors are viewed as having (except where express shareholder approval is required, whether statutorily or under a corporation's articles, bylaws or other applicable governing documentation) the absolute power to manage the affairs of a corporation, even if their decisions contravene the express wishes of the shareholders (including a majority shareholder[140]). Accordingly, notwithstanding statutory intervention (such as derivative actions,[141] oppression remedies[142] and shareholder proposals[143]), which may have sought to provide a rebalancing of the diverging shareholder and manager interests, the rights of shareholders seeking to protect their interests are limited.

A realignment of interests, from directors being able to ignore the wishes of a majority of their shareholders to a process of making directors more accountable to their ostensible constituents, may be required if the *self-interest* of directors is to become more aligned with that of shareholders. For example, if shareholder intervention through the use of their latent voting power (which historically, at best, was only a minor nuisance to corporate managers)[144] is to become a more effective tool, there must first be a means of overcoming shareholder apathy. Moreover, the challenges raised by "public choice" theorists will need to be addressed. *Public outrage and reaction to issues that all can*

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[138] See *LAC Minerals v. International Corona Resources Ltd.*, [1989] 2 S.C.R. 574, 61 D.L.R. (4th).
[139] See *Maple Leaf Foods Inc. v. Schneider Corp.*, 42 O.R. (3d) 177, [1998] O.J., No. 4142 [*Schneider*]. Followed in *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.* (2003), 30 B.L.R. (3d) 288, 120 A.C.W.S. (3d) 60 (Sup. C.J.); *Barney v. Stamford*, 103 A.C.W.S. (3d) 723, [2001] O.J. No. 676 (Sup. C.J.); *C.I. Covington Fund Inc. v. White* (2000), 10 C.P.R. (4th) 49, 10 B.L.R. (3d) 173, 22 C.B.R. (4th) 183, 101 A.C.W.S. (3d) 504 (Sup. C.J.); *Toronto-Dominion Bank v. E. Goldberger Holdings Ltd.*, 43 C.P.C. (4th) 275, 95 A.C.W.S. (3d) 509, [1999] O.J. No. 5324 (Sup. C.J.); *Re Francisco Gold Corp.* (2002), BCSC 1054, 114 A.C.W.S. (3d) 992, (B.C.S.C.).
[140] See *Schneider, ibid.* at 191.
[141] *CBCA, supra* note 37, ss. 239-40.
[142] *Ibid.*, s. 241.
[143] *Ibid.*, s. 137(1).
[144] See Carol Goforth, "Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but not Too Late" (1994) 43 Am. U.L. Rev. 379 at 385-426.

relate to, including requiring shareholder votes on potential conflicts of interest with management, such as the legal right to impose director and officer compensation limits, may be areas where shareholder intervention and approval may be appropriate.[145] However, providing for shareholder intervention is by no means a guarantee that such tools will be used, or if used, will be done effectively. Conversely, the absence of instruments to enable effective shareholder intervention (short of taking legal action, usually *ex post* to attempt to validate one's claims with all the cost, time, effort, personal expense and sacrifice that such actions require) is to ensure that directors' interests will continue to be aligned with management.

3.2.2. Control of the Board of Directors (Board Capture)

Final decision-making authority (unless delegated by the board of directors to management), at least with respect to material decisions, has been and continues to be vested in and exercised "formally" by a board of directors. However, boards generally exercise their authority in a reactive as opposed to a proactive manner.[146] "Rational" board decisions and *the business judgment rule* require obtaining the facts and related intelligence, as well as professional advice, with respect to a proposal (which also helps to insulate the board of directors from liability[147]). Such information is almost always provided by management or its proxies and can and usually does pre-determine the outcome of board deliberations. As a result, the board is generally captive to management and a strong, effective CEO, given the *funneling syndrome,* is able to manage and control its actions or more precisely, its reactions.

Where initiatives arise externally in terms of the CEO (such as, for example, a loss of confidence by the market in the CEO), the board of directors (or a committee thereof) is

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[145] [Emphasis added]. In Patrick McGeehan, "Chief Agrees to Salary Cap of $6 Million at Hollinger" *The New York Times (Late edition)* (23 May 2003) C1, it was reported that Conrad Black, Chairman CEO and Publisher of Hollinger International, indicated that he will "limit his annual pay" to $6 Million". However, this appeared to be a "voluntary reaction by Conrad Black to challenges facing him", not a mandatory requirement. *Ibid.*

[146] Confirmed by *DSI*, *infra* note 154, statements 24 & 25.

required to bypass the *funneling syndrome* and deal directly with the matter.[148] Under such exceptional circumstances (motivated by their own *self-interest*), boards of directors can and do initiate actions. However, these would be the exception to the findings that boards of directors are generally reactive as opposed to proactive[149] and are usually constrained by the *funneling syndrome.*

The composition of a board of directors that includes management, further negatively impacts independent governance and enhances board capture. A president and CEO of a corporation (and other members of management) are not neutral. It is to be assumed that any matter that management brings before the board of directors for approval would have his (her or their) unequivocal support. Therefore, on any such issue, before discussions begin at the board level, there would be at least one (or more, depending upon how many members of management are on the board) strong advocate(s) and vote(s) in favor of the proposal.

If one were to accept the position that a board of directors is to provide advice, assistance, questioning and an independent review with respect to proposals submitted by management for its approval (at least in the limited sense that board members have not worked on the proposal, have no personal capital invested and can look at it in an unencumbered and less biased manner than management), then one can legitimately question whether any representative from management, including the president and CEO, should sit as a peer (or superior if he (she) is also chairman of the board) on a board of directors. Senior management should naturally be present at the meetings of a board of directors to make presentations and to provide the rationale for a proposal. However, they should not, after advancing their position, then be asked to participate in deliberations

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[147] See *Peoples Department Stores Inc. (trustee of) v. Wise*, [2003] Q.J. No. 505, rev'g [1998] Q.J. No. 3571, leave to appeal to S.C.C. granted, [2003] S.C.C.A. No. 133 [*Wise*]. On October 29, 2004, the Supreme Court of Canada dismissed the appeal. See 2004 SCC 68.

[148] See e.g. Laura M. Holston, "Forced to Act, Disney's Board Considers Its Next Step" *The New York Times* (5 April 2004) C1, where it was reported that "directors are expected to debate how powerful they should become in light of the recent shareholder revolt that led to Michael D. Eisner losing his chairman's title....What has emerged is a board forced to take action because shareholders are demanding it".

[149] Confirmed by the DSI results. See *DSI*, *infra* note 154, statements 24 & 25.

regarding management recommendations(s). There is a fundamental conflict of interest in the "advocate" also being asked to act in what should be an impartial "judicial capacity" and in the "final approval/governance" role. This appears to be analogous to external auditors being asked to install information systems, then being requested to provide an "independent audit opinion", which would include an assessment of the quality of their own work. Such actions, although common in the recent past, are now frowned upon (if not also expressly disallowed).[150] Yet, an analogous situation of having management sitting in an adjudicative role on a board of directors and deciding on the efficacy of its own work (recommendations to the board) is still the norm and receives support.[151] Tacit recognition of this anomaly, this conflict of interests, is displayed by the growing practice of having "in-camera sessions" at the end of both board and committee meetings, without management present.[152] However, it is questionable whether that really addresses the substantive issue or is merely an attempt at a workable compromise.

The need to address this matter is not yet widely accepted nor acknowledged. Furthermore, a contrary view was advanced by the Higgs Report, which suggests that "[t]here is a greater risk of distortion or withholding of information or a lack of balance in the management contribution to the boardroom debate, where there is only one, or a very

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[150] *Sarbanes-Oxley Act of 2002*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, s. 301 (2002) (codified as amended in scattered Sections of 15, 28 U.S.C.) [*SOX*], provides requirements for committee membership and to enhance the functions of the audit committee. SOX requires that all members of the audit committee be independent directors, defining independence very narrowly to mean that these directors may neither accept any consulting, advisory, or other compensatory fees from the company (other than in their capacity as directors or committee members), nor are they to be affiliated with persons of the corporation nor any of its subsidiaries. See also Janis Sarra, "Symposium – Enron and Its Aftermath: Rose-Colored Glasses, Opaque Financial Reporting, and Investor Blues: Enron as Con and the Vulnerability of Canadian Corporate Law" (2002) 76 St. John's L. Rev. 715 at 762, which states that "[c]urrent [Canadian] practices create incentives for auditors to compromise the reliability of financial statements in order to retain lucrative consulting contracts and to preserve close working relationships with corporate managers"; Bill 198, *Keeping the Promise for a Strong Economy Act (Budget Measures)*, 3d Sess., 37th Leg., Ontario, 2002 (assented to 9 December 2002) [*Bill 198*].

[151] See U.K., Department of Trade and Industry, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Stationery Office, 2003) [*Higgs Report*].

[152] See e.g. online: <http://www.ccgg.ca/web/website.nsf/web/CCGG_Guidelines/$FILE/CCGG_Guidelines_Oct03r.pdf> [*Guidelines*], which outlines the "Corporate Governance Guidelines for Building High Performance Boards" as set out by the Canadian Coalition for Good Governance (Version 1.0 dated October 2003), which recommends (as best practices) to "[r]equire chair to held in camera sessions of independent directors without management present, at every board meeting and every committee meeting".

small number of executive directors on the board".[153] Notwithstanding these views, which are consistent with past practice (and have received qualified support from the *detailed survey and interview,* also referred to herein as the *DSI*),[154] management can be extremely effective in presenting and participating in a discussion without being given the right to sit on a board and vote on its own recommendations.

Board capture is not merely facilitated by the *funneling syndrome* and by management sitting on a board of directors. It is also compromised by the relationships of management to members of the board. Directors who have family, business, social or economic ties to the CEO or other officers are also more likely to side with (or to be a captive of) management.[155]

Board capture is a function not only of factors such as the *funneling syndrome, the business judgment rule* and relationships, but also of the most basic of human instinct, *self-interest.* Disagreement breeds conflict, whereas support has its own rewards, both tangible and intangible. As a result, unless the duty of directors to become proactive when it is appropriate is made mandatory and they are held legally accountable to the shareholders in a manner that exposes them personally to shareholder (and investor) liability in a meaningful (as opposed to a purely theoretical) manner, the *status quo* will

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[153] *Higgs Report, supra* note 151 at 33.

[154] The strong majority of those interviewed in the DSI continued to support the presence of the CEO on the board, but barring exceptional circumstances (such as a possible successor to the CEO), no other officers of the corporation. A few agreed that no officers should sit on the board. However, it was suggested that this requires academic review, examination and public debate (much as took place with the separation of the non executive chairman and CEO), before it may be embraced.

[155] That helps to explain why 93.1% of those queried in the DSI (with no neutrals) supported statement 43 that "[a]ny ties between management and Board members should be fully disclosed to management". *Ibid.*, statement 43. See generally *BCI Telecom Holdings, Inc. v. Jones Intercable, Inc. et al.* (1998), 3 F. Supp. 2d 1165, dealing with a dispute about corporate governance, where the controlling shareholder sought to invoke the business judgment rule, to support an action that had been agreed to by the controlling shareholders' nominees to the board of directors, notwithstanding that the transaction involved the controlling shareholder and a corporation that he wholly owned. The court held that such action was an "anticipatory breach of the shareholders agreement" and issued an injunction to restrain the proposed "related party transaction" and ruled that such transaction be undertaken "only with the approval of the unrelated directors" as provided for in the shareholders agreement. As an additional example of the challenges that this can raise, see also Walter Hamilton & Thomas S. Mulligan, "The Nation: Stock Market Ex-CEO Is Sued" *Los Angeles Times* (25 May 2004) A1, where it notes that "[t]he suit also named Kenneth

continue. In other words, barring the introduction of meaningful accountability (such as *personal accountability and responsibility, also referred to herein as PAR*),[156] the rational path and the one of least resistance for directors, motivated by *self-interest*, is that which supports directors continuing to align with management and the preservation of the *status quo*.

3.3. COMPENSATION

The establishment of CEO (as well as officer and director) compensation is indicative of the challenges faced in seeking to implement more effective corporate governance. For any person, other than one who is self-employed, the determination of salary should be subject to effective checks and balances (other than the check and balance of what the business can afford, applicable to a self-employed owner/manager). However, a review of the manner in which it is established within corporations may assist in framing the challenges stemming from *self-interest,* conflicts of interest, and the need for more proactive intervention and greater accountability.

The proactive role of management in the determination of executive compensation was described by Lucian Bebchuk, Jesse Fried and David Walker, who wrote that "[much] of what is observed in the world of executive compensation can be explained by managerial opportunism and influence over captive boards of directors".[157] They have suggested, and experience would appear to support their suggestion, that "[executive] pay practices reflect the actions of powerful executives who can influence the terms of their own pay packages, and do so in a way that 'camouflages pay' to address the concerns that would face the members of the board of directors and therefore act to "mitigate external scrutiny

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Langone, a close friend of Grasso who headed the NYSE's compensation committee from mid-1999 to mid-2003. The suit alleges that Langone misled colleagues about Grasso's earnings".

[156] The notion of *personal accountability and responsibility* (*PAR*) is discussed in Chapter 9, Section 9.5.2., below.

[157] See Lucian Arye Bebchuk *et al.*, "Managerial Power and Executive Compensation" (2002) 69 U. Chi. L. Rev. 751 at 752, quoted in Kevin J. Murphy, "Explaining Executive Compensation: Managerial Power versus the Perceived Cost of Stock Options" (2002) 69 U. Chi. L. Rev. 847. See also Hamilton & Mulligan, *supra* 155, where the suit alleges that "[a]fter one NYSE board member questioned Grasso's pay in a private conversation.... Grasso quickly learned of the dissent and confronted the director, who ultimately reversed course and voted for that year's compensation package...".

and criticism".[158] While acknowledging that the "optimal contracting" and "managerial power" explanations are not mutually exclusive and that both may play a role, Bebchuk, Fried and Walker have concluded that management power and control can better help explain patterns and practices of executive compensation. In particular, they have argued that managerial power can explain several "puzzling" features of option plans, including why exercise prices are set at grant-date market prices and are not indexed to general market movements (but are often reset following market declines), why options often contain so-called "reload" provisions, and why firms allow executives to exercise early and diversify (or otherwise hedge the risk of their option and stock holdings),[159] which serves to distance and not to align management and shareholder interests.

According to Bebchuk, Fried and Walker's assessment, there is a lack of effective checks and balances in the establishment of compensation.[160] No matter whether one agrees or disagrees with these commentators, a review of what happens in practice may assist in an appreciation of the challenge and may suggest a solution.

Anecdotally, two mechanisms appear to be used to establish the salary of the CEO of a corporation. The first, the "competitive marketplace", is used when officers (including, the CEO) are hired externally. Firms will retain personnel consultants who are generally paid a percentage of the first year's total cash compensation (salary and bonus) to recruit the appropriate candidate. The higher the compensation that is to be paid to the executive in question, the larger the fee payable to the recruitment agency. This traditional mode of compensation has a built-in incentive to maximize, not minimize, executive pay. Furthermore, since corporations work on a relative as opposed to absolute pay structure, the higher paid the CEO, the more that can be earned by his (her) direct reports.[161] There

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[158] Murphy, *ibid.* at 848.
[159] *Ibid.* at 851.
[160] One respondent to the McGill Law School Graduates' *PS*, for example, volunteered the comment that "[c]ompensation of CEOs is out of whack with reality." (17 February 2004) Lawyer 35-44, Partner in a law firm. The DSI statement that "Executive Compensation was out of control" was also strongly supported by 68.3% of respondents (71.82 % when those who were neutral were excluded).
[161] In practice, barring very exceptional circumstances, no one is paid more than the CEO.

is therefore an inherent internal corporate bias to seek to ensure that wherever possible, the CEO is paid at the higher as opposed to the lower end of the range.

As well, it must be recognized that when one seeks to engage an individual externally, if the candidate is not looking to leave his current employer, the candidate may need to be "enticed away". This requires the payment of a premium over his (her) current compensation, offsets for whatever the individual is forced to leave behind (such as unvested stock options or pension expectations) and protection against the vagaries of entering into a new business enterprise (that is, downside protection in case things do not work out). Furthermore, if the individual is perceived to be a "superstar", the cost of hiring the person in question, including the incentives required to encourage the individual to "jump ship", rises correspondingly. All of the foregoing are generally incorporated into a contract, drafted at the expense of the new employer by legal counsel experienced in this line of endeavor. The result is that unlike internal promotions, the cost of which can be managed more effectively (at least in the short term), external hires generate additional complexities and concerns. External hires provide the candidate and the placement agency that seeks to bond with the individual (a future source of revenue for the agency), in the absence of a very strong board of directors (or a committee thereof that is mandated to pursue filling the post), with incentives that can lead to maximizing as opposed to minimizing compensation packages.

Furthermore, compensation packages generally set the minimum levels of compensation (as well as the minimum terms in the event of termination). Should the recent CEO hire not work out, the amounts paid to sever the relationship are clearly set out in the "honeymoon document" (that is, the document that was drafted while the corporation was seeking to entice their chosen candidate to join it) as drafted by counsel for the new hire (and paid for by the corporation). Alternatively, if the new addition exceeds expectations, then the contractual arrangements will be subject to renegotiation to reset compensation, failing which the risk of losing this "outstanding individual" will be raised as a "potential issue of concern".

The second approach to executive compensation is internal. It entails a theoretical as opposed to market determination of what should be paid to officers (and a similar process is usually used to arrive at compensation for board members). This task is almost always undertaken by or under the direct supervision of officers of the corporation, with the assistance of "expert" outside advisors. The expert "independent" advisors report to management (usually the Vice President Human Resources or an equivalent officer function). As well, these outside consulting firms provide a wide array of other corporate consulting services and always seek to position themselves to provide additional services to management (as well as to be referred to others, where they can furnish their expertise).[162]

These "independent" advisors have a gatekeeper role. They are there to help "independently" assess "comparative data" and assist in arriving at what should be paid to the officers (and directors) of the corporation (while at the same time hoping to later access all of these same individuals for additional business). Comparative data can be helpful. However, information enabling the comparison to be made is generally assembled by management with a proper understanding of the "rules of the game", and when finally amassed externally, is funneled through management (the application of the *funneling syndrome*). The end result is that the use of external compensation advisors can often be more of an exercise in expensive number crunching (and providing support for a recommendation from management) than in arriving at a true indication of competitive pay scales. Subject to "independent" comparative studies (with all their inherent weaknesses) and potential outrage factors (internal by the directors, based on their own knowledge and experience, or concern over the "newspaper test", namely determining whether it will engender public outrage when the directors comply with mandatory reporting and whether management and the board of directors will want to take the heat[163]) there do not appear to be effective external constraints on the power and authority

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[162] For an example of such a consulting firm, see online: Mercer Human Resource Consulting <http://www.mercerhr.ca>. It is believed Mercer has a 60% share of the major corporate work in Canada.

[163] A classic case in point comes from the NYSE, where a US $140-million "board-approved" pay package for Dick Grasso, its Chairman and CEO, raised a public outcry and led to Grasso's resignation. See Kate Kelly *et al.*, "Grasso Quits NYSE Amid Pay Furor; Behind Chief's Departure, A Profit Squeeze,

of the board of directors to determine CEO and officer (and for that matter director) compensation. It therefore appears that the directors and officers are in effect acting as principals on matters where they are in a clear conflict of interest.[164]

It is interesting to recognize that often CEOs who are hired in the "competitive market" undertake a "total compensation review" for the "senior executive team" (which by definition includes their own function) shortly after they join a corporation. This should be surprising, given that they would have recently joined the corporation in question after a competitive search and therefore, supposedly, on competitive terms; their total compensation should then be a reflection of the market. Nevertheless, this has been a recurring general observation. As well, where individuals are promoted from within and where the CEO may have spent his (her) whole career with the same corporation, "independent studies" are usually undertaken annually to ensure that the CEO in question is paid competitively. It would be interesting to ascertain whether any studies based on independent advice had ever recommended that the salary of a CEO of a corporation under review be reduced (although I have little doubt that the compensation of his (her) direct reports have in fact been adjusted downwards based on such studies) and what, if any, actions were taken as a result. An assessment of the rationale behind this initiative could be open to debate and could no doubt be justified. Nevertheless, an analysis of the correlation between the hiring of a CEO and "salary adjustments" (other than increases in line with the corporation generally) could be informative and revealing. However, such an initiative is be beyond the scope of this thesis.

Unless the board of directors (or a committee thereof) engages an "independent advisor" with clear guidelines and reporting to the board (usually through the compensation committee of the board of directors) and such advisor is unconstrained by future business considerations with the management of the corporation (by being expressly precluded by

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Governance Questions; Exchange at a Crossroads" *Wall Street Journal* (18 September 2003) A1 (ProQuest).

[164] *CBCA*, *supra* note 37, s. 120(1) provides that a director shall not vote on any contract in which he is a party or has a material interest (that is, where there is a conflict of interest). However, *ibid.*, s. 120(5)

the board or by statute from otherwise dealing directly or indirectly with the management of the corporation), effectiveness will be constrained by innate conflicts and by the application of the *funneling syndrome*. Absent a legal requirement, there may be little incentive, especially for directors who attempt to avoid confrontations, and who may have the greatest need for more proactive involvement, to become more personally engaged in a potentially adversarial compensation-setting process (or for that matter for almost any potential controversy). The time, effort and potential conflict that plays a more proactive role in CEO (and officer) compensation entails may not be warranted by current, or even potentially increased, director compensation.[165] Furthermore, unless statutorily imposed, directors engaging in this activity may be viewed as having "usurped" the currently perceived functions of management and having become engaged in what is often surreptitiously referred to as "micro managing". Such an initiative by board members, whether voluntarily adopted or imposed by law, could lead to constructive friction (or destructive, depending upon one's perspective as to whether a board should continue to be a collegial body[166] or engage, at least where conflicts of interests may exist, in constructive friction). Whether the board as representatives of the owners (the shareholders) is positioned to constructively challenge management and should proactively govern the affairs of the corporation is still an issue that engenders vigorous reaction and debate.[167]

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excludes from the foregoing prohibition, any contract that is "one relating to his remuneration as a director, officer, employee or agent of the corporation or an affiliate".

[165] An added complexity becomes one of what additional compensation (if any) should be paid to the directors for this "expanded role". See generally, "Heavier Workload, Demand Boost Directors' Pay by 30%" *The Globe and Mail* (18 May 2004) B1, which deals with additional compensation to be paid to directors.

[166] Weber argues that "established groups" tend to form "collegial bodies" as forums where a "process of adjustment" can be worked out over "conflicts of interest by compromise". See Wallace Clement, *The Canadian Corporate Elite: An Analysis of Economic Power* (Toronto: McClelland and Steward, 1975).

[167] The general consensus from the DSI is that boards are and should be collegial bodies, reactive and not proactive, and that barring exceptional circumstances and a loss of confidence in the CEO and/or any senior management team, should be supportive of and work with, as opposed to challenge management.

3.4. SELF-INTEREST IN DEALING WITH MATERIAL CORPORATE INFORMATION

Control over the "creation" and the "timing" of "material events"[168] and therefore the concomitant disclosure of material changes (as mandated by the law[169]) places great power and control in the hands of the CEO. Such disclosure is a necessary pre-condition to the operation of the "efficient market". As a result, the timing of disclosure can affect personal fortunes. Regulatory effort both in Canada and the United States appear to be focused on seeking to ensure equal and simultaneous access to material information. However, such information is subject to constraints and filtering before a decision is ever made to release it. Quite often how "potentially material information" is to be dealt with and when it becomes material is not resolved until the CEO makes a determination as to what he (she) would like to do (including assessing expectations as to the board's reaction).[170] As a result, the *funneling syndrome* is effectively at play in the ascertainment and the control of the timing of disclosure of material information.

The management of material corporate information, including the potential for its misuse, can take a number of forms. At one extreme is the abuse of the confidentiality of material information, by using it or by making it available to others for personal gain. Such abuse is generally illegal and can lead to sanctions.[171] That issue is not addressed specifically here.

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[168] Clearly, not all material events are within the control of the corporation. They can be caused by events external to the corporation, such as the loss of a material contract.

[169] See e.g. *OSA*, *supra* note 6, s. 76(1), which provides that "[n]o person or company in a special relationship with a reporting issuer shall purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed."

[170] See *ibid.*, s. 76, which provides, subject to a "necessary course of business" defence, that no person or company that proposes to make a takeover bid, become party to a reorganization, amalgamation, merger, arrangement, etc. with a reporting issuer to acquire a substantial portion of a reporting issuer's assets may inform another person or company of a material change until it has been generally disclosed.

[171] For a discussion of insider trading (from a US perspective), see generally Thomas C. Newkirk & Melissa A. Robertson, "Insider Trading – A U.S. Perspective" (Speech delivered at the 16th International Symposium on Economic Crime, Jesus College, Cambridge, U.K., 19 September 1998), online: SEC <http://www.sec.gov/news/speech/speecharchive/1998/spch221.htm>.

At the other extreme are "ostensibly legal" although "potentially unethical" forms of "abuse". These can result from the fact that judgment is integral to many business and accounting matters. As a result, many decisions that need to be taken by officers of a corporation require detailed review, lead time and analysis before a determination is made as to whether they will be implemented. This usually occurs quite legitimately, as many of these matters need to be analyzed, understood, discussed and sometimes even negotiated with external parties before a "course of action" is finally decided upon. As well, they often need the concurrence of the board of directors. These decisions can materially impact corporate expectations and reported financial results. However, there is generally a degree of management discretion as to the timing.

Corporate expectations in the "efficient market" are therefore impacted by a number of factors, all in and of themselves quite legitimate. These can include business decisions, such as announcing a proactive thrust (alone or with others) into new markets, announcing the acquisition, disposition or break-up of a "holding company" (thereby releasing the usual holding company discount[172]) or matters such as acquiring or disposing of operations. As well, it could entail financially related matters such as decisions as to when to capitalize expenditures or expense the amounts in question; how to treat goodwill and the recognition, timing and recording of any impairment; when to do depreciation reviews or actuarial studies (relating to pension funding and accounting) and the assumptions that go into such reviews; decisions on litigation and the likelihood of success or failure, as well as how to treat these and other contingencies; the establishment of accounting reserves and increases or decreases thereto; and as to decisions to take a major write-off,[173] which would serve to impact earnings, both in the

[172] A holding company discount applies when the sum total of all companies in a group trades for less that what the individual companies making up the group would sell for if the holding company were disaggregated. For a case in point, see <http://www.haskayne.ucalgary.ca/research/media/2002_17.pdf>.

[173] For example, if a building depreciated at a constant rate of $10 million a year, with a $50-million remaining cost to be depreciated, is written off as being worthless given a decision to make certain "organizational changes" (and it will now be torn down at no additional cost to the corporation in return for relinquishing the rights to the salvaged material), then a ten million dollar depreciation expense a year previously charged to the profit and loss statement will no longer count as a charge in that statement, subsequent to the year of the write-off of the residual cost of the building. As a result, prospectively, there

year in which it was to be taken and prospectively, by reducing costs going forward (as a result of the major write-off). As well, differences in accounting practices from one jurisdiction to another,[174] the timing of the implementation of proposed accounting changes,[175] whether they will only apply prospectively (or also retroactively) and the degree of discretion available to the corporation can all lead to material differences in reported financial results.[176] Furthermore, legitimate actions such as decisions to dispose of assets can generate improvements in reported earnings.[177] Obviously, there is flexibility and discretion in managing the timing of many of these actions, all of which impact stock market values attributed to the equity of the corporations as well as reported corporate earnings. As a result, the CEO has the ability, within parameters, to manage the

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will be the appearance of a ten million dollar improvement in earnings (until the 50 million dollars that should have been charged annually to earnings is written off, or for five years in this example).

[174] See Hill, *supra* note 52 at 591 where, referring to W.A Wallace & J. Walsh, "Apples to Apples: Profits Abroad" Financial Executive (May-June 1995) 28, he noted that the study "tried to quantify the extent of these differences by comparing various accounting measures and profitability ratios across 22 developed nations including Australia, Britain, France, Germany Hong Kong, Japan, Spain and South Korea" and "found that among the 22 countries, there were 76 differences in the way cost of goods sold is was assessed, 65 differences in the assessment of return on assets, 54 differences in the measurement of research and development expenses as a percentage of sales, and 20 differences in the calculation of nest profit margin." Nor is this considered an aberration; many of Canada's largest and most widely held corporations make reference to this accounting difference in a note to their financial statements. For an example of the reconciliation of Canadian and US GAAP required for inter-listed corporations, see e.g. BCE Inc., *2003 Annual Report* (Montreal: BCE Inc., 2004), note 26 (BCE is listed on the TSX and the NYSE, among other stock exchanges.).

[175] For an example, relating to stock option accounting,, see *CICA Standards and Guidance Collection*, s. 38: stock-based compensation and other stock-based payments, online: <http://www.knotia.ca/Knowledge/View/Document.cfm?kType=1&linkType=ftch&dbID=403&documentID=64&paragraphID=89#para_89> (access restricted to CICA members).

[176] See Al Rosen, "Pushing the Wrong Buttons: Canadian Executives are Being Given Leeway to Choose the Profit They Want to Report" *Canadian Business* 76:18 (29 September 2003) 25 (ProQuest). Rosen, a forensic accountant, notes that "[e]vidence of a significant shift in the way Canadian corporate profits are calculated, and how these profits can be bloated relative to US accounting rules is plentiful. Some of the more outrageous examples are pension accounting, goodwill write-downs, currency exchange rules, convertible debt treatment and tax asset disclosure." For an example of notes reporting the differences between Canadian and U.S. GAAP, see BCE, *supra* note 174.

[177] For example, in the case of capital assets that have appreciated in value (such as land located in downtown area in a major metropolitan area, purchased for five million dollars in, say, 1940, and with a current market value of one hundred million dollars over cost), the timing of the sale of the asset could generate a substantial gain and would "distort" the reported earnings.

anticipated prospects as well as the reported earnings of a corporation (or in colloquial terms to "manage expectations" and to "manage earnings").[178]

Where compensation was tied to earnings (that is, a CEO received a bonus based upon the reported earnings of the corporation), *self-interest* did not motivate generating substantial expectations or earning variations. Bonuses were paid based on achieving or exceeding financial (or other internal) business targets, and substantial earning swings or generating "excitement in the market" generally provided relatively little additional financial reward. Furthermore, if one exceeded the target substantially in a given year, it generally served to raise the financial bar for the following one.[179] As a result, substantial swings were not in the interests of management; rather, "smoothed earnings" as opposed to wide earnings gyrations (actually or expected) were.

The inclusion of stock options in executive compensation changed this scenario. Officers were provided with "derivative rights", often annually, to acquire stock at preset prices, for a fixed period of time (usually five to ten years). These stock options enabled management to leverage their personal financial returns based on the reaction of the "efficient stock market" to publicly disclosed (or assumed, whatever the basis for the assumption) corporate events, many of which were well within the control of management. Since there appeared to be a correlation between the prices at which stocks would trade and the information that was being fed through the *funneling syndrome* into the market (concerning the results or prospects of a corporation) and the reports of analysts' reactions, all such information became critical to the prices at which corporate equity traded. Managing investor relations or seeking to impact analyst and media coverage became highly focused and if successful, potentially very profitable, especially if it resulted in dramatic stock-price fluctuations.

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[178] *DSI*, *supra* note 154, statement 59: "Corporate earnings are managed; (i.e. management tries to smooth out earnings to meet street expectations)", which was supported by 90.5% of respondents (92.73% when the neutrals, were excluded).

[179] Sustained growth, as opposed to wide gyrations, was in the interests of management; accordingly smoothing of earnings took place. The overstatement of earnings in any year merely raised the financial bar for management in the subsequent year. Accordingly, self-interest and the *funneling syndrome* served to encourage earnings growth management, *ceteris paribus*.

Since an "unanticipated increase in quarterly results" or an announced acquisition (whatever the longer-term impact) could, with relatively high multiples (where stocks traded as a function of actual or anticipated earnings) generate substantial increases in the price of a publicly traded share in a relatively short period of time and had no impact on reported corporate earnings (as the costs of stock options were not reported as an expense but were "merely viewed as a dilution of shareholders' equity and reported as notes to the financial statements[180]), the ability to directly affect one's own net worth without negatively impacting corporate earnings soon became very apparent to those running corporations (and their compensation consultants). As a result, if one had been granted a substantial number of options and they were "rechargeable" (that is, replaced if exercised above a certain share price or on other agreed-upon conditions), incentives to act to maximize personal net worth (without necessarily benefiting the corporation longer term) and the ability to achieve that personal objective were now available to management in general and the CEO in particular within the new rules of the game. That is not to suggest that executives went to the extremes of Enron or WorldCom; that would be fallacious. However, once it became clear that personal interests could benefit handsomely from actions that might (or at worst might not) benefit the corporation, the risk/reward became skewed; personal and corporate interests were misaligned. A review of recent results, their impact on the executives in question and a comparison of executive as opposed to Corporate (shareholder) performance over a defined period of time have not been undertaken in this endeavor. For now, it will be left up to the reader to assess whose interests were best served by the introduction of stock options (geared to irrational market performance, and not necessarily to that of a corporation alone, that allowed the officers to speculate in the stock of "their corporation", which they could impact or manipulate, both positively and negatively, while in office). Recent events would suggest that stock options as historically structured did not serve to align the interests of management with the shareholders (as opposed to with speculators whether within or outside of the

[180] This has since changed. See online: Knotia.ca <http://www.knotia.ca/Knowledge/View/Document.cfm?kType=1&linkType=ftch&dbID=403&documentID=64&paragraphID=90#para_90> (access restricted to CICA members).

corporation), nor did they help to address the issues raised by the separation of ownership and control.

While the illegal misuse of insider information has been and should continue to be addressed and monitored both internally through codes of conduct and externally, through monitoring and legal sanctions, the second challenge (that is, of legally manipulating information or actions for personal gain) has not yet been meaningfully addressed. Given that the objective of effective corporate governance is to seek to address the issues that arise from the separation of ownership and control, the failure to deal effectively with this latter issue is at best unfortunate and at worst will invite recidivism.

3.5. CONCLUSION

It has been noted prophetically and confirmed anecdotally by contemporary events that "[i]f investors should come to doubt the worth of promises made to them, investment in the economy as a whole would fall."[181] Confidence that "promises" will be kept and that "trust" will not be abused appears paramount. Nevertheless, strong economic motivation (that is, substantial personal wealth creation and retention) with relatively little personal risk appears to rationalize pursuing *self-interest* at the expense of the corporation. The effectiveness of the directors, as first-tier (or primary) checks and balances, putatively defending the interests of the shareholders, suffers from innate deficiencies. There appears to be a general lack of accountability to the shareholder, in fact and in law. Moreover, enforceability of that accountability appears more illusory than factual. Accountability is to the corporation, which in practice means that it is to management. How to engender confidence most effectively, when all appears to be affected directly or indirectly by *self-interest,* continues as an ongoing quest. External regulation, aligning the interests of management and shareholders, and the alleged efficiency of the market, all seem to have run into challenges and at best, their credibility has been questioned. Unless the shortcomings can be effectively addressed, with accountability in fact and in law to

[181] Easterbrook & Fischel. "Contractual Freedom", *supra* note 90 at 1447.

the shareholders (and the investing public), directors will continue to align, quite rationally and in their *self-interest,* with management.

A brief review of the other challenges raised within corporations to attempt to address *self-interest* may assist in focusing more specifically on the nature of the issues faced in striving for improved corporate governance.

Chapter 4

Checks and Balances
(Confining, Structuring and Checking Discretion)

4.1. INTRODUCTION

To address the challenges raised within corporations by the conflicting *self-interests of management and shareholders,* and to help enhance the credibility and reliability of corporate information, effective checks and balances[182] are required. An assessment of their efficacy and an appreciation of the rationale for their shortcomings may assist in the quest for more effective corporate governance.

4.2. GATEKEEPERS

Gatekeepers (which can be included in tiers one, two and three[183]) are allegedly independent parties whose views engender credibility because of supposed "professional competence and independence" (and include directors as well as securities commissions, self-regulating organizations (SROs), stock exchanges, accountants,[184] lawyers, analysts, investment advisors, rating agencies and the media). They are viewed by some as "[the] primary safeguards on whom investors rely to assure that accurate and meaningful disclosure reaches the market."[185]

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[182] Or "confining, structuring and checking discretion". See Davis, *supra* note 21 at 4, who defines discretion with respect to a public officer as "whenever the effective limits on his power leave him free to make a choice among possible courses of action or inaction". This definition can apply equally in the case of directors and officers (especially the CEO) of corporations. It is this discretion, coupled with *self-interest* that effective corporate governance must seek to "confine", or to borrow from accounting terminology, to subject to effective "checks and balances" (the term used herein). See generally Chapter 4, below.

[183] This will be addressed in greater detail in Chapter 6, Section 6.6., below.

[184] For the history of the founding and the evolution of the Institute of Chartered Accountants of Ontario, see e.g. <http://www.icao.on.ca/index.cfm/ci_id/1194.htm>.

[185] John C. Coffee, Jr., "The Acquiescent Gatekeeper: Reputational Intermediaries, Auditor Independence and Governance Accounting" (2001), Columbia Law and Economics Working Paper No. 191, online: <http://ssrn.com/abstract=270944>.

Two basic challenges face non-director gatekeepers (as they do directors[186]). The first, information that they receive, is generally (but not always) subjected to the *funneling syndrome.*[187] The second conflict caused by *self-interest,*[188] the source of their livelihood (often the corporations), may well be at odds with the expectation that they should be acting in the broader "public" as opposed to their own "parochial" interests.

One should question whether it is any more realistic, barring legal compulsion, to expect others (individuals, corporations or business entities), as opposed to management or the board of directors of a corporation, to act as effective "gatekeepers", working to safeguard shareholder interests when such actions may be contrary to their own *self-interests.*

4.3. CHALLENGES FACED BY GATEKEEPERS – SELF-INTEREST

Self-interest is not limited to any single individual or group; it is innate to all (including regulators). Revelations confirmed by insiders such as Levitt, a former Chairman of the Securities and Exchange Commission (which often met with official skepticism if not tacit acquiescence), are disturbing.[189] They demonstrate that regulatory institutions, ostensibly established to help buttress and protect the position of the investing public, suffer from innate deficiencies and their own *self-interest.* In his book entitled "Take on the Street: What Wall Street and Corporate America Don't Want You To Know",[190] Levitt provides an insider's insight into the workings of Wall Street, revealing the challenges facing the investing public, as well as the regulator (who ought to act on the public's behalf and protect their interests) against the well orchestrated self-interests of corporate, professional and political pressure groups. Such revelations serve to confirm the pervasiveness of the problem and to demonstrate how the failure to deal effectively

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[186] See Chapter 3, above.
[187] The subject, touched on in the introduction, will be addressed in greater detail in Chapter 6, below.
[188] This matter is also addressed in Chapter 6, below.
[189] See generally Jonathan R. Mancey, "Wall Street Versus Main Street: How Ignorance, Hyperbole, and Fear Lead to Regulation", Book Review of *F.I.A.S.C.O.: Blood in the Water on Wall Street* (1998) 65 U. Chi. L. Rev. 1487.
[190] Arthur Levitt, *Take on the Street: What Wall Street and Corporate America Don't Want You to Know, and what You Can Do to Fight Back* (New York, Pantheon Books, 2002).

with this basic characteristic of human nature can, and does, work to frustrate more effective corporate governance.

Financial institutions, whose analysts play a gatekeeper role, are also constrained by *self-interest.* At the center of capital markets, they provide a wide spectrum of services (including acting concurrently or sequentially as advisors, lenders, underwriters and analysts) and often for the same, but at other times for different and even opposing, reasons. They are therefore often in a clear conflict of interest. In seeking to address this conundrum, legal fictions referred to as "Chinese Walls" are "theoretically" put into place to separate those conflicting operations. However, these activities usually take place within the same overall consolidated business entity (which can include a single corporation or, where structural separations exist, a group of legal entities all controlled by the same corporation and officer group). Financial institutions had historically recommended securities to prospective purchasers without disclosing their status as owners of the securities in question, that their compensation was directly affected by how successful they were in marketing such securities and even more significantly, that their lucrative investment banking opportunities were often tied to their success in these related fields of endeavor. Financial institutions appeared to have been using their analysts and research reports to ingratiate themselves with and to win favor from potential clients by recommending the purchase of their securities to the investing public (including many of their own clients), whether justified or not. The incentive appeared not to be to service their investing clients or the public, but *self-interest*, to win lucrative banking business, including participation in initial public offerings, the financing of material acquisitions and the participation in takeover bids, even if it meant sacrificing the well-being of certain of their clients and the investing public. Given the potential to generate considerable fees from such activities, their personal economic incentive appeared to outweigh the risk that one's reputation could be damaged or that sanctions might theoretically be imposed from biased advice. When measured against the perceived limited potential risks, the substantial returns appeared to be acceptable, rational and warranted. Furthermore, all of this was or should have been readily apparent to members of the business community, professionals and others who were actively involved in or

regulated the public financial markets. These contemporary revelations were costly at least in appearance (for example, in the United States they culminated with Morgan Stanley, Credit Suisse First Boston, Bear Stearns, Goldman Sachs, Lehman Brothers, US Bancorp Piper Jeffray and UBS Warburg [now UBS Paine Webber], members of the financial community with what were generally perceived to be "sterling reputations", paying US $1.4 billion to settle these claims). However, these settlement costs can be viewed as merely another cost of doing business and pale in comparison to the losses suffered by investors. Furthermore, the named firms, while agreeing to the record fine, "neither admitted to nor denied the regulators' allegations that they deceived investors".[191]

The fact that most of the major investment houses were apparently engaged in similar practices serves to confirm that where an aggressive approach appears to be successful, "best practices" (which on an after-the-fact basis may well be "worst practices") suggest that you emulate what is being done. There is a desire to "run and to be perceived to be running" with the best; there is comfort in what it is suggested is the "herd instinct". Actions of others are imitated, while one ignores one's own sources of information, intuition, experience and judgment. One does not want to be left out of what it is perceived to be opportunities, and one may be too arrogant to be prepared to admit that one has not yet really absorbed or understood that which is being advanced. One appears to want to keep up with the apparent leader, whether one really understands or appreciates the implications of what is being undertaken. Furthermore, there is safety in numbers. If everyone acts in a similar manner, it appears (and even becomes) the "norm". If there is a downside, it is that everyone is expected to suffer equally, so the relative

[191] Marcy Gordon, "Senators Eye $1.4B Wall Street Settlement" *Associated Press* (7 May 2003), online: Parker & Waichmann <http://www.yourlawyer.com/practice/news.htm?story_id=5807&topic=Morgan Stanley Stock Fraud>. Nor is this limited: the *self-interest* of those involved in mutual fund companies, brokerage firms and hedge funds, it has been suggested, threatens to undermine investor confidence in the $7 trillion mutual fund industry. See e.g. Andrew Balls, "Mutual Fund Industry Facing Lack of Trust and Low Returns" *Financial Times* (11 November 2003) 50; "Insider Trading at Mutual Funds," Editorial, *The New York Times* (30 October 2003) A-28 (ProQuest), which points out that "[m]utual funds are supposed to be the small investors' sanctuary on Wall Street, a way for them to get in on the action without fear of being taken.... But an ever-widening series of inquiries suggests that many of these consumer-friendly investment vehicles have been improperly manipulated by Wall Street insiders."

damage to a gatekeeper's reputation if a problem arises, relative to one's peers, is acceptable. As Keynes noted, perhaps prophetically, "it is better for reputation to fail conventionally than to succeed unconventionally."[192]

Other putative gatekeepers such as rating agencies interact with, review presentations by and engage in discussions with management and their advisors. These all take place in "apparent confidence" and assist the agencies in arriving at corporate ratings. Alternatively, or in addition, they may be focusing their determinations on publicly available information. Questions could be raised as to whether, absent public sector regulation, market forces provide sufficient checks and balances on the activities of these information-dependant SROs for the work that they undertake. As well, the issue of whether it is even feasible for individual countries to regulate the activities of multinational organizations of theses types can also been raised. A more detailed review of this area of activity, other than recognizing the information dependency of this gatekeeper, is required to try to understand why rating agencies appear to have failed the public and what needs to be done to help address this conundrum but that is beyond the scope of this paper. However, superficially one can assume that they were "duped" by the data made available to them by management and their professional advisors (barring any information to the contrary). Alternatively, one can examine, in detail, the economics that motivate the functioning of theses rating agencies with a focus on their *self-interest* and see where such examination leads.[193]

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[192] John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936) at 158.

[193] See e.g. Frank Protnoy, Professor of Law, University of San Diego Law School (Testimony before the US Senate Committee on Governmental Affairs, 24 January 2002), where it is reported that he stated: "the three major credit rating agencies-Moody's, Standard and Poor's and Fitch/IBCA- received substantial, but as yet undisclosed, fees from Enron. Yet just weeks prior to Enron's bankruptcy filing- after most of the negative news was out and Enron was trading at just $3 per share- all three rating agencies still gave investment grade ratings to Enron debt".

It has been suggested that lawyers (who initiate class action lawsuits on behalf of "injured shareholders") also act as "gatekeepers".[194] Such lawyers, it can be argued, have a positive effect on corporate governance as the threat of a class action suit helps to ensure compliance. It is beyond the scope of this work to deal with this issue in great detail. However, it is argued by those within or advising business,[195] supported by some within academe,[196] that the principal person who benefits from such action is the lawyer and that litigation is in fact a poor means of seeking to protect shareholder interests. The long-term (continuing) shareholder who has neither bought nor sold shares of the corporation during the period that gives rise to the shareholder's suit (for example, for allegedly misleading disclosure) is subject to at least the following penalties. First, he (she) loses if the trading price of the stock is negatively affected in the longer term as a result of the allegation of wrongdoing. Second, it is posited, based on anecdotal experiences and *DSI* discussions, that he (she) loses because assets of the corporation (both people and money) are diverted and expended (i) to defend management (generally, whether such management remains with the corporation or not); (ii) to pay for the cost of the lawsuit; (iii) to pay the cost of "buying a settlement" if such action is taken to "minimize the disruption factor" that any lawsuit involving key members of a management entails, (iv) to pay for the resolution of the litigation, if it is resolved by a negative judicial decision and (v) to pay for the higher insurance premiums that litigation engenders. Furthermore, in what may appear to be perverse but reflective of reality, litigation may inadvertently serve to further entrench and increase the cost of management. One may well need to take conservatory actions (and seek to retain the goodwill of officers who may be critical to litigation, but in other circumstances one might consider terminating) so as to seek to ensure that the position of management, at least insofar as it relates to litigation with third parties, is aligned with that of the corporation and its shareholders. Litigation, actual or threatened, may therefore result in the deferment, if not in the nullification of corrective

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[194] See generally Coffee, "Understanding Enron", *supra* note 76; The Attorney as Gatekeeper: An Agenda for the SEC (2003), online: <http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID395181_code030423630.pdf?abstractid=395181>.

[195] This was suggested during the DSI interviews.

[196] Douglas C. Buffone, "Predatory Attorneys and Professional Plaintiffs: Reforms Are Needed to limit Vexatious Securities Litigation" (1995) 23 Hofstra L. Rev. 655.

action that a board of directors might otherwise have taken with respect to a member(s) of its senior staff (in the absence of third-party considerations).

Stock exchanges such as the NYSE and the TSX are also viewed as playing a gatekeeper role. Clearly corporations that list on such exchanges are required to comply with its listing requirements. The TSX, sensitive to the inadequacies of corporate governance, has played a proactive role in ostensibly seeking improvements.[197] A by-product of this effort has been the requirement to report on compliance with "voluntary corporate governance guidelines" or as it is sometimes referred to anecdotally, although not necessarily incorrectly, "check-box governance". While this may be positive, as it could serve to heighten attention and focus on corporate governance, its impact on more effective corporate governance is far from clear. Unless the process results in substantive, positive change and helps to create or protect value, this effort could well lead to little more than another exercise in paperwork and bureaucracy. One can rightfully question whether there is any empirical evidence to support that this extensive effort has resulted in any meaningful, substantive improvement in corporate governance.

As well, it should be recognized that the TSX is constrained by practical realities (as are other exchanges); its clients and its *sine qua non,* the reason for its existence, are the actual or potential listings of corporations. Accordingly, corporate views and interests, as reflected by those in *de facto* control, must be a primary consideration in any action(s) taken by the TSX (and other exchanges). As well, corporations do not have to list on the TSX; alternatives are available (for example, NASDAQ). Exchanges compete for listings (and the fees generated thereby) and cannot be seen to impose constraints that would encourage its constituents (current and prospective) to list elsewhere. As a result, exchanges will react when their interests and those of their constituents are aligned (for example, the introduction of the voluntary corporate governance guidelines). However, absent compulsion, it would be naive to assume that exchanges (including the TSX,

[197] See *Dey Report, supra* note 14; *Fleming Report, supra* note 14; *Allen Report, supra* note 14; "Saucier Report", *supra* note 14.

which is itself publicly traded) would voluntarily initiate changes that conflict with the best interests of their constituents, including specifically the management of corporations.

It could also be suggested that the media has been playing a proactive role in focusing on the challenges facing the business world and in heightening public awareness. It could be argued that not only does this increase readership and/or viewers and thereby sell advertising, but it is also a role that a responsible media should be playing. Effectively, the media could be serving as a check and balance and acting as a "gatekeeper" by focusing public attention on excesses, the result being that this will assist in bringing them more into check. However, one can rightly question the motivation of the media. Is it sensationalism and increased readership or are they motivated by the public interest, or in certain cases may it also be a combination of both? Irrespective of the rationale, there is little doubt that there is a role for the media. However, how effective this role will be in assisting in implementing effective corporate governance may well be a function of whether this reporting will be *ex post*, as generally appears to be the case, as opposed to *ex ante*, which entails investigative reporting at substantial cost and effort. A detailed examination of this area is beyond the scope of this paper. However, in focusing on the media as an additional instrument of corporate governance, one would have to ensure that adequate motivation exists to encourage the media to play a proactive as well as a reactive role. Based upon anecdotal experience, getting the media actively involved *ex ante* is generally difficult at best. Accordingly, while the role of the media to disseminate publicly available information and to comment thereon *ex post* may well be an important instrument of governance, assuming *ex ante* intervention would generally appear to be the exception as opposed to the rule.

Accountants (the external auditors) play and should perform a special role, given their access to source data and their supposed independence.[198] However, it should be noted that notwithstanding their unique position (their ability to verify the assertions of management in a relatively unconstrained manner and to provide an "independent

[198] This will be focused on in greater detail and addressed in Chapter 6, below.

opinion" on the financial statements of a corporation), their independence was compromised when they expanded their services into other related areas of customer needs. That they were seeking to be, and in fact were, responsive to their "clients' professional business requirements was the rationale for the migration by the external auditors into other areas of activity. However, this served to raise a core issue, "conflict of interests", as the *self-interests* of external auditors conflicted with the need to play a proactive gatekeeper role.

Rather than retaining and vigorously defending their position of independence, the external auditors clearly appear to have aligned themselves with the interests of management (in effect, their client). Nor was this evolution concealed. To cite but one example, in a 25 June 2001 speech by the then-acting Chairman of the Securities and Exchange Commission, Laura S. Unger (basing herself on the then-latest proxy filings for more than half of the Fortune 1000 companies) reported that non-audit fees then comprised 73% of the total fees companies paid to accounting firms. She further pointed out that according to the Commission's estimates, consulting services were growing three times as fast as the basic auditing function. All of this served to raise questions as to auditors' independence. Furthermore, even though she noted that the SEC was aware that public companies such as Waste Management, Cendant, Sunbeam and Microstrategy were announcing accounting irregularities too often, and such events were raising concerns about the integrity of financial statements ("restatements" resulted in total market losses of $31.2 billion in 2000, $24.2 billion in 1999 and $17.7 billion in 1998, growing by more than 76% from 1998 to 2000), little appeared to have been done to address this conundrum.[199] Furthermore, when it is recognized that shares were bought and sold and employee compensation and bonuses paid based on reported financial data that had to be restated, one must appreciate that the integrity of the efficient market was under attack, at best, and in doubt, at worst. It should also be noted and recognized that the mere identification of a concern, even documented as it was by the SEC, was not

[199] Laura S. Unger, "This Year's Proxy Season: Sunlight Shines on Auditor Independence and Executive Compensation" (Speech delivered to the Center for Professional Education Inc, Washington, D.C., 25 June 2001), online: SEC <http://www.sec.gov/news/speech/spch502.htm>.

sufficient to overcome the inertia motivated by *self-interest* inherent in our contemporary system of corporate governance.[200]

Suggesting that gatekeepers can and should act in a manner that is contrary to their own or vested *self-interests* is to raise the very same issues that are at the core of the corporate governance debate; corporate governance breaks down when *self-interest* is not aligned with acting in the best interests of a clearly identified constituency and there is little or no substantive accountability. Further, one must appreciate the ability of individuals to rationalize, sometimes that which retrospectively appears to be irrational. As has been noted, "[h]uman nature may incline everyone acting in subjective good faith to rationalize as right what is merely personally beneficial".[201] The ongoing challenge therefore facing pragmatic academics is to endeavor to help to ensure that *self-interest,* at odds with the interest(s) that one is trying to protect, is effectively constrained and is aligned closely with the broader interest(s) that one is seeking to achieve, and that there is accountability. *Absent the foregoing, gatekeepers will continue to fall short of the objective of helping to ensure effective corporate governance.*

4.4. INFORMATION DEPENDENCY: ALTERNATIVE SOURCES OF INFORMATION

The practical significance of the supposedly divergent perspectives and approaches to governance is their common theme; it is reflected in the need for checks and balances to act as a constraint when required on *self-interest.* Whether one deals with the world of business or politics, it is posited that checks and balances are a necessary pre-condition to the effective containment of power and to the constraint of an inappropriate pursuit of personal interests. Where achieved, it is the result of a division of responsibility (that is, the potential for abuse[202]) and authority (that is, the power to abuse[203]) and the

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[200] Note that *SOX*, *supra* note 150 in the United States and *Multilateral Instrument 52-110 – Audit Committees*, 27 O.S.C.B. 3252 (26 March 2004) [*MI 52-110*] in Ontario, due to the apparent loss of confidence in the capital markets generally and the external auditors, more specifically, sought to place constraints on the external auditor's performance of services that could negatively impact rendering an "independent audit opinion".

[201] *City Capital Associates Ltd. Partnership v. Interco Inc.*, 551 A.2d 787 at 796 (Del. Ch. 1988).

[202] Referred to herein as "PA" and discussed in Chapter 10, below.

[203] Referred to herein as "A" and discussed in Chapter 10, below.

implementation of accountability.[204] Like political institutions (a supposed means to an end that also requires checks and balances), the corporation appears to have taken on a life of its own, which as a result necessitates similar constraints. This was highlighted as early as 1918 when Von Kommenden Dingen noted that "the enterprise assumes an independent life, as if it belonged to no one". He further noted "[t]he depersonalization of ownership, the objectification of enterprise, the detachment of property from the possessor, leads to a point where the enterprise becomes transformed into an institution which resembles the state in character."[205] Given the foregoing, the corporation no less than the state is required to be constrained by a system of checks and balances to help ensure accountability.

However, checks and balances (essential for minimizing *self-interest* and increasing agency costs) appear to be information-dependant, whether the source of information is internal or external. They seem to be capable of being affected, appropriately or otherwise, by the ability to benefit oneself through the control of information at the expense of others, especially when there is little perceived risk of detection or sanctions. Lack of transparency and control over information can assist in the reaching of such a conclusion. Information is an essential pre-condition to effective planning, implementation, coordination, management, reporting and control of the affairs of a business; it is the lifeline of a business. As a result, it is recognized both anecdotally and academically that structured sources of information (which give rise to the *funneling syndrome*), when it takes place below the level of a board of directors within a corporation, need to be and are often bypassed by management.[206] Effective presidents visit stores, factories, distribution centers and management unannounced. They meet with customers and they have their alternative sources of information. However, when similar

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[204] This idea was developed by Locke in his *Two Treatises of Civil Government* (1690), Montesquieu's *The Spirit of Laws* (1748), as well as later influential American constitutional thinking. See Raphael LaPorta *et al.*, "Judicial Checks and Balances" (2003), online: Social Science Research Network Electronic Library <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=410821# PaperDownload>.

[205] Walther Rathenau, *In Days to Come*, trans. by Eden & Cedar Paul (London: 1921, G. Allen & Unwin) at 120-21 (*Von kommenden Dingen*), cited in Berle & Means, *supra* note 2 at 309.

[206] See Henry Mintzberg, *The Nature of Managerial Work* (New York: Harper & Row, 1973); H. Edward Wrapp, "Good Managers Don't Make Policy Decisions" *Harvard Business Review* (September-October 1967) 91.

actions are suggested as being appropriate for board members so as to avoid being captive to the *funneling syndrome* (especially where interests can conflict), there is often the pejorative suggestion that this is "micro managing". If one refrains from going into detail, "he (she) may soon find himself subsisting on a diet of abstractions, leaving the choice of what he eats in the hands of his subordinates"[207] (a feature quite common in traditional board settings). Furthermore, it has been recognized that a president (and it is suggested that also holds true for any decision maker) must not be limited in his (her) sources of information: "No doubt he (the president) needs the data that advisors can provide. He also needs to know the little things they fail to mention".[208]

Barring personal knowledge, experience and access to alternative sources of information, control of the information flow is needed in order to manage the outcome of a decision-making process. Nevertheless, it is recognized anecdotally that, in the business world as is also often true more generally, one may decide with one's heart[209] and rationalize with one's head; he (she) who controls the information will be in the best position to convince the others of the rationality of a recommended action.

The foregoing is inconsistent with the neo-classical theory that "assumes that the decision maker ... knows all the alternatives that are available for choice, can compute the expected value of utility associated with each alternative and chooses the alternative that maximizes utility".[210] Neo-classical theory is not supported by business practice. The cost of obtaining information as well as information availability, accessibility, ability to accumulate and format it in a meaningful manner, as well as the time required to digest the information and to make the necessary decisions in competitive markets all serve to bring into question the practical validity of the neo-classical ideal. Rather, bounded rationality as advanced by Herbert A Simon, which suggests that "the decision maker must search for alternatives, has egregiously incomplete and inaccurate knowledge about

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[207] Wrapp, *ibid.* at 92.
[208] Richard E. Neustadt, *Presidential Power: The Politics of Leadership* (New York: Wiley, 1960) at 53.
[209] Especially, if as has been noted during the DSI: (i) the board seeks to align with management (a claim supported by 90.5% of respondents), and (ii) to support management and the CEO (agreed with by 100% of respondents).

the consequences of actions and chooses actions that are expected to be satisfactory (attain targets while satisfying constraints)"[211] is more consistent with business reality. Board members, constrained by a lack of knowledge and time, cannot maximize in the realm of the ideal but must in reality accept compromises. They must act based on the information presented to them and on their own knowledge base, however obtained, as opposed to a theoretical economic ideal of being omniscient.

If the prime source of information in corporate decision making is and of necessity must be management, then any constraints on the flow of information to the board of directors as addressed by the application of the *funneling syndrome* will almost always lead to the logical conclusion outlined and advanced by that provider of the information. This almost complete dependency of board members on information filtered by senior management in effect serves to create the opportunity for using the property of others for one's own benefit in a relatively risk-free environment. This can be achieved not through a misappropriation of funds (which would be illegal and result in a very high risk of detection) but rather by actions that can be rationalized as serving not only personal but also "corporate interests". It may result from what in effect is market manipulation, such as by creating events that suggest that future earnings will greatly exceed expectations and then cashing in (through, for example, stock options) on the reaction of the inefficient market to this information.[212]

Members of the board of directors are therefore generally information-dependant on management (the *funneling syndrome*); barring exceptional circumstances (where, for example, the personal knowledge, however obtained, or experience of a director puts him (her) into conflict with the recommendations of management), a director who should be exercising independent judgment will side with and be supportive of management's recommendations. If one is to address this paradox, then alternative and/or supplementary

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[210] Herbert Alexander Simon, *Reason in Human Affairs* (Stanford, Calif.: Stanford University Press, 1983). at 17.
[211] *Ibid.*
[212] See Dean Roger Martin, "The Fundamental Problem with Stock-Based Compensation" *Rotman Management Magazine* (Winter 2003), online: Joseph L. Rotman School of Management <http://www.rotman.utoronto.ca/rogermartin/fundamental_problem.pdf>.

sources of information must be proscribed whenever management may be in a conflict of interest, to flow directly to the board of directors. As well, accountability and dependency of these sources must, in law and in fact, be to the board of directors, not to management.[213] It is this fundamental challenge that must be addressed if more effective corporate governance is to be achieved and concomitant confidence of the investing public is to be warranted.

4.5. CONCLUSION

Each of the three tiers of checks and balances[214] are contributors in seeking to ensure, advertently or otherwise, more effective corporate governance. Nevertheless, they appear to have fallen short in the achievement of the required objective. Inaction appears to be a function not merely of the *funneling syndrome* (although it may have been applicable in some cases), but of the rationalization of the *status quo*, motivated by *self-interest.* Personal gratification is not limited to management but can apply equally, barring effective checks and balances, to gatekeepers. Just as *self-interest* serves to constrain effective governance in the case of management, it can also serve as an impediment in the case of the gatekeepers who are buoyed on by increasing the agency costs paid for by the corporation, to align with management.

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[213] It is suggested that this is subliminally, if not overtly, recognized by the detailed survey at question number 39, where 97.6% of those polled (100% when excluding those who claimed to be neutral) agreed to the statement that "[d]irectors should be able to independently hire, at company expense, outside advisors, to assist them in making decisions".

[214] Addressed in Chapter 1 at 17.

Chapter 5
Control of the Corporation

5.1. INTRODUCTION

Control carries with it the authority and the ability to achieve objectives. With the separation of ownership and control in the modern, widely held, publicly traded corporation, the ability to act (even when legal control is prescribed as a matter of law, to an individual or a body) may not be sufficient to enable such rights to be effectively exercised. Control should be assessed and understood from at least a dual perspective, proactive and reactive.

Proactive control can be taken to mean the micro or macro management of a corporation. Micro and macro proactive management are a function not only of legal authority and competence, but also of access to relevant, accurate and timely information and the ability to achieve desired ends. Proactive control includes the initiation of action.

In contrast, reactive control is primarily a judicial function; it enables one to respond based on factors or events submitted for or that require a decision. Absent a need (as opposed to a desire) for the board to react, given the *funneling syndrome*, the control of key information that a CEO possesses, the relationship that exists with the board of directors and the disruptive factors caused by an unplanned or even orchestrated departure of a CEO, the CEO can in practice, barring a loss of confidence in him (her), control the proactive actions and most reactions of the board and thereby the corporation. However, events such as the departure or a financial crisis triggered by the actions (or inactions) of the CEO, or where the direction of the corporation is "visibly challenged", may force a board to become proactive (that is, to initiate actions, independent of the CEO), even though in reaction to events.[215]

[215] *DSI*, *supra* note 154, statements 25 & 24, confirm that directors are perceived to be reactive (a view held by 88.4% off respondents; 92.66% when the neutrals were excluded); only 7.3% (7.87% when the neutrals

Even well-intentioned board members, devoid of personal or other relationships and truly independent of management, could (absent being able to circumvent the *funneling syndrome*), be prevented from being able to play a meaningful, proactive role (even with the time, knowledge and intellectual capability to understand all of the interrelated issues). This would suggest that boards of directors often review and approve issues on what may well be a *pro forma* basis. Barring a system of effective checks and balances, boards of directors are captive to and dependant on management (and more specifically the CEO) and are not in effective control of the enterprise.

5.2. INDEPENDENT DIRECTORS

The current area of focus and activity in a search for more effective corporate governance appears to be focused on the "independent director".[216] It has nevertheless been suggested both within academe and anecdotally[217] that inside directors have vested interests to strive for excellence in performance as well as the technical and corporate knowledge and experience to be able to achieve the same.[218] The Higgs Report[219] appears to endorse this more traditional perspective. While it states in the summary of its recommendations that at least half of the members of the board, excluding the chairman, should be independent, it nevertheless argues that management should be strongly represented on the board. It goes on to suggest:

> [T]here is a greater risk of distortion or withholding of information, or lack of balance in the management contribution to the boardroom debate, when there is only one or a very small number of executive directors on

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were excluded) believed that directors were proactive. As well, it is to be noted that the board of directors in the cases of both Lord Black, see McGeehan, *supra* note 145, and Eisner, *supra* note 148, only reacted in response to public intervention and pressure; they did not initiate action.

[216] For definitions of independent directors, see *Guidelines*, *supra* note 152.

[217] In the *PS* of the McGill Faculty of Law graduates, one respondent noted: "Just because a company is public does not mean that the founders and significant shareholders should not be on the board as well as involved in management- what counts is that the MAJORITY of the directors are independent and where there is a strong management-board nexus, that directors REALLY be independent, not just seemingly so." (18 February 2004) Lawyer 35-45, employed in a publicly traded company.

[218] Eugene F. Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J. Pol. Econ. 288 at 289-91; J. Lynch, *Activating the Board of Directors: A Study of the Process of Increasing Board Effectiveness* (Ph.D. Thesis, Harvard Business School, 1979) [unpublished]; Kenneth E. Scott, "corporation Law and the American Law Institute Corporate Governance Project" (1983) 35 Stan. L. Rev. 927.

[219] See *Higgs Report*, *supra* note 151 at 5.

> the board. *For this reason, I recommend that the Code provides that there should be a strong executive representation on the board.*[220]

The counter position supporting independent directors, although by no means novel,[221] appears to reflect the current North American consensus. The TSE,[222] the NYSE[223] and Nasdaq[224] (in addition to the SEC[225] and OSC[226]) as well as practitioners, institutional investors[227] and academe[228] have converged on the independence of directors as a possible solution to address the many identified corporate governance ills. Their suggestion that the empowerment of independent directors could allow for more effective decision making, which in turn could also lead to greater public trust and shareholder value has intuitive appeal.[229] Furthermore, it is also being suggested that independent directors should have a meaningful financial interest (that is, an equity interest such as owning shares) in the corporation on whose board they sit. This is being posited as a contemporary solution to help address the challenges raised by the inadequacies of effective corporate governance (and is receiving support).[230] The objective appears to be an attempt to revert to the *status quo ante* by seeking to reunite both ownership and

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[220] *Ibid.* at 33 (suggested Code provision A.3.2).

[221] For example, in a May 1994 article of Business Lawyer, (1994) 49 Bus. Law. 1243, dealing with the 1994 edition of the Corporate Director's Guidebook, was recommended that "at least a majority of the members of the boards of publicity held corporations should be independent of management". See <http://www.lexis.com/research/retrieve/frames?_m=cb45125681345cfd98a78b3217fdf127&csvc=fr&cform=free&_fmtstr=CITE&docnum=1&_startdoc=1&wchp=dGLbVtz-zSkAW&_md5=20cec3cb6107d7755d54e88b7fffaa02>.

[222] See TSE, Toronto Stock Exchange Amends Corporate Governance Guidelines" (26 August 2002), online: <http://www.tsx.com/en/mediaNews/newsreleases/news2355.html>.

[223] See NYSE, "Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors" (1 August 2002), online: NYSE <http://www.nyse.com/pdfs/corp_gov_pro_b.pdf>, which supports the position that a majority of the directors should be independent.

[224] See NASDAQ, "Summary of NASDAQ Corporate Governance Proposals" (13 September 2002), online: NASDAQ <http://www.Nasdaqnews.com/about/corpgov/corpgovprop0913.pdf>, which parallels the views of the NYSE as to the need for independent directors.

[225] *SEC*, *supra* note 6.

[226] *OSC*, *supra* note 6.

[227] See generally *CCGG*, *supra* note 62.

[228] See Laura Lin, "The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence" (1996) 90 Nw. U.L. Rev. 898; James D. Cox, "Symposium: Lessons from Enron. How Did Corporate and Securities Law Fail? Managing and Monitoring Conflicts of Interest: Empowering the Outside Directors with Independent Counsel" (2003) 48 Vill. L. Rev. 1077.

[229] R. William Ide, "Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight" (2003) 54 Mercer L. Rev. 829.

[230] See *CCGG*, *supra* note 62.

control in the same individual(s). While it is still not clear what constitutes independence[231] and while the fees that are being paid to these "independent" directors may well leave them with the impression that they are to manage as opposed to govern, the utilization of "independent directors" is increasing.[232] However, the challenges faced by directors that have yet to be addressed are: how can they (i) be positioned to be proactive as opposed to being merely reactive, (ii) continue to maintain their independence (notwithstanding their ongoing interaction over time with other board members and management) and (iii) help prevent control (where conflicts between the interests of the CEO and shareholders may arise) from being monopolized by the CEO, and thereby help to protect shareholders' interests and wealth.

Whether empirical evidence will support that independent directors will be more proactive than reactive in their role, help to create greater value and possess a higher degree of *CIA,* still needs to be addressed. However, it is interesting to note that Bebchuk, Coates and Subramanian, have made the following observation with respect to independent directors: "[W]hile many of the targets in our data set had a majority of independent directors, these targets did not perform considerably better in serving the shareholder interests. This finding suggests that the absolute confidence that our critics would place in independent directors is unwarranted."[233]

The mantra of independence, in and of itself, may not provide the protection that many are seeking.[234] The traditionally suggested "independence" of firms of "chartered

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[231] For definitions of independent directors, see *ibid.*

[232] Ronald J. Gilson & Reinier H. Kraakman, "Reinventing the Outside Director: An Agenda for Institutional Investors" (1991) 43 Stan. L. Rev. 863.

[233] Lucian Arye Bebchuk *et al.*, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy" (2002) 55 Stan. L. Rev. 887 [Bebchuk *et al.*, "Powerful Antitakeover"]. See also Lucian Arye Bebchuk *et al.*, "The Powerful Antitakover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants" (2002) 55 Stan. L. Rev. 885 at 887-88 [Bebchuk *et al.*, "Powerful Antitakeover: Further Findings"].

[234] For example, the board structure and composition at Enron appeared to be leading edge, as it was comprised (86%) of ostensibly outsiders with significant ownership interests and included "only" two members of management (the Chairman of the board and former CEO and the President and CEO), and twelve non-employee outsiders (including five CEOs and four academics). See generally Stuart L. Gillan & John D. Martin, "Financial Engineering, Corporate Governance and the Collapse of Enron" (Draft 6 November 2002), online; <http:/www/be.udel.edu.ccgi> [Gillan & Martin, "Enron"]

accountants" (external auditors), with detailed knowledge of the affairs of the client firms that they audited, failed to assist in protecting the interests of shareholders.[235] One may therefore question, for many reasons, including the *funneling syndrome,* board capture and the reactive as opposed to proactive inclinations of boards of directors and how supposedly independent directors operating within the essentially unchanged structure (notwithstanding increased compensation and being able to meet in the absence of the CEO or other members of management) will assist in establishing more effective corporate governance.

Clarity with respect to what is required and expected of "independent directors" so as to make them accountable in a meaningful manner is essential. As well, they must be equipped with the tools necessary to enable them to fulfill their obligations, and valid concerns, such as potential personal liability, must be effectively addressed.[236] Unless these issues are dealt with by legislation, clearly outlining what is expected of independent directors, providing them with the legal ability to obtain the requisite information and limiting their legal exposure, one may end up with risk averse, less than technically competent, "independent", well-paid directors who attempt to protect themselves against adverse consequences, as opposed to governing the corporation in the best interests of its constituents.

5.3. CHANGES IN CONTROL

The issue of changes in control has relevance to this thesis insofar as it may serve to assist in providing the shareholder with an effective check and balance on those in *de facto* control of the corporation. Where management interests may conflict with those of shareholders, a hostile takeover bid if successful and not frustrated by the actions of management may serve to unleash increased value and remove otherwise entrenched

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[235] See *ibid.*, where it was suggested, *inter alia,* that the conflict of interest problems (the lack of independence) may have led to the failures on the part of Anderson.

[236] See *DSI, supra* note 154, statement 30, where 72% agreed (78.38% when the neutrals are excluded) that "Director liability (or potential liability) is a factor in getting people to accept a directorship".

officers and board members.[237] Management however has been able to evolve entrenchment powers from the "pacman tactics",[238] to the "scorch and burn approaches",[239] to the sophisticated poison pill defenses of the mid 1980's,[240] all of which were designed to frustrate the plans of a prospective acquirer. As well, state-sponsored legislation to constrain unfriendly takeover attempts "ostensibly in broader community interests" (but which serve to entrench management at the expense of shareholders) is a further indication of the effectiveness of management's ability to protect its interests.[241] Such proactive actions, which serve to further the interests of management at the expense of the shareholder, bespeaks of the extent of the shift in corporate power and control.

In order to address this recognized conflict, one solution would be for the courts to treat as improper all management actions taken in response to hostile takeover bids, even actions that ostensibly serve only to ensure that a company's shareholders will receive a higher price for their shares. It is postulated that if all defensive tactics were to be prohibited, "acquisition-minded" companies would search more actively and aggressively for attractive takeover targets, and managers of all companies would be forced by events to work more diligently to advance shareholders' interests in order to avoid being ousted

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[237] See generally James A. Brickley, Jeffrey L. Coles & Rory L. Terry, "Outside Directors and the Adoption of Poison Pills" (1994) 35 J. Fin. Econ. 371-390; Paul Mallette & Karen L. Fowler, "Effects of Board Composition and Stock Ownership on the Adoption of Poison Pills" (1992) 35 Academy of Management J. 1010-35 [Mallette & Fowler, "Poison Pills"]

[238] Where assets, including companies or divisions thereof, are acquired not for what are bona fide business and strategic reasons, but to attempt to thwart an unfriendly takeover by making an acquisition more expensive.

[239] Where desirable assets, divisions or subsidiaries are disposed of and the proceeds paid as a dividend to shareholders to make the target less attractive.

[240] Mallette & Fowler, "Poison Pills", *supra* note 237.

[241] Also called "shareholder rights plan", a "poison pill" is "[a]ny tactic by a company designed to avoid a *hostile takeover*. One example is the issuance of *preferred stock* that gives *shareholders* the right to *redeem* their *shares* at a *premium* after the *takeover*". See online: InvestorWords.com <http://www.investorwords.com/3727/poison_pill.html>. See also Douglas Stewart, "Tactical Shareholder Rights Plan", online: Queen's University <http://qsilver.queensu.ca/law/torys/tactical%20shareholder%20rights%20plan.pdf> for an overview that also includes key Canadian case law on the subject. See also generally John H. Matheson, "Corporate Governance at the Millenium: The Decline of the Poison Pill Antitakeover Defense" (1999) 22 Hamline L. Rev. 703.

by takeover bids.[242] One can argue with this thesis, advanced by Easterbrook and Fischel, as it ignores the impact of latent as opposed to apparent anti-takeover devices. Latent anti-takeover devices include those that can be put into place, ostensibly for commercial reasons, all as a part of the normal, day-to-day business activities of a corporation. These can include contractual rights that may be triggered or undertakings that may be terminated in the event of a change in control (such as financings becoming due, puts back to the corporation in the case of preferred equity issues and contracts with key customers that could be unilaterally cancelled by the customer, all in the event of a change in control).[243] This raises an apparent contradiction. Management, supportive of "market efficiency", argues against the need for regulatory intervention to protect the interests of shareholders. However, it does not appear to endorse the same rationale when its interests are threatened. As a result, unless management is supportive, a hostile takeover at best becomes more difficult, risky and costly to achieve; at worst, it serves to reduce or dissuade potential suitors. This may in effect force potential purchasers to negotiate with management. However, whether certain of the "self destruct type anti takeover devices" can be effectively defused may well be more a function of the degree of management's *self-interest* in introducing these hidden obstacles as opposed to seeking to maximize shareholder interests.

The position of management is further buttressed by contractual arrangements. Employment contracts, golden parachutes and other contractual rights protecting management in the event of a hostile or even a negotiated takeover may well serve to entrench the interests of management at the expense of the shareholders. As well, it may even motivate management, in certain cases, to support a takeover at what may be perceived to be the expense of the shareholders.[244] It is this factor that an effective system

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[242] See Easterbrook & Fischel, "Economic Structure", *supra* note 9; Elliott J. Weiss & Lawrence J. White, "Of Econometrics and Indeterminacy: A Study of Investors' Reactions to 'Changes' in Corporate Law" (1987) 75 Calif. L. Rev. 551.

[243] Arlen & Talley, "Precommitment and Managerial Incentives", *supra* note 121 at 577.

[244] See Keith McArthur, "Key Air Canada director O'Brien Leaves at Critical Point" *The Globe and Mail* (29 November 2003) B1, where it was reported that with respect to a proposed restructuring that was required under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36. which was the result of the stewardship of the incumbent management, potential investors (seeking to take over a financially restructured Air Canada, where shareholders and others were required to make financial sacrifices to keep

of corporate governance needs to help address. Creative solutions are required if confidence in the integrity of management and an assurance that it will act in the best interests of their constituents (as opposed to its own best interests) is to be effectively responded to and addressed.

There is a need to ensure accountability.[245] However, empirical data needs to be obtained to assist in ascertaining whether legislated actions will merely generate additional compliance costs (to ensure that the CEO and other affected officers are well protected from liability) or will assist in achieving more effective corporate governance.

5.4. LACK OF ACCOUNTABILITY TO THE SHAREHOLDERS

While it can be argued that shareholders are the owners of a corporation or, under alternative theories, that other constituents should also be served,[246] it is nevertheless significant that, under either scenario, the obligations of the directors are not to the shareholders or to the other putative constituents. It may also help to explain the lack of accountability to the shareholders. Rather, their obligations are to the reified entity, the corporation.[247] The composition, structure and makeup of the board of directors can impact the manner in which a board will react (as well as initiate action when and where required).

An assessment of the director appointment process and an appreciation of the practical limitations on their effectiveness may assist in better understanding why the loyalty of directors is not to the shareholders. Furthermore, it may help to identify more clearly the challenges that need to be addressed.

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the corporation from going bankrupt) potential investors suggested the following: "In Trinity's initial letter of intent, it proposed setting aside 10 per cent of the company's shares for management options or other similar instruments. Cerberus [a second bidder] said it would set aside at least 5 per cent, but specified that the airline's top two executives would each get 1 per cent of the shares." See also *Schneider*, *supra* note 139.

[245] Something that, *supra* note 150, appears to be trying to achieve.

[246] See Blair & Stout, "Team Production", *supra* note 98 at 264-65.

[247] See *Schneider*, *supra* note 139.

Directors of widely held, publicly listed corporations are frequently appointed for a variety of reasons, including economic (for example, to obtain access to business, financial or other required support), social (for reasons of family and friends or to meet commitments) and political (such as affiliations and connections, as well as reputation and prestige).[248] As well, reciprocity may be a factor ("I sit on your board, you sit on mine")[249] or it may constitute a form of perceived acquired right (a representative of your firm has always been appointed to this board). Therefore, competence (that is, ensuring that board members will take the time to really understand the issues and to make a meaningful contribution) is not necessarily nor always the driving force.[250] That is not to suggest that competence is not a factor; rather, considerations that have traditionally led to individuals being appointed to boards often met parochial interests rather than corporate ones. The lack of commitment to the interests of an unknown group (the shareholders who are usually widely dispersed) can also be a factor. As well, available time is a consideration, as for many, being a director is usually viewed as a part-time, "prestigious and networking position", especially for CEOs who have corporations of their own to run. As a result, the time and effort allocated to the task can be commensurate with one's perspective of one's role and available time.[251]

Cooperation and support of management avoids potential conflicts; disagreements with management entail more work, effort, stress and time. Since for directors who are also busy executives time is at a premium, a board would tend to lean in the direction of supporting the CEO (and his/her direct reports)[252] or replacing them (once there is a loss of confidence), thus minimizing time and effort requirements. As well, directors'

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[248] 95.3% of the DSI interviewees (97.54% when excluding the neutrals) confirmed in statement 27 that "[p]restige is a key factor in the acceptance of some directorial positions". *DSI*, *supra* note 154, statement 27.

[249] See *ibid.*, statement 41. This appears to be falling into disfavour as only 25% (28.57% when the neutrals were excluded) supported permitting the continuance of cross board relationships.

[250] See *ibid.*, statement 26, which indicates that only 36.6% (43.9% when the neutrals were excluded), believed that directors "generally spend the time required to really understand the issues" and to make a meaningful contribution", both of which go to the competence in the performance of their roles.

[251] It was pointed out frequently in comments during the DSI that this is changing.

[252] See *DSI*, *supra* note 154, statement 21, where all believed that the board of directors is generally supportive of the CEO.

compensation, although increasing,[253] is still generally insignificant relative to the obligations that directorships could and should entail. Where the foregoing is or continues to be true (that is, directors are paid rather modestly, although the amounts are increasing), one can only assume that compensation is not a key attraction[254] in getting people to sit on such boards.

Being able to participate effectively requires knowledge and information, most of which (even when it comes from outside advisors, including auditors, legal counsel and investment advisors) is controlled by the CEO and management; in this case, the *funneling syndrome* applies. Furthermore, given the complexity of issues facing international corporations, many directors lack the background to deal with these issues. As a result, by default they are generally captive to information prepared by staff, often with the assistance of outside experts and advisors who help advance the position of management. As well, the time available at board meetings to address and discuss important issues is usually controlled by the chairman of the board and is generally measured in terms of hours, not days. Given the many other issues on an agenda, time is generally a luxury. Consistent with time pressures that many still active in business face, it is not an uncommon practice to see directors (who are still actively employed) miss participating in unscheduled (*ad hoc*, quickly called) meetings or leave scheduled meetings before all business on an agenda has been addressed, given their demanding personal schedules and flight arrangements (when they do participate in person).[255] Barring specific expertise on the part of a director, access to independent advice and the availability of time, board members are generally inclined to follow, without vigorous discussion or debate, the recommendations of management. Furthermore, to the extent that a director is a CEO of another commercial enterprise, his views, sympathy and predisposition will naturally (all other things being equal) be supportive of the position of management (a view based on anecdotal experience, but not necessarily negative). In addition, it is important to recognize the role played by a CEO in the director selection

[253] Based on discussions with, and information obtained from, compensation consultants.
[254] See *DSI*, *supra* note 154, statement 28, where only 19.5% (21.62% where the neutrals were deleted) believed that "director compensation was a key factor in directors staying on a board".

and retention process[256] (notwithstanding that they must generally still be "elected" at the Annual General Meeting (AGM) by the shareholders (a matter usually of form as the slate in a corporation is almost universally elected). Strong CEOs play a proactive role in the selection and retention process (and can initiate or help engineer the removal of directors). Therefore, a director who continually challenges the positions advanced by management (other things being equal) may, as has been suggested in the course of the *DSI*, be viewed as an "outcast" and find his/her days on the board of directors numbered. The foregoing is often coupled with the fact that directors receive the information package at the last moment with the need for a quick decision. It is therefore no surprise that the outcome of such a process, if blindly accepted by a board of directors, must be reactive and the conclusions reached generally preordained.

While "independent directors" were recommended by the TSX[257] and are being advanced by the OSC (they are a proffered solution to help address the lack of effective governance), the application of the TSX directive was discretionary. It was not legally mandated and was thus subjected to all the limitations associated with "guidelines". Furthermore, it is still far from clear that independent directorships in and of themselves will help ensure that the interests of shareholders (or the other constituents) will be better protected. This in part is due to the fact that politics, as in most aspects of life, play a role in the life of directors. Those who support management will find that they are dealt with differently than directors who tend to challenge them. Furthermore, benefits can flow from sitting on a board of directors; directors are not precluded from dealing with the company on whose board they sit (although this would appear to be decreasing and is increasingly being frowned upon[258]). As a result, directors may sometimes benefit directly (by work being given to them or their firm) or more importantly, indirectly (by

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[255] This is based on anecdotal data and observations made over a period of thirty years.

[256] 83.3% of DSI respondents confirmed statement 18 and were of the view that the CEO played a pivotal role in the appointment of new directors. However, only 71.8% (or 75.66% when excluding the neutrals), supported DSI statement 19 that the CEO played a pivotal role in the removal of directors. See *DSI*, *supra* note 154, statement 18.

[257] See *Dey Report*, *supra* note 14, ¶¶ 5.7-5.8.

[258] According to *DSI*, *supra* note 154, statement 40, that directors should be allowed to engage in consulting or other activities with the corporation on whose board they sit, was only supported by 19.5% (21.04% when the neutrals were excluded).

being introduced to others and networking with individuals and corporate leaders who can use them, their services, their firm or their products) often quite legitimately in what can be a win/win scenario. This may help to rationalize the historically low level of director compensation, especially for CEOs of corporations, where sitting on a board of directors was (and still is) perceived to be more of a development and networking experience for CEOs than a way to augment one's compensation.[259] As well, the relatively low level of director compensation appeared to confirm that little was expected from that office. Quite often, accepting a directorship of a corporation was more a function of prestige, networking and looking for opportunities, personal as well as business, than a way to protect the interests of shareholders and potential investors. For some directors, being on a board of certain corporations was recognition that "you had arrived".[260] You were being "recognized by your peers" and the loss of the board seat would be ill perceived. In such instances, unless a threat to a director's *self-interest*, the corporation's interests would become secondary.

As well, the proxy process appears in fact to be controlled by management.[261] Barring a very strong, non-executive, independent chairman of the board and/or an equally capable board of directors, the president and CEO can in fact directly, overtly or surreptitiously manage if not seek to control who is "elected" to the board of directors.[262]

In dealing with director elections (notwithstanding the formalities whereby shareholders confirm the "management slate"), there is a lack of direct linkage back to the shareholders of a corporation. Rather, such shareholders appear to be more akin to an

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[259] Fees paid to officers of a corporation for sitting on boards of other corporations must sometimes be remitted to the corporation that employs them (and is not to be retained by the individual). Whether or not this is generally the case, there appears to be a broad consensus that amounts received as director's fees were historically not the key factor in the rationale for agreeing to sit on the board of directors of a corporation.

[260] All those who responded to statement 27 in the DSI agreed that prestige was a key factor in the acceptance of some board positions. Clearly, at least directorships in Canada's largest widely held publicly traded corporations (such as those in banking, communications, transport or insurance) fell within that ambit, and the loss of a board seat was to be avoided as it resulted in a concomitant loss of the related prestige.

[261] 92.7% of those interviewed agreed to DSI statement 86 that proxy solicitation is very much a tool of management. *DSI*, *supra* note 154, statement 86.

absentee landlord than the owner of a business. Their "proxies", if exercised at all, are generally signed over to management, so that the outcome of voting at an annual general meeting of shareholders is usually a foregone conclusion. The directors face relatively few shareholders (other than institutional investors or vested interests groups). Such a meeting is generally a staged event, organized and orchestrated by management with very little substantive as opposed to procedural value. Such a meeting, barring exceptional circumstances such as a contested takeover bid, is generally devoid of any real substance. As a result, the lack of perceived and factual accountability to the general body of shareholders come as no surprise. Even at the annual general meeting of shareholders, the role of the directors (other than the chairman of the board, who chairs the meeting) is usually limited to being asked to stand up and be recognized, either when being thanked for their work or upon being re-elected (usually a foregone conclusion). Directors are expected to "mingle briefly with shareholders" before being called to a "board meeting" where "formalities are dealt with" in a process-oriented as opposed to substantive manner. The annual general meeting also provides management with an opportunity to meet with the press and to tell its corporate story. The conundrum that one therefore faces is how to attempt to make the directors more accountable to their constituents at large in a manner that is meaningful, effective and not a bureaucratic nightmare.[263]

5.5. CONCLUSION

Barring exceptional circumstances that require proactive action on the part of a board of directors (such as ongoing, unacceptable earnings inconsistent with the performance of business peers, dishonesty, manifest shareholder discontent, unrest and media attention) and notwithstanding putative checks and balances, the CEO rather than the board of directors is generally the source of proactive control. This is reinforced by positions taken by the CEO with the board, as competence on the part of the CEO (who acts as the focal point of the executive team), absent a loss of confidence in a CEO, is generally taken as a given. Boards of directors support and align with the CEO; this was clearly put in the *DSI* by one interviewee, a board member, who noted that until a decision is made to change a

[262] However, the interviewees suggested that this is changing.

CEO (as he (she) has lost the confidence of the board), the CEO "has our full confidence and support". Blind support for a CEO (although it was suggested by interviewees that this was changing) can be rationalized by a number of considerations relating to the complications and efforts required to disengage a CEO. These can include disclosure implications, the financial cost (given the common practice of having a pre-existing employment contract designed to protect the interests of the CEO), the disruptive factor, the uncertainty associated with any new hire and the potential impact on the price of the stock of the corporation that an unplanned departure may engender. These factors all help to explain the inertia that operates to avoid seeking to dislodge a CEO, absent external events that may require a board of directors to react.[264] These hurdles provide a CEO with reasonably broad latitude in the manner in which a corporation is managed. They encourage a CEO, and appropriately so, as long as the interests of the CEO and the corporation are properly aligned, not only to lead the corporation but also to be proactive and to seek to take and to be in control. As long as a CEO manages to meet a board of directors' minimum expectations, and barring external pressures forcing a board of directors to react, a CEO is generally the prime, if not the sole, source of proactive corporate action and in control of the activities of the corporation. To the extent that such a position does not lead to conflicts of interests (that is, the sacrifice of shareholder interests for the benefit of the CEO and his/her direct reports), such a proactive CEO role can work for the benefit of all.[265]

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[263] That challenge is addressed in Chapter 9, below.

[264] See McGeehan, *supra* note 145, recounting the actions of the Board of Directors put into place by Lord Black once its members were subjected to external pressure, as a case in point.

[265] As one respondent to the McGill Faculty of Law *PS* noted, "[m]any CEOs and management treat public companies as if they were their own private corporation." (17 February 2004) Lawyer 35-44, partner in a law firm.

Chapter 6

The Funneling Syndrome and Self-interest

6.1. INTRODUCTION

CIA[266] on the part of those who are responsible for the affairs of a corporation (both directors and officers) are, it is postulated, at the core of rebuilding investor confidence. To increase the likelihood that this can be achieved, two pre-conditions must be considered and addressed: one procedural and the other substantive. Each will be dealt with in this chapter.

6.2. PROCEDURAL

The *funneling syndrome* is an explicit recognition of an implicit reality of corporate life. All material information as it ascends to the highest level of authority for decision-making purposes within a corporation is funneled through and controlled by the CEO (or the chairman and CEO where these functions are still combined) or his (her) delegate. The result is that very little material information ever proceeds to the board of directors unless and until it is "cleared by or on behalf of the CEO". This is also generally true not only of internally generated information but also of externally sourced information and advice provided to the corporation. External consultants and advisors are generally subjected to pressures, both explicit and subliminal, to align with management. As a result, all information and advice going to the final decision makers through or on behalf

[266] Competence is not merely a function of institutionalized education; it can also be a product of experience, including in-depth knowledge of key customers, how they operate or other factors that can assist a corporation in succeeding. While complementary educational programs may add value, establishing "competency exams" as a pre-condition to being capable of serving on a board of directors may work to disenfranchise otherwise qualified and valuable board members. Caution should be exercised to ensure that members are not bypassed or rejected as a result of bureaucracy and structure. Being legally obligated to clearly describe the board member selection process as well as the attributes of the individual director and the reasons that he (she) had been selected, may do more to ensure that qualified directors are elected, than merely introducing additional, purely bureaucratic as opposed tomore meaningful, checks and balances.

of management, to assist a board of directors in reaching informed and reasoned decisions is filtered.[267]

The *funneling syndrome* can have both a positive and a negative connotation. It can be positive in the sense that all material information will have been reviewed by or on behalf of the CEO, which should help ensure that the data provided is accurate, complete and properly in context. It can also be negative in that a lack of alternative, independent information going to the board of directors facilitates abuse. Factual information can be filtered to remove or downplay negative factors and thereby to distort the message portrayed by the information. Factual information can be slanted to support a position, but still be founded on truth. Unless a process can be developed to circumvent the *funneling syndrome,* even competent directors with integrity will be unable to ensure effective corporate governance.[268] Barring dealing more proactively with this challenge, directors, regulators and the efficiency of the market will all be captive to the "controlled" information flowing through or from the corporation; at best, they will only be able to react to receiving misinformation on an *ex post facto* basis.

6.3. SUBSTANTIVE

The substantive issue raised by the *funneling syndrome* centers on how to address the challenges that it raises. For those who do not, or convince themselves that they seek not to "abuse the system" (which will be true of most business executives), the only

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[267] This was, in effect, confirmed by Ron Osborne, who in dealing with the alleged "nuclear mess" that led to his sacking as president of Ontario Hydro was quoted as saying: "Any board is as good as the information it gets. If I were a board member of OPG, I wouldn't have done anything else". It would appear that Ron Osborne was suggesting that the board was not to blame as it was captive to the information provided by management, and that had he been a member of the board of directors, he would have acted no differently than the board. See Richard Mackie, "Axe Falls in Nuclear 'Mess'" *The Globe and Mail* (5 December 2003) A1. See also Holston, *supra* note 148, who reported that in response to suggestions that the two former board members (Messrs Disney and Gold), who were now very critical of Mr. Eisner, "voted to approve and in some cases championed the very business decisions that they now condemn". In a rebuttal letter, Messrs Disney and Gold said that "*they agreed to the investment based on faulty financial projections from management*" [emphasis added], another reported example of the *funneling syndrome.* See also Hamilton & Mulligan, *supra* 155, where it was alleged that "[w]hen a law firm hired to advise the board's compensation committee questioned Grasso's [the Chairman and CEO] pay, it was simply cut out of the process".

[268] Janet McFarland, "OPG Directors Had Talent, Sadly the Wrong Kind" *The Globe and Mail* (17 December 2003) B2; Holston, *ibid.*

substantive issue associated with additional checks and balances may be added administrative costs (that is, the cost of the increased bureaucracy). However, assuming that new requirements are focused on those that would not "voluntarily comply", then required changes must be "mandatory" as opposed to being dependant on voluntarily imposed compliance. This therefore suggests (unlike the positions advocated by the TSX Reports in Canada[269] and the Higgs Report in the United Kingdom[270]) a statutory basis for attempting to deal with this matter.

Those with a statutory foundation for their actions include the board of directors, shareholders, external auditors and the regulators. Under the Canada Business Corporations Act, a board of directors has the statutory right and obligation to manage or supervise the management of the business and affairs of a corporation.[271] However, a divergence of views exists as to how this role should be executed.

The first perspective suggests that the board of directors and management should operate in a collegial manner with the board working with, advising and counseling management. Unless there is a crisis or a lack of confidence in a CEO and termination is being contemplated, the board of directors would be expected to be supportive of management.[272] The role of the board in taking corrective action and challenging the *funneling syndrome* would be *ex post* as opposed to *ex ante*. They would therefore only seek to intervene on an after-the-fact basis, once a problem has arisen, as they would otherwise have little reason to engage in challenging what is being proffered by management. Obtaining access to "independent" or "unfiltered" information or data would be inconsistent with the collegial approach. It has been suggested in the *DSI* that circumventing management to obtain "independent" information is not effective as it creates friction and ups the ante for hiding and withholding information. It has been further argued that in a non-collegial atmosphere, management could view the sharing of

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[269] See *Fleming Report*, *supra* note 14; *Allen Report*, *supra* note 14; *Dey Report*, *supra* note 14; "Saucier Report", *supra* note 14.
[270] See *Higgs Report*, *supra* note 151.
[271] *CBCA*, *supra* note 37, s. 102.
[272] Myles L. Mace, *Directors: Myth and Reality* (Boston: Harvard Business School Press, 1971).

information in a transparent manner as inimical to their *self-interests,* that transparency on the part of management could lead to what they perceive to be punishment and that management would therefore seek to hide, as opposed to share, information. It was therefore suggested by advocates of the collegial approach that "bypassing management" to access information would create conflict. They further noted that if independently sourced information or advice received by the board of directors differed from that presented by management, a resolution of the inconsistency would be required. This could serve to put management and the board of directors at odds, create conflict and raise questions as to "who really runs the corporation", management or the board of directors?

Recognition must be given to the practical issues associated with abandoning the traditional cooperative collegial approach for a potentially more adversarial structure, which may be termed "constructive tension". Cooperation and acquiescence are much easier and less time-consuming than engaging in the independent accessing of information and/or challenging management (either offline, outside the forum of the board meeting or, in the absence of sufficient lead time to do so, at the meeting itself).[273] Furthermore, where management is challenged, confronted and remains, it is to be noted that life for the director in question (or the involved directors) may become more difficult and uncomfortable. Such change however will generally be subtle and covert as opposed to being direct and overt (and in some cases can be, and will be rationalized, as being consistent with human nature). For example, a CEO who previously was "always available" could, having encountered constructive criticism from an individual director at a board meeting, become more difficult for that director to access. Detailed information (outside of what is provided to all members of the board of directors) may become more challenging to obtain in a timely manner. At best, the added difficulty in accessing information would be attributable to the positive application of the *funneling syndrome,* which would operate to ensure that no information is provided before it is cleared,

[273] For a discussion of how management in effect controls information, see Jensen, *supra* note 34. It has also been suggested in the interviews that circumventing the funneling syndrome will not work as it creates a perception of punishment which is disproportionate, unilateral and not subject to appeal.

understood and all the potential "pitfalls" have been addressed by the CEO. At worst, such a reaction would be to prevent providing "ammunition" that the CEO may perceive could be used to frustrate his (her) achieving a desired objective or could be used to "attack" him (her). As well, a failure to play by the collegial rules of the game could, given the networking that takes place amongst CEOs of corporations,[274] result in word getting out that "this director" is a "difficult individual", which could impact his (her) directorial and other prospects.

Given the power and control of the CEO (and even more so if the CEO also happens to be the chairman of the board of directors), challenging management in general and the CEO in particular is therefore rarely consistent with the "*self-interests* of a director".[275] Rather, acquiescence and acceptance of the *funneling syndrome* is both easiest in practice and most conducive to preserving, if not enhancing, one's own position. This will help to explain (which has been experienced by many board members[276]) why directors often agree "offline" (after the board meeting and outside earshot of management) with a position taken by an individual board member on an issue, critical of or challenging management, but will remain silent, if not supportive, of management at the board meeting itself. Accordingly, unless forced to do so by events that can threaten the *self-interests* of the directors in question, such as being required to react *ex post,* once the damage has been done and no alternatives are available, there is little incentive to the

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[274] See e.g. online: Canadian Council for Chief Executives <http://www.ceocouncil.ca>, composed of the CEOs of Canada's leading corporations. According to the site, "its member chief executives head companies that administer in excess of $2.3 trillion in assets, have annual revenues of more than $550 billion, and account for a significant majority of Canada's private sector investment, exports, training and research and development".

[275] An example cited in one interview involved a director who took copious notes. Each time the President and CEO was inconsistent with what he had previously stated, the director in question, referring to the notes, would challenge the President. While the President was eventually terminated by a unanimous decision of the board of directors, the director who had effectively monitored the President (and who was proven to be right) nevertheless did not receive any acknowledgement for the proactive role played; instead, the life of this director was never made easy.

[276] It has been confirmed in the interviews that were conducted as well.

average director to circumvent the *funneling syndrome*. As a result, directors tend to be reactive as opposed to proactive.[277]

As well, positions advanced by management, supported by internal and external advisors on whom directors are by statute authorized to rely,[278] serve to insulate directors from potential liability given the *business judgment rule.* Furthermore, directors are usually indemnified and insured at the expense of the corporation.[279] Legislative incursions have also been made to further insulate directors from accountability to shareholders and the corporation (other than for breaches of their duty of loyalty). Legislation has been introduced in certain US states seeking to reduce or eliminate directors' personal liability to a corporation or its stockholders for breach of their fiduciary duty of care.[280] While the foregoing may appear radical, it should be recognized that given the *business judgment rule,* insurance and the due diligence defenses[281] that are available to directors (as well as the indemnification of directors that is a prevalent practice of corporations), shareholders of a corporation effectively pay for the costs of lawsuits and any judicial awards when the directors of a corporation are sued (whether or not the suit is successful). This would suggest that director or officer accountability, a key element of effective corporate governance, is in practice often more theoretical than real.[282]

Having focused on the challenges posed by the *self-interests* of those in control and managing a corporation, the matters previously raised will be re-examined. The objective will be to endeavor to ascertain if they can be better appreciated in light of the *funneling syndrome.* Such a review will include a re-examination of issues relating to the control of the proxy machinery by management; the treatment of takeover bids, including staggered

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[277] *DSI*, *supra* note 154, statement 24: "Directors are generally proactive" was only supported by 7.30% (7.87% when the neutrals were excluded). *Ibid.*, statement 25: "Directors are generally reactive" was supported by 88.40% (92.66% when the neutrals were excluded).

[278] See *Wise*, *supra* note 152.

[279] *CBCA*, *supra* note 37, s. 124.

[280] See generally Victor Peterson & Alison N. Zirn, "Corporate Drectors, LLC's and liability. Its not settled but caution is advised" (2003) 12:6 Bus. L. Today, online: <http://www.abanet.org/buslaw/blt/2003-07-08/Peterson.html>.

[281] See *Bill 198*, *supra* note 150.

[282] This will be addressed in Chapter 9, below.

boards and poison pills; enabling as opposed to constraining corporate charters, including blank check authority to issue shares and multiple voting; the current role of the auditor; and shareholder rights.

6.4. SEEKING TO ADDRESS CORPORATE GOVERNANCE ISSUES IN LIGHT OF THE FUNNELING SYNDROME

6.4.1. Introduction

The 1985 decision of the Delaware court in *Smith* v. *Van Gorkom*[283] appeared to recognize implicitly (although not explicitly) the challenges created by the *funneling syndrome*. "Informed business judgment" appeared to be required for directors to meet the burden under the *business judgment rule.* Merely relying on management, without due diligence, notwithstanding the credentials of the directors in question, was deemed to be insufficient to discharge the burden required of a director in the fulfillment of his (her) duties. While this may have been viewed as a laudable step forward on the road towards more responsible corporate governance, experience may well challenge that assumption. A sufficiently documented trail of expert counsel, often prepared with the advice and assistance of external advisors "retained by the corporation" (legal, investment and accounting advice, to name but three) to be able to demonstrate that the decisions of the board of directors were supported by professional advice often appears in practice to be what constitutes "due diligence" and "informed business judgment". The counsel received is often based on assumptions, the sources of which are usually management. Unless independently assessed and challenged, the value of such advice may often be suspect. It can result in being little more than an expensive number-crunching exercise, as the core of the propriety of the support for the actions to be taken should be the validity of the assumptions and not the mathematical accuracy of the output flowing from the exercise. The result of the Van Gorkom decision has been that a laudable objective (of attempting to provide a check and balance on what in effect is the *funneling syndrome*),

[283] See *Van Gorkom, supra* note 71.

which it is posited is as necessary as it is difficult, now often results in bureaucratic defensive file building.[284]

The result should not be surprising. The interests of retained experts are, and will almost always continue to be, to meet the needs of those who are paying for their services. Today, barring truly exceptional circumstances, it is management who makes the decisions and authorizes payments for those services,[285] not the diffused group of shareholders with whom consultants and advisors have no real contact or relationship, nor the board of directors with whom they generally have relatively little interaction (other than to support the final proposal that has been vetted and is almost always introduced and positioned, if not also presented, by management). "Effective directors" need to find a meaningful way to resolve *the weaknesses raised by the funneling syndrome;*[286] that continues to be the challenge and a valid quest in the search for a means of helping to achieve more effective corporate governance.

6.4.2. Control of the Proxy Machinery

Management control of the proxy machinery has been recognized as an issue, at least since the writings of Berle and Means.[287] Such management control has been referred to as a system of managerial capitalism.[288] It should be recognized that the contemporary proxy process, barring hostile intervention (such as in a contest for corporate control), is by or on behalf of management. The transfer agent that counts the votes is appointed by and reports back to management. Proxies may be solicited by or on behalf of the board of

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[284] A case in point is the engagement letter, drafted by legal counsel on behalf of external auditors that appear to be structured to constrain liability. A detailed study of the terms of the letter(s) of engagement is beyond the scope of this thesis. However, since shareholders are being asked to confirm the appointment of the external auditors, perhaps the terms of such proposed engagement should be subjected to public scrutiny, a matter that deserves further consideration.

[285] During the DSI, one lawyer advised that when employed as "independent counsel" by an "independent committee of a board of directors" the lawyer required that a retainer be paid to cover the fees, in advance, so that advice could be given, unconstrained by billing and payment concerns (considerations) during the completion of the mandate.

[286] [Emphasis added].

[287] See Berle & Means, *supra* 2 at 129, where they noted: "The proxy machinery has thus become one of the principle instruments not by which a stockholder exercises power over the management of the enterprise, but by which his power is separated from him".

[288] See Matheson, *supra* note 241.

directors and management of the corporation, by the corporation and its affiliate(s) or by an agent, usually a corporation.[289] All costs of solicitation (on behalf of management and the board of directors) are borne by the corporation. More importantly, in the period leading up to an annual general meeting, management receives feedback as to contentious issues, if there are any, and once the proxy material has been sent out, votes are tallied and the count is reported to the management of the corporation, often on a daily basis.

While voting is "confidential", in practice confidentiality has no significant effect on voting outcomes.[290] As well, two issues related to voting should be recognized. The first is that management is well aware, prior to the vote, of its likely outcome. Under such circumstances, management has the ability to negotiate informally, to seek support for its position, both before the proxy has been prepared and, if required, once it has been mailed out. Furthermore, knowledge of the monitoring capability of management can also impact voting on a controversial issue, as it is recognized that relationships can suffer (as can future sources of revenues) if institutional investors are known to have voted against the position of the corporation. Second, confidential voting innate to any democratic system was not voluntarily adopted in Canada. Its introduction reflected a precatory initiative by institutional investors and a negotiated settlement with major corporations (after having been discussed for a number of years) to avoid it being submitted as a shareholder proposal.

Confidential voting was (and is) a potential challenge to the *funneling syndrome.* Depending on the mode of implementation, management control over the decision-making process can be negatively impacted. However, the negotiated acceptance of confidential voting in Canada has preserved the essence of the *funneling syndrome.* Management agreed to institute confidential voting. However, when access to the proxies is required for "legal purposes" (a matter that management would decide, as no

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[289] See e.g. online: Georgeson Shareholder Communications Canada Inc. <http://www.georgesonshareholder.com/index2.asp?f=1>.

[290] See Roberta Romano, *Does Confidential Proxy Voting Matter?* (2002), [unpublished working paper, archived at Berkeley Center for Law Business and the Economy], online: <http://www.law.berkeley.edu/institutes/law_econ/workingpapers/PDFpapers/Romano-f02.pdf>.

alternative mechanism is offered as to how that would be independently dealt with) management has access to the information. As well, companies engaged to do the solicitation continue to be under the control of and paid by management. As a result, it has not unduly constrained the ability of management to control the process, and the *funneling syndrome* continues to apply. The current structure of confidential voting and its affected changes are not perceived to have had any significant impact on voting *per se*.[291]

Notwithstanding certain minor changes that have been introduced, the reality is that the proxy process still places the democratic machinery of the corporate governance process squarely within the control of management and the board of directors. The selection of the "slate" (that is, directors put forward for the shareholders to support) is in fact and in law controlled by the board of directors (subject to the previously noted impact of the CEO). A detailed review is beyond the scope of this dissertation. However, it is revealing to note that many of the deficiencies noted seventy years ago continue to constrain the democratic process.[292] Unless the *funneling syndrome* is addressed and a majority of truly independent directors are elected[293] by the shareholders (which for all practical intents and purposes could be viewed as a "hostile takeover attempt), merely electing one or two "independent directors" through the existing proxy process, while personally gratifying to some, will not serve to address the basic challenges that serve to weaken our current system of corporate governance.

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[291] Romano, *ibid.*; Bernard S. Black, "Shareholder Passivity Reexamined" (1990) 89 Mich. L. Rev. 520.
[292] See generally Berle & Means, *supra* note 2.
[293] Independent in thought and action (qualitative factors), as opposed to meeting prescribed rules (quantitative factors) as appeared to be the case in the makeup of the Enron board. See Gillan & Martin, "Enron", *supra* note 234. See also generally Roberta S Karmel, "American Law Institute's Corporate Governance Project: Independent Directors: The Independent Corporate Board: A Means to What End?" (1984) 52 Geo. Wash. L. Rev. 534.

6.5. TAKEOVER BIDS, INCLUDING POISON PILLS, STAGGERED BOARDS, SUPER MAJORITY "FAIR PRICE" PROVISIONS, TAKEOVER STATUTES AND NON-STOCKHOLDER CONSTITUENCY LAWS, MULTIPLE VOTING SHARES

Takeover bids are being focused on from the perspective of how they can serve as a tool for more effective corporate governance,[294] to assist shareholders in maximizing the value of their investment and in minimizing agency costs. Takeover bids, being market driven, are consistent with the efficient market theory. If one accepts the thesis of the efficiency of the market,[295] then one should accept the right of any and all shareholders to determine how they wish to deal with their investment (including by disposition). In an efficient market (unconstrained by the *funneling syndrome*), maximizing the monetization of investments should not be artificially constrained. One approach (that of the "property modelists")[296] postulates that the shareholders should retain the ability to accept or reject an offer for their shares (which, barring a takeover bid, shareholders are not prevented from doing every day on an individual basis in the supposedly efficient market). The board of directors, under this approach, should not be permitted to frustrate the ability of the shareholders to deal with their property (their shares) as they deem it to be most appropriate. In contrast to the foregoing approach, there are those who argue that the board of directors should have the primary decision-making role (the "entity modelists"[297]). Advocates of this school of thought argue that when boards of directors make reasoned decisions in good faith that a takeover bid is not in the long-term best interests of the corporation, the decision of the board of directors should prevail.

Where a corporation is operating in an optimum manner, all other things being equal, a rational buyer seeking to acquire control of the corporation in question should not pay

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[294] Frank H. Easterbrook & Daniel R. Fischel, "Limited Liability in the corporation" (1985) 52 U. Chicago L. Rev. 89 at 98, where they note that a takeover could act to stimulate management to perform effectively and increase share price failing which they could risk being displaced.
[295] See Chapter 2, Section 2.2.1., above.
[296] See William T. Allen *et al.*, "Symposium: Management and Control of the Modern Business corporation: Corporate Control Locations: The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide" (2002) 69 U. Chi. L. Rev. 1067 at 1075.
[297] *Ibid.* at 1076.

more than market price for the shares of the corporation (assuming that one accepts the efficient market thesis). Unless the potential purchaser has discovered how to improve the profitability of the corporation, in ways unavailable or unknown to the incumbent management, and thereby such potential justifies paying a premium over current market prices for the corporation's shares, or unless (given the *funneling syndrome*) material information has not been shared with the market, the "efficient market thesis"[298] would suggest that the shares at market are "fairly priced". Alternatively, paying more than market would be rational if the market in question were not as efficient (at least in the short term) as economists would have one believe or if it were subject to non-economic factors or erroneous assumptions that motivated a purchaser's actions. Value would therefore appear to be subjective, subject to both quantitative and qualitative factors.

While there is a divergence of views as to how this matter should be addressed,[299] the entity modelists approach, which is reflective of the position of incumbent management, appears to generally prevail. Poison pills, staggered boards, super majority "fair price" provisions, takeover statutes and non-stockholder constituency laws, as well as multiple voting shares and latent anti-takeover devices, are all within the arsenal of those purporting to protect the interests of their constituents, the shareholders, often whether or not that reflects the desires of those on whose behalf they purport to act. A detailed taxonomy of anti-takeover devices and an examination thereof is beyond the scope of this thesis. Nevertheless, it is worth noting that constraints on the rights of shareholders to dispose of their shares would appear to be rationalized and defended when the interests of management conflict with those of shareholders. Public interest (as interpreted by

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[298] See Chapter 2, Section 2.2.1, above.

[299] See Lucian Arye Bebchuk, "The Case for Facilitating Competing Tender Offers" (1982) 95 Harv. L. Rev. 1028 [Bebchuk, "Case for Facilitating"]; Bebchuk *et al.* "Powerful Antitakeover: Further Findings", *supra* note 233; John C. Coffee, Jr., "Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance" (1984) 84 Colum. L. Rev. 1145; Frank H. Easterbrook & Daniel R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harv. L. Rev. 1161 [Easterbrook & Fischel, "Proper Role"]; Ronald J. Gilson, "A Structural Approach to corporations: The Case against Defensive Tactics in Tender Offers" (1981) 33 Stan. L. Rev. 819 [Gilson, "Structural Approach"]; Ronald J. Gilson, "Lipton and Rowe's Apologia for Delaware: A Short Reply" (2001), Working Paper No. 197, online: Columbia Law School – The Center for Law and Economic Studies <http://www2.law.columbia.edu/law-economicstudies/papers/wp197.pdf>; Martin Lipton, "Pills, Polls, and Professors Redux" (2002) 69 U. Chi. L. Rev. 1037.

management) appears to override real private interests (the ownership rights of the shareholders) and the integrity of the process can legitimately be questioned. It would appear to be a tautology if shareholders are allowed to sell into the market at market prices (and are not constrained from doing so on an individual basis) that they should be allowed to do so as a collectivity at a premium, should they wish to do so.

Bidders for corporate control, motivated by their personal economic interests, can therefore assist in acting as monitors if all defensive tactics are prohibited.[300] Such "acquisition-minded" individuals and companies will search more proactively for attractive takeover targets if they have the economic incentives *(self-interest)* to do so. To assist in the optimization of such intervention and thus enable existing shareholders to maximize their returns, (either from incumbent management or by selling out to new management in a takeover), management restrictions and other impediments to takeovers must be capable of being removed by the actions of the owners (the shareholders). To be meaningful to potential purchasers, takeover bids must be capable of being addressed and resolved in a timely and relatively risk-free manner. If such actions are less likely to be frustrated by those in office (whose conflict of interest should be recognized and addressed), it should increase the likelihood that inefficiently run corporations will be subject to the checks and balances of potential takeovers. The impartiality of shareholders in responding to potential takeovers would generally be greater than that of officers and board members who suffer from an innate conflict (including the prospect of being replaced in the event of a successful takeover). To ask management to support a takeover that may not be in its best interests is to fail to recognize the impact of *self-interest.*

Other devices that serve to frustrate takeovers also need to be reassessed and re-evaluated. For example, the use of greenmail[301] or the adoption of poison pills[302] by

[300] See Eeasterbrook & Fischel, *supra* note 9.

[301] "Greenmail" occurs when a potential purchaser of a corporation is effectively "bought off" using corporate assets. See generally Andrei Shleifer & Robert W Vishney, "Greenmail, White Knights, and Shareholder's Interests" (1986) 17 Rand J. Econ. 293-309.

[302] A poison pill is a defensive measure whereby the acquisition of more than a defined number of shares in contemplation of a potential takeover, without the support of management (that is, ostensibly, the board of directors) results in the automatic implementation of actions such as the issuance of additional voting

management questions the integrity of those in control. Nevertheless, such action can be rationalized on the grounds that the board of directors has been given the mandate to act on behalf of the shareholders, and shareholders cannot be trusted, nor should they be permitted to get involved in the day-to-day activities of their corporation.[303] However, such actions, formulated as being taken to prevent shareholders from getting involved in the management of the internal affairs of a corporation, would appear primarily in "pith and substance" to prevent shareholders from deciding what to do with their investment (the shares that they own) and only secondarily as a byproduct of a decision by the "new shareholders" to impact the future of the management of the corporation. The practical result appears to be that shareholders are being deprived of their right to dispose of their property, their shares, at an offered price and when that is the case, are being held captive by the incumbent management. Continued legislative regulatory oversight and more proactive and timely intervention at the request of a potential purchaser may continue to be required[304] to deal with this conundrum.

6.6. ROLE OF THE EXTERNAL AUDITOR (SHAREHOLDERS' AUDITOR)

"So long as accounting standards are not hardened, and the law does not impose any specific canons, directors and their accountants may frame their figures, within limits, much as they choose".[305] This challenge, noted in 1932, is not only of historical importance but is a contemporary issue as well. For example, the *Economist* noted that "accounting rules ... offer plenty of opportunity for manipulation" and that "the growing use of derivatives and off-balance-sheet financing and the rising importance of intangible assets such as brands and goodwill have all posed challenges to traditional accounting, none of which has been resolved entirely satisfactorily".[306] Furthermore, *Business Week*

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shares to all current shareholders, other than to the party seeking control, which effectively operates to considerably lessen the chance of a takeover. See Mallette & Fowler, "Poison Pills", *supra* note 237.

[303] See *Schneider*, *supra* note 139 at 190-92, where the Court noted: "It must be recognized that the directors are not agents of the shareholders. The directors have the absolute power to manage the affairs of the company".

[304] For an example of a particularly debated shareholder rights plan, see *Re Cara Operations Limited and The Second Cup Ltd.* (9 January 2002), online: OSC <http://www.osc.gov.on.ca/en/Regulation/Orders/2002/ord_20020109_cara-2ndcup.htm>.

[305] Berle & Means, *supra* note 2 at 182.

[306] "Think of a Number" *The Economist* 367:8380 (2 May 2002) 19 at 19-20 (ProQuest).

noted "an alarming erosion in the honesty and reliability of financial information about companies".[307]

Thus, the pivotal role of this key gatekeeper (the external auditor), the one structured to be "independent" with access to source documents and the ability to act not only as a watchdog, protecting the interests of its constituents, but also as a bloodhound (the forensic accountant) to furrow out and uncover wrongdoing, does not appear to have been fully and effectively exploited. While the importance of their role has been recognized, their ability to respond to recurring challenges has faltered.[308]

While many are aware of contemporary accounting challenges, including the unfortunate demise of Arthur Anderson,[309] one of the "big five" accounting firms", it is to be noted that we are witnessing a repeat of events not merely of the 1930's but also of the relatively recent past, the 1970's. At that time, in the midst of the challenges once again facing the accounting profession, a partner in the accounting firm of Coopers & Lybrand (now integrated into one of the remaining big four) made the following key observations and comments:

> The accounting profession has been under intense scrutiny this past year. Not since the 1930s, when the congressional hearings that established the Securities and Exchange Commission were held, has there been such interest in accounting. Renewed congressional interest probably began with the highly publicized business failures that occurred over the past few years. The sudden failures of publicly owned companies, such as Equity Funding, Penn Central, Four Seasons Nursing Homes, and National Student Marketing, *raised questions of why there was little or no prior warning from the auditors that anything was wrong.*[310]

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[307] Mike McNamee, *et al.*, "The Reluctant Reformer: Will SEC Chairman Harvey Pitt Crack Down on Corporate Abuses?" *Business Week* (25 March 2002) 72 (ProQuest).

[308] See responses to the *DSI*, *supra* note 154, statements 108 & 110.

[309] See Roberta S, Karmel, "Securities Regulation: A New Watchdog for Public Accountants" [15 August 2002] N.Y. L.J. 3, where she notes that "[the] major accounting firms that audit the largest public corporations have become too big, too concentrated and too powerful, especially in Washington. The former Big Eight has become the Final Four without any protest by the SEC or the Antitrust Division. Indeed, the Department of Justice hastened the demise of Arthur Anderson by its criminal prosecution of the firm."

[310] Roy D. Thylin, "Accounting Developments" (1977) 1 J. Acct., Auditing & Fin. 264.

Notwithstanding the identified challenges, relatively little of real substance appears to have been done. As a result, fourteen years later, Robert Mednick, a partner in the now defunct accounting firm of Arthur Anderson and chairman of its worldwide committee on professional standards, rather than focusing on the advances made within the profession to address the recognized and identified deficiencies, made the following prophetic observation:

> The accounting profession desperately needs a process for completely reengineering the audit function and regaining the public's confidence.... I believe investors and others want and expect more: more of the why's—not simply what's—of financial data; *and more early warning that a company is making poor decisions or may be on the brink of financial collapse.*[311]

Nor was he alone in his thinking. At about the same time, Robert K. Elliott and Peter D. Jacobson of KPMG Peat Marwick (one of the remaining big four), identified a similar challenge, although they may have differed as to who was responsible for this recognized shortcoming. They noted:

> The U.S. financial accounting model ... is broken and needs to be fixed. Its periodic, historical, cost-based financial statements served the bygone industrial era well but are not sufficient for evaluating information-era companies...Today's periodic, historical, cost based financial statements do not provide as complete a set of relevant entity-specific data as is feasible *to enable potential investors to understand the economic risk of investing*; this undermines the spirit of management's discharge of its fiduciary responsibility to shareholders.[312]

Whether one should lay the blame at the feet of management or the auditors may well be irrelevant. The important point is that there appeared to be recognition within the profession that accounting was suffering from identifiable shortcomings and that notwithstanding the repeated warning signs, this was not being addressed.[313] The failure

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[311] Robert Mednick, "Reinventing the Audit" *Journal of Accountancy* 172:2 (August 1991) 71

[312] Robert K. Elliott & Peter D. Jacobson, "U.S. Accounting: A National Emergency" *Journal of Accountancy* 172:5 (November 1991) 54. [Emphasis added]

[313] See "The Twister Hits; Enron" *The Economist* 362:8256 (17 January 2002) 71 (ProQuest), where it was observed:

> Andersen is not the only offender. This week, the SEC rebuked another of the "big five" firms, KPMG, for investing in a fund whose accounts it audited. In 2000, another giant, PricewaterhouseCoopers, was found guilty of no fewer than 8,000 violations of SEC

to respond effectively to recognized deficiencies, may have served to help lay the foundation for many of the challenges that continue to plague the investing public.

The inability of the accounting profession to meet the needs of the investing public should not be surprising. Notwithstanding their suggested independence and their self-regulatory status in Canada,[314] chartered accountants (or certified public accountants in the United States) were highly dependant for their financial success on management. It was clear that management played a proactive role in the selection of external auditors,[315] their compensation, their retention, and the hiring of the external auditor's firm to perform numerous other lucrative (non-audit) services on behalf of and for the benefit of the corporation. Notwithstanding being intimately tied to management, the external auditors were nevertheless called upon to act in what could well be contrary to their own *self-interest* and to offer an "independent opinion on the financial statements of the corporation".

Whether the *Sarbanes Oxley Act* and its equivalents in other jurisdictions will alter the workings of the management-auditor relationship in a substantive way, as opposed to merely affecting the process and manner in which such relationships will be documented, is still an open issue that will need to be measured, assessed and addressed. Attempts to link auditors (often referred to as the shareholders' auditors) to the shareholders[316] and sever what may, in extreme cases, have been an incestuous relationship with management, may be required to help foster a perception and a reality of greater integrity in the process. However, given the proximity of the working relationship between management and the external auditors as well as their interdependence and collegiality,

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rules covering employee shareholdings in audit clients. The infractions were minor. But they raise a question: if accountants cannot follow rules separating their financial interests from their clients, how can they be trusted to insulate their firms' corporate interests.

[314] See *Professional Code*, R.S.Q. C-26 and relevant Regulations; *Chartered Accountants Act*, S.O. 1956, C. 7, s. 5; *Public Accountancy Act*, R.S.O. 1990, C. P-37 and relevant Regulations.

[315] See *DSI*, *supra* note 154, statement 46.

[316] See *ibid.*, statement 53, which suggests that external auditors should be elected by the shareholders, based on a comittment of what they will do, and which only received 35.0% support among respondents (37.84 % when the neutrals were excluded).

mutual support may well continue to be sought after, propelled forward or constrained by their respective "self-interests".

One can question whether other suggested approaches to deal with this conundrum have resulted in real as opposed to ersatz inroads being made. The statement made before the Canadian Standing Committee on Banking, Trade and Commerce on 13 February 2003, that PricewaterhouseCoopers (one of the remaining "big four" accounting firms) "takes its responsibilities to the investing public very seriously" and that "[q]uality, integrity and excellence have been, and remain, our core values with respect to all service that we provide to clients",[317] appears inadvertently to confuse two points and may intermingle rhetoric with substance. The substantive issue is how external auditors (such as PricewaterhouseCoopers) help to ensure accountability to investors so as to help instill confidence in the capital markets (as investors, shareholders under the current legal paradigm are not "clients" of the accounting firms). That accounting firms may serve their clients (that is management) well is not in dispute, nor is it the substantive issue relating to more effective corporate governance. After all, management can and in practice does hold the external auditors accountable. Either the external auditors produce as management wishes, or they risk being replaced. The challenge to achieving more effective corporate governance is to attempt to make the external auditor a more effective check and balance on management, and to help protect the interests of investors. That requires that the interests of the external auditors be aligned with those of investors, not those of management.

In dealing with this latter issue, the testimony on behalf of PricewaterhouseCoopers[318] helps to highlight the challenge. Rather than attempting to identify and be responsive to the problem at hand, PricewaterhouseCoopers appears to have engaged in what may well be a circular exercise, which may help to explain the failure to address and move forward

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[317] Senate, "Proceedings of the Standing Committee on Banking, Trade and Commerce" (13 February 2003), online: Parliament of Canada <http://www.parl.gc.ca/37/2/parlbus/commbus/senate/Com-e/bank-e/12evb-e.htm?Language=E&Parl =37 &Ses=2&comm_id=3> (Kevin J. Dancey, CEO, Canadian Senior Partner, PricewaterhouseCoopers Canada) [Senate, "Proceedings"].
[318] *Ibid.*

in the resolution of previously identified concerns. In testimony it has been stated: "The questions are about company executives, boards of directors, auditors, analysts, regulator and the media. All of these are members of what I will refer to in this presentation as the corporate supply chain."[319] This appears to be a tautology but adds little to a constructive debate. However, the suggestion that the problem is caused by an "expectations gap, -- the gap between what the public perceives we do when we perform an audit and what accounting and auditing standards actually require us to do,"[320] appears to miss the point, and it may well be an integral part of the problem.

Accounting and auditing standards in Canada are in effect set by the accounting profession,[321] with proactive input, if not guidance, and even pressure to assist in the final outcome from the management of the corporations, who are in fact the clients of the accounting firms.[322] Furthermore, traditionally, as has been noted in the *DSI*,[323] the interests of the external auditors are intertwined with and often dependant upon the goodwill and benevolence of management. This creates a conundrum for the profession if they are looked upon (as they are) to provide "independent opinions" that have credibility due to their expertise, access to information and supposed independence. The challenges faced by external auditors, even those acting in good faith (as most do), is therefore often daunting, given client pressure, the novelty and complexity of many of the accounting issues that surface, the lack of precedent and the creativity of management and their professional advisors. As a result, statements certified as being in accordance with generally accepted auditing standards (GAAS) or generally accepted accounting principles (GAAP), while meaningful to accountants, may well be of questionable value

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[319] For a more detailed description of the 'corporate supply chain', see Samuel A. DiPiazza & Robert G. Eccles, *Building Public Trust: The Future of Corporate Reporting* (New York: John Wiley & Sons, 2002).
[320] See Senate, "Proceedings", *supra* note 317.
[321] Generally Accepted Accounting Principles (GAAP) are "[t]he common set of accounting principles, standards and procedures. GAAP is a combination of authoritative standards set by standard-setting bodies as well as accepted ways of doing accounting". See online: VC Experts <http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=158>. See online: Canadian Institute of Chartered Accountants <http://www.cica.ca>, which is responsible for the development of Canadian GAAP, as well as Generally Accepted Auditing Standards (GAAS). See Frank D'Andrea, "Introduction to Accounting in Canada" [undated], online: AccountingEducation.com <http://accountingeducation.com/pdffiles/canadatg.pdf.>
[322] See Levitt, *supra* note 190.

to the general public.[324] They can nevertheless add value if they justifiably help to instill confidence in the value of the financial statements (whether understood and warranted or not). However, absent such purpose, the audit opinion accompanying the "audited financial statements" would appear to serve little useful purpose for the investing public.[325]

If the foregoing premise is valid, then the external auditors are failing to meet expectations in their role. While a detailed examination of the accounting and auditing standards and the accounting profession are beyond the scope of this paper, one conclusion can nevertheless be drawn: They should be a means to an end (that is, they should meet the needs of the financial community and of the investing public and be accountable to that constituency) and not be an end unto themselves. If external auditors are not to assist in helping to ensure that the reader of the financial statements (including a shareholder or potential investor) is given a fair picture of the financial affairs of a corporation, so as to enable them to make an intelligent decision in reliance thereon (failures appreciated by members of the accounting profession long before these recent breakdown in corporate governance), then credibility will and deserves to be lost. Confidence in the value that they add will and should suffer accordingly. Unfortunately the state of our current law[326] does not appear to recognize such obligations arising out of the contract of services entered into by the external auditors of the corporation. As a result, under the present judicial interpretation of the law, the external auditors, barring very special circumstances, are contractually accountable not to the shareholders but rather to the client, the "corporation". One may need to reassess whether in light of the

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[323] See *DSI*, *supra* note 154, statements 46 & 47.

[324] Anecdotal testing of the public's understanding of the value of GAAP and GAAS merely suggested that this helped instill confidence (that is, it was viewed as being better than getting statements without such a report), but there was little other appreciation as to what it meant.

[325] See "The Twister Hits; Enron", *supra* note 313, reporting the views of Baruch Lev of New York University's Stern School of Business, who believed:

> America's accounting standards are becoming ever less meaningful. [They] fail to reflect a blurring of corporate boundaries caused by the proliferation of joint ventures, outsourcing, and so on. Nor do they fully report the emergence of new sorts of assets (such as intangible assets) and liabilities (off-balance-sheet financing, derivative contracts, etc.). This creates an environment in which firms can too easily manipulate figures: facilitating what Mr. Levitt says is a move towards "indecipherable" earnings.

foregoing deficiency a change in the legislation to ensure accountability is required[327] or whether others, independent of the accounting profession, should be empowered to help ensure accountability to the investing public.

Auditors (as other successful professionals) have been and continue to be motivated to serve the needs of their clients; that much continues to be clear. They have been effective in meeting the needs of the corporation as represented by management, even when such actions appear to have raised issues of conflicts (for example, counseling on the development or the installation of management information or billing systems and then auditing the work of their own office when issuing an audit report).[328] Such duality (or multiplicity) of roles have created conflicts of interests. To address this issue, a façade, the Chinese wall, was created. It has been suggested that what was done on one side of the wall (for example, auditing) was completely and effectively cut off from other activities (on the other side of the wall) within the same accounting firm (such as management consulting). The Chinese wall was an attempt to deal practically with continuing to enable accounting firms to act in their *self-interest* (in what would otherwise be a conflict of interests). However, these walls appear to be under attack and may in law, given the pronouncement of Mr. Justice Binnie,[329] be starting to crumble.[330]

While the Supreme Court of Canada has not yet ruled explicitly on the efficacy of Chinese wall for the accounting profession, the issue may eventually have to be judicially

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[326] *Hercules Managements Ltd. v. Ernst & Young*, [1997] 2 S.C.R. 165, 146 D.L.R. (4th) 577 [*Hercules*].

[327] See Grace Hession, "Auditor Independence and Liability in Canada: Are We Ready for Third Party Liability?" (2003) U.B.C. L. Rev. 575.

[328] Attempts are being made by the regulator to address this issue. See e.g. *MI 52-110*, *supra* note 200.

[329] See *R. v. Neil*, [2002] 3 S.C.R. 631, 2002 SCC 70 [*Neil*].

[330] In *Drabinsky v. KPMG et al.*, 41 O.R. (3d) 565 at 567, [1998] O.J. No. 4075, where the plaintiff sought an injunction restraining the accounting firm KPMG (of which plaintiff was a client) from further investigating the financial records of a company of which plaintiff was a senior officer, Ground J., grouping lawyers and accountants, said: "I am of the view that the fiduciary relationship between the client and the professional advisor, either as a lawyer or an accountant, imposes a duty on the fiduciary *beyond the duty not to disclose confidential information*. It includes a duty of loyalty and good faith and a duty *not to act against the interests of the client*." [Emphasis added]. Some members of the accounting profession assert the efficacy of "Chinese Walls" in accounting practices, even with respect to the affairs of *current* clients. Whether this belief is justified in the absence of informed consent from the clients concerned is an issue for another day. Insofar as legal profession is concerned, Ground J.'s view of the duty of loyalty to current clients is unassailable".

addressed.[331] However, a condition precedent to the resolution will have to center on who should benefit from the identified obligations of loyalty and good faith, referred to by the Supreme Court. If the corporation continues to be the client (as opposed to the shareholders), then given anthropomorphism, the duty by default would appear to continue to be owed to management.

There is strength in the dynamic nature of business, but weakness in the retrospective nature of accounting for it. Novelty in business transactions negates "general acceptance", a pre-condition to GAAP. The result is that many accounting issues that surface in our rapidly changing economy are often viewed by accountants as being unclear, and how they should be accounted for without precedent (as opposed to being clearly permissible or disallowed). This requires that independent professional judgment be exercised. However, such judgment is often placed under substantial time and client pressures, given the need to make disclosure promptly as input to the supposed efficient market. Premature or inappropriate disclosure inconsistent with the approach taken (or to be taken) by one's peers can put a corporation at a competitive disadvantage, negatively impacting the price of a corporation's shares, including the value of outstanding stock options. Conversely, being aggressive and displaying the best possible accounting posture can have the reverse impact on reported results and on related stock prices. Hence, to suggest that what has been termed "aggressive accounting" is at the core of many of the problems is to fail to recognize that the market often leads the accounting profession and not *vice versa*. Accounting by its very nature tends to be reactive as opposed to proactive, as it is business creativity that generates the need to decide on how to report. However, the accounting profession needs to provide clearer, more transparent accounting, including explaining clearly and transparently how it handles novel practices and their potential impact (unencumbered by client pressure), so as to ensure that a fair picture of the true financial position of the corporation is shared with the reader of their reports.

[331] It appears to have been addressed in *SOX*, *supra* note 150, and *Bill 198*, *supra* note 150, where the multitude of services traditionally undertaken by the external auditors was recognized as impeding their ability to conduct and give an "independent opinion". However, whether this will result in the repackaging of previously independent services to fall within the ambit of what are now audit functions, will only be capable of detailed review on an *ex post facto* basis.

Unless that objective is achieved, a less than accurate picture of the state of affairs of a corporation will continue to be provided.

Two cases that serve to highlight the aforementioned type of challenges are (a) accounting for stock options and (b) the treatment of goodwill.

6.6.1. Stock Options

Stock options,[332] a derivative instrument, are a right to acquire stock of a corporation at an agreed-upon price after a certain date (the date that the options vest) for a specified period of time (the term of the stock option) at an agreed to issue price (the stock option exercise price) whether or not the corporation needs the capital (as the timing is at the discretion of the option holder, subject to the terms of the grant). Stock options suffer from an innate deficiency in terms of accountability; they are a stealth (or hidden) form of transferring wealth from shareholders to management. They traditionally have not been reflected in the financial statements as a cost of doing business, even though they can have as direct an impact on shareholders' equity as earnings or losses.[333] Just as losses decrease (or to put it another way, dilute) shareholders' equity, the issue and exercise of stock options also has a similar effect. That is because options enable a holder to acquire shares of a corporation at a price below which they would otherwise sell for in the market at the time of their exercise. It is this difference, foregone annually, that is the "contingency cost" to the business (as the "loss" only arises if the stock option is exercised and the "stock is trading in the money"; that is, the exercise price is less than the price at which the stock is trading).

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[332] The CICA Handbook states: "A stock option is a contract that gives the holder the right, but not the obligation, either to purchase or to sell a certain number of shares of stock at a predetermined price for a specified period of time." *CICA Handbook*, s. 3870.07(q), online: Knotia.ca <http://www.knotia.ca/Knowledge/View/Document.cfm?kType=1&linkType=ftch&dbID=403&documentID=64> [*CICA Handbook*].

[333] This is now changing. See *ibid.*, Accounting Recommendation, Specific items, s. 3870, "stock based compensation and other stock based payments". However, the manner in which costs are reported is still far from clear. The use of the Black Scholes methodology, an economic valuation process, results in a "reduced cost being reported" compared to more conventional accounting and needs to be critically re-

Stock options can motivate irrational and even fraudulent behavior for personal gain, whether intentional or subliminal. The prospect for a breakdown in corporate governance and for fraudulent actions to take place, as noted by Johnson, *et al.* in their study, "Executive Compensation and Corporate Fraud",[334] appears to increase according to two factors; first, the portion of total compensation that is equity based (the higher the equity stock option base, the greater the incentive to take advantage of this prospect for personal gain) and second, the ability to exercise options during the term of office. Furthermore, the risk of being caught and prosecuted (for actions, many of which were technically within the letter of the law even if they were ethically questionable[335]) and the financial reward (material to the recipient in question) would appear to many to be an acceptable trade-off. Substantial executive stock option gains can be rationalized on the basis that such are the result of an aggressive market and entrepreneurial action. While the firm in question may at the end fail (although that is not what management may ever have intended) and the captains of industry walk away with their "stock option gains", those are, it can be argued, the "risks of the game" that investors knowingly accept. However, any such suggestion is simplistic at best and raises questions as to the integrity of the process.

Notwithstanding the rhetoric to the contrary, stock options as currently structured are not aligned with shareholders' interests. Rather, they cause shareholder and manager interests to conflict. While shareholders may desire to see the value of their investment grow over time, speculators may seek more erratic stock price variations, as gyrations will increase

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examined. A suggestion being proffered for "accounting for the cost of stcok options" is advanced in Appendix C, below.

[334] Shane A. Johnson, *et al.*, "Executive Compensation and Corporate Fraud" (2003), online: Social Science Research Network Electronic Library <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=395960>.

[335] Such as structuring the ability to realize the economic value of stock options without being forced to report such action to the public, (given the structure of the transaction); complying with the words but not the "spirit of the law". See Karen Howlett, "Insiders' Stock Dealing Loophole Targeted" *The Globe and Mail* (25 October 2002) B1; Scott Adams, *et al.*, "Insiders Sold Millions: As Reporting Window Closes, 'Secret' Sales Soar" *The National Post [Toronto]* (11 March 2004) FP1, which deal with the required disclosure (retroactively of such transactions that are still outstanding). This matter has now been addressed by the OSC through *Multilateral Instrument 55-103 – Insider Trading for Certain Derivative Transactions (Equity Monetization)*, 27 O.S.C.B. 2361 (27 February 2004) [*MI 55-103*], which seeks to ensure that "substance" prevails over "form". As a result transactions which in economic terms are similar, in fact, to insider trading, (notwithstanding their form), must now be reported and transparent to the market.

the opportunity to profit. Stock options would appear to place the CEO in the same position as the speculator, as stock price gyrations can work to his (her) advantage (the greater the volatility of the stock, the more valuable the stock options) with little concomitant accountability, given that the legal system is not well equipped to deal with this anomaly.

A sizable grant of stock options can generate substantial gains, especially when compared to comparable cash-based compensation (where cash bonuses may also be capped). This can be illustrated by the following simplified example. If one grants one million options to a CEO vesting immediately, exercisable at ten dollars at any time during a five-year period (or vesting at 25% a year over a four-year period and having a life of ten years), and one can get the stock, once vested, to increase to fifteen dollars, the exercise of the options can result in a gain of five million dollars for the officer in question. This can be accomplished in a number of ways, including by announcing an acquisition, by reporting substantially higher quarterly results than expected, and by getting those with influence in the capital markets, such as analysts, to buy into and sell the company's story with a favorable spin. Self-interests (as exemplified in stock options) provide a very strong incentive to ensure that the CEOs (or other officers in similar positions) interests benefit by helping to generate and where possible to exercise control over information that the "efficient market" will absorb. The impact of the CEO's actions and of those working with him (her) (that is, the other officers, and in some cases even board members, who also get option grants on terms similar to the CEO's but in lesser amounts) could, as a result of a single transaction, reward the CEO (and the others helping him (her)) legally (or in some cases, based on the actions by the CEO and his accomplices, fraudulently[336]) with the ability to harvest on the basis of one transaction, more than one could otherwise expect to earn, let alone save, in a lifetime.[337] There is therefore an incentive (propelled by *self-interest*) to seek to reap these "relatively" risk-free rewards.

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[336] See *Re Bre-X*, [1998] A.J. No. 1370.

[337] Favorable tax treatment given to "earnings of this nature" serves to further magnify their importance to the beneficiaries and motivate their continued use.

As well, if a sufficient number of others in an organization (not just officers) are put in the same position, there is a built-in incentive to attempt to preserve and benefit from this highly rewarding "stealth" compensation vehicle. Once it is perceived to be working, competitive pressures (and interrelated boards and business associations, as well as the assistance of consultants) help ensure that this becomes a generally accepted means to compensate, reward and retain executives. Like a "ponsi scheme", as long as everyone appears to win, the saga continues. When the share prices in question start to fall, the losers are not those who hold options because, unlike shareholders, they have none of their own money at risk and, furthermore, often have options replenished at the lower prices (or supplemented or displaced by other compensation schemes). Rather, the losers are the owners of the shares, the shareholders. This should not, however, be surprising, although it often is, even to the more sophisticated investors. As was noted by Adam Smith,[338] Berle and Means,[339] and Easterbrook and Fischel,[340] personal interests are forceful motivators. Therefore, barring appropriate and effective checks and balances, where the financial rewards are relatively large and the risks correspondingly small, one will rationally take the risk. The challenge from a governance perspective is not to ignore the lessons learned, but to benefit from them. Options (with appropriate checks and balances to ensure accountability and to prevent abuse) may serve a useful purpose. However, there is a need to help ensure that they are used in a manner that is transparent and that align the interests of the shareholders and management, as opposed to creating conflicts. How one can seek to address the challenges raised by the use of stock options will be addressed in this thesis.[341]

6.6.2. Goodwill

A second example of a challenge faced by the accounting profession is the treatment of goodwill. Goodwill can be described in a number of ways.[342] However, it is, in practice,

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[338] *Supra* note 94.
[339] *Supra* note 2.
[340] *Supra* note 9.
[341] See Chapter 9, "Tools And Rationale To Help Address Self Interest And The Funneling Syndrome", below.
[342] See e.g. *CICA Handbook, supra* note 332, which indicates that "Goodwill is the excess of the cost of an acquired enterprise over the net of the amounts assigned to assets acquired and liabilities assumed".

the difference between the price paid for an acquisition of a business and the value attributed to the assets acquired at fair market value (namely, the price that would be paid between a willing buyer and seller under no compulsion to sell in the open market).[343] One should question why any rational person (or corporation) would pay more than the fair market value of the underlying assets of a corporation (less of course deducting liabilities assumed). The theoretical reasoning, if one were behaving rationally, is that those acquiring the corporation believe that they will be able to earn more than incumbent management with the assets, or that the total is worth more than the sum of the parts. This, it can be assumed, will be achieved in a number of ways, including combining operations, increasing revenue by selling the products and/or services of the acquired business through the purchaser's distribution network, or to their larger and different customer base, refinancing (financial engineering) or breaking up the acquired entity and disposing of the parts, or undertaking numerous other actions to increase aggregate revenues, decrease combined costs, or both. To the extent believed by the market, the foregoing can have a positive impact on the share value of the acquiring company (as well as the target shareholders who are usually offered a premium, which can be substantial, to encourage them to accept the offer.)

The downside to an acquisition of a business is that it usually serves to generate goodwill, (the excess of the cost of the acquisition over the value allocated to specific assets purchased[344]). Acquisitions (until relatively recently, at least in the United States) were dealt with in one of two ways. One, referred to as the pooling of interests,[345] allowed two

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[343] See *ibid.*

[344] *Ibid.*

[345] According to CICA Notes, online: Knotia.ca <http://www.knotia.ca/Knowledge/View/Document.cfm?kType=1&linkType=ftch&dbID=403&documentID=81&paragraphID=19#para_19>, a "method [of] business combinations in which the ownership interests of two or more companies are joined together through an exchange of voting shares and in which none of the parties involved can be identified as an acquirer can be considered *pooling of interests* in the sense that the shareholders combine their resources to carry on in combination the previous businesses." They point out:

> [U]nder the pooling of interest method, the assets and liabilities are combined and are accounted for in the combined company's financial statements at their carrying value in the combining companies' records. The reported income of the combined company includes income of the combining companies for the entire fiscal period in which the combination took place. Financial statements of the combined company presented for

corporations of about equal size to merge without generating any goodwill. A detailed review of pooling-of-interest accounting is beyond the scope of this thesis; the importance from a "market perspective", however, is that this enabled the two companies after they joined to show better financial results, as pooling allowed the generation of goodwill to be avoided. In contrast, if two companies merged and were unable to use the pooling of interests accounting concept, they were forced to generate goodwill and were required to write off this intangible asset over a period of time, not to exceed forty years.[346] The rationale appeared to be that one would be paying a premium over the market value of the underlying assets to enable the corporation to earn "super normal profits"; that is, profits above and beyond a "normal return" on the cost of the acquisition. As a result, the additional unallocated cost was to be offset (written off as a cost) against the additional benefit that was to be received, over its estimated useful life of this intangible asset. The net effect of these two approaches was that mergers that could be orchestrated as the "pooling of interests" would show better net income than comparable companies generating goodwill that had to be recorded as a cost of operating the combined businesses. If the efficient market thesis were correct, then the manner of accounting for an acquisition should have been irrelevant to investors. However, the intensity of discussions over this matter[347] and its irrational resolution appears to suggest

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> prior periods are restated to reflect the financial position and results of operations as if the companies had been combined since their inception. Income of the combined company includes income of the combining companies for the entire fiscal period in which the combination took place. Financial statements of the combined company presented for prior periods are restated to reflect the financial position and results of operations as if the companies had been combined since their inception.

[346] See e.g. Melody Petersen,"Big Oil: The Arithmetic–A Premium of Billions Will Vanish on Accounting Ledgers" *The New York Times* (2 December 1998) C3, where it was reported:

> Critics say that the accounting method, known as a pooling of interests, is not in the best interest of shareholders because it does not hold executives accountable for their actions if the total price they pay -- stock valued at $80 billion in Exxon's case -- is too high.... If the companies were forced to use purchase accounting, analysts estimate that a $50 billion premium would be written off over 20 years. The result: Exxon Mobil would have to reduce earnings by $2.5 billion a year for the next two decades. The annual $2.5 billion write-off would have eaten up 21 percent of the $11.7 billion that the two companies reported in combined profits last year. "That would be a pretty good hit to earnings and could affect the landscape," said Jay Wilson, an oil analyst with J. P. Morgan Securities."

[347] See e.g. Laura M. Holson, "Accountants are Preparing for Months of Debate over Abolishing a Rule on Corporate Mergers" *The New York Times* (19 February 1999) C6, where she noted that the controversial plan to limit pooling of interests would be "the first round of what is expected to turn into months of intense lobbying and debate".

that packaging and marketing, as with the selling of any product and service, may be critical as to how (potential purchasers) investors react and the prices that they are prepared to pay.

The apparent resolution of the conundrum raised by pooling versus merger accounting is to allow goodwill be to be carried on the books of a corporation until there has been a permanent impairment of goodwill, in which case the carrying value will have to be reduced or the goodwill completely written off.[348] However, the decision as to whether there has been permanent impairment is anchored in judgment and is fraught with danger. If a corporation is doing well, then it can be argued that there is no need to write-off any goodwill, as the results would suggest that the corporation should continue to carry the asset, based on the firm's performance. However, if a corporation is performing badly and when it may least be able to afford a substantial write off, there may be a need to expense the asset that has been carried as valuable for years but which, at a point in time when the corporation may be least able to afford a financial hit, is assumed to have precipitously lost value. This seems to suggest that earnings in the previous years, when the value of the asset was deteriorating or being consumed, may well have been overstated and that the deferment of the write-off merely assisted in the legitimization of managing earnings. While this may be perceived as being an unduly critical assessment of the role played in dealing with the treatment of goodwill, it nevertheless points to a departure from the conservative rules of traditional accounting to arriving at what appears *prima facie* to be an irrational accommodation. Most importantly however, it appears to suggest that the ability to manipulate the "efficient market" is greater than many have suggested, or were prepared to agree to in the past, primarily because, unlike classroom economics where it is assumed that *ceteris paribus* applies, that is inconsistent with reality.

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[348] As of January 2002, the following rules apply *inter alia*: "Goodwill should be recognized on an enterprise's balance sheet at the amount initially recognized, less any write-down for impairment". Furthermore, "goodwill is not amortized. It is tested for impairment...". It is further provided that "[a] goodwill impairment loss should be recognized when the carrying amount of the goodwill of a reporting

The focus on accounting for stock options and goodwill are merely two examples of the many challenges that face the information flowing into the supposedly efficient market. These are illustrative of matters that need to be addressed by proponents of the "efficient market thesis". They appear to argue, without an adequate appreciation of the impact of *self-interest* and the *funneling syndrome,* that one can rely on the "efficient market" to ensure that shares are properly and efficiently priced and that external intervention is neither warranted nor required.

Returning more specifically to the role of the external auditor, it is axiomatic that disappointing a client (especially if it is major one) – a likely source of future revenue - cannot be in any auditor's best interests. Contemporary events have demonstrated how far auditors (in an effort to assist management) will go,[349] usually (but not always) within the confines of existing rules. If helpful to their clients, they may also seek to alter those rules, as has been noted in the case of goodwill, or to delay changes, as has been the case in accounting for the cost of stock options,[350] to help meet the very practical needs of clients. Accordingly, the historic relationship where an auditor, in effect, reports to those that it should be monitoring (if one accepts that independently monitoring and reporting on the financial activities within a corporation continues to be the role of the external auditor) is innately defective. Legislation such as the Sarbanes-Oxley Act[351] in the United States and National Instrument 52-210 in Canada[352] appear to be attempting to address

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unit exceeds the fair value of the goodwill. An impairment loss should not be reversed if the fair value subsequently increases". *CICA Handbook, supra* note 332, ss. 3062.22, 3062.23 & 3062.5.

[349] For an indication of how far it was believed that the external auditors had gone, see U.S. General Services Administration, News Release, "GSA Suspends Enron and Arthur Andersen and Former Officials" (15 March 2002), online: General Services Administration, <http://w3.gsa.gov/web/x/publicaffairs.nsf/0/576435646c09ff9185256b7d004800b8?OpenDocument>:

> Regarding Andersen's suspension, GSA took this action based upon indictment released yesterday. The indictment alleges that Andersen, at numerous locations throughout the world, knowingly, intentionally, and corruptly destroyed documents and other information relating to Andersen's work for Enron, and that these actions were taken to impair official proceedings. Under federal law, an indictment for such an offense is adequate evidence of misconduct to support suspension of a government contractor.

[350] According to Levitt, *supra* note 190 at 107 & 108, respectively, when the Financial Accounting Standards Board (FASB) tried to crack down on accounting for stock options (or the lack thereof), in 1993, it "ran into a phalanx of corporate, Congressional and auditing opposition" even though "[t]he FASB considered this [the treatment of stock options] deceptive accounting".

[351] See *supra* note 155.

[352] See *MI 52-110, supra* note 200.

this deficiency. However, it is premature to assess how effectively they are or will be in achieving their objectives. While having the external auditors reporting directly to the audit committee of a board of directors may be perceived to be an improvement and might well prove to be helpful, it will nevertheless also raise a conundrum. Increased agency costs, defensive documentation and positioning to avoid potential liability rather than providing the shareholders with meaningful additional checks and balances may well be the end result, given the innate overriding *self-interest* of the members of the audit committee. If that proves to be the case, the legislation, while admirably motivated, may inadvertently fail, if the objective was to align audit committee and investor interests.

Current legislation (even as augmented by Sarbanes Oxley) still retains an anomaly; it has the external auditors engaged by and reporting to the directors, whose interests are generally more aligned with management than shareholders. If the role of the external auditors is to act as the "shareholders' auditors", as they are often colloquially but incorrectly referred to, it may be necessary to render the external auditors accountable to the shareholders in a manner that is meaningful to that constituency. The historical creativity of the accounting profession to respond effectively to the needs of management must be matched with an equally effective response to the needs of shareholders, failing which consideration should be given to whether this role should be the responsibility of a different, independent body. The risk of losing one's historically protected position or opening the market to competitive alternatives should assist in finding more creative solutions to meeting the needs of shareholders. Perhaps the efficiency of the market and *self-interest* should be conscripted to find more efficient solutions to the current challenge.

If one believes in the efficacy of the market, then it can be argued that auditors should have to bid for the audit function,[353] be responsible to the shareholders to deliver on their

[353] *DSI*, *supra* note 154, statement 58, was supported by only 18.4% of respondents (19.98% when the neutrals were excluded).

commitment[354] and have the accounting profession help to ensure that what their members undertake to do is useful and of relevance to the shareholders. The critical issue is to determine to whom the auditors should in law and in fact be responsible. Should it be to the audit committee, a proxy for management notwithstanding the rhetoric, or should it be to the shareholders? Clearly, being directly responsible to the shareholders would be a marked departure from the *status quo* and may not be widely supported by management. However, a failure to revisit the underlying philosophical approach to auditing is nothing more than the equivalent of "moving the chairs around on the Titanic"; one may be left with the impression that changes are being made but in the end, the result will not be altered.

To continue to intimate that the external auditor is the shareholders' "watchdog", but to have him compensated and rewarded by those that he (she) should be monitoring, may not only constitute a classic case of conflict of interests, but may continue to constitute a foundation for future problems. Competent accountants, given the structure of many contemporary accounting firms, would have to conclude that notwithstanding artificial instrumentalities such as Chinese walls, conflicts of interests continue to abound. While structural separations serve to provide the appearance of propriety, they nevertheless do not remove the financial incentives, fueled by *self-interest*, that motivate risk taking amongst members of the same firm. This, in turn, leads to a propensity for the rationalization of irrationally aggressive actions, and at times, even potential or actual illegal activities, as evidenced by the actions of Arthur Anderson in the Enron[355] affair. "Auditor effectiveness, like board effectiveness, hinges on the ability to act as an independent gatekeeper".[356]

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[354] *Ibid.*, statement 47: Only 12.2% of respondents (12.83% when the neutrals were excluded) believe that the external auditors are primarily loyal to the shareholders.
[355] U.S. General Services Administration, *supra* note 349.
[356] Jonathan Macey & Hillary A. Sale, "Observations on the Role of Commodification and Governance in the Accounting Industry" (2003) 48:4 Villanova Univ. School of Law L. Rev. Symposium Issue 27.

The establishment of "supervisory boards",[357] initiated and paid for by the accounting profession and "reporting to the public", sought to be responsive to the challenge. While potentially positive from a public relations perspective, it may even assist in achieving greater national uniformity in the approach and the documentation of the external audit and accounting functions. That may help the profession. However, unless action is taken to address underlying issues that are at the core of the challenge to more effective corporate governance, it is still unclear how such broadly based boards will help to identify and be responsive to the specific challenges that need to be addressed. Unless initiatives are taken to identify and deal with substantive issues (an example of which can be seen in the decision of the Supreme Court of Canada in *R. v. Neil*,[358] challenging the propriety of Chinese walls in use by accounting firms), one may not be addressing the core issues. The real issues, such as whether accounting firms should be required to divest themselves of their consulting practices and should it be mandatory (an action that some accounting firms have unilaterally taken, given the conflicts of interests that acting in both capacities raises), will determine whether rhetoric as opposed to proactive action will prevail. The devil as always is in the detail.

A detailed analysis of the activities of such supervisory boards as well as of the liability of accountants[359] is beyond the scope of this study. However, that accountants have the ability to assist in ensuring effective corporate governance (given their pivotal role in

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[357] See e.g. the Accounting Standards Oversight Council, which describes itself, in an advertisement printed in *The Globe and Mail* (25 March 2004) B11, as "an independent body established by the Canadian Institute of Chartered Accountants to oversee the activities of the Accounting Standards Board (AcSB) and the PSAB. *Reporting to the public* and consisting of 24 prominent business and government leaders, the Council brings a broad perspective to complex issues facing standard setters. AcSoc's responsibilities include appointing the PSAB members and providing input on strategic priorities. AcSOC members, many of whom represent particular constituencies, include regulators, investors, and other users, preparers and auditors of financial reports". See also a reference to the Auditing Assurance Standards Oversight Council (AASOC), similarly set up by the CICA as "an independent body" to oversee the activities of the "Auditing and Standards Board (AASB). A press announcement of the appointment of Moira Burke, FCA to the AASOC, printed in *The Globe and Mail* (25 March 2004) B12 also states that "[t]he AASOC is an independent body established by Canada's Chartered Accountants to oversee the AASB *Reporting to the public* and consisting of prominent leaders from business and regulators, it supports the AASB in setting auditing and assurance standards. AASOC's responsibilities include appointing AASB members and providing strategic priorities." [Emphasis added]

[358] *Neil, supra* note 329.

[359] See Julie Faussie, "Limiting Liability in Public Accounting Suits: A Desperate Appeal from a Beleaguered Profession" (1994) Val. U. L. Rev. 1041.

being able to access and understand the corporation and in helping to set generally accepted accounting and auditing standards) is unequivocally clear. The challenge, nevertheless, to more effective performance is to ensure that they are accountable to and compensated by those whose interests they should serve, namely the shareholders. How to do so effectively is a continuing challenge. The profession can be reactive and defensive or proactive and innovative in a meaningful manner. More creative thought, planning, action and measurable results are required to deal with this conundrum and to find meaningful solutions, failing which, less rational statutory or judicial reactive intervention, or the '"competitive market", should over time provide more realistic alternatives to their "required role".

6.7. SHAREHOLDER RIGHTS

A polarization of views can exist with respect to shareholders' rights and clearly has a bearing on one's approach to the development of the tools of more effective corporate governance.[360] At one extreme, it can be rationalized that shareholders are in fact the owners of the business, and that directors and officers are, in substance if not in law, "their agents", seeking to maximize shareholder value. Under this approach, shareholders should be able to play a meaningful role in the direction of the affairs of their business. At the other end of the spectrum (which appears to reflect the contemporary views of the shareholders of corporations) is the suggestion that the management of the affairs of a corporation has been delegated by the shareholders to the board of directors and by the board of directors to the officers. Under this scenario, the rights of the shareholders have become limited ones, but are primarily the "right to vote"; that is, to deal with issues that are usually dealt with at the annual general meeting of shareholders.[361] The traditional and more recent contemporary expectation appears to be that shareholders who disagree with management would not seek a confrontation (given the problems associated with public choice and free-rider issues) but would sell their shares.[362] Clearly, these two precepts are at opposite ends of the spectrum of shareholder potential for involvement

[360] Robert B. Thompson & Gordon D. Smith, "Toward a New Theory of the Shareholder Role: 'Sacred Space' in Corporate Takeovers" (2001) 80 Tex. L. Rev. 261.
[361] *CBCA*, *supra* note 37, s. 135(5).

and are in conflict. The acceptability of certain proposed tools of more effective governance will be a function of one's perspective on these conflicting positions.

6.8. CONCLUSION

Unless the *self-interest* of the officers, directors, shareholders and advisors is sufficient to act as an effective check and balance and to warrant active intervention in the case of actual or potential abuse, proactively as opposed to reactively, achievement of greater *CIA* on the part of those who opt to circumvent such requirements will continue to be a laudable but an unrealistic objective. Tools of more effective corporate governance should help to assess accountability in a quantifiable manner, enable directors and officers and third parties to ascertain if progress is being made or if one is merely engaging in rhetoric, and ensure that accountability is enforceable in a meaningful manner.

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[362] See Olson, *supra* note 64.

Chapter 7

Conclusion Re Academic Review Tempered By Interviews and Anecdotal Experiences

7.1. INTRODUCTION

A consensus appears to exist amongst academics as to the genesis of the prime challenge facing corporate governance, namely diverging interests arising out of the separation of ownership and control and the concomitant increase in agency costs. However, unanimity does not exist with respect to at least two related areas. First, the issue as to whose interests should be protected, the shareholders[363] or all who deal with the corporation,[364] including employees and suppliers, is an area of competing positions. Second, the approach to be taken when seeking to address the identified problem, namely, should it be achieved through a system of external intervention (proactively by statutorily empowered regulators such as the Securities and Exchange Commission (SEC) in the United States or the Ontario Securities Commission (OSC) in Ontario, Canada), or by a greater reliance on the efficiency of the capital markets, lacks unanimity.[365]

7.2. INTERESTS TO BE PROTECTED

With respect to the first issue (whose interests should be protected), a for-profit corporation is established to achieve commercial as opposed to social purposes (although achieving social objectives consistent with the best interests of its shareholders is not inconsistent with commercial primacy).[366] To achieve these commercial ends, investor

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[363] According to Berle & Means, *supra* note 2 at 244, "[t]he stockholder is therefore left as a matter of law with little more than the loose expectation that a group of men, under a nominal duty to run the enterprise for his benefit and that of others like him, will actually observe this obligation".

[364] Blair, *Ownership and Control*, *supra* note 103 at 191: "An alternative theory about whose interests boards should represent is implicit in the recommendation by Michael Porter that boards of directors should include representation from all significant stakeholders, including major customers, suppliers, financial advisors, employees, and even the surrounding community".

[365] For a discussion of the efficient market, see Chapter 2, Section 2.2.1., above.

[366] Any suggestion that it is an all-or-nothing proposition would be, it is submitted, to mis-state the dichotomy; rather it is an issue of which interests are paramount and how the other related interests can serve to advance the primary one.

confidence and their willingness to provide capital is required. Accordingly, principles that seek to re-enforce shareholder interests and increase confidence in capital markets should anchor more effective corporate governance.

Principles focused on helping to create and protect shareholder value and thereby operating to instill greater investor confidence could provide a clearer, more unequivocal focus, capable of being assessed on both an *ex ante* and an *ex post* basis. It should not be diluted by a public versus private agenda. That is not to suggest that non-shareholder interests should be ignored. To the extent that addressing the requirements of other constituents is complementary to furthering the interests of shareholders, they should be actively pursued. However, public as opposed to private agendas should be pursued by the public institutions that have been set up to meet such needs,[367] or by the introduction of laws of general application that apply equally to all. Government (as opposed to for-profit corporations), with the mandate to act in the public interest and with the ability to levy taxes to pay for the cost of such actions or to introduce laws of general application (which the corporations cannot do), should be the residual custodian of the public interest. "Commercial corporations" that have been established for more parochial business purposes should not be burdened with charges that are inconsistent with acting in their shareholders' best interests. Confusion as to whose interests are to be served by the corporation increases the challenges to successfully achieve more effective corporate governance. Boards of directors have sufficient obstacles to confront in meeting their charges effectively, even when the only interests that they have to try to reconcile are those of the shareholders (current, potential or former ones) and management.

7.3. APPROACH TO ADDRESSING CORPORATE GOVERNANCE CHALLENGES

With respect to the second issue (how to address and to effectively deal with corporate governance challenges), there may be no facile single approach or solution. While an attempt can and should be made to develop principles, it nevertheless must be recognized that multiple forces can, do and will continue to have an affect on the evolution and the

[367] See generally Salamon, *supra* note 4.

application of corporate governance. That is due to numerous applicable factors (including those referred to herein), as well as "path dependence, institutional complementarities, bounded rationality and comparative advantage".[368] Since corporations are by their very nature complex and evolutionary, and serve as the *nexus* of varying and what may often be competing interests (including not only those of the shareholders but also those of employees, customers, suppliers and management, to name but five), simplicity, while perchance applicable in the world of *ceteris paribus,* would not appear to be within the realm of commercial reality. It is recognized that these interests, although conflicting at times, do need to coalesce and function effectively together for a commercial corporation to optimize its competitive position and endeavor to be profitable. The maximization of shareholder value and the instilling of investor confidence can nevertheless not ignore the other constituents that play an integral role in wealth creation. While the interests of the shareholder should be the focal point of corporate direction, ignoring the other critical inputs for success would be inconsistent with the aforementioned goals and therefore must be a concern, although not the primary one, of management and of a board of directors.

7.4. THE CHALLENGES – CONFLICTS OF INTERESTS

Conflicts of interest exist in the world of business[369] and are an integral part of corporate reality. Micro-conflicts, such as self-approval of executive and director compensation, can and do exist. Such conflicts can be both direct, in terms of the amounts paid out, and indirect, in terms of benefits and other perks assumed as a result of office. Conflicts can also be macro, in the sense that they can have an effect on not only the individual but also the future of a firm. A case in point is management (including a board of directors) reaction to takeover bids (which can threaten their continuance with the corporation). Such conflicts, both micro and macro, cannot be effectively addressed from a governance

[368] Sanford M. Jacoby, "Employees and Corporate Governance: Corporate Governance in Comparative Perspective: Prospects for Convergence" (2000) 22 Comp. Lab. L. & Pol'y J. 5

[369] See e.g. Stephen Labaton, "Growing S.E.C. Role in Big Board Reform" *The New York Times* (26 September 2003) C1, reporting that "[t]he securities commission has been battered by its failure to root out major accounting fraud at large corporations and *conflicts of interest* on Wall Street and continues to struggle to avoid being eclipsed by the states." [emphasis added]

and public confidence perspective unless they can be dealt with in a transparent manner, with demonstrable checks and balances to counter director and officer *self-interests*. More effective corporate governance needs to ensure that no individual or group (other than the owners) is permitted to "self-approve" actions that may benefit themselves (at the expense of the owners). There appears to be a need to ensure that where the potential for lack of transparency and conflict exists, "independent external assessment", clearly responsible and accountable to the shareholders (with shareholders having the ability to override their putative representative's position), is available.

There have been attempts to deal with conflicts of interests in a number of ways, including through legislation[370] (legislatures establish minimum applicable legal standards), through regulators (the SEC in the United States and the provincial regulatory authorities such as the OSC in Canada, both of which play an overseeing role), by management and the board of directors (through internal, self-imposed corporate guidelines and practices), by the litigation lawyer (through the shareholder's private right of action) and by the media (through coverage). However, to date these checks and balances seem to have been an inadequate remedy. They appear to have been operating in a defensive corporate governance environment, not necessarily in seeking to address the challenges of *self-interest* and the *funneling syndrome,* but in endeavoring to ensure that all ostensibly appeared to be doing what was required. Rather than doing what was optimum, an appropriate paper trail seemed to be the objective of governance so that in the event of regulatory intervention or litigation, the board of directors and management would be able to ensure that they were appropriately protected. As well, given external pressures and the reality of the marketplace,[371] the ability of the regulator to intervene proactively on substantive issues, especially when faced with a well-documented paper

[370] See e.g. *CBCA*, *supra* note 37, s. 120(1), which provides that "[a] director or officer shall disclose to the corporation ... the nature and extent of any interest that he or she has in a material contract or material transaction, whether made or proposed, with the corporation". *Ibid.*, s. 120(5), states that a director required to make a disclosure pursuant to Section 120(1) of the CBCA "shall not vote on any resolution to approve the contract or transaction", subject to specific exceptions.

[371] See Levitt, *supra* note 190 at 10, where he indicates that subsequent to being appointed Chairman of the SEC he saw "a dynamic" he indicated he had not "fully witnessed before", namely "the ability of Wall Street and corporate America to combine their considerable forces to stymie reform efforts".

trail, has often been equivocal.[372] The *status quo* may well have assisted in ensuring the creation of employment opportunities for professional advisors. However, one can and should question whether the added bureaucracy has served the investing public's interests. Alternatively and more unfortunately, has it failed and is it continuing to fail in its objective? Is it dampening confidence and constraining risk taking, so essential to the success of our western economic way of life?

There is a need to address conflicts of interests and to thereby seek to create greater investor confidence. To achieve such objectives, it is posited that directors and officers' exposure to meaningful sanctions for failing to disclose where one is in a conflict of interests (and refraining from participating in the decision making) needs to be revisited. Holding the corporation liable (directly or indirectly) to other "former shareholders, for director and/or officer malfeasance[373] and in effect using the assets of the corporation to compensate such injured investors is to insulate and fail to hold directors and officers accountable. The *status quo* operates to sacrifice the investment of shareholders who remain with a corporation, for the benefit of those who abandon it. Where applicable, such a result would appear to be the antithesis of good governance. Such an approach does not serve to protect the interests of shareholders who invest for the long term, as opposed to speculators. Basic principles must be postulated; if agreed upon, tools of governance, guided by these principles, are required to help realign shareholder, director and officer interests.[374] Corporate governance should not, it is posited, be designed to seek to ensure that the speculator is protected (be it those in control or a third party). Rather, it should assist in helping to instill greater investor confidence by seeking to

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[372] See Levitt, *ibid.* at 10-14, where he refers to the pressure that was brought to bear to have the Financial Accounting Standards Board (FASB) back down on a proposal to expense stock options as the proposed rule "would have crimped earnings and hurt the share price of many companies". Levitt writes that he advised FASB to "back down" and notes this as "the single biggest mistake" during his years of service. Furthermore, he notes that "[w]hen we proposed new rules to make sure that auditors were truly independent of corporate clients, some fifty members of Congress promptly wrote stinging letters of rebuke." Levitt also notes that even subsequent to Enron and WorldCom, "[a]ccounting lobbyists tried to impede reforms, but Congress had no choice but to act".

[373] The term malfeasance includes, for our purposes, actions benefiting the CEO and corporate officers directly and personally, but at the expense of the corporation and its shareholders.

[374] This will be addressed in Chapter 9, below.

ensure that the *self-interests* of investors and management are balanced, aligned and subject to appropriate checks and balances.

The *funneling syndrome* (and the resultant axis and the control of the information being with the CEO) and *self-interest* appear inadvertently or otherwise to create or to perpetuate an environment that is conducive to conflicts. Unless checks and balances raise and address these issues, decisions taken by the CEO (supported by an informationally constrained and often captive board of directors) can only be realistically assessed in such an environment on an *ex post facto* basis.[375] Furthermore, even if a concern is raised on an after-the-fact basis, the CEO is generally well protected (barring fraud or illegality) and indemnified for his (her) actions or inactions and insulated from his (her) malfeasance, all at the expense of shareholders.

The CEO, directors and senior management often appear to be acting as "a principal" rather than on behalf of the shareholders. However, when exposed to potential liability, they take shelter behind the façade that they are merely, in effect, an agent of the corporation and are to be indemnified and protected by it. It is this lack of personal accountability that needs to be addressed.[376] If *competence and integrity* are integral to effective corporate governance and investor confidence, then *accountability* is the key pre-condition to helping to ensure that required competence and integrity exists. However, accountability, while essential, is often difficult to police. *Self-interest* requires enforceable accountability,[377] failing which it will continue to challenge effective corporate governance.

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[375] See McFarland, *supra* note 268, which suggests that Ontario Power Generation would appear to have been a case in point. It had a board including CEO Ron Osborne (a respected accountant and business executive, who was recruited in 1998, leaving his position as CEO of Bell Canada to take on this assignment); Chairman Bill Farlinger (a former chairman of accounting firm Ernst & Young); Arthur Sawchuk, retired CEO of DuPont Canada, and current Chairman of Manulife Financial; Richard Thomson, the retired Chairman of Toronto-Dominion Bank; Paul Godfrey, CEO of the Toronto Blue Jays; and Jacques Ménard, Chairman of BMO Nesbitt Burns. McFarland notes that "Despite their impressive résumés, however, the ... board proved unable to prevent a debacle from unfolding at OPG." *Ibid.* at B2.

[376] This will be dealt with in Chapter 9, below, which argues for the introduction of *PAR* (personal accountability and responsibility).

7.5. SHAREHOLDER APPROVAL OF ACTIONS

Shareholder prior approval of management actions, as a means of seeking to enforce accountability, is not readily acceptable,[378] as it is argued, supported generally by corporate law,[379] that boards of directors rather than shareholders "shall manage the business and affairs of a corporation".[380] However, there appears to be some acquiescence,[381] albeit limited, to shareholders being empowered to take a more proactive role in the affairs of corporations in areas of potential abuse. As well, legislative initiatives have also made inroads; for example, shareholder proposals[382] could be put forward that, in effect, operate to constrain management. As well, Canadian securities legislation (for example, the Ontario Securities Act and regulations) has recognized a role for shareholder participation where conflicts of interests arise. This is reflected, under the Ontario Securities Act, in at least two instances. The first requires shareholders to approve certain aspects of stock option plans.[383] The second applies to related party transactions[384] (where a controlling shareholder seeks to enter into a transaction with the corporation that he (she) controls), and approval by a majority of the minority (which excludes the votes of the majority shareholder) in transactions of that nature are required.

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[377] This is addressed in Chapter 9, below.

[378] See *DSI*, *supra* note 154, statements 70 (on shareholder loans) & 102 (on executive compensation). It is to be noted that a parallel can be drawn between the arguments that are advanced against giving the shareholders a greater vote in the determination of the affairs of "their" corporation, to those advanced in Great Britain, against extending the vote to those disenfranchised, politically. In W.L. Guttsman, *The British Political Elite* (New York: Basic Books, 1963) at 69-70, the author outlines certain of the reasoning advanced at the time, against extending the franchise: "The defenders of the established order at the time ... thought that even the moderate extensions of the franchise would 'open the flood gates.' There could be no equality in political society... To let all have a say in the Government would shift power from the 'people' that is a responsibility of society, to the population which included the mob. Instead of democracy you would have 'fool and knavery'."

[379] See *Schneider*, *supra* note 139 at 190-91.

[380] See *CBCA*, *supra* note 37, s. 102(1), which provides that "the directors shall manage, or supervise the management of, the business and affairs of the corporation".

[381] Those interviewed in the DSI agreed that shareholders should play a more proactive role in the granting of stock options. See *DSI*, *supra* note 154, statements 75 & 101, which require shareholder approval of "total" annual stock option grants; *ibid.*, statement 77, which suggests that stock option grants should only be re-priced with specific shareholder approval). There appears to be recognition that in "proven and recognized areas of abuse" (as has been demonstrated in the case of stock options), shareholder intervention is appropriate.

[382] See *CBCA*, *supra* note 37, ss. 103(5) & 137.

[383] See *Ontario Securities Commission Rule 45-503 – Trades to Employees, Executives and Consultants*, 22 O.S.C.B. 117 (16 October 1998, as amended effective 1 December 2002 & 31 March 2003).

[384] See *Ontario Securities Commission Rule 61-501 – Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions*, 23 O.S.C.B. 971; 25 O.S.C.B. 943 (1 May 2000) [*OSCR 61-501*].

Accordingly, a more proactive role for shareholders, where the potential for abuse as a result of *self-interest* exists, is now a recognized feature, albeit still in its nascent stage, of more effective governance. The issue still to be confronted is whether, notwithstanding the challenges associated with seeking to encourage shareholders to become more proactive, greater potential shareholder involvement should be introduced, given the hurdles faced. Small shareholder apathy needs to be acknowledged. Nevertheless, having more effective shareholder tools that could serve as a threat and be available for use in extreme cases could, in and of itself, help to provide for more effective governance.

The ongoing challenge faced is to seek to ensure that the actions taken by a CEO, officers and board of directors are not rationalized as being in the corporation's (shareholders) best interests, when in fact they are driven by the *funneling syndrome* and parochial *self-interests*. The use of external independently obtained sources of information that can circumvent the *funneling syndrome* and can provide unencumbered information, views and opinions was and is recognized as being required.[385] This role was and is to be performed by the external auditor. However, for reasons outlined herein, including conflict of interests and management capture, this role has been less than effectively accomplished by the accounting profession. The issue is, therefore, twofold. First, how can one make this external audit function more effective and second, how can competitive sources of information be used as checks and balances to ensure more effective governance?

Recently imposed changes such as holding external auditors directly accountable to the audit committee of the board of directors as is required by Sarbanes Oxley Act[386] and National Instrument 52-110[387] appear to be an admission of the current external auditor/ management conflict. However, it is premature, absent empirical evidence, to conclude

[385] See *DSI, supra* note 154, statement 39, where all interviewed agreed "[d]irectors should be able to independently hire, at Company expense, outside advisors to assist them in making decisions". A review as to how often this is done in practice is beyond the scope of this study. However, it is anecdotally suggested that it is a relatively infrequent (although increasing) occurrence, barring exceptional circumstances, such as actions of an "independent committee" in "reaction to a takeover bid".
[386] See *SOX, supra* note 150, s. 204.
[387] *MI 52-110, supra* note 200.

whether the mandated changes will effectively address the challenges (even though it may help by moving the external auditors one step away from control by management). Only independent monitoring of the recently imposed changes will reveal whether these initiatives will address the innate conflicts that the external auditor faces and will continue to encounter, or whether regulator-imposed sanctions on the auditor for a failure to comply, will help to realign the external auditor's allegiance and help engender greater investor confidence.

In addition, other sources of information reported on in a quantifiable, credible and comparative manner (obtained from the participants contributing to the success of a corporation, such as employees, customers and suppliers) may be required. These other constituents[388] play a key role in the development and the success of the corporation. Such independent data (with a full appreciation of both its strengths and weaknesses) could be used by the board of directors (and investors) as an added source of independent information to help them assess performance and to measure, on a comparative basis, the components that help to drive the success of the corporation.

Who is best positioned to perform this function is an issue that requires more and detailed research, study, analysis and debate. Whether this function can or should continue to be performed by accounting firms or by others capable of independently assessing the effectiveness of the corporation is far from clear. However, rather than anchoring effective corporate governance on a system that has too often failed in the past to meet the needs of investors, a search for alternatives may be required. The issue may well be that protecting shareholder interests and achieving more effective corporate governance may require the adaptation of alternative or supplemental tools. That such tools exist no longer appears to be in dispute.[389] Acceptance of independent advisors to assist the board of directors in reaching decisions, albeit on an exceptional basis, is tacit recognition that

[388] Blair, *Ownership and Control, supra* note 103.

[389] See e.g. DiPiazza & Eccles, *supra* note 319 at 113, who note that "Royal Dutch/Shell seeks input from its stakeholders", and praise the manner in which the company meets the information needs of its shareholders. They also note that Telstra (an Australian company) "has taken the extraordinary steps to identify, monitor, and report on customer satisfaction". *Ibid.* at 115.

there is a need to by-pass the *funneling syndrome*. Nevertheless, such actions will not be readily accepted by management and could lead to friction (constructive or confrontational depending on one's perspective). Some have argued strenuously[390] that such an approach should not be pursued. Whether "bypass mechanisms" will be further developed and used to assist in ensuring transparency and accountability as a check and balance on those in control, or will be constrained by fear of offending management having a vested interest in the *status quo* and the *funneling syndrome* needs to be an ongoing issue of focused debate.[391] However, while this thesis advocates a structured (as opposed to *ad hoc*) by-passing of the *funneling syndrome*, how one should most effectively seek to implement such additional checks and balances is beyond its scope. It is however noted that inroads into this area of endeavor have been and are being made.[392] There is therefore a need to question, challenge and seek to pursue how new innovative instruments can be made to serve the interests of shareholders, help sustain investor confidence and become imbedded for more effective corporate governance.

7.6. IMPLEMENTATION

Statutory amendment (as opposed to requirements imposed by the regulators such as the OSC or the SEC) is a time-consuming, costly and highly political process. Accordingly, seeking to ameliorate corporate governance through legislative action, while laudable and in the final analysis often ultimately necessary if one is to impose minimum requirements on all who would otherwise fail to comply, may not be the optimum short-term solution. A practical approach in seeking to deal with the challenge may need to be pursued. The *Canada Business Corporations Act* (CBCA) would appear to provide such an avenue.

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[390] This is based on DSI-related discussions.

[391] *Higgs Report*, *supra* note 151 at 33, refers to this concern when it rationalizes keeping management (non-executive directors) on boards of directors. Furthermore, like many (but not all) of those interviewed as part of the DSI exercise, *ibid.* at 29, ¶6.14, suggests "[t]hat all non-executive directors must be able and willing to inquire and probe. They must have sufficient strength of character to seek and obtain full and satisfactory answers within the collegiate environment of the board". However, rather than explaining how to circumvent challenges such as those created by the *funneling syndrome*, Higgs suggests that the basis for questioning and challenging the accepted thinking of the executive is "through their relative distance from day to day matters, combined with experience acquired elsewhere", clearly arguing for a retention of the status quo.

The CBCA permits shareholders to "make a proposal, to make, amend or repeal a bylaw"[393] and provides that while the directors shall manage or supervise the management of the "business or affairs of a corporation",[394] the directors' ability to act is subject to act to the "articles, bylaws or a unanimous shareholder agreement".[395] Accordingly, it would appear that a shareholder proposal to pass a bylaw that requires a corporation to put certain additional checks and balances into place[396] is capable of being achieved pursuant to the CBCA. Institutional investors could take the lead in seeking to have changes of this nature initiated by negotiation or by means of a shareholder proposal.[397] However, attempts to have similar changes introduced by statute (as opposed to by means of shareholder action) may raise a number of issues, constitutional and practical in nature.

Constitutionally, one would have to determine whether a desired change is within the authority of the Federal Government or, in pith and substance, is within the jurisdiction of the provinces as pertaining to property and civil rights.[398] Assuming that governance of federally incorporated corporations is constitutionally valid, the second substantive issue is that given the ability of a corporation to continue (that is to transfer) to another jurisdiction,[399] the introduction of legal constraints at the federal level (unless followed in parallel by all provincial jurisdictions) may result in corporations engaging in jurisdictional shopping. Such actions could be rationalized by those in control on numerous grounds, including the spin that such action is required to provide the required flexibility, without regulatory intervention, to maximize value for the shareholders.

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[392] DiPiazza & Eccles, *supra* note 319. See also Danish Ministry for Trade and Industry, "A Guideline for Intellectual Capital Statements: A Key to Knowledge Management", online: Global Reporting Initative <http://www.globalreporting.org.>.

[393] See *CBCA*, *supra* note 37, s. 103(5).

[394] See *ibid.*, s. 102(1).

[395] See *ibid.*, s. 103(1).

[396] This is addressed in Chapter 9, below.

[397] However, for many of the reasons previously noted in Chapter 2, Section 2.5., above, they may lack the appropriate incentives to help the market as a whole, as opposed to only their own constituents.

[398] For a discussion of the "pith and substance doctrine" and a test for its application to specific matters, see *General Motors of Canada Ltd. v. City National Leasing*, [1989] 1 S.C.R. 641 at 666-69, [1989] S.C.J. 28.

[399] See e.g. *CBCA*, *supra* note 37, s. 188(1), which provides, *inter alia*, that "a corporation may apply to the appropriate official or public body of another jurisdiction requesting that the corporation be continued as if it had been incorporated under the laws of the other jurisdiction".

Given the challenges faced in attempting to introduce mandatory corporate governance requirements, changes made voluntarily, although theoretically feasible and plausible (especially where it is motivated by a desire to pre-empt legislative intervention), are nevertheless unlikely to constrain those who would seek to abuse the system. Absent being motivated, (that is, having meaningful sanctions apply), those who would otherwise pursue self-gratification at the expense of their positions of trust are unlikely to be effectively constrained, or to be held accountable in any meaningful manner. As a result, unless corporate governance requirements are mandatory, by virtue of being introduced as a bylaw (or made applicable to all by regulation or other legal means), change is unlikely to be uniformly implemented. More effective tools of corporate governance would then suffer from an innate deficiency; they would not, in practice, apply to those who may most need to be constrained. Voluntary codes or guidelines would not address the limited few that find pursuing *self-interest* at the expense of others acceptable. Such individuals, who may well be a small minority (as is generally true of such elements, including criminals), necessitate mandatory, legally enforceable obligations. Accordingly, to suggest (as was the case in some of the interviews) that the problem faced is one that must be addressed through a change in "corporate culture" is acceptable. However, the substantive issue, not clearly dealt with, is how one should change culture, and what are the effective sanctions that will help to ensure compliance by those who would otherwise fail to comply. One position advanced to the author was that it cannot be legislated; rather in practice, good corporate governance must be endorsed, accepted and voluntarily adopted and practiced by the business community and become part of the corporate way of life. That suggestion, although well intentioned and laudable, appears idealistic. It fails to address how a voluntary process will make individuals who refuse or fail to comply accountable to the shareholders and to the investing public.

It is hard to appreciate how voluntary guidelines will help to address the challenges faced by the lack of public confidence in industry in general and the financial markets in particular. Legal accountability (however instituted most effectively, be it by by-law, regulation or legislative enactment) must be viewed as an acceptable price to pay in seeking to regain credibility and to re-establish confidence with the investing public.

Many with vested interests in the *status quo* argue that one should not substantively alter the manner in which corporations are managed. It is suggested that corporations should unilaterally move forward, on the basis of what reflects best practices and that they should publicize their actions in that respect (an approach that had been advanced by the TSX). However, such an initiative, although tried, seems to date to have failed. In order to deal with the few leaders of corporations that malign the strong majority, minimum standards of corporate governance need to be legally implemented. Should the foregoing not take place, the ability to navigate around the requirements, propelled by the *funneling syndrome* and *self-interest*, can and over time will continue to frustrate more effective corporate governance.

7.7. CONCLUSION

The common element in these potentially conflicting factors is the role of information, where and how it will be obtained and its ability to assist the decision making of a board of directors. The challenge continues to be to attempt to arrive at solutions based on "principles", anchored in academe but translated into "tools of governance" and then tested in the world of commercial reality. Any such proffered solutions need to require and enforce *CIA* on the part of the directors and officers of a corporation, to assist in responsible decision making and to ensure that relevant information is made available to those responsible for the governance of the corporation. As well, that objective must be achieved in a transparent, unscreened and focused manner, one that is mandatory (that is, one that is imposed by law) if it is to succeed in addressing and controlling *self-interest* and the circumvention of the constraints of the *funneling syndrome.*

Chapter 8
Empirical Research

8.1. INTRODUCTION

To complement the theoretical academic initiative that was tempered by anecdotal experience, empirical research and fieldwork was undertaken. This latter initiative involved four phases.

The initial phase, structured as a *DSI*,[400] focused on individuals actively involved in business and in the governance of corporations. The objective was to obtain the candid (off-the-record) views of directors and officers of corporations, as well as those closely aligned with and offering services to management (such as lawyers, accountants and members of the financial community) regarding how they believed corporations operated, in practice, rather than in law or in theory. To achieve this objective, phase one involved a three-step process. The first step of phase one was to develop a matrix,[401] which interviewees were asked to complete. The matrix was designed to elicit their views, in a quantitative as opposed to qualitative manner, as to where the greatest power and fewest constraints (that is, checks and balances) existed with respect to the key players, members of management, the directors and the shareholders of a corporation (that is, the center(s) of power and control within a corporation). In the second step, a detailed questionnaire was given to each interviewee.[402] During the last phase of step one, the *DSI* interviewees[403] were asked to respond to a "Public Survey",[404] which was also to be used with others in phases two, three and four. The *Public Survey (PS)* was created to provide a common basis of comparison for the different groups being surveyed.

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[400] Also referred to herein as the DSI.
[401] See Chapter 1, Section 1.2., table 1, above.
[402] The DSI questionnaire is included in Appendix A, below.
[403] Twenty-eight of the 43 interviewees subjected to the DSI were asked to complete the *PS* (as the *PS* was developed part way through the DSI interviews and I did not return to reinterview those with whom I had already met).
[404] Also referred to herein as the *PS*. The *PS* is included in Appendix B.

The second phase involved using the *PS*[405] with a homogeneous group, namely members of the accounting profession. This was pursued with the assistance of representatives of the Canadian accounting profession,[406] who canvassed Canadian chartered accountants.

The third phase involved seeking to ascertain the views of another group with common characteristics, namely individuals within the legal profession or with a background in law. Using the *PS*, graduates of the McGill Faculty of Law were the focus of this initiative.

Lastly, the *PS* was to be used to assess the views of a heterogeneous group, the general public.

All participants were advised that discussions were on a confidential, not for personal attribution basis. Given that the *PS* was to be used with all four groups, consistency or substantial deviations in responses were the areas of primary focus.

8.2. PHASE 1: STEP 1 - CENTER(S) OF EFFECTIVE POWER AND CONTROL WITHIN A CORPORATION

The survey was conducted in person at private meetings. It attempted to arrive at an assessment of where, in practice, the "center(s) of effective power and control" existed within a corporation on a comparative as opposed to absolute basis. The objective was to derive these conclusions by having the interviewees complete the matrix, described below in Table I, without advising the participants as to the purpose of the exercise. [407]

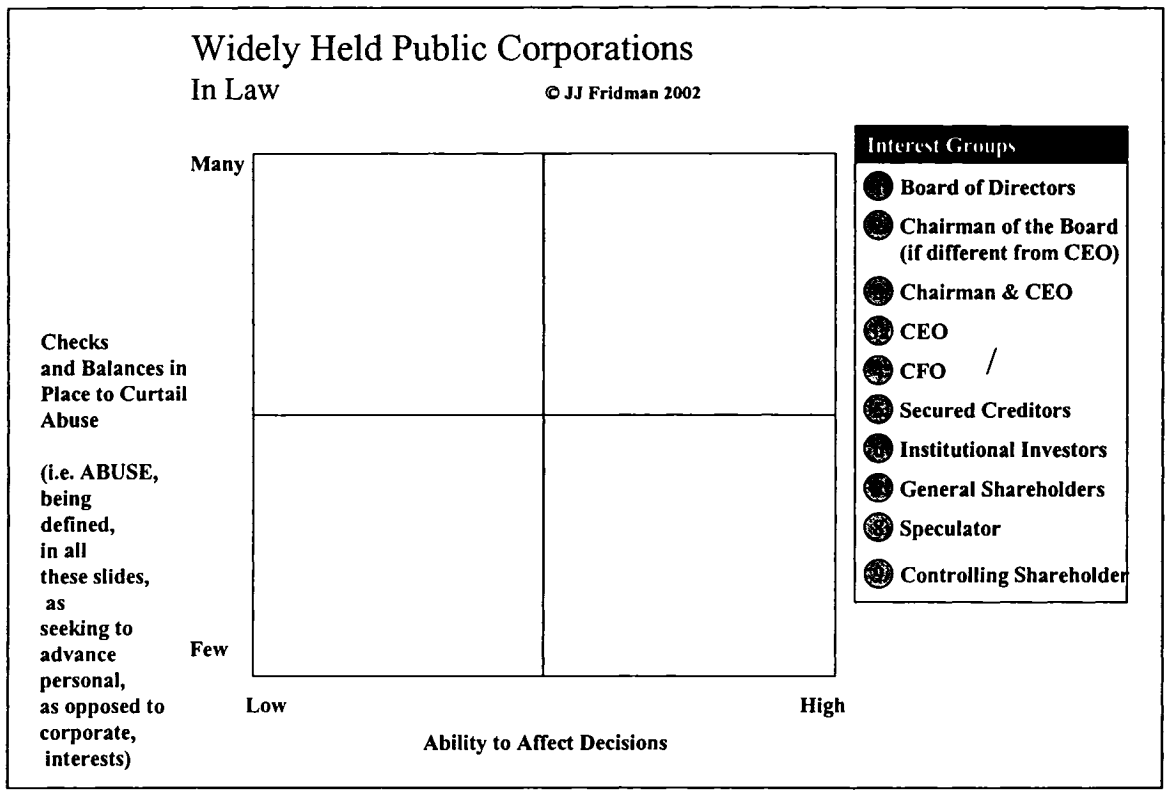
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[405] Minor modifications were made to the *PS* and a French version was also prepared and used (at the request of *CA Magazine*).

[406] *CA Magazine* also controlled the actual conduct of the survey to ensure confidentiality and to protect the identity of their members, who participated in this survey.

[407] The meetings served to highlight a potential problem. In some cases, there appeared to be confusion created by the structure of the matrix, as the horizontal axis was not set up on the same basis as the vertical axis. The horizontal axis reflected the ability to effect decisions going from low to high, that is, the ability to affect decisions increased as one moved along the horizontal axis. However, the vertical axis was structured in the reverse order; few checks and balances suggested great ability to affect decisions while moving upwards on the vertical axis towards greater checks and balances reflected a lesser ability to do so. If this matrix is to receive greater or continued use an adjustment to the matrix to correct for this anomaly should be considered. Furthermore any reader in attempting to self-test using this matrix should be

Table I



The approach taken in dealing with the interviewees was as follows. Each interviewee was asked to assume that he (she) was dealing with a widely held, publicly listed Canadian corporation. The interviewee was then requested to consider the ten categories (individuals and groups) listed on the right-hand side of the matrix and to assess what role "in practice" (as opposed to in law) each plays in the decision making (that is, in the management and control) of such a corporation. Having considered the foregoing, the individual was then required to locate each of the ten categories on the matrix (in other words, to place the number corresponding to the individual and group on the matrix) based upon their personal views and experience and relative to two considerations. The first consideration had to do with the "ability to affect decisions" (on the horizontal axis) and the second, with the "checks and balances" in place to curtail abuse (on the vertical

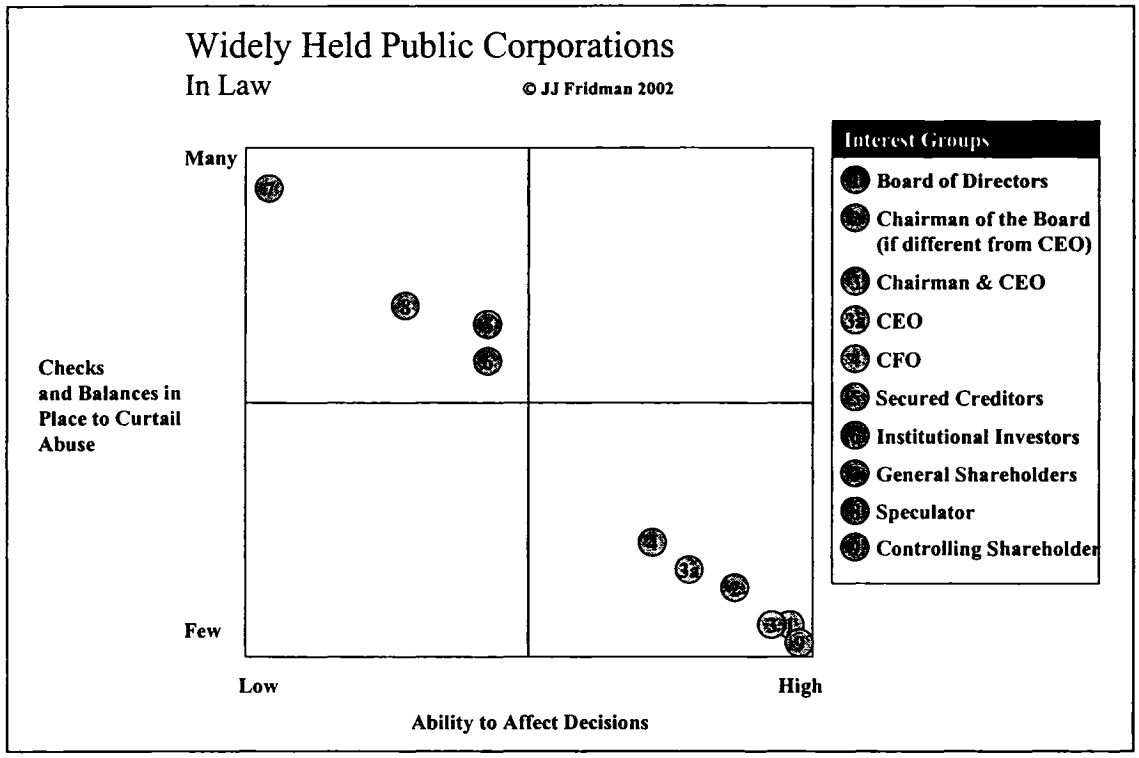
sensitive to this structural anomaly. Notwithstanding the identified inconsistency in the structure of the matrix (which was not modified so as to ensure that all were assessed against a common frame of reference) it did elicit responses in the manner sought.

axis), abuse being defined in all cases as having the *ability* to advance personal *(self-interest)* as opposed to corporate interests, whether or not such action was taken. While ten categories were included, the points of primary interest were two-fold. First, it was to ascertain where the board of directors, chairman (non executive) of the board, chairman and CEO, CFO, general shareholders and controlling shareholders were positioned in the views of the interviewee and second, their relative as opposed to absolute locations. The other categories were merely added to reinforce the internal validity ...and to provide points of potential interest.

A second matrix was prepared using the exact same format as the one submitted to the interviewee. However, this one attempted to place the ten categories (listed on the right-hand side) according to an assessment of where they should be positioned as a matter of law. Table II noted below indicates where the categories would be located, based upon a legal review of their ability to affect management and control. [408]

[408] The rationale for the positioning is included in Appendix D.

Table II

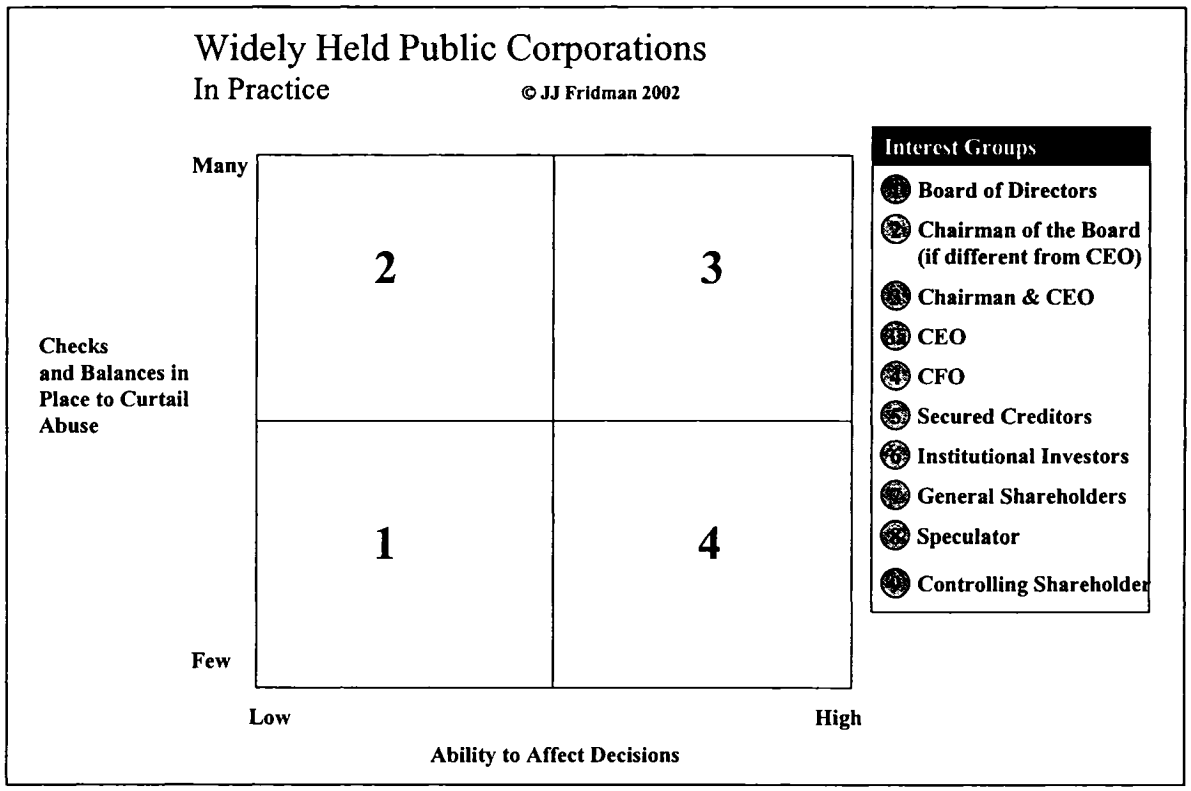


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8.3. ATTRIBUTES OF THE QUADRANTS IN THE MATRIX

Each of the quadrants in the matrix, highlighted as 1, 2, 3 and 4 in Table III below, is designed to reflect attributes of certain positions in business.

Table III



Quadrant four, reflecting ownership, encompasses the maximum ability (relative to the positions reflected by the other quadrants) to exercise control and direction. Those within its ambit are viewed as having the greatest ability to affect decisions and to be subject to the lowest levels of checks and balances. As a result, those falling within the ambit of quadrant four, have the maximum ability to exercise effective control of a corporation.[409]

Quadrant three was designed to encompass officers[410] of a corporation. Officers have (to varying degrees depending on the position) a relatively high ability to effect decisions

[409] They are designated as having the highest level of authority (A) to get things done, namely 1 (or 100%) See Subsection 8.7., below.
[410] They are designated as having a level of authority of 0.75 (or 75%). See Subsection 8.7., below.

(especially within their respective areas of expertise, similar to owners). However, they are viewed as being subject to greater checks and balances to prevent abuse (more constrained, at least in theory) than an owner or a partner.

Quadrant two was designed to encompass a junior clerk, or administrative official, with strict guidelines as to what he (she) can do. This position was viewed as having relatively little discretion (relative to the other three positions) and a very low ability to affect decisions.[411]

Quadrant one was structured to reflect the rights of partners.[412] The ability to control decisions is viewed as being less than that of the owner (as power must be shared with other partners). Nevertheless, the checks and balances to curtail "abuse" are still relatively limited, given the power of a partner to bind the other partners by his (her) actions. Accordingly, while viewed as having less of an ability to affect decisions than an owner, given the role of other partner(s), the checks and balances in place were viewed as paralleling those of the owner quadrant (which, in effect, a partner would legally be).

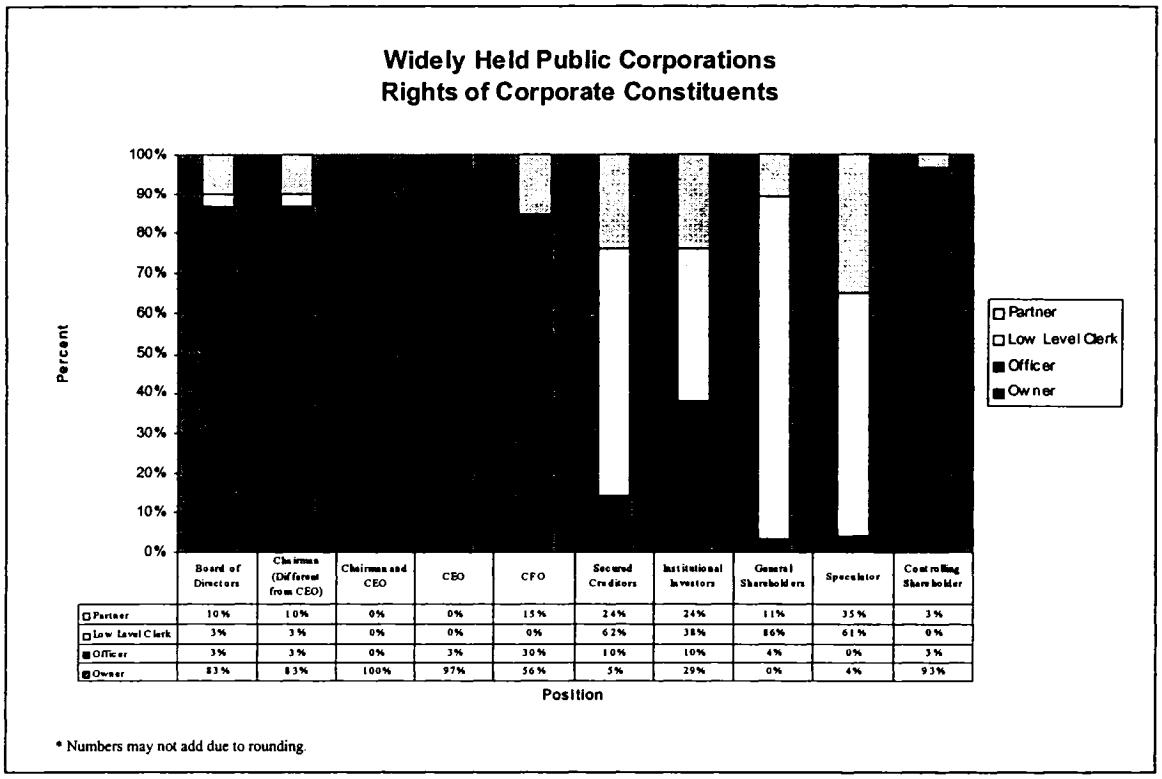
8.4. RESULTS OF FOCUS GROUP INTERVIEWS[413]

The results of the *DSI* participants' completion of the matrix exercise are reflected in Table IV below.

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[411] They are designated as having a level of authority of less than 0.5 (or 50%). See Subsection 8.7., below.
[412] These are designated as having a level of authority half way between that of an "owner" and that of an "officer", that is 0.875 or (87.5%). See Subsection 8.7., below.
[413] These results are based on thirty interviewees who completed the matrix.

Table IV



	Board of Directors	Chairman (Different from CEO)	Chairman and CEO	CEO	CFO	Secured Creditors	Institutional Investors	General Shareholders	Speculator	Controlling Shareholder
Partner	10%	10%	0%	0%	15%	24%	24%	11%	35%	3%
Low Level Clerk	3%	3%	0%	0%	0%	62%	38%	86%	61%	0%
Officer	3%	3%	0%	3%	30%	10%	10%	4%	0%	3%
Owner	83%	83%	100%	97%	56%	5%	29%	0%	4%	93%

* Numbers may not add due to rounding.

While perhaps not surprising, the results were nevertheless revealing. Included in the fourth quadrant, the "ownership" module, by 100% of respondents were the chairman and CEO (the combined role), by 97% the CEO and by 93% the Controlling Shareholder. Interestingly, those with the lowest relative level of support were the Board of Directors and the non-executive chairman of the board, which both received the identical support of 83%. It is to be noted that even when those within these categories were placed outside the fourth quadrant, they were nevertheless generally located in close proximity to it for these participants. Accordingly, the very strong consensus was that these individuals were viewed as possessing and having the ability to exercise ownership rights.

Conversely and of perhaps greater importance from a corporate governance perspective, 86% included the owners of a corporation, the shareholders, in the second quadrant (that of a junior clerk or an administrative official). Clearly this exercise seems to suggest that relatively few of those most sophisticated in the running of corporations see shareholders as possessing attributes of ownership.

If one is to help address this apparent misalignment, then it is suggested that rules, concepts and processes, the tools of governance, need to bring shareholders closer to the fourth quadrant, not distance shareholders from it. Using the data collected, an attempt will be made to focus on how this can be done in a meaningful and pragmatic manner. The objective will be to attempt to arrive at incremental changes and then seek to assess, through individual focus interviews, if such suggestions can be effective in seeking to assist in shifting the position (and rights and powers of shareholders) in the direction of quadrant four, namely towards that of owners.

8.5. INDIVIDUAL FOCUS REVIEW ISSUES OF PUBLIC INTEREST

8.5.1. Introduction

The assessment of perceptions on issues related to corporate governance, an integral part of the *DSI* process, was conducted through a lengthy questionnaire. The approach was exploratory (without reference to statistical sampling techniques), but snowballed when certain interviewees suggested meetings with other prominent members of the business and professional community.[414] The results reported herein as a "general consensus", grouped together all positive and negative responses. Those that indicated that they "agreed", or "agreed strongly" were grouped together as were those that "disagreed" or "disagreed strongly" to arrive at the "general consensus".[415]

In excess of one hundred questions were posed. The questions were grouped around sixteen subheadings, the findings of which will be reported on in a similar manner. The objective was to gage the views of individuals with business experience (such as business executives, chairmen and CEOs) or professional business-related experience (such as lawyers, accountants, financial advisors and investors) on many of the corporate governance issues. The confidential, not-for-personal-attribution basis was stressed with each of the interviewees. While the initial objective was to conduct all of these interviews

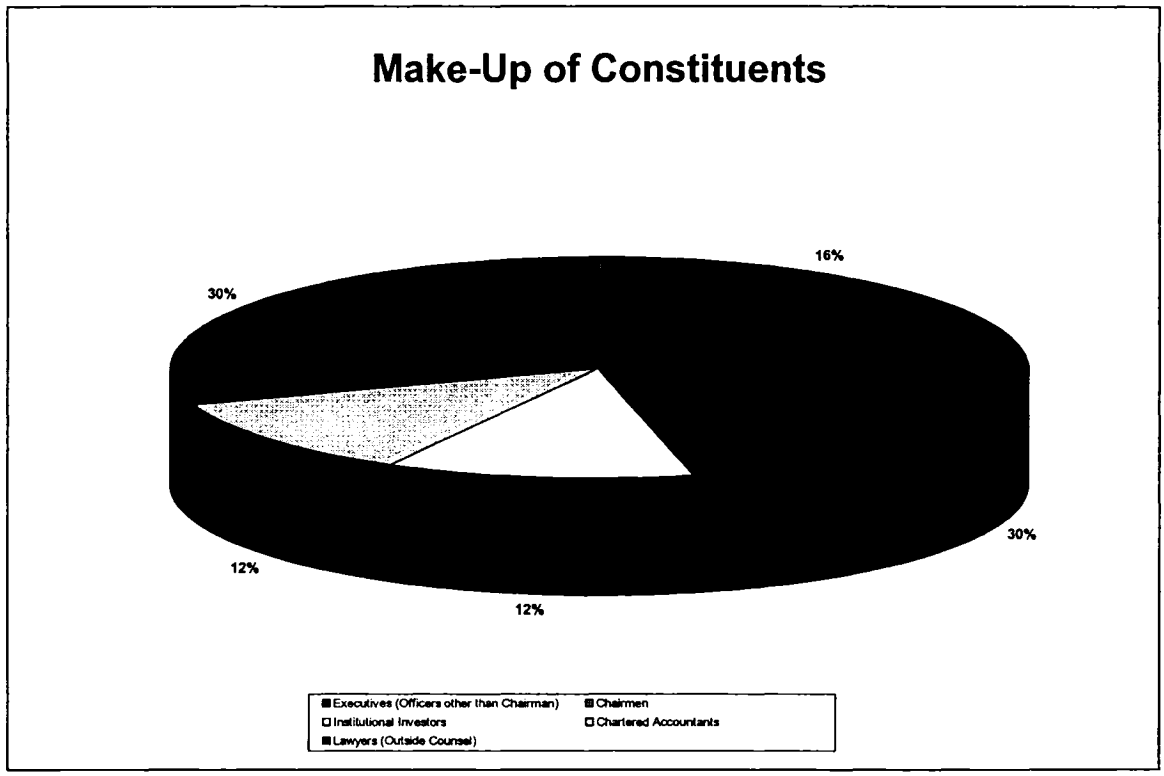
[414] Those canvassed were initially to be limited to 30. However, due to snowballing, 43 individuals were in fact interviewed. Other than those with timing conflicts, only one person who had been approached refused to be interviewed.

[415] A detailed breakdown of the responses received to the *detailed survey and questionnaire process* is included in Appendix E, below.

in person, the length of the questionnaire and the schedules of those approached for feedback required, in a limited number of the cases, that the questionnaires be filled out at the convenience of and in private by the interviewee. Comments (in addition to answering the questionnaire) were invited and received, and are reflected herein. It should be noted that given the time commitment required (an interview, on average, lasted two hours), relatively few individuals were selected for the interview. Furthermore, given the knowledge base of the individuals and notwithstanding the general sophistication of their relative fields of endeavor, not all questions were responded to (the levels of knowledge relating to the field of corporate governance varied quite widely) and in some cases, answers were qualified. As well, some minor modifications were made to the questionnaire used at the outset, based on the initial feedback received. As a result, this exercise was viewed as being directional. The results as reflected herein as well as the related research and tools of governance that evolved from this exercise were re-discussed with some of the individuals that were interviewed as part of this initial process and their feedback was reported.

The composition of the interviewees subjected to the *DSI* is indicated in the Table V. However, given the relatively small size of the sample, information was not disaggregated by category of respondent.

Table V DSI: CONSTITUENTS SURVEYED



8.5.2. The Chairman

There appeared to be a strongly held consensus that the chairman should be separate from the CEO,[416] not surprising given the direction taken in Canada to separate these functions. However, notwithstanding the importance attributed to this separation (and its growing acceptability and support, as noted herein) it was surprising to find that on the suggested statement that effective checks and balances are in place between the position of the "chairman" (non executive) and that of the "CEO",[417] the views were relatively evenly divided. As well, in what appeared to be an attempt to encourage and provide the appearance and the substance of greater independence, there was strong support for the position that a former CEO should be precluded from occupying the position of

[416] *DSI, supra* note 154, statement 1: supported by 86% (88.11% when those who indicated that they were neutral were excluded).
[417] *Ibid.*, statement 3: supported by 48.6% (54.55% when those who indicated that they were neutral were excluded).

chairman.[418] Consistent with the foregoing, the position that the chairman should have access to the information required to make decisions that are at odds with recommendations of management[419] was strongly endorsed.

The efficacy of the role of the chairman, as currently constituted, did not receive substantial support. When it was suggested that ineffective chairmen are not tolerated and are replaced, this view received very limited support.[420] On the contrary, it was suggested that ineffective chairmen, in practice, stay in office and are not replaced. *It is therefore not surprising that the general consensus was that there is a need to introduce changes to make the position of non-executive chairman more effective.*[421]

While concerns were raised that introducing a non-executive chair could prove to be costly for smaller corporations, it was also suggested and recognized that more independence in decision making could be achieved by distancing a chairman from management and by having a person, independent of management, "lead the board". It was also noted that there should be effective checks and balances between the board and management, not just between the chairman and the CEO, as it was suggested that the chairman is merely a "facilitator", not the "decision maker". Otherwise, it was postulated that the CEO could effectively be replaced by the chairman (a concern that was raised in a number of discussions). It was also suggested that a director should have access to information, but that this should not be tantamount to redoing management's job; you "either trust management or fire them", the concern being that one should not have to duplicate the work being done by management to be able to perform one's supervisory and monitoring role.

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[418] *Ibid.*, statement 2: supported by 61.9 % (76.51% when those who indicated that they were neutral were excluded).

[419] *Ibid.*, statement 6: supported by 58.4 % (80% when those who indicated that they were neutral were excluded). However, it should be noted that some who opposed the statement suggested that this right should not be limited to the Chairman, but should be available to all directors, and therefore opposed the statement because they read it to mean "to the exclusion of other directors", something that was not intended by the interviewer.

[420] *Ibid.*, statement 8: supported by 17.1% (19.48% when those who indicated that they were neutral were excluded).

It was further suggested that checks and balances are only effective if the board is prepared to be "constructively critical" and to accept "constructive tension" in its dealings with management, something it was suggested that "new directors" not "entrenched by their own decisions" may bring to the table. Hence it was postulated that *perhaps limited terms of office*, resulting thereby in seasoned as well as new directors serving on the board at any one point in time (as well as an appropriate board committee rotation policy) could assist in improving the system of checks and balances.

However, it has been noted that limiting terms of office (just as past suggestions that the external auditors [accounting firms] be rotated), will raise substantive, policy and political concerns that absent a strong consensus, support and, if proven necessary, a legislative foundation, may not withstand the reaction of vested interests or practical pressures.

8.5.3. The CEO

The general consensus was that the CEO was very much at the center of activity within the corporation. The CEO was compared to royalty,[422] being perceived as playing a prime (key) role in the appointment[423] and the removal of directors,[424] in the retention or the changing of external auditors,[425] in interacting with the external auditors (on issues of major importance),[426] in engaging outside legal counsel,[427] and in participating on key

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[421] *Ibid.*, statement 9: supported by 75.6% (83.81% when those who indicated that they were neutral were excluded).
[422] *Ibid.*, statement 10: supported by 88.4% (92.66% when those who indicated that they were neutral were excluded).
[423] *Ibid.*, statement 11: supported by 92.7 % (there were no neutrals in response to this question). However, when the wording was slightly changed from playing a "prime role in the appointment of directors" in question 11 to playing a "pivotal role in appointing new directors", in question 18, the respective percentage dropped to 83.3% (there were no neutral responses).
[424] *Ibid.*, statement 19: supported by 71.8 % (75.66% when those who indicated that they were neutral were excluded).
[425] *Ibid.*, statement 13: supported by 75.6% (81.55% when those who indicated that they were neutral were excluded).
[426] *Ibid.*, statement 12: supported by 77.5% (83.78% when those who indicated that they were neutral were excluded).
[427] *Ibid.*, statement 15: supported by 67.5% (75 % when those who indicated that they were neutral were excluded).

board committees.[428] The CEO was also viewed as being actively involved in determining compensation, including the chairman's,[429] the board of directors',[430] his (her) direct reports[431] and his (her) own.[432] However, it was suggested by some that given recent events, this was in the process of changing, with boards now taking a much more proactive role.

Accordingly, when examining the issues of checks and balances and the players who are critical to its success, namely the board of directors and the external auditors, the role played by the CEO in the appointment and retention of the directors and the external auditors, and the power exercised by the CEO over their continuance in their roles, *power and control appears inappropriately weighted in favor of the CEO.* As well, the role of the CEO in the determination of compensation, another area of potential conflict, would appear to be an inherent challenge to the governance process that needs to be addressed.

8.5.4. The Directors

Given the pivotal role played by the CEO in the life of the directors (including their appointment, their removal, and their compensation), it is not surprising that most of the individuals canvassed were of the view that directors are closely aligned with[433] and are generally supportive of the CEO.[434] Consistent with the foregoing, it was interesting to note that there was a strong consensus that directors were not prepared to ask the tough questions (only a minority believed that they were prepared to so act)[435] nor make the

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[428] *Ibid.*, statement 16: (a) the audit committee, 68.4% and 74.27%; (b) the corporate governance committee 73.7% and 92.32%; (c) the compensation committee 87.2% and 94.47% and (d) other committees, 82.10% and 96.93% respectively In all cases, the first percentage indicates the percent of total support and the second one the percentage of favourable opinions, excluding those who indicated that they were neutral.

[429] *Ibid.*, statement 17(a): supported by 76.9% (78.95% when those who indicated that they were neutral were excluded).

[430] *Ibid.*, statement 17(b): supported by 77.5 % (81.58% when those who indicated that they were neutral were excluded).

[431] *Ibid.*, statement 17(c): supported by 87.2% (89.44% when those who indicated that they were neutral were excluded).

[432] *Ibid.*, statement 17(d): supported by 100% (there were no neutrals).

[433] *Ibid.*, statement 20: supported by 90.5 % (there were no neutrals).

[434] *Ibid.*, statement 21: supported by 100% (there were no neutrals).

[435] *Ibid.*, statement 22: supported by 33.3% (39.98% when those who indicated that they were neutral were excluded).

difficult decisions, other than when they had no alternative.[436] Not surprisingly, those interviewed indicated that directors were not proactive,[437] but reactive.[438] As well, only a minority of the respondents agreed with the statement that directors generally took the time required to "really understand the issues" and "to make a meaningful contribution".[439] Almost all canvassed agreed that prestige is a key factor[440] in agreeing to become a director and a strong majority agreed that potential director liability[441] is a factor impacting a person's decision to accept or to reject a board position. Most agreed that compensation was not a key factor in agreeing to stay on a board,[442] although a majority felt that compensation was inadequate[443] albeit improving, given the demands on directors.

As well, *the general consensus* favored **limiting the number of directors on a board,**[444] **having a minimum and a maximum term,**[445] **limiting the number of boards that a director can sit on**[446] and **disallowing a retiring CEO from sitting on the board of the corporation from which he had retired.**[447] A majority also indicated that **employees** (other than just the CEO) **should also be prohibited from sitting on the boards of**

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[436] *Ibid.*, statement 23: supported by 71.4% (81.04% when those who indicated that they were neutral were excluded).
[437] *Ibid.*, statement 24: that they were considered proactive was only supported by 7.3% (7.87% when those who indicated that they were neutral were excluded).
[438] *Ibid.*, statement 25: supported by 88.4% (92.66% when those who indicated that they were neutral were excluded).
[439] *Ibid.*, statement 26: supported by 36.6 % (45.47% when those who indicated that they were neutral were excluded).
[440] *Ibid.*, statement 27: supported by 95.2% (97.54% when those who indicated that they were neutral were excluded).
[441] *Ibid.*, statement 30: supported by only 72.5% (78.38% when those who indicated that they were neutral were excluded).
[442] *Ibid.*, statement 28: only 19.5% (21.62% when those who indicated that they were neutral were excluded) believed that compensation was a key factor.
[443] *Ibid.*, statement 29: 41% (47.02% when those who indicated that they were neutral were excluded) thought that director compensation was adequate, given the demands on them.
[444] *Ibid.*, statement 31(i): supported by 85.4 % (there were no were neutrals).
[445] *Ibid.*, statement 31(ii): supported by 56.4% (59.43% when those who indicated that they were neutral were excluded).
[446] *Ibid.*, statement 31(v): supported by 75% (81.08% when those who indicated that they were neutral were excluded).
[447] *Ibid.*, statement 32: only 33.3 % (36.84% when those who indicated that they were neutral were excluded) thought that former CEOs should be allowed to sit on the boards of the corporations from which they retired, after their retirement.

directors of companies from which they retired,[448] that **current professional advisors should not be allowed to sit on boards of their clients**[449] (although former professional advisors should not be so restricted,[450] subject to the comments in numerous cases that a cooling off period before accepting a board position should apply) and **that directors should not be allowed to engage in consulting or other activities with the corporations on whose boards they sit.**[451]

The issue of seeking to align the interests of the directors and the shareholders was also canvassed. A majority agreed that **directors should own a "meaningful number of shares"**[452] (although what was meant by "meaningful" was not defined) in the corporation on whose board they sit, that **stock options were not an appropriate way to compensate directors,**[453] and that **cross board relationships** (that is, an individual sits on your board and you sit on his (hers)) **should not be permitted.**[454] As well, to improve the quality of decision making (and in effect, to bypass the *funneling syndrome*, although this concept as such was not raised with the interviewees), there was unanimity (by all who proffered an opinion) that **access to outside independent advice to assist directors should be permitted.**[455]

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[448] *Ibid.*, statement 33: only 23.8% (26.3% when those who indicated that they were neutral were excluded) supported allowing former employees to sit on boards of corporations from which they retired, after their retirement.

[449] *Ibid.*, statement supported 34: only 21.4% (23.6% when those who indicated that they were neutral were excluded) were in support of allowing current professional advisors to sit on the board of clients

[450] *Ibid.*, statement 35: supported by 63.4% (70.29% when those who indicated that they were neutral were excluded).

[451] [Emphasis added]. *Ibid.*, statement 40: 19.5% (21.04% when those who indicated that they were neutral were excluded) were nevertheless still in favor of allowing directors to engage in consulting or other activities with corporations on whose boards they sat.

[452] *Ibid.*, statement 37: supported by 64.3% (69.07% when those who indicated that they were neutral were excluded).

[453] *Ibid.*, statement 72(b): only 17.1% supported granting options to directors (19.48% when those who indicated that they were neutral were excluded).

[454] *Ibid.*, statement 41: cross board relationships were only supported by 25% (28.57% when those who indicated that they were neutral were excluded).

[455] *Ibid.*, statement 39: supported by 97.6 % (100% when those who indicated that they were neutral were excluded).

Some interviewees noted the importance of collegiality in the boardroom and suggested the need for a process that embraced compromise and adjustment[456] rather than opening the door to disagreement and potential conflict. A board meeting in-camera without management, it was also suggested, was sub-optimal, created different categories of participants and generated a lack of trust, rather than encouraging the team approach that was desirable.

8.5.5. The External Auditors

With respect to the appointment of external auditors, the general consensus was that in fact management,[457] not the board directors[458] nor the shareholders,[459] appointed the external auditors, that the external auditors were primarily loyal to management,[460] and not to the shareholders[461] or the directors,[462] and that the **external auditors should not be allowed to engage in consulting as well as in the audit function for a client.**[463] As well, in terms of their role, the strongly held view was that external auditors do not make the tough calls[464] (other than in cases where little discretion is required in making the determination). Only a minority of those surveyed agreed **that the external auditors should be rotated in a meaningful manner,**[465] as some suggested that "the big four" were substantially the same, and mandatory rotation, when there were in fact only four

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[456] A process identified in Max Weber, *The Theory of Social and Economic Organization*, trans. by A.M. Henderson & Talcott Parsons (New York: Free Press, 1964).

[457] *DSI*, *supra* note 154, statement 46: supported by 66.7% (69.99% when those who indicated that they were neutral were excluded).

[458] *Ibid.*, statement 45: only 35.7% (42.89% when those who indicated that they were neutral were excluded) believe that the board of directors, in fact, appoints the external auditors.

[459] *Ibid.*, statement 44: only 11.9% (12.19% when those who indicated that they were neutral were excluded) believe that the shareholders, in fact, appoint the external auditors.

[460] *Ibid.*, statement 49: supported by 75.6% (83.81% when those who indicated that they were neutral were excluded).

[461] *Ibid.*, statement 47: only 12.2% (12.83% when those who indicated that they were neutral were excluded) agree with the statement that the external auditors are primarily loyal to the shareholders.

[462] *Ibid.*, statement 48: only 33.3% (35.88% when those who indicated that they were neutral were excluded) believe that the external auditors are primarily loyal to the directors.

[463] *Ibid.*, statement 50: only 33.3% (35.88% when those who indicated that they were neutral were excluded) agreed that the external auditors should be allowed to engage in consulting as well as the external audit function.

[464] *Ibid.*, statement 51: only 31.7% (35.88% when those who indicated that they were neutral were excluded) supported the statement that external auditors make the tough calls, other than in the clearest of cases.

players, is to merely increase the cost for the corporation without any substantive changes. However, most strongly agreed that that there should be a split between those firms that do the audit function for a corporation and those that perform other roles (such as consulting, personnel-related matters and systems development) as there was a view that greater competitive opportunity existed for the "special requirements".[466] However, there appeared to be a widely held view that external auditors, given their knowledge of corporations, should not be constrained from providing tax assistance.

In terms of trying to make external auditors more accountable to the shareholders, when it was suggested that *they should be elected, based on what they committed themselves to do,* the majority were opposed to the idea.[467] As well, the suggestion that a "tender process" be used with pre-qualified external auditors who would be chosen by a vote of the shareholders based on written bids that would include price as well as deliverables, was reacted to quite negatively.[468] However, the majority of those surveyed supported **giving the audit committee of the board the authority to hire and to fire the external auditors.**[469] Furthermore, of those who offered an opinion, only a small majority showed confidence in an accounting board to oversee the activities of accounting firms, which was viewed by almost an equal number as being merely another level of "red tape".[470] Notwithstanding continued inroads in external auditors seeking to limit their liability both contractually, by means of the terms of their engagement letters as well as through successful lobbying efforts and the introduction of limited liability partnerships

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[465] *Ibid.*, statement 52: supported by only 40.5% (44.75% when those who indicated that they were neutral were excluded).

[466] *Ibid.*, statement 54: supported by 75.6% (79.5% when those who indicated that they were neutral were excluded). Given *SOX*, *supra* note 150 and initiatives by Canadian regulators, such as *MI 52-110*, *supra* note 200 and *MI 55-103*, *supra* note 335, most respondents, although supportive, also perceived these changes as already being a part of current governance requirements

[467] *Ibid.*, statement 53: only supported by 31.7% (35.14% when those who indicated that they were neutral were excluded).

[468] *Ibid.*, statement 58: supported by only 18.4% (19.98% when those who indicated that they were neutral were excluded).

[469] *Ibid.*, statement 56: supported by 59.5%% (62.5% when those who indicated that they were neutral were excluded).

[470] *Ibid.*, statement 57: supported by 45.9% (51.52% when those who indicated that they were neutral were excluded).

(LLPs),[471] **exposing the external auditors who purportedly fail in their duties to lawsuits on behalf of those who rely on the audited financial statements** (shareholders and others) (which would be contrary to the current state of the law in Canada) *was strongly supported*[472] (other than by those with vested *self-interests*).

8.5.6. Disclosure

There were a number of issues raised that may perhaps surprise some, and that clearly have an impact on the efficient market thesis. First, there was an almost unanimous view[473] that earnings are managed (that is management tries to smooth out earnings to meet street expectations). However, there was a suggestion that this is becoming more difficult and that ultimately making the wrong short-term decisions will "catch up" with the corporation in question. Second, only a minority were of the view that material information was disclosed to all at the same time,[474] although a strong majority were of the view that meetings with analysts were a way of selling the corporation's vision of the future and gaining stock support, and that analysts believed that they were getting "unique" information,[475] (although it was noted that selective disclosure is now being followed more closely by the regulators). A majority however believed that disclosure is well-managed by corporations, in the interest of ensuring full and prompt disclosure of material information to all at the same time[476] (which would appear on its face to be inconsistent with the first set of observations). As well, a majority indicated that **officers should be held personally responsible for "failing to release material information in**

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[471] For the statutory basis of LLP's, in Ontario, see *Limited Partnerships Act*, R.S.O. 1990, c. L-16. In Quebec, see *Professional Code*, *supra* note 314, ss. 187.11-187.20; *Civil Code of Quebec*, ss. 2186-2235. See also generally Macey & Sale, *supra* 356.

[472] *DSI*, *supra* note 154, statement 55: it was supported by 85% (87.18% when those who indicated that they were neutral were excluded).

[473] *Ibid.*, statement 59: it was supported by 90.5% (92.73% when those who indicated that they were neutral were excluded).

[474] *Ibid.*, statement 60: it was supported by 43.9% (48.67% when those who indicated that they were neutral were excluded).

[475] *Ibid.*, statement 63: 75% (81.79% when those who indicated that they were neutral were excluded) agreed with the statement that "Meetings with analysts are a way of giving the analysts 'confidential information' in return for their agreement to 'push' the stock."

[476] *Ibid.*, statement 64: supported by 63.4% (68.39% when those who indicated that they were neutral were excluded).

a timely manner"[477] or for "**selectively disclosing material information**",[478] and a majority supported the view that **there should be liability for the officer in question, as opposed to a fine against the corporation**[479] (and that there should be no reimbursement of the fine by the corporation). The reactions would appear to support the concept of the *funneling syndrome*, as it was accepted by most of those surveyed that the CEO had control over the material information and how it should be handled and should personally bear the costs for a failure to comply with the law, given his (her) pivotal role in how information is controlled and released.

8.5.7. Compensation

There appeared to be a general consensus that executive compensation was out of control.[480] There was also a strongly held view that management and the CEO play a key role in the determination of executive compensation, under the supervision of the compensation committee of the board of directors.[481] Although it was suggested to the interviewees that the real checks and balances in the determination of executive compensation, in addition to the work done by management, were the "independent reports" produced by "independent compensation consultants" that provide the board with "independent and credible information" as to what management should be paid,[482] the responses were ambivalent. A number of those who agreed with the statement suggested that they did so because that was the way compensation determination was supposed to work in theory. However, they made it clear that they had misgivings about its efficacy. It was noted by almost all that management selects the independent consultants who work with management to prepare the information that is used to guide

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[477] *Ibid.*, statement 61(a): supported by 70.7% (74.34% when those who indicated that they were neutral were excluded).
[478] *Ibid.*, statement 61(b): supported by 75.6% (79.5% when those who indicated that they were neutral were excluded).
[479] *Ibid.*, statement 62: supported by 65.9% (69.22% when those who indicated that they were neutral were excluded).
[480] *Ibid.*, statement 65: supported by 68.3% (71.82% when those who indicated that they were neutral were excluded).
[481] *Ibid.*, statement 66: supported by 90.2% (92.51% when those who indicated that they were neutral were excluded).
[482] *Ibid.*, statement 67: supported by 50% (51.28% when those who indicated that they were neutral were excluded).

in the determination of compensation (although on an exceptional basis, it was noted that this was changing). As a result, some greeted with sarcasm the attribution of independence to the external consultants and disagreed with the statement on the grounds that the consultants were not "independent" of management; others agreed with the statement only because that was the way is should work in practice.[483]

Given the above-noted observations, it should come as no surprise that executive compensation was viewed as being "out of control". The views on prophylactic checks and balances, such as prohibiting loans to management, were almost evenly divided, with the majority of those who offered an opinion being in support of such checks and balances.[484] However, substantive changes, such as the suggestion that **officer compensation should be subject to shareholder approval** at the time of the initial hire,[485] was not favorably received. Furthermore, even when the suggestion was modified so that only shareholder approval would be required for increases above specific limits agreed to in advance by the shareholders,[486]there was little support for this suggestion. An opponent suggested that these recommendations entailed micro-management and could lead to the "wrong results" for the "wrong reasons".

8.5.8. Stock Options

There was strong support for the utilization of stock options as a means of compensating management.[487] Stock options were viewed as being an integral part of current management compensation, even though their utilization could be viewed as being analogous to "gaming" (that is, exercising and immediately thereafter disposing of the shares acquired with the options was recognized as being inconsistent with seeking to

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[483] Checks and balances, similar to those applicable to the hiring of the external auditors, may need to be made legally mandatory, to help re-establish confidence in the integrity of the process.
[484] *DSI*, *supra* note 154, statement 69: supported by 46.3% (51.33% when those who indicated that they were neutral were excluded).
[485] *Ibid.*, statement 102(a): only supported by 12.2%% (12.83% when those who indicated that they were neutral were excluded).
[486] *Ibid.*, statement 102(b): only supported by 22.0% (23.11% when those who indicated that they were neutral were excluded).
[487] *Ibid.*, statement 72(a): supported by 70.7% (82.69% when those who indicated that they were neutral were excluded).

align the interests of management and the owners and was viewed by some as being more akin to gambling, as timing rather than long-term corporate performance appeared to be critical to how much one made on exercising options). A legal requirement to hold onto the stock acquired through the exercise of the options for a legally prescribed period[488] was generally volunteered as the solution to the challenge (even though in detailed discussions, it was recognized that "manipulation" could still take place to benefit those in control).[489] However, while continuing to support their use (albeit in some modified role for management including the president and CEO) a substantial majority opposed their grant to members of a board of directors.[490] A small minority suggested the complete abolition of the use of stock options, given the impact that management can have on stock prices. Stock options, it was posited, could intentionally or subliminally result in the manipulation of stock values (and concomitantly, stock option values) and the requirement of a specified hold period, it was a argued, would not address this potential for abuse. However, others suggested that since stock options were an integral part of executive compensation, attempting to abolish them was not realistic and that as a result, stock options, or a derivative thereof, would continue so as to enable management

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[488] As is required under US Securities Law with respect to the purchase and sale of shares (but not of options). See *Securities and Exchange Act of 1934*, *supra* note 6, s. 16(b)(also known as the "short swing profit rule").

[489] This was viewed as being capable of being accomplished directly, by creating a series of events so that the stock of the corporation in question would "peak" when the CEO (and senior management) were to dispose of their holdings; or clandestinely, through 'equity monetization schemes' in which economic interests were in effect disposed of by insiders (such as officers and directors) who realized (monetized) the current market value of their shares (with only the "naked ownership" of the shares, without any economic consequences for such holding, continuing to be held by the officers and other insiders in question). In form these holders continued to have legal title to the shares, although no longer any economic interests. However, legally they were not technically required to make any public disclosure that these events had transpired. This practice was knowingly in place long before action was taken to address this legal, if "circumspect" manner of realizing underlying economic value, notwithstanding one's role in the activities of a corporation. Adams, *et al.*, *supra* note 345 noted:

> When the Ontario Securities Commission deadline to disclose equity monetization deals passed this week, it brought into the open a highly controversial practice that has allowed dozens of corporate executives to quietly sell stock without notifying other shareholders. Under Multilateral Instrument 55-103, Insider Reporting for Certain Derivative Transactions (Equity Monetization) is now required for any such schemes that are still outstanding; substance and not form is now to prevail and accessing the conomic gains accruing to stock options while circumventing the "reporting requirements" is now prohibited.

See also *MI 55-103*, *supra* note 335.

[490] *DSI*, *supra* note 154, statement 72(b): only 17.1% (19.48% when those who indicated that they were neutral were excluded) supported granting stock options to directors.

to leverage personal returns. If one accepts that, in practice, given the impact of the *funneling syndrome*, and the posited ability of management (and more specifically the chairman and CEO, or the CEO where there is a non-executive chairman) to in effect, control the board of directors, and that *self-interest* applies no less to management than to a board of directors, then it would appear to be irrational to argue for the continued use of stock options in their current form for management, notwithstanding the broad consensus that they should be disallowed, in the case of members of the board of directors (other than management). The irrationality of the *status quo* for management is further buttressed by the results of the matrix analysis,[491] which suggested that the chairman and CEO (and even the CEO where he (she) was not the chairman), was perceived to have greater power and control than a board of directors.[492] Nevertheless, based on the *DSI*, this dichotomy of views clearly exists. It may be attributable to the fact that there continues to be a perception, true in law but perhaps less so in fact (barring external intervention), that a board of directors is in fact in control of a corporation. As a result, this ultimate control group, the board of directors, should avoid being placed in a conflict and should be seen to be, and should be, independent. If one accepts the foregoing, then members of a board of directors should not be subjected to the vagaries and potential incentives to abuse stock options (although it appears to still be accepted that management, even when they sit on the board of directors, should not be subjected to the same constraints).

There appeared to be recognition, on the part of interviewees, that the *status quo* insofar as it applied to stock options was unacceptable. Therefore, acceptance, subliminal if not overt, that management (the CEO and other senior officers) were subjected to many of the same challenges, as members of a board of directors appeared to exist. As a result, there was strong support for the notion that certain additional checks and balances were warranted, including that management stock options should not vest immediately[493] (that is, that there should be a holding period before they are vested). As well, a strong

[491] As was noted in Table IV of this Chapter.
[492] *Ibid.* at 149.

majority supported that stock acquired pursuant to the exercise of stock options should be required to be held for a period of time after their exercise,[494] (although the length of the period was not defined). However, the suggestion put forward, in an attempt to advance more stringent checks and balances, that **unless the exercise of vested options were both pre-approved by the board of directors and the exercise date pre-announced publicly,** options should not be capable of being exercised until three years after retirement, was strongly opposed.[495] It was noted, with some justification, that requiring officers to be locked into stock options, the value of which can be negatively impacted by a new CEO (and management team) over which, post departure, they would have no control, would be unacceptable. (However, there was limited minority support for the suggestion, when the period was limited to one complete accounting cycle after the CEO left the employ of the corporation, as it was recognized that dramatic change would normally not be made immediately. As well, if there were any latent concerns or problems, they would probably be raised within the first year after the transition of the CEO). Furthermore, there was a general consensus that the **annual total grant of stock options should be subject to shareholder approval,**[496] that stock options **should be long term in nature** and related to the performance of the corporation (adjusted to take out normal growth) so that payment is only made for above "normalized growth",[497] that **the cost of stock options should be recorded as a cost** of doing business in the corporation's income statements[498] and that **re-pricing of stock options should not be allowed,** save and except with prior shareholder approval.[499] Furthermore, and perhaps most importantly, it was recognized by a strong majority that the current system of stock

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[493] *DSI, supra* note 154, statement 74(a): supported by 95.1% (97.54% when those who indicated that they were neutral were excluded).
[494] *Ibid.*, statement 74(b): supported by 68.3% (69.98% when those who indicated that they were neutral were excluded).
[495] *Ibid.*, statement 74(c): only supported by 30% (32.13% when those who indicated that they were neutral were excluded).
[496] *Ibid.*, statement 75: supported by 65.9% (69.22% when those who indicated that they were neutral were excluded).
[497] *Ibid.*, statement 76: supported by 68.4% (70.73% when those who indicated that they were neutral were excluded).
[498] *Ibid.*, statement 73: supported by 82.9% (87.17% when those who indicated that they were neutral were excluded).
[499] *Ibid.*, statement 77: supported by 90.2% (there were no were neutrals).

options encourage management to take *short-term risks to maximize "potential upside"* at the expense of longer-term value creation.[500]

Stock options appear to provide the opportunity and encourage actions that may serve to benefit their holders at the expense of the shareholders. As well, given the almost unanimous observation that "earnings are managed" and the existence of the *funneling syndrome,* it would appear that absent effective "tools of governance", including more effective accounting and reporting, stock options create the opportunity for abuse while limiting abilities to effectively monitor and control any such potential occurrence on an *ex ante* basis. As a result, *stock options* (as well as any future derivatives similar thereto), if not abandoned as a means of compensating management (notwithstanding their justifiable fall from favor in the case of members of a board of directors), should be more effectively circumscribed and their potential for abuse constrained by more effective tools of governance.

8.5.9. Liability

There was a majority view that directors[501] and officers[502] should be held "personally liable" to the corporation (that is, they should not be indemnified nor insured by the corporation) for malfeasance (that is, where they benefit personally but the corporation and its shareholders suffer losses), but only up to the amount of compensation that they received from the corporation.[503] This would, in effect, cap personal liability and not put the total net worth of an individual director or officer at risk. In terms of whistle blowing as a means of being able to help uncover potential wrongdoing, most supported that it should be encouraged.[504] Conversely, most supported introducing restrictions on

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[500] *Ibid.*, statement 78: supported by 82.9% (87.17% when those who indicated that they were neutral were excluded).
[501] *Ibid.*, statement 79: supported by 61% (564.14% when those who indicated that they were neutral were excluded).
[502] *Ibid.*, statement 80: supported by 55% (59.46% when those who indicated that they were neutral were excluded).
[503] Many volunteered that "criminal liability" should, of course, continue to apply. However, they also recognized that in practice criminal sanctions were rarely effectively used.
[504] *DSI, supra* note 154, statement 83: supported by 72.5% (87.14% when those who indicated that they were neutral were excluded).

shareholder class action lawsuits[505] and were of the view that lawyers were the only real winners in such litigation.[506]

The foregoing would suggest that **whistle blowing should be encouraged,** that perhaps there **should be caps on director and officer liability** and **that class action lawsuits should be constrained,** as the only real winners appear to be the lawyers.

8.5.10. Proxy Solicitation

The view that proxy solicitation is very much a management tool was almost unanimous;[507] that management solicits proxies in a fair and transparent manner was almost evenly divided with slightly more of those who offered a view, in agreement with the statement;[508] and that shareholders should be given more leeway in proxy solicitation[509] (without providing any details as to what this would entail) was strongly supported (however, almost a quarter of respondents were neutral).

It would appear that the views expressed by Berle and Means more than seventy years ago[510] continue to be supported by the reactions of the limited focus group, that proxy solicitation is still very much *a management tool.*

8.5.11. Role of Investment Community and Analysts

There appeared to be a very strong consensus that the investment community[511] does not act in a fair and reasonable manner[512] and does not act in the investing public's best

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[505] *Ibid.*, statement 84: supported by 65% (78.79% when those who indicated that they were neutral were excluded).
[506] *Ibid.*, statement 85: supported by 71.1% (77.11% when those who indicated that they were neutral were excluded).
[507] *Ibid.*, statement 86: supported by 92.7% (no one was neutral on this matter).
[508] *Ibid.*, statement 87: supported by 43.2% (54.61% when those who indicated that they were neutral were excluded).
[509] *Ibid.*, statement 88: supported by 56.4% (73.64% when those who indicated that they were neutral were excluded).
[510] Berle & Means, *supra* note 2 at 129, have stated that "[t]he proxy machinery has thus become one of the principle instruments not by which a stockholder exercises power over management of the enterprise, but by which his power is separated from him".
[511] The investment community includes bankers and their constituent arms, investment bankers, brokers, financial advisors and analysts.

interests.[513] Analysts were similarly viewed as not acting or operating independently of the investment banking and underwriting parts of their business.[514] There was almost unanimity in the view that bankers do not avoid conflicts of interests.[515] Furthermore there was a strongly held view that the investment community and analysts should be liable for their actions and should not be indemnified by the firms for whom they act;[516] and that investment analysts should be liable to the public for misleading information.[517]

Given the foregoing rather negative assessment of the investment community and analysts and the critical role that they play in the efficiency of the market, if the views expressed herein are reflective of the public's reaction, *then strong, transparent steps are required* to be taken *with appropriate sanctions* to help restore confidence in these players, who are integral to the efficient operation of the financial markets.

8.5.12. Role of Shareholders

It is interesting to note that most interviewed agreed that shareholder approval is generally nothing more than a rubber stamp of what management wants to do[518] and that shareholders have no real power.[519] Furthermore, a strong minority viewed shareholder proposals as an effective way to exercise shareholder power.[520] As well, the statement

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[512] *DSI*, *supra* note 154, statement 89: only 17.5% (17.95% when those who indicated that they were neutral were excluded) supported the view that the investment community acts in a fair and reasonable manner.

[513] *Ibid.*, statement 90: only 10% (10.81% when those who indicated that they were neutral were excluded) support the view that the investing community and analysts act in the investing public's best interests.

[514] *Ibid.*, statement 91: only 9.8% (10.29% when those who indicated that they were neutral were excluded) supported the view that the investment analysts operate independently of the investment banking and underwriting parts of their business, and act in a fair and reasonable manner.

[515] *Ibid.*, statement 92: only 7.5% (8.33% when those who indicated that they were neutral were excluded) believed that bankers avoid conflicts of interests.

[516] *Ibid.*, statement 93: supported by 70.7% (78.38% when those who indicated that they were neutral were excluded).

[517] *Ibid.*, statement 94: supported by 77.8% (82.33% when those who indicated that they were neutral were excluded).

[518] *Ibid.*, statement 95: supported by 75.6% (79.6% when those who indicated that they were neutral were excluded).

[519] *Ibid.*, statement 96: supported by 70.7% (76.27% when those who indicated that they were neutral were excluded).

[520] *Ibid.*, statement 97: supported by 41.5% (47.27% when those who indicated that they were neutral were excluded).

suggesting that shareholders be given greater flexibility to get together on issues received strong support.[521]

On the issue of whether shareholders should elect as opposed to merely confirm the slate of directors, views were almost equally divided (although this was supported by a small majority).[522] However, a majority opposed a similar recommendation when it came to the election of external auditors.[523] On the issue of whether the policy on stock option grants (as opposed to the number to be granted) should be approved by the shareholders before such grants have any force or effect, this was very strongly supported.[524] In terms of compensation, the suggestion that executive compensation should be subject to shareholder approval based on overall limits established by the board at the initial hiring was very strongly opposed.[525] While there appears to be a consensus that the role of the shareholders is rather limited and perfunctory in most cases, suggestions that greater controls be given to the shareholders were by no means widely supported. There appears to be a concern that granting a greater role to shareholders, notwithstanding greater visibility and transparency, could lead to mismanagement.

8.5.13. Role of the Regulator and of the Government

The suggestion that the regulator should only be involved as a last resort, on an exceptional basis, rather than being brought in as another level of "red tape" to deal with the current issues facing the business community, was greeted with strong views, with the majority agreeing with this statement.[526] It would appear that while there was substantial support for **regulatory intervention** to deal with the challenges facing the financial market, the majority only sought intervention **as a last resort**.

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[521] *Ibid.*, statement 98: supported by 70.0% (82.35% when those who indicated that they were neutral were excluded).

[522] *Ibid.*, statement 99: supported by 54.75% (51.35% when those who indicated that they were neutral were excluded).

[523] *Ibid.*, statement 53, that "External Auditors should be elected, based on a commitment as to what they will do", was only supported by 35% (37.84% when the neutrals were excluded).

[524] *Ibid.*, statement 75, that "Stock option grants should be subject to shareholder approval", was supported by 65.9% (69.22% when the neutrals were excluded).

[525] *Ibid.*, statement 102(a): supported by only 13% (12.2% when the neutrals are excluded). *Ibid.*, statement 102(b): supported by 23% (22% when the neutrals are excluded).

The suggestion that the role of the government should be limited to bringing in legislation to deal with issues that need to be addressed (if that is the only realistic option) was supported by a strong majority of respondents.[527] However, concerns were expressed that representatives of regulators (including governments) do not make the best business people and that while they should establish policy, they should not seek to micro-manage through legislation or regulations, as this could serve to create problems as opposed to assisting in addressing and resolving them.

If one accepts the foregoing, it can be argued that governments and regulators should establish principles to govern the operation of the financial markets, as opposed to detailed rules, and that corporations subject to regulatory oversight should then be obliged to manage within the established principles, with **external intervention, whether by government or regulator, only instituted as a last resort.**

8.5.14. Accounting

There was general agreement that accounting provides great flexibility and enables the manipulation and management of earnings "within the confines of the law"[528] (with the exception of one interviewee, who expressed the view that that there was flexibility but that it was "not great"). Furthermore, on the issue that accounting needs to identify "recurring income" and to distinguish it from the "one time items", there was unanimity by all who proffered a view that this should occur.[529] There was almost universal support (except from those within the accounting profession) for the statement that accountants do not respond to the information needs of shareholders in a clear and concise manner,[530] and only a minority supported the view that the annual report adds value for

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[526] *Ibid.*, statement 103: supported by 62.5 (68% when the neutrals are excluded).
[527] *Ibid.*, statement 104: supported by 80.5% (87% when the neutrals are excluded).
[528] *Ibid.*, statement 105: supported by 80.5 % (91.69% when those who indicated that they were neutral were excluded).
[529] *Ibid.*, statement 106: supported by 95.1% (100% when those who indicated that they were neutral were excluded).
[530] *Ibid.*, statement 107: positive responses were received by only 10% (12.12% when those who indicated that they were neutral were excluded).

shareholders.[531] The majority were also of the view that related party transactions (that is, transactions with people or companies that have a close relationship to a corporation) should be expressly reported on by the external auditors, to the shareholders, as a specific item of disclosure, and not buried in the notes to the financial statements.[532] As well, in terms of being happy with the work done by the external auditors for the shareholders, the views appeared to be slightly negative (although more pronouncedly negative when the members of the profession were excluded from the statistics).[533]

Clearly, the foregoing, if truly indicative of the general perception of the role of external auditors, would suggest that the issue that the profession faces is not an expectation gap as has been suggested,[534] but rather substantive issues that need to be recognized and addressed if the credibility of the profession is to be re-established. If the accounting profession as currently constituted fails to respond more effectively, alternative intermediaries to help meet the needs of investors may have to supplement if not to displace the accounting profession.

8.5.15. The Media

Based upon the focus discussion and review, there appears to be disaffection with the media. Only a minority supported the statement that the media accurately reflects the state of corporate governance.[535] Views on the suggestion that the media is an ally of the shareholder in dealing with corporate governance problems were almost evenly divided, with the majority supportive when those who expressed no opinion (*i.e.*, were neutral) were excluded.[536] The suggestion that the media is an ally of business and reflects their

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[531] *Ibid.*, statemnment 108: supported by 35% (38.89% when those who indicated that they were neutral were excluded).
[532] *Ibid.*, statement 109: supported by 77.5% (81.58 when those who indicated that they were neutral were excluded).
[533] *Ibid.*, statement 110: supported by 44.7% (50% when those who indicated that they were neutral were excluded).
[534] See DiPiazza & Eccles, *supra* note 319 at 156.
[535] *DSI*, *supra* note 154, statement 111: supported by 22% (24.36% when those who indicated that they were neutral were excluded).
[536] *Ibid.*, statement 112: supported by 45% (54.55% when those who indicated that they were neutral were excluded).

viewpoints received only limited support[537] with slightly stronger support (but still less than a majority support) for the suggestions that the press is responsible when dealing with the issues of corporate wrongdoing[538] and those of corporate governance.[539] While the views of those that indicated that they were neutral or agreed with the statement was about equal to the negative responses, it is worth noting that the negative responses generally greatly exceeded the positive.

The lack of strong confidence in the media, which could be viewed as an important gatekeeper if truly reflective of the general perceptions, is somewhat disconcerting.

8.5.16. The Sarbanes Oxley Act of 2002 (SOX)

It is interesting to note that most of the people surveyed indicated a familiarity with this legislation.[540] The majority also indicated a belief that SOX would work to improve corporate governance by holding corporate executives and accountants responsible in a prescribed manner.[541] There was also support expressed by a majority for expanding civil and criminal liability in the securities area;[542] consistent with the foregoing, the majority supported similar legislation being enacted in Canada.[543] This would appear to suggest that the majority either agreed with the benefits associated with SOX-type legislation, or given events that were underway, the inevitability of similar legislation being introduced and a reluctant acceptance of a new reality.

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[537] *Ibid.*, statement 113: supported by 25% (27.03% when those who indicated that they were neutral were excluded).
[538] *Ibid.*, statement 114: supported by 40% (48.48% when those who indicated that they were neutral were excluded).
[539] *Ibid.*, statement 115: supported by 34.2% (44.82% when those who indicated that they were neutral were excluded).
[540] *Ibid.*, statement 116: supported by 92.3% (94.76% when those who indicated that they were neutral were excluded).
[541] *Ibid.*, statement 117: supported by 58.6% (66.36% when those who indicated that they were neutral were excluded).
[542] *Ibid.*, statement 118: supported by 69.2% (77.15% when those who indicated that they were neutral were excluded).
[543] *Ibid.*, statement 119: supported by 59.5% (68.79% when those who indicated that they were neutral were excluded).

8.6. PUBLIC SURVEY (*PS*)

To gain a better appreciation of the issues raised by the initial fieldwork, a public survey more limited in scope was initiated.[544] Twenty-one questions were initially developed (subsequently expanded to twenty-three questions)[545] that were to be posed to four different groups.

The first group included those subjected to the *DSI*. However, only twenty-eight of the forty-three individuals subjected to the *DSI* were asked to complete the public survey (given the timing of the completion of the document). The second group to be surveyed consisted of members of the Canadian Institute of Chartered Accountants (CICA), who given their training and role in corporate governance, it was posited should be reasonably sophisticated in their appreciation of the subject matter. The third were graduates of McGill University's Faculty of Law, who it was postulated, should be reasonably sophisticated in legal matters and in their appreciation of corporate governance. The last to be surveyed were to be members of the general public. The objective was to compare the results, *inter se*, to see if there was an alignment between the views of the four groups (and to try to relate these results to the other, more detailed research derived from the *DSI*). This effort was to provide a basis of comparison and was undertaken to focus on generic as opposed to detailed views.

If everyone perceived the challenges in a relatively similar manner, this would suggest that at least those from within the corporation (directors and officers) and those most closely aligned with the corporation and providing services to it, had a common appreciation of the issues faced. As a result, with respect to where a common perspective of the challenges existed, a unified approach to the problem of corporate governance could be appropriate. However, if there were important differences in perception, then this gap as well as other more common substantive issues would need to be addressed.

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[544] Attached hereto as Appendix B, below.

8.6.1. The Survey of the Detailed Survey and Interview (*DSI*) Members

In order to carry out a more focused comparison of those subjected to the *DSI* and to the others surveyed (the latter being surveyed through the use of the Internet), twenty-eight individuals from the *DSI* group were asked to complete (and completed) the *Public Survey*. Two questions were added to the questionnaire at the request of the CICA after the *DSI* surveys had been substantially completed (and as a result, these changes were only addressed by the last five *DSI* interviewees). The first requested change recognized that restrictions existed on the ability of chartered accountants to buy shares (especially of corporations of which they are the external auditors). As a result, a "new" statement was added, namely that "I currently own mutual funds that include shares of publicly traded corporations". As well, when surveying "intentions" to re-enter the market, the question was modified by adding the words noted hereinafter in italics: "Over the next twelve months, I intend to purchase shares of publicly traded corporations, *either directly or through the purchase of mutual funds*". The second change that was requested was not to merely ascertain whether boards of directors should be independent of management but the following statement was added: "I believe that boards of directors of publicly traded corporations *are in fact* independent of management".[546]

8.6.2. The Survey of Members of the Canadian Institute of Chartered Accountants (CICA)

This survey was conducted online through a web browser by iTracks Inc.[547] on a statistically valid basis. A random selection of CICA members who were Canadian chartered accountants (excluding those who had been contacted with respect to any other CICA survey within the past twelve months) were sent an email asking them to participate. The email provided a link to the survey and to control access, a password to login. Five thousand members were contacted (3,500 in English and 1,500 in French) followed by a reminder. Five hundred eighty-six (586) replies were received (407, or

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[545] The questionnaire was subsequently expanded to 23 statements at the request of the CICA.

[546] A blacklined version of the modified *PS* is attached hereto as Appendix F.

[547] Online: Itraks.com <http://www.itracks.com>. The detailed results of this survey are included in Appendix G, below.

11.63%, responses from the English requests, and 179, or 11.93%, from those in French) with an overall response rate of 11.72%.[548]

8.6.3. The Survey of McGill Faculty of Law Graduates

The McGill Faculty of Law survey was structured to comply with the internal, self-imposed requirements of McGill University. Consistent with its confidentiality policy, it was designed to protect the privacy of graduates. Individuals were initially not contacted directly; at the outset, the process was not proactive. Rather, it was designed to be reactive; information relating to the requested survey was hosted on the McGill Faculty of Law graduates' Internet site[549] and viewers were invited to fill out the hosted questionnaire and have it returned anonymously. Notwithstanding the cooperation of McGill University, this passive approach resulted in only seventeen individuals providing the sought-after information (including four who described themselves as students). Given the limited number of responses, follow-up discussions were pursued with McGill University. It was agreed that graduates of the Faculty of Law who had made their email addresses publicly available through the school (and could therefore be accessed by the public) should not object to being asked (but not obliged) by email to respond to the survey. McGill therefore agreed to contact the graduates in question and to seek their cooperation (all responses to be remitted to the author on an anonymous basis). This latter initiative resulted in a 20.34 % response rate (double the norm).[550]

8.6.4. The Public Survey

The *Public Survey* was initially to be pursued in cooperation with a national newspaper. However, that initiative was not successfully concluded. As a result, the use of the Internet to provide a sample based on snowballing was attempted. Individuals were asked to reply to an email, with the survey attached. Recipients of the email were advised that all the information would be dealt with on a confidential, not-for-personal-attribution

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[548] A response rate of 10% or better was considered good by iTracks Inc.

[549] Online: McGill Faculty of Law – Alumni and Development <http://www.law.mcgill.ca/alumni>.

[550] The proactive intervention (without any follow up email) resulted in 83 additional responses being received to 408 email requests that had been sent out (for a total of 100 responses) to this combined initiative. The statistics, related to this survey, are included in Appendix H.

basis. They were also asked to forward the email to friends or acquaintances and invite them to respond. The results of this initiative were less than satisfactory. However, the costs of conducting a statistically valid Canadian sample were prohibitive.[551]

8.6.5. Findings

The *PS* revealed that most of those interviewed[552] (*DSI*, chartered accountants and graduates of the McGill Faculty of Law) owned shares in one or more publicly traded corporations (directly or through mutual funds), planned to re-enter the stock market during the next twelve months[553] (notwithstanding less than unequivocal support for how effectively it was operating) and had a good understanding of corporate governance.[554] Accordingly, they would appear to have a personal (and not only a business or a professional) interest in the effectiveness of the stock market(s).

Most of those surveyed appeared to believe that they understood the difference between the roles of management and of the boards of directors;[555] most believed that primary responsibility for how a corporation performs rests with management[556] (a strong majority[557] of the chartered accountants also believed that it rested with the directors) and very few[558] believed that it rested with the shareholders.

In terms of corporate oversight, the majority of the *DSI* interviewees believed that the "management of most publicly traded corporations act in the best interests of their shareholders;[559] slightly less than a majority of the chartered accountants and a majority

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[551] The results of this "alternative initiative" were of limited probative value, and are therefore not incorporated into this report. See Appendix I, below.
[552] DSI 92.9% directly, 40% through mutual funds; CA's 60.8% directly, 74.9% through mutual funds; McGill Law 72.0% directly and 75.5% through mutual funds. [The amounts total greater than 100% as many interviewees invest both directly and indirectly, through mutual funds] All statistics related to the *PS* are reported in the same order, DSI first, then CA's and lastly the McGill Faculty of Law graduates.
[553] 92.9%, 72.7% and 79.0%, respectively.
[554] 96.3%, 80.0% and 79.0%, respectively.
[555] 100%, 92.9% and 95.9%, respectively.
[556] 67.9%, 94.9% and 87.4%, respectively.
[557] 83.3%.
[558] 7.0%, 14.2% and 18.6%, respectively.
[559] 67.9%.

of McGill Faculty of Law graduates shared that view[560] (the balance offering no opinion or disagreeing). A majority indicated that they believed that management of most publicly traded corporations act in their own best interests[561] and that boards of directors of publicly traded corporations act in the best interests of their shareholders.[562] If one were to accept that assessment, then there should be constructive tension between the board of directors and management when personal and corporate interests conflict. However, the *DSI* suggested that most board members pursued a collegial as opposed to a "confrontational" environment and that conflicts (labeled "constructive tension") were the exception and were generally avoided, unless there was no alternative.

While there appeared to be a general consensus that boards of directors should be independent of management,[563] less than a majority believed that to be the reality.[564]

On the role of external auditors, those with business experience appear to be much more insightful than the chartered accountants (whose views and responses should suffer from an innate bias in these matters) and McGill Faculty of Law respondents. While all appear to agree that the external auditors of publicly traded corporations help protect the interests of the shareholders[565] (as it was put quite succinctly by one respondent, to which would one attach greater credibility, to audited or to un-audited financial statements?), those within *DSI group* were nevertheless more skeptical that they help to give shareholders a fair picture of the true financial position of the corporation[566] or that external auditors act independently of management to help protect the interests of shareholders.[567]

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[560] 49.5% and 58.1%, respectively.
[561] 51.9%, 59.7% and 63.8%, respectively.
[562] 71.4%, 68.3% and 71.4%, respectively.
[563] 100%, 91.4% and 77.2%, respectively.
[564] 38.5%, 20.9% and 33.0%, respectively.
[565] 57.1%, 79.9% and 68.4%, respectively.
[566] 42.9%, 82.3% and 61.9%, respectively.
[567] 37.0%, 70. 1% and 58.1%, respectively.

As well, less than a majority believed that that regulators were doing an effective job in protecting the interests of investors[568] and most did not believe that the media were trustworthy in reporting on business affairs.[569] Only a minority believed, when it came to management compensation of publicly traded corporations, that they were not overpaid.[570]

In terms of stock options, while most believed that they understood how such options work,[571] a small majority supported their continued use in management compensation,[572] and only a minority agreed that stock options should continue to comprise part of director compensation.[573]

Regarding the issue of whether the CEOs of most for-profit, publicly traded corporations are honest and trustworthy, the majority appeared to agree[574] (although in the case of the chartered accountants and McGill Faculty of Law graduates, a lesser majority agreed). In terms of having confidence that stock markets operate effectively, slightly less than half to just over a majority were supportive;[575] not a very strong endorsement of the financial markets. However, there appeared to be majority support for the statement that corporate governance serves to protect shareholders[576] (although this was far from unequivocal support).

If one were to factor "personal bias" into the responses, there appears to be a consistency to the overall direction of the data received (notwithstanding some variations in the specific percentages in support of or opposed to a position).

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[568] 32.1%, 46.3% and 36.7%, respectively.
[569] 25.0%, 20.0% and 29.3%, respectively.
[570] 48.1%, 37.2% and 33.0%, respectively.
[571] 96.4%, 89.7% and 93.0%, respectively.
[572] 53.6%, 54.5% and 45.8%, respectively.
[573] 11.1%, 28.2% and 30.5%, respectively.
[574] 67.9%, 53.8% and 52.0%, respectively.
[575] 48.1%, 56.0% and 51.6%, respectively.
[576] 57.7%, 76.7% and 61.6%, respectively.

A detailed analysis of the demographic information obtained as a result of the interviews[577] is beyond the scope of this thesis. However, the general direction and the perspectives of those from within (those involved in the *DSI*) were compared to those from without (primarily the graduates of the McGill Faculty of Law and the CICA); notwithstanding different perspectives and biases, there was a general consistency in the views expressed and opinions offered.[578]

8.7. Conclusion

The results of the empirical work would appear to support the view that many people think that management (as exemplified in the "chairmen and CEOs" and "CEOs") act in their own *self-interest*, that directors are not independent of management and that the CEO can have the greatest impact on a corporation's performance with the fewest constraints, notwithstanding that in theory checks and balances exist and in law they are not the owners of the corporation. A chairman of the board and CEO (or CEO, even if he is not chairman of the board of directors) in fact exercises ownership rights (rather than rights of mandate or of agency) in dealing with the corporation. Management has the greatest flexibility in dealing with the corporation, constrained only by the actions of third parties (in theory the board of directors or the shareholders) or by law. Even though most individuals filling these positions may well be honorable, potential for abuse would exist if one were to accept that these officers have the ability to act as they wish, subject to legal constraints (be they imposed by statute or otherwise). More specifically, the ability to take personal advantage would appear to be a function of two factors, namely authority and opportunity. These can be viewed as having the rights analogous to those of an "owner"[579] and can be presented by the following simple formula:

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[577] Demographic information relating to the *PS*, namely age, gender, marital status, education, profession, employment and salary, was obtained (for indicative purposes, such data relating to the McGill Faculty of Law, graduates are included in chart form in Appendix J). However, given the directional nature of the research, a detailed examination of the data and an attempted correlation between the views and the demographic information (to ascertain of there is any identifiable relationnship between the demograpics and the responses of interviewees), is beyond the scope of this thesis.

[578] For a comparison, in the aggregate, of responses received from the DSI, the Chartered Accountants and the graduates of the McGill Faculty of Law, to the *PS*, see Appendix K, below.

[579] *Black's Law Dictionary*, *supra* 127 at 1259, defines the word "owner" as "he who has dominion over a thing, real or personal, corporeal or incorporeal, which he has a right to enjoy and to do with as he pleases,

$$PA^{580} = A^{581} \times O^{582}$$
$$= A \times (1\text{-}RAM^{583})$$

It is postulated that *PA*, the potential to abuse factor, is a function of authority *(A)* and of opportunity *(O)* to abuse. The risk of abuse mitigation factors *(RAM)* can approach but never equal one, as you can reduce but never eliminate risk. To the extent that a proposed course of action will expose the party to risk of sanction, then the likelihood of action being taken for personal as opposed to corporate benefit will be reduced but it will never be eliminated. In applying this formula to the results of the surveys referred to in Table 1,[584] the following is suggested:

Chairman and CEO: $PA = A \times (1\text{-}RAM)$
$1 \times (1\text{-}RAM)$

It should be noted that the "*RAM* factors" can and should be reviewed, discussed and considered on an ongoing basis by a board of directors in the context of the specifics of their own corporation, by comparing their *PA* on an absolute basis (that is, year over year) and relative basis against their competitors (where such information is available) to assess their absolute and relative *PA* factor. Boards of directors should begin to focus specifically on *PA* and in so doing begin to appreciate the degree of control officers have over the activities of the corporation and what actions they, as a board of directors, can

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even to spoil or destroy it, as far as the law permits, unless he is prevented by some agreement or covenant which restrains his right." Art. 947 C.C.Q. defines ownership as: "the right to use, enjoy and to dispose of property fully and freely, subject to the limits and conditions for doing so determined by the law. Ownership may be in various modes or dismemberments".

[580] "PA" stands for "potential to abuse".

[581] "A" stands for "authority".

[582] "O" stands for "opportunity to abuse".

[583] RAM (i.e. "risk of abuse mitigators") will always be equal or inferior to 0. For example, if the external auditors disagree with the position of management and will issue a qualified report, one attaches a RAM to that (e.g. say 0.7 as the external auditors have access to source data, cannot be easily displaced and have an "aura of independence); if the lawyers disagree, one will subtract a value (for example, say 0.2, as "management can 'opinion shop' unless there is an ongoing relationship with a specific law firm); and subtract 0.09 for other factors. These factors can be refined and reviewed by a board of directors in deciding on the degree of a real check and balance that exists in any specific case.

[584] Table 1 sought to ascertain which individual(s) or group(s) has the greatest potential and ability to abuse, whether abuse takes place or not.

and should be taking to meet their obligations (in light of possible as opposed to actual *PA* concerns). The *PA* factor is an attempt to get boards of directors thinking in terms of what to many is intuitive, in a more structured and focused manner.

As well, in addressing the roles played by the various constituents in the *RAM* factor, one must seek to ascertain what sanctions are to be applied where the constituents fail to play the role incumbent on them, to make this system of corporate governance work more effectively.

Chapter 9

Tools and Rationale to Help Address Self-Interest and the Funneling Syndrome

9.1. INTRODUCTION

Tools of more effective corporate governance can be both proactive in terms of their implementation on an *ex ante* preventative basis as well as reactive, *ex post* in response to breakdowns in corporate governance. However, even under the best of circumstances, breakdowns in corporate governance can and will occur,[585] as individuals often act in "subjective good faith" and rationalize courses of action that just happen to be in their, but not necessarily *ex post facto* in the shareholders', interests. Absent meaningful sanctions, personal accountability can, as circumstances evolve, be rationalized away. Accordingly, no one is immune from *self-interest*, including directors, officers and auditors to name but three. Checks and balances should not only seek to ensure compliance but must also endeavor to hold those that fail to comply accountable in a meaningful manner.[586]

9.2. RISK OF ABUSE MITIGATORS (RAM): STRUCTURAL MITIGATION – GOVERNANCE, MANAGEMENT AND OWNERSHIP

The weaknesses in corporate governance caused by the existence of *self-interest* and the *funneling syndrome* must, it is postulated, be addressed by a clearer demarcation of

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[585] The PA factor can approach, but never equal 0; a cost-benefit analysis needs to be undertaken to assist a board of directors of a corporation in determining how far it should move to reduce its PA factor.

[586] The following comment to the *PS* by a graduate of the McGill Faculty of Law effectively addresses the argument for meaningful sanctions:

> As a criminal lawyer I'm not prone to being a big believer in altruistic human behaviour although you would be astonished at how many (albeit a minority still) of my colleagues act in such a manner everyday. Nevertheless it is apparent that power certainly corrupts, particularly the notion that because someone is a success that they are owed more and more of whatever they can get their hands on. Corporate governance appears to be the hotbed of such profligacy. *Now if all the so-called reputable scam artists got prosecuted maybe the environment would change. There is nothing like the fear of retribution of some sort to calm the overly acquisitive. Too bad there is absolutely no sign of that ever happening.*

[Emphasis added] (2 March 2004) Lawyer over 55; self-employed).

responsibilities and accountabilities.[587] It requires the creation of a more meaningful separation of the rights and obligations in the role of each of the constituents of a corporation. It can be viewed as a three-legged stool comprising a board of directors, management and the shareholders of a corporation. This is required if there is to be a rebalancing of the power structure within a corporation and if checks and balances are to become more than mere rhetoric. Being subjected to a reallocation of responsibilities (many of which by default or design have accrued to the CEO or his (her) proxies) could serve to create friction in what has evolved into a symbiotic, non-confrontational, collegial relationship. Empirical evidence, serve to support the foregoing and helps to explain the general consensus derived from the *DSI* that "boards of directors are reactive[588] as opposed to proactive"[589] and that "ineffective chairmen" (and directors) are generally tolerated.[590] While creative tensions between management and the board of directors appear to be more acceptable in the post-Enron era, the historically evolved collegiality and team approach continues to be the sought-after mantra. Shareholders of corporations (other than major institutional investors) are generally not factors to be considered in widely held, publicly listed corporations and are usually (barring exceptional circumstances) viewed as nothing more than a rubber stamp of what management wants to do.[591]

In dealing with the servicing as opposed to the governing of a corporation, it is worth noting that most of those interviewed perceived there to be a conflict in the performance of both functions when applied to outside directors. Relatively few (other than those with the strongest professional *self-interest*) of those interviewed in the *DSI* process were in favor of allowing directors to engage in consulting or other activities with the corporation on whose board they served.[592] The very strong majority appeared to recognize that governing (while also advising the corporation) raised valid issues as to impartiality both

[587] See John Carver, *Corporate Boards that Create Value: Governing Company Boards from the Boardroom* (San Francisco: Jossey-Bass, A Wiley Company, 2002).
[588] See *DSI*, *supra* note 154, statement 24.
[589] See *ibid.*, statement 25.
[590] See *ibid.*, statement 8.
[591] See *ibid.*, statement 95.
[592] See *ibid.*, statement 40.

from a substantive as well as an optics perspective. If the foregoing historical evolution raised valid concerns in the case of outside (non-management) directors, one may question why a similar analogy would not apply equally to management. Why should managers with responsibility for daily operating decisions (including making recommendations to the board of directors) be put into a potentially conflicting position by acting as directors who not only manage but also govern the corporation? Management acting in both capacities would appear to be in a clear conflict of interests, a situation that appears not only to be tolerated especially in the case of the CEO but in some jurisdictions to even be rationalized to include a broader spectrum of employees.[593]

If, as it has been suggested, trust is central to the governance process,[594] then trust must continue to be warranted. Demonstrated accountability can serve to justify its continued applicability. Notwithstanding comparisons of CEOs with royalty,[595] such an analogy should not be used to justify, or to rationalize, the unfettered rights of CEOs. Absolute power spurred on by *self-interest* corrupts, absolutely. Effective governance must recognize and be responsive to this challenge.

To seek to address what should be a separation of roles, namely governance and management, boards of directors must be made to act and be seen to be acting as representatives of the shareholders. They must be independent (in thought and action) of management. More specifically, it should be made demonstrably clear that they govern on the shareholders' behalf and are accountable to them. Conversely, management, with authority delegated to them by the board of directors and *de facto* responsibility for the running of the corporation, should work to deliver results. If one accepts the foregoing as the appropriate mantra in the case of corporations, then both the board of directors and management (employees and suppliers just as customers) should be recognized as being

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[593] See *Higgs Report*, *supra* note 151.
[594] "Trust is Central to Governance Process: An Interview with Roger Martin" *Boardroom* 9:5 (September/October 2001) 1.
[595] See *DSI*, *supra* note 154, statement 10, where most agreed that CEOs are sometimes compared to royalty.

contributors to a common goal but should not, in such cases, engage in overlapping and what could well be conflicting tasks.

A corporation encompasses individuals performing complementary tasks and possessing different attributes (and includes employees, suppliers, customers, management and directors, to name but a few of the critical players), all of whom can contribute to its success. However, dealing with and on behalf of competing constituencies while concomitantly acting as a representative of and being accountable to the owners (the shareholders) raises conflicts and makes it more difficult for directors to act to fulfill an abstract obligation to act honestly, in good faith and in the best interests of the corporation[596] (as reflected in the "owners"). Directors should not be put into a position where they are required to serve two or more masters under what can be conflicting circumstances. The same rationale suggests that representatives of non-owner constituents who may similarly be required to serve competing interests should not participate as members of a board of directors. Although management in general and a president and CEO in particular are contributors to the success of a corporation (much as employees and suppliers are, even though one could argue that the role of management is significantly more important), one could logically conclude that they suffer from many of the same innate conflicts as do other interest groups and should therefore, given similar considerations, not be on its governing body. A board of directors of a corporation is required to govern. Management, in contrast, needs to manage to operate the entity and deliver the required results. These divergent roles would suggest that no one from management should assume the role of a director. However, excluding management (including the president and CEO) from the board of directors is not a popular, readily acceptable or given *self-interest*, a notion that will evolve naturally (even though it is posited that it is a logical one).

It was pointed out by officers and directors during the interview process[597] (to rationalize having the president and CEO and sometimes other members of management on the

[596] See *CBCA*, *supra* note 37, s. 122(1)(a).

board of directors) that both management and the board of directors are viewed as being "part of the same team" and need to work together and complement one another to achieve optimum results. The complementary and essential roles of all that are required to contribute to success of a corporation are accepted. However, to suggest that all members of a team must have equal status and authority is as irrational as it is self-serving.

Recognition that anyone from management (including specifically the president and CEO) should not concurrently be a director of a corporation for which they work is implicit in many of the more contemporary actions that have evolved in recognition of and in reaction to this anomaly. Furthermore, *self-interest* and the *funneling syndrome* necessitate having a separation between those who manage and those who govern. No one should be responsible unto himself (herself) if checks and balances are to operate effectively. Everyone should be accountable to a higher authority. While there continue to be strong views to the contrary (although there was interest in pursuing the dialogue relating to the exclusion of all management from becoming members of a board of directors from a number of interviewees), a brief review of this evolution may assist in explicitly addressing and focusing on what has been implicit for some time, namely that there is an inherent conflict between being a member of the management team and of being a director of the same corporation. **As a result, the tools of more effective governance should require that management in general and the president and CEO in particular should not be members of the board of directors of a corporation.**[598]

9.2.1. The Officer/Director – Inherent Conflict of Interest

In what appears to be an attempt to address the anomaly of having an officer also act as a director, an evolutionary process has taken place. This has included introducing "independent directors"[599] (as opposed to merely having management nominate

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[597] We refer to the DSI, which has focused on Canadian corporations.
[598] Highlighting throughout this chapter is to focus attention on recommended tools of more effective governance.
[599] *Supra* note 62.

individuals, who act for and on behalf of management);[600] introducing the concept of a "lead director",[601] whereby an individual could take over the role of the Chairman (who in the past was often also the president and CEO, a practice that has been changing in Canada but that is still prevalent in the United States) when issues arose where he (she) could be in a conflict of interest; having the board of directors meet periodically "in camera" to deal with issues of potential conflict[602] without management present; seeking to separate the role of the chairman of the board of directors and the CEO (that is, the introduction of a non-executive chairman);[603] to having the board of directors (or a committee thereof) meet at the end of each board and committee meeting without management present.[604] This evolutionary process appears to be directed towards circumventing management control of the governance process and encouraging more open, unencumbered discussion amongst directors. Further recognition (subliminal if not overt) that management should not be members of the board of directors is evident from an examination of the board committee structure (such as the audit committee, governance committee and the compensation committee, the latter which is also charged with setting the terms of ongoing employment of the president and CEO). These three

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[600] For the historical evolution of independent directors in the USA, see Roberta S. Karmel, "The Independent Corporate Board: A Means to What End?" (1984) 52 Geo. Wash. L. Rev. 534; Ira M. Millstein & Paul W. MacAvoy, "The Active Board of Directors and Performance of the Large Publicly Traded corporation" (1998) 98 Colum L. Rev. 1283.

[601] "Many wonder, 'How can the board of independent directors effectively monitor a CEO who as Chairman controls the timing of, and the agenda for, meetings?' The lead director concept espoused by the New York Stock Exchange does not get the job done." Douglas M. Branson, "Enron – When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform?" (2003) 48 Vill. L. Rev. 989 at 1015.

[602] *CCGG, supra* note 62.

[603] However, the introduction of a non executive chairman is not the panacea to solving the problems of self-interest, the funneling syndrome and the lack of accountability as is evidenced by the UK experience in the 2001 Marconi Plc debacle where, as was pointed out by Claire Moore Dickerson:

> Over-optimistic management estimated unrealistically high sales and failed to pay attention to its customers and market position. In all of these activities, the non-executive Chairman of the Board, intended to be the independent check on policy, was Hurn. ... If the firings of three-eighths of an 8,000-person work force in Britain and the destruction of ninety percent of the share value were not enough to generate outrage, two other factors directly related to Simpson and Hurn fueled the stockholders' ire. First, Simpson's golden parachute amounted to £1 million, and Hurn's to £300,000. Second, as the company's stock price sank, Marconi management had tried to rebase the stock options that Marconi had previously issued to its executives.

Claire Moore Dickerson, "Ozymandias as Community Project: Managerial/Corporate Social Responsibility and the Failure of Transparency" (2003) 35 Conn. L. Rev. 1035 at 1042-43.

[604] See *CCGG, supra* note 62.

committees have come to exclude management from their membership (but not from participating as a source of information and knowledge).[605]

In its current state of evolution this process appears to be incomplete. Rather than excluding management from the governing body, the board of directors has sought to "work around the problem" in a politically expedient, non-confrontational manner. Rather than being proactive and addressing what appears to be a clear case of conflict, boards have been reactive. They have sought to find a politically acceptable compromise,[606] namely by excluding officers where there may be an appearance of conflict, but continuing to endow them with the title and other attributes of directorships. Regulators also appear to have embraced this circuitous approach of dealing with this issue. In the United States, SOX has gone so far as to in effect create a "board within a board"; the audit committee of the board is now to have more powers and authority than the board of directors (which in most cases in the United States still have the CEO of the corporation acting as the chairman of the board). Under SOX, the board of directors (a committee) has in effect been replaced by a "subcommittee" thereof that is legally empowered to hire and to fire the external auditors.[607] Given the foregoing, one might question why there appears to be such a reluctance to recognize reality. The frustration of

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[605] Support for this position by DSI interviewees was almost unanimous.

[606] Another example of how political expediency attempts to deal with issues in form, but not in substance is currently underway in the United States; the chairman of the board should, it is submitted also be the Chief Governance Officer (CGO) of the corporation. However, where the CEO is also the chairman of the board, this creates a conflict between governing and managing. As a result rather than separating the role of Chairman and that of CEO to avoid conflict but to appear to deal with this apparent conflict in a politically acceptable manner, a trend began about a decade ago that the NYSE indicates is still in its nascent stage; it apparently counts about 30 corporations including Pfizer Inc. Baxter International Inc. and Sunoco amongst its supporters. The NYSE indicates that the function of a CGO should, as adapted from the American Society of Corporate Secretaries, typically include the following functions; (i) Keep directors current on corporate governance trends and issues; (ii) Relay concerns of institutional investors to the board along with information on institutional ownership of the company; (iii) Consider ways to recruit and retain directors with diverse skills and backgrounds; (iv). Encourage top management to view the board as a resource for the company; (v). Ensure that the board is informed about the business issues of the company, including proper financial reporting; (vi) Assist the board during the board, committee and director evaluation process; (vii) Distribute board meeting agendas in a proper and timely manner after getting comments from directors and executives; and (viii). Encourage directors to direct, not micromanage, the affairs of the company and guard against their being too hands-off. It is worth noting that as a result of the recent challenges facing the NYSE, the function of Chairman and CEO within the NYSE are now separated; clearly a reactive as opposed to proactive initiative. See "Governance Champions" *NYSE Magazine* (3 July 2003), online: NYSE < http://www.nyse.com/events/1057189598880.html>.

failing to reach the logical conclusion is as irrational as it is self-serving. It is indicative that the current system of corporate governance, fuelled by *self-interest* (although others could argue that it is for "practical considerations"), seeks to work around rather then deal directly with the apparent challenges raised.

9.2.2. Rationale Preventing the Logical Evolution (Excluding Management from the Boards of Directors)

The *DSI* revealed that gaining a seat on the board of directors of a widely held, publicly listed Canadian corporation carries great prestige[608] (whereas compensation and other rationale for accepting such a position was relatively less important[609]). It is therefore not surprising that those possessing the duality of roles, officer *cum* director, would be reluctant to voluntarily forego the publicly perceived prestige and any actual or potential related power and benefit(s) of being a member of the board of directors of "their" corporation. As well, the contemporary Canadian practice of putting the president and CEO (and to a lesser extent other senior executives) on a board of directors operates to reduce the prospects of a voluntary reversal of the *status quo*.

The current "expectation" and perceived "entrenched right" that a president and CEO sit on his (her) board of directors makes change difficult. If by exception a president and CEO were to be excluded from board membership notwithstanding contemporary convention, then this would serve to create two classes of presidents, those that appear to have the confidence of a board of directors and are allowed to sit on the board and those who do not. As a result, continuing with the *status quo* of having a president as a member of the board of directors and working around the "problem" may be viewed as a practical way of dealing with current realities. The foregoing is a rationale for the acceptance of the *status quo*, notwithstanding cognition by some that the current situation is much less than ideal. An alternative is for there to be explicit (as opposed to implicit) recognition

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[607] See *SOX*, *supra* note 150, ss. 101-09.
[608] See *DSI*, *supra* note 154, statement 27, where all agree that prestige was a key factor in some directorial positions.
[609] See *ibid.*, statement 28, where only a minority viewed compensation as being a key factor in directors staying on a board.

that having management sit as directors is not good corporate practice and that the separation of management from those who govern corporations is both desirable and conducive to more effective corporate governance. However, there is a need to appreciate that this proposal is unconventional and could be viewed as being potentially confrontational. As well, given natural inertia, gaining acceptability will be challenging. The contemporary and predominant view would continue to support a management presence on the board of directors (including at least the president and CEO, with some suggesting that a potential successor from management should also be considered for a board seat).[610]

There are additional practical challenges. One must recognize that the market for executive talent is a competitive one. As a result, if certain employers hold out board positions (with all the attraction that is entailed thereby), it places the corporation that is seeking a president and CEO and not also offering a position as a member of the board at a "competitive disadvantage" in recruiting talent. As well, for those officers with employment contracts that "guarantee them a position on the board of directors", any attempt at unilateral change will be difficult and costly at best and could at worst divert attention from the operating issues facing a corporation. It might lead to confrontation, something that most boards of directors try to avoid. As a result, barring "focused institutional pressure" or "legislative intervention", boards of directors will seek to avoid this structural anomaly and will search for solutions that are reactive to this problem as opposed to seeking to deal with this issue on a proactive basis. Boards will generally continue to seek to "work around" a problem rather than risk upsetting a collegial working environment. Expediency supports leaving a "modified *status quo* in place", as it is politically least disruptive.

As a result, given vested rights, *self-interest* and natural inertia, the "team approach and the collegial view" held by many of the respective roles of management and boards of directors, as well the innate power of management, the desire of directors to be reactive

[610] For a position supporting the presence of management on a board of directors, see *Higgs Report, supra*

as opposed to proactive[611] and the desire to avoid the tough decisions and conflicts[612] that could arise from attempting to deal bilaterally with this challenge, a transitional evolutionary process appears to have been adopted, spurred on from time to time by "best practices". However, to arrive at the optimal conclusion, institutional pressure and as a last resort "legislative intervention" may be required. Inroads are being made in dealing with this problem. However, there appears to be a reluctance to face this challenge directly, rather than continuing to deal with it in an indirect, circular and collegial manner.

Having management as the master and the servant, the advocate and the judge (decision maker), the employer and the employee, and a key (if not the key) player in determining the composition of the board of directors[613] and in the appointment[614] and retention of the external auditors,[615] is to suggest that the *status quo* has innate structural flaws, that is conflicts of interest, whether they come to the fore or not. As a result, if confidence building requires not only doing what is right but also in being seen to be doing what is rational and proper, to walk-the-talk, then there appears to be an inherent flaw in current corporate governance.[616] Failing to deal directly with a recognized anomaly should not serve to instill confidence in investors. Why should one believe, given the foregoing, that boards of directors will not as a rule do what is expedient rather than what is right? This should serve to raise concern about a board initiating action to prevent (as opposed to react to) potential corporate-wrongdoing and is endorsed by the *DSI*, which supports the view that boards are not proactive but reactive.[617]

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note 151, ¶ 8.6.

[611] See *DSI*, *supra* note 154, statements 24 & 25.

[612] See *ibid.*, statement 23, which is supported by 71.4% (81.04% when the neutrals are excluded).

[613] See *ibid.*, statement 11 (repeated for validation purposes in question 18), where it was recognized by a strong majority that "CEOs play a pivotal role in the appointment of (and in question 20) in the removal of directors".

[614] See *ibid.*, statement 46, where 66.7% (69.99 % when those who indicated that they were neutral were excluded) agreed that "management in fact appoints the external auditors".

[615] See *ibid.*, statement 13, where 75.6% (81.55% when those who indicated that they were neutral were excluded) agreed that "CEOs in practice play a key role in the retention or the changing of the external auditors".

[616] However, there appears to be a general consensus from the representatives of business interviewed, that while this was true in the past, it is now changing.

[617] *Supra* note 215.

The foregoing is not to suggest that management should not participate at meetings of boards of directors and of committees thereof. They should. However, they should be there as management, not as directors. It is recognized that one can debate whether the role of the board should be one of governing or one of managing.[618] For purposes of this thesis and as outlined previously herein, it is suggested that for corporations (that tend to be national if not international and usually complex in scope) the role of the board is to govern, not to manage the day-to-day affairs of the corporation. Active management participation in board meetings would enable board members to benefit from the views of management. However, when deliberations are to take place (all of which should by law be required to take place in confidence with a breach of the rule of confidentiality resulting in immediate dismissal "for cause" from a board) directors who under current structures and tools of governance may be reluctant to speak their mind, to ask the tough questions,[619] would have both the opportunity and structural environment, with less fear of retribution, to speak out and attempt to act in the best interests of the corporation.

The need to exclude management from being appointed to the board of directors of the corporation for which they work should ideally be implemented voluntarily, initially perhaps through guidelines and acceptance as best practices, much as has taken place with respect to the separation of the roles of chairman and president and CEO in Canada. However, should that not be feasible (and for the reasons outlined herein, it is doubtful that it would be easily introduced voluntarily), shareholder proposals advocating this separation could be considered. Nevertheless, given vested *self-interest*, it may in the final analysis require legislation (including potentially by increased regulatory intervention) as the only realistic way of introducing this suggested tool of more effective corporate governance.

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[618] See Jill E. Fisch, "Corporate Governance: Taking Boards Seriously" (1997) 19 Cardozo L. Rev. 265.
[619] *DSI*, *supra* note 154, statement 22: only 33.3% (39.98% when the neutrals were excluded) believed that directors were prepared to "ask the tough questions".

9.2.3. The Role of the Chairman

Under the foregoing hypothesis (where directors govern and management including the CEO manage), the chairman of a board of directors should be non-executive (that is, separate from that of the CEO), a perspective that was strongly supported.[620] His (her) role should be that of a chair of a committee and as a committee member (the committee being the board of directors), and acting with and through that committee to oversee the governance of the corporation. As well, the position of chairman should be separate from and not involved in the management of the affairs of the corporation (as that should be the role of the CEO and the management team). This position should not be integrated into nor become a part of management. There should be a distinction in theory and in fact between the "doing" and the "governing of the affairs" of the corporation. As a result, given the focus on supervision as opposed to "hands on management" and the need to be independent of management, **it should be a part-time as opposed to a full-time office.**[621]

Former CEOs should not be promoted to the role of chairman of the board[622] of "their corporation", nor should they be asked to sit on its board of directors post-retirement.[623] This is not to suggest that prior CEOs do not have value that they can contribute to the corporation. However, this can be achieved by availing oneself to an individual's expertise, if, as and when required in a consultative capacity. Encumbered by all that a former CEO has championed, as well as relationships that have been built up, including with staff, external advisors and the members of the board of directors over the years, effective checks and balances may well be impeded (or be perceived to be improperly affected) by pre-existing relationships. As a result, providing for a clear break post-retirement (with access for transitional assistance as required) provides for the review and

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[620] *Ibid.*, statement 1: "Chairman should be a separate position from that of the CEO" was supported by 86% (88.11% when the neutrals are excluded).

[621] See *ibid.*, statement 5: only 25.6 % (29.73 when the neutrals are excluded) agreed that "[t]he position of Chairman should be a full time job".

[622] *Ibid.*, statement 2: "Former CEOs should be precluded from occupying the post of Chairman" was supported by 61.9 % (76.51% when the neutrals are excluded).

[623] *Ibid.*, statement 32: "Former CEOs' should be allowed to sit on the boards (of the corporation from which they retired) post retirement" was supported by only 33.3 % (36.84 when the neutrals are excluded).

detailed analysis of the corporation by the new CEO, who has only a limited period of time to address and to redress any issues that were inherited before it becomes attributable to his (her) regime. Any factors that could or might be perceived to frustrate such a process from taking place would serve as an encumbrance on more effective corporate governance. Preventing a CEO from assuming the chairmanship of his former corporation and from sitting on the board of directors will help to ensure that the *funneling syndrome* is subject to some measure of checks and balances and that the *self-interests* of the successor operate as checks and balances on the *self-interest and information constraints* (should any have existed, whether inadvertent or intentional) of the retiring CEO.

Another factor that needs to be addressed is the practical difficulty faced in seeking to remove ineffective chairmen. Given the stature of many chairmen and the prestige (and power) associated with the position, ineffective chairmen are generally tolerated and are not replaced.[624] A suggested approach to this highlighted challenge is to provide for the mandatory rotation of this function (with a chairman being elected annually by the board of directors, but in not being permitted to continue in this office for more than a limited defined period of time (say, for example, five one-year terms; in other words, for a maximum of five years). This should assist in helping to ensure that a chairmanship is more than just an "acquired right", that a change does not serve to embarrass anyone, that there is the possibility of competition for this role and that there is an ability and an opportunity to make a difference. As well, given that this potential position would in fact then be open to all directors, one may have an incentive to ensure that one is proactively involved, engaged and gearing up for when one may be called upon to take on this function.

By divorcing the position of chairman from that of CEO, by ensuring that former CEOs do not sit on the board of directors (and therefore do not attain the position of non-executive chairman of "their corporation" post-retirement) and by providing

for an orderly and timely transition of chairman (that is mandatory rotation after a specified period of time), more effective tools of governance can be introduced to help address the two fundamental challenges focused on in this thesis; *self-interest* and the *funneling syndrome*. The *self-interest* of a successor (whether a retiring chairman or CEO) may well conflict and act as a check and balance on the *self-interest* of the incumbent. As well, if the incumbent CEO is not to continue, either as chairman or as a director after retirement, then the prospect of anomalies or potential problems surfacing increases, motivated by the *self-interest* of the successor. Any failure to do so may make the new CEO personally accountable for the actions of his (her) predecessor. As a result, preventing a CEO from assuming the position of chairman of the board (or even of a director) post-retirement should facilitate (but will never guarantee) that a more thorough assessment of activities under his tutelage would be reassessed, addressed and dealt with in an unencumbered manner. As well, rotating the chairmen of the board should help address natural inertia, ensure that specific relationships that may have devolved over time do not work to the detriment of the corporation and operate to bring new thoughts and approaches to dealings between the board of directors and management.

While none of these suggestions guarantee improved performance, they do seek to create an environment that is more conducive to responding to the challenges raised by the *funneling syndrome* and *self-interest*.

9.2.4. The Role of Directors

If directors of corporations are to govern (and management is to manage) the process of appointing, retaining and disengaging directors should help to ensure that directors are not beholden to the CEO and that effective directors are appointed and ineffective ones "retired". As has been confirmed by the *DSI*, the CEO plays a prime role in the appointment,[625] removal[626] and in the compensation[627] of directors. Thus, it should come

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[624] *Ibid.*, statement 8: "Ineffective chairmen are not tolerated and are replaced" was supported by only 17.1 % (19.48% when the neutrals are excluded).
[625] *Ibid.*, statement 13 (applying to directors): agreed to by 75.6% (81.55% when the neutrals are excluded). *Ibid.*, statement 18 (applying to new directors): agreed to by 83.3% (there were no neutrals)
[626] *Ibid.*, statement 19: agreed to by 71.8% (75.66% when the neutrals are excluded).

as no surprise that directors are generally most closely aligned with the CEO,[628] are generally supportive of the CEO,[629] are not prepared to ask the tough questions[630] and are unlikely to make the tough decisions unless they have no alternative.[631] Furthermore, when it is recognized that many directors do not spend the time required (whether due to a lack of time, interest or ability) to really understand the issues so as to be able to make a meaningful contribution,[632] it is not surprising to find an observation made in the 1960's, that "the board of directors is normally a passive instrument of management",[633] continues at least pre-SOX to appear to be applicable. To attempt to make directors more responsible to the owners in the case of corporations, a number of modifications are posited.

First, the **appointment process must be made transparent, with management** (including the CEO) specifically **excluded from the director decision-making process.**[634] As previously noted, the CEO should not sit on the board of directors of a corporation and should not be involved in the board appointments, directly or indirectly (other than providing input). The input of any CEO who will be actively engaged with the board should be taken into account by the board of directors but should never be a determinative factor.

Second, **individuals who may have divided loyalties** such as professional advisors, both current[635] and former ones,[636] **should not be allowed to sit on the board of directors** of

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[627] *Ibid.*, statement 17(b): agreed to by 77.5% (81.58% when the neutrals are excluded).
[628] *Ibid.*, statement 20: agreed to by 90% (There were no neutrals).
[629] *Ibid.*, statement 21: agreed to by 100%.
[630] *Ibid.*, statement 22: "Directors are prepared to ask the tough questions" only received an affirmative reply by 33.3% (39.98% when the neutrals are excluded).
[631] *Ibid.*, statement 23: "Directors are not prepared to make the tough decisions, other than when they have no alternative" was agreed to by 71.4% (81.04% when the neutrals are excluded).
[632] *Ibid.*, statement 26: "Directors generally spend the time required to "really understand the issues" and make a "meaningful contribution" was only agreed to by 36.6% (45.47% when the neutrals are excluded).
[633] John Kenneth Galbraith, *The New Industrial State* (New York: Signet, 1967).
[634] This is discussed in greater detail in Section 3 of this chapter.
[635] *DSI, supra* note 154, statement 34: "Current professional advisors should be allowed to sit on the boards of their clients" was only agreed to by 21.4% (23.67% when the neutrals are excluded).
[636] *Ibid.*, statement 35: "Former professional advisors should be allowed to sit on the boards of their clients" was supported 63.4% (70.29% when the neutrals are excluded) (subject to a mandatory "cooling-off period", as was suggested in numerous cases).

a client's corporation, but in the case of a corporation's former professional advisors, the prohibition should only apply until the end of a "cooling-off period". However, the "cooling-off period" should not be arbitrarily set (unless the period is for an arbitrary minimum period). Rather, it should include sufficient time to allow for the departure of the officers with whom the professional advisor had interacted. In addition, the retired professional should not have any involvement or continued participating financial interest in his former employer (if the former employer continues to deal with the corporation). This should assist in the perception and the reality of greater independence in the decision-making process.

Third, to help ensure that directors have the time to govern and do not accumulate board seats simply for the "prestige factor",[637] **the board of directors of a corporation should be required to identify, review and comment on the number of boards** (be they public, private, government or of any other nature) in addition to that of the corporation that prospective and incumbent **board members have agreed to be limited to** as a pre-condition to accepting to be nominated to the board of directors of the corporation (as they all require time and effort to perform adequately). This review and determination should be undertaken annually by the board of directors (or a Committee thereof such as a governance committee), but on an individual rather than an aggregate basis (as it is very unlikely that director situations will be identical) and reported on publicly with other material relating to the AGM. It should be included in the proxy material and be available to shareholders and the public when they are called upon to "elect" directors.

The director "acquired-rights syndrome", motivated by *self-interest*, which in effect assumes that all other things being equal, directors will remain in office for life (until compulsory retirement age intervenes), makes it difficult in the collegial atmosphere in which boards of directors often operate to remove ineffective directors. Director

[637] *Ibid.*, statement 27: "Prestige is a key factor in some directorial positions" was agreed to by 95.2% (97.54% when the neutrals were excluded).

assessments[638] (including self-assessments) may assist in monitoring directors' performance and may even get directors to become more proactive (depending on the capability and role played by the chairman of the board or the "lead director" in effectively using the results of such action to address identified weaknesses) and may lead to improved governance. However, in order for a credible assessment process to exist, directors must be held accountable to a "higher authority".[639] Greater detailed research is required to assess and ascertain the true potential and practical value of director assessment(s). Such an undertaking is however beyond the scope of this thesis.

So as to attempt to address the "acquired-rights syndrome", boards of directors should have maximum, publicly disclosed terms of office for board members, including a publicly disclosed policy of asking directors to volunteer their resignation if they were appointed for specific reasons or subjected to "understandings" (such as to represent a certain geographical region, area of activity or limiting their board(s) or other commitments) and their situation has changed.

The current arbitrary policy of requiring directors to resign at a pre-set age (say 70, which is often designated as a mandatory retirement age for directors) is as illogical as it is capricious. It is predicated on the desire not to offend ineffective directors and is nothing less than a form of age discrimination (and may very well be illegal).[640] Rather than

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[638] See Bank of Montreal, "Governance and Nominating Committee Charter" (25 November 2003), online: BMO.com <http://www2.bmo.com/bmo/files/event/3/1/gov_nom_eng.pdf>.

[639] While accountable to the shareholders, the regulators and to the courts, in practice such recourses are generally of theoretical, as opposed to practical, value for the shareholders. This is addressed herein in part by the development of the concept of *PAR* (personal accountability and responsibility on the part of directors, officers and external advisors), and other more effective tools of corporate governance.

[640] For instance, Quebec's *Charter of Human Rights and Freedoms*, R.S.Q. c. C-12, s. 10 prohibits discrimination on the basis of age "except as provided by law". In Ontario, the *Human Rights Code*, R.S.O. 1990, c. H-19, s. 5(1), provides that "[e]very person has a right to equal treatment with respect to employment without discrimination because of ... age" pursuant to a relatively recent legislative amendment. At the Federal level, the *Canadian Human Rights Act*, R.S.C. 1985, c. H-6, s. 9(2), still provides that "it is not a discriminatory practice for an employee organization to exclude, expel or suspend an individual from membership in the organization because that individual has reached the normal age of retirement for individuals working in positions similar to the position of that individual." However, the Canadian Human Rights Commission has noted that "[i]t may be that most people do not want to work beyond the 'normal retirement age' for their occupation, but compulsory retirement clearly discriminates against those who are capable of working and want to do so. It is high time this form of discrimination ceased to be protected by the *Canadian Human Rights Act*." See Canadian Human Rights Commisison,

dealing directly with the challenges of the acquired rights, the collegial approach to boards has resulted in the expedient supplanting the rational. Anecdotally it is noted that there are relatively young directors that should be replaced that for purely political and partisan reasons are not. Conversely, in conducting interviews for this thesis, individuals were met who would not have met the "age test" but who would be a most valuable addition to any corporate board of directors. To yield to an irrational, arbitrary and expedient age criteria rather than predicating board membership on *competence integrity and accountability,* primarily because such action avoids potential confrontation and embarrassment, is to waste resources that it is continuously suggested are limited and perhaps even in short supply.[641] It may be more appropriate to deal directly with the challenge faced by appointing the best and removing ineffective board members directly (that is, through a proactive assessment process; however, in practice most assessments are "self-assessments" and do not lend themselves easily to such action) or through limited terms of office, but not purely as a function of age. With limited terms of office, the best will continue to find opportunities and bring their "experience with them". Furthermore, after (say a maximum of) a decade on the board of a corporation, both the director and the corporation may benefit from changing members and introducing

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"1996 Annual Report", online: <http://www.chrc-ccdp.ca/publications/1996_ar /page9-en.asp>. This is clearly indicative of a growing trend against mandatory retirement in Canada on public policy grounds. Further, the permissive formulation of s. 9(2) entails that private actors (including corporations) need not wait for a blanket prohibition, in Federal legislation, of mandatory retirement on the sole basis of age in order to take action against it now within their own organizations. See generally Andrea York, "Time to Retire the Mandatory Retirement Policy?" (2001) 8 Employment & Labour L. Rep. 11.

[641] A survey of corporate directors published in Patrick O'Callaghan & Associates, in partnership with Korn/Ferry International, *Board Governance and Director Compensation in Canada* (2003) indicates that 61% of those surveyed believe there is a shortage of qualified corporate directors in Canada. This survey result is available online: Korn/Ferry International <http://www.kornferry.com/Library/Process.asp?P=Articles_Detail&CID=550&LID=1>. See also e.g. "Symposium on Corporate Directors" (November 2003) at 14, online: <http://ssrnn..com/abstract=471640>, where Martin Lipton of the legal firm of Wachtell, Lipton, Rosen and Katz states:

> Today it has become extremely difficult to recruit new directors.... The combination of the reforms, together with the litigation and reputation exposure, has done two things. One, most major companies are now limiting the number of boards their CEO can serve on. Many, many companies today say to their CEO, "you can only serve on one outside board" for a combination of reasons, but the principal one is that the job of a director today takes so much time that an active CEO really doesn't have the time to serve on three, four or five boards. At best, that's something that a retired CEO can do.

It is up to the reader to assess whether "trophy board members" or "working board members" are what more effective corporate governance requires and whether this is a "concern" or a "benefit" to achieving more effective corporate governance.

successors with new ideas and perspectives. As well, new directors may be less entrenched in the past and more open to the prospects of the future. By effective planning, directors could be replaced in a manner that ensures a continuous blending of the benefits of the past with the unencumbered views of newer directors helping to plan for the future.

Distancing the board members from the control of management (especially that of the CEO); ensuring that the appointment process for directors is not controlled by management; ensuring that individuals with divided loyalties are prevented from accepting a board position until the issues giving rise to the potential conflicts are no longer applicable; limiting the number of boards that a director can sit on (and explaining the rationale for the decision); providing for maximum terms that will require changes in board composition (and not artificial, discriminatory age-limiting factors that mandate retirement) and ensuring that all of this takes place in a transparent and publicly disclosed manner, should help ensure more effective corporate governance.

9.2.5. Strategic Management

It is postulated, given the *funneling syndrome,* that a board of directors of a corporation is generally constrained in terms of the information that is made available to it. If that is the case, they may not be well-equipped to establish a valid strategy. However, it is posited that a board should at the very least be (with outside sources of added intelligence, as required) in a position to ensure that the strategy advanced by management and submitted to it for approval appears is reasonable (and is altered if, as, and when required), that it is in place and that *management is accountable* for effectively implementing the strategy as recommended to and approved by the board of directors. More specifically, if management is to be held accountable for the corporate strategy, then the board of directors should, in conjunction with management, establish the yardsticks that are to be used in assessing the success or failure of the strategy, challenge the strategy to ensure that it is reasonable and play a proactive monitoring role so that management delivers on its promises to the board (and indirectly to the shareholders), failing which they need to understand from management (with independent advice obtained as required) why the

strategy is not being effectively executed and whether the strategy needs to be changed, and if so, why. Unless management is held accountable for the strategy as originally developed and implemented, or as varied after review with and concurrence by the board, the results of strategic planning may serve *self-interests*, as opposed to broader corporate and related shareholder objectives.

Accountability to shareholders, if it is to be meaningful, requires clearly outlining objectives and then being held accountable to deliver on one's promises.[642] **Requiring the board to report, *ex ante*, on the corporation's strategy and direction** (subject to confidentiality required for competitive market purposes) in as transparent a manner as possible, with identifiable and measurable yardsticks, **to report on the corporation's achievements relative to its plan on an *ex post facto* basis** and to have the accuracy of what is reported independently confirmed should assist in achieving greater accountability. Unless there is a mechanism to enable shareholders to assess and understand the strategy and direction of the corporation and its success in delivering on what was intended (and the results are not open to manipulation), the debate over whether the directors or management are the final decision makers as to the strategy and direction of the corporation would appear to be more of an exercise in "infighting" amongst competing interests than a viable effort to realistically improve corporate governance and look out for the interests of shareholders.

9.3. TRANSPARENCY AND ACCOUNTABILITY IN CORPORATE LEADERSHIP

Transparency and greater public visibility are tools that may assist in attempting to repatriate powers now *de facto* possessed by management in general and the CEO in particular. To the extent that any individuals agree to stand for election to a board of directors, their background (including all relevant information that relates to their competence and integrity, and past and present affiliations) and the details of the process "used to select the individual(s)", as well as a report by the board of directors as to why

[642] It has been suggested that this may serve to the competitive disadvantage of a corporation, by providing competitors with access to valuable information While raised frequently when "relevant information" is

each person, in their considered opinion, is the best candidate (over all the others considered), should be made available to shareholders before a decision is taken with respect to the candidates. This should place a greater burden on a board seeking and being seen to fulfill its fiduciary obligations. As well it may serve to help to further distance the board from the *de facto* constraints of a CEO.

To help ensure that the reporting is accurate, such information could be verified and certified by an independent third party.[643] The purpose of such review would be to confirm the accuracy and completeness of what is being disclosed. To ensure accountability, *liability* on the part of both the disclosing party (that is, failure to comply should constitute a breach of what should be a legal fiduciary obligation to disclose imposed by the regulator) and the certifying party (need to exercise due diligence to ensure that the facts are complete and accurate) *should be mandatory*. If individuals are being asked to vote for directors (who in theory, if not yet always in fact, are to act in the best interests of the shareholders) then both the detailed *curriculum vitae* of the individual, certified (with legal liability as to completeness and accuracy) by both the candidate for office as well as an independent third party, should assist in ensuring that shareholders are well aware of who the person is, what relationships (business, family or otherwise) the candidate has with any officers (or other directors) of the corporation,[644] and how this person was chosen and why he (she) is being put forward as a candidate. Should concerns then be raised, whether by individuals, institutions or the media, given all that is being (or has failed to be disclosed), then an additional check and balance to attempt to make candidates more accountable to the public in general and investors in particular could result.

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required to be disclosed, this should be capable of being addressed by providing generic as opposed to "issue specific" competitive information.

[643] See e.g. online: Kroll Inc. <http://www.krollworldwide.com>, which engages in background screening. Some recruiting firms already engage in detailed background searches but that is not yet a widespread activity, nor one that is publicly disclosed.

[644] See *DSI*, *supra* note 154, statement 96 (supported by 70.7%; 79.5% when the neutrals were eliminated) that "[s]hareholders have no real power". According to *ibid.*, statement 95, "[s]hareholder approval is nothing more than a rubber stamp of what mamagement wants to do" (supported by 70.7% and 79.5% respectively).

9.4. STRUCTURAL CHANGES: ESTABLISHING A MORE MEANINGFUL ROLE FOR SHAREHOLDERS

Individual shareholders have little incentive to become actively engaged in the affairs of corporations; they face a rational apathy problem.[645] As a result, they are generally perceived to be little more than a rubber stamp of what management wants to do, with no real power.[646] Institutional shareholders, by contrast, are perceived as being more proximate to controlling shareholders and are viewed as being positioned and capable of playing a more proactive role, one that management and boards of directors need to take into account. To address the issues raised by small investors, one needs to ascertain whether shareholders can be provided with "meaningful roles". Additional "tools of governance" that may be useful in instilling greater investor confidence, available for use if, as and when the need arises, may assist in that endeavor. Based on public choice considerations, it is unlikely that these additional tools of governance will be used in other than egregious cases. They should therefore be viewed as contingent rather than actual challenges to management. Nevertheless, their mere existence and availability can provide an additional check and balance that may help protect the interests of investors.

It had been suggested during the *DSI* that granting shareholders greater power is inconsistent with the way corporations are or should be managed, as shareholders lack the knowledge, experience or interest to become meaningfully engaged.[647] However, such a response, even if not motivated by *self-interest* and a desire to avoid the potential loss or dilution of power, still begs the question as to how those in control, the CEO (and management), are then to be made and held accountable. If effective checks and balances

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[645] Robert Charles Clark, *Corporate Law* (Boston: Little, Brown, 1986).

[646] See *ibid.*, statement 95, supported by 75.6% (79.5% excluding the neutrals). See also *PS*, where the following comment was volunteered: "On the whole, I feel that boards of directors too often act as a rubber stamp of management, and it is only when the possibility of true accountability (such as personal responsibility arising in the context of a CCAA filing) becomes a clear and present danger that boards tend to step back and take a more independent stance." (18 February 2004) Lawyer 35-45; employed in a publicly traded company.

[647] It is noted that these statements parallel those made when debates as to enfranchising the disenfranchised and bringing democracy to the masses were debated. See e.g. Guttsman, *supra* note 388 at 69-70, where he states: "There could be no equality in political society ... [Claridge asserted] to let all have say in the Government would shift power from the 'people', that is a responsibility of society, to the population which included the mob. Instead of democracy you would have 'fool and knavery'."

and accountability are incapable of being voluntarily implemented by recognizing shareholder rights of ownership, then more proactive public (state) intervention may be required. This is by no means a novel thought[648] as the introduction of the securities and exchange laws in the 1930's and SOX more recently are only two such examples of such intervention.

In Canada, when it was perceived to be required, the Ontario Securities Commission entered the field of corporate law to protect the interests of investors. They introduced the requirement of a vote of a "majority of the minority shareholders" to approve a corporate action, when the interests of a controlling shareholder conflicted with those of a minority.[649] Expanding on that precedent, where the interests of management and the board of directors could conflict with those of the shareholders, would also appear appropriate. The same rationale that supported regulatory intervention to protect the minority from the majority shareholder (two types of owners with unequal powers) could be made to apply to protect the interests of the shareholder from abuse from "management" who have become "*de facto* putative owners". In such cases, it can be rationalized that potential regulatory intervention is warranted. Whether one is a controlling shareholder or in *de facto* control, with the potential (whether exercised or not) to act in a manner inconsistent with the best interests of the shareholders and in one's own *self-interest,* creates similar challenges. The development of tools to protect against such potential abuse and self-dealing continues to be a rational quest.

Where the interests of management (including the board of directors) could be in conflict with those of the shareholders, such as in matters of director or management compensation, the grant of stock options, dealing with a potential takeover bid or related party transactions, more effective checks and balances would appear to be required.

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[648] See Dodd, *supra* note 102; Adolf Augustus Berle, "For Whom Corporate Managers are Trustees: A Note" (1932) 45 Harv. L. Rev. 1365.
[649] See *OSCR 61-501*, *supra* note 384, ss. 8.1-8.2.

Approval by a majority of the shareholders who vote on such an issue without any proactive solicitation of votes by management or the board of directors for a position could serve to provide for a structure with more effective checks and balances. The role of management and the board of directors in such instances would be to provide the information to the shareholders in a prescribed form, with the final decision resting with a majority vote of the shareholders. This rule could be made to apply to all areas where there is a potential conflict of interests. However, this could serve to transfer effective power and control to institutional investors, given the impact of "public choice" and the lack of incentive for shareholders with a relatively small number of shares to participate actively in any such events; they might instead vote with their feet. To seek to address and to resolve this issue, *where shareholder approval is being sought this could require a majority in favor, as well as a majority of all shareholders voting on the issue who own more that a prescribed number of issued and outstanding common shares [say 2%] of the corporation in question.*[650] This should help to ensure that control is not, in effect, being transferred from one group management, to another group such as large institutional investors, without providing any protection to the broader investing public.

9.4.1. Conflicts of Interests Rules

It is posited that to seek to address potential conflicts of interests, three basic rules should be legally imposed if more effective tools of governance are to be introduced. First, **no officer or director should be permitted to participate in, or be present during, the deliberations with respect to the approval of a proposed action where he (she) is in a potential conflict of interests.** Second, there should be a **disclosure obligation**, with mechanisms put into place to help ensure **that all such instances of potential (and actual) conflicts are publicly disclosed**. Third, **meaningful sanctions need to apply** for a failure to comply with these rules.

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[650] If introduced, regulatory monitoring should be undertaken and reported upon, to assess how it is working in practice and to make changes, as required, helping ensure that it is meeting the predefined objectives.

A review of instances where this could be applicable should help to more appropriately frame this issue.

9.4.1.1. Director Compensation

A cardinal characteristic of effective checks and balances is that no one should approve his (her) own material actions (from both the individual's and/or a corporation's perspective). For example, one would find it unacceptable to have an employee set his (her) own level of compensation (without requiring any other approval). Yet, notwithstanding regulatory, judicial, gatekeeper, market and shareholder oversight[651] in respect of directors of corporations, self-approval almost always takes place.

Boards of directors set and approve their own levels of compensation. The fact that historically, director compensation may have been kept to relatively modest levels may be easy to rationalize. The prestige and other perceived benefits of sitting on a board of directors (including generating business for yourself or your company, both with the corporation on whose board you sat or through contacts made as a result of the networking opportunities that board membership created) and the relatively little that was sought or expected more than offset the modest stipends that were traditionally paid. As well, board memberships could be viewed as fulfilling one's social (business) obligations (this is, what was expected of leaders of business). There also appeared to have been an aura of reciprocity, as being asked to sit on a board entailed "returning the favor", either with an invitation to sit on your board or by helping to put your "sponsor" (often the CEO) on a board of equal importance or by another means. It was therefore not surprising that some could infer that an "old boys' network" with a "club-type" atmosphere existed in corporate circles.

With the apparent recurring challenges raised by such relationships and the highly visible business failures, greater emphasis appears to be focused on trying to obtain more credible, independent and effective directors and to compensate them appropriately.

[651] Lynne L. Dallas, "The Control and Conflict of Interest Voting Systems" (1992) 71 N.C.L. Rev. 1.

However, unless the criteria for selecting directors and the suggested compensation is exposed to shareholders, *ex ante*, for review and approval, the board of directors has the ability to continue to engage in what can be perceived to be unencumbered self-dealing. Providing for proactive shareholder involvement in at least those areas of conflict caused by *self-interest*, including prior shareholder approval of perceived conflicting actions rather than *ex post* exposure (as is currently almost always the case) may help generate greater investor confidence by avoiding public outcry in response to perceived inappropriate actions.[652] It is therefore suggested that **all director compensation**[653] **should be subject to public disclosure, scrutiny and prior shareholder approval** at the annual general shareholders' meeting before any increases in compensation can have any force or effect. Since uniformity should also be required, pre-approval of director compensation should be legally imposed by the regulator.[654] For those corporations that would comply voluntarily, this adds no additional burden, but for those that would otherwise have failed to comply, mandatory applicability helps to ensure uniformity of disclosure and compliance.

9.4.1.2. Management Compensation

While the compensation committee of the board of directors (generally composed of only "outside", that is, "non-management" directors) plays a role in the determination of executive compensation, this is generally more a matter of form than of substance; management plays a key[655] if not the "pivotal role". The generally accepted practice is that management retains "independent outside advisors" who conduct the surveys

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[652] See "NYSE Chairman Grasso Resigns" *CNN.com* (18 September 2003), online: <http://www.cnn.com/2003/US/09/17/wallst.grasso/>. The extent of *ex post facto* damage is evident in the report of the resignation of NYSE chairman Grasso as a result of his controversial compensation package, which included a lump sum payout of $139.5 million in deferred compensation and retirement payments. However, the same article notes: "At an August 7th meeting of the compensation committee of the NYSE board of directors, Grasso had expressed concern about the potential negative publicity resulting from disclosure of the package" based on calls that he, Grasso, had received, but the Committee members decided to proceed.

[653] Including specifically the total compensation of the president and CEO, as well as any other officer(s) who also sit (or it is proposed should sit) on the board of directors.

[654] Interestingly, if a CEO also continues to be a director, this could support the view that his compensation should be subject to shareholder approval, as peers should not be setting the salary of their co-director.

[655] To the effect that management and the CEO play a key role with respect to executive compensation, *DSI*, *supra* note 154, statement 66, was supported by 90.2% (92.51 % when the neutrals are excluded).

forming the foundation for their compensation. Furthermore, these same firms retained to provide "independent advice on director and on management compensation" are usually also retained by management to perform other services for the corporation. Accordingly, the *self-interests* of these independent advisors are aligned with management. It has now belatedly come to be recognized that external auditors cannot be expected to serve two masters, or, in other words, conduct what should be an independent audit while at the same time seek to obtain other business from the management of the corporation.[656] However, in the case of compensation, such conflict of interests (especially in the determination of the compensation of the CEO) is not only allowed to exist but appears to be prevalent. Furthermore, it appears to be buttressed by what can be termed "comparative and competitive rationality",[657] especially when dealing with the compensation of the CEO (although it is also applicable to other key officers of a corporation as well as to the board of directors). To deal with this structural conflict, it is suggested that **the firm that advises a board of directors with respect to "officer human resource matters" (including compensation) should be prohibited from providing any other services to the corporation.** Any exception to the foregoing should be required to be reviewed and pre-approved by the board of directors (or a committee thereof) and the rationale for any departure reported on annually by the board of directors of the corporation in the material made available to shareholders at their annual general meeting.

9.4.1.3. Ownership Rights

Shareholders of corporations have relatively limited ownership rights; they can vote with their feet if they disagree with the manner in which "their corporation" is being run. In an attempt to provide for greater accountability and to address the challenges of *self-interest* and the *funneling syndrome,* repatriation of ownership rights, but only in cases where the representatives of the owners are in an actual or a potential conflict of interests, is being postulated. This envisages the prospects, but not the necessity, of a more proactive role for shareholders of a corporation. It is posited that shareholders should be provided with

[656] See *SOX, supra* note 150, s. 206.

the legal right to approve or to turn down transactions, *ex ante*, where those who would otherwise deal with the matter are in a potential, or an actual, conflict of interests.

In addition to compensation matters that may create conflicts of interests, another case in point is the manner in which takeover bids are handled. It has been suggested that unconstrained takeover ability operates as a check and balance on incumbent management and a board of directors.[658] It is nevertheless recognized that management and the board of directors are not passive, uninterested observers; *self-interest* motivates action and intervention, both overt and covert.[659] In recognition of this inherent conflict, (and given that anti-takeover devices tend to help reduce shareholder value[660]), shareholders should be able to play a more proactive role.[661]

It has been suggested that even if shareholders have a comparative advantage over management (including the board of directors) in responding to takeover bids, this would not necessarily be value enhancing. It is argued that management can and in fact does take steps to frustrate what could be shareholder (as opposed to management and director) supported takeover bids.[662] The steps that can be taken to negate shareholder aspirations can be both apparent and hidden. As a result, the risk to a prospective purchaser from latent anti-takeover devices and to the final outcome increases where management (and director) support is lacking. This results in an increase in the expected potential purchaser-required returns.[663] In recognition of these challenges, takeovers can

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[657] See Appendix L, below, for a review of this matter.
[658] See Easterbrook & Fischel, "Takeover Bids", *supra* note 124.
[659] See Bebchuk *et al.*, "Powerful Antitakeover", *supra* note 233; Bebchuk, *et al.*, "Powerful Antitakeover: Further Findings", *supra* note 242; James Cotter & Marc Zenner, "How Management Wealth Affects the Tender Offer Process" (1994) 35 J. Fin. Econ. 63; Easterbrook & Fischel, *ibid.*; Gerald T. Garvey & Gordon Hanka, "Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage" (1999) 54 J. Fin. 519 at 520; Paul A. Gompers, *et al.*, "Corporate Governance and Equity Prices" (2003) Quarterly J. Econ. 107.
[660] Marianne Bertrand & Millinathan Sendhil, "Is there Discretion in Wage Setting? A Test Using Takeover Legislation" (1999) 30 Rand J. Econ. 535; Garvey & Hanka, *ibid.*; Gompers *et al.*, *ibid.*
[661] Bebchuk, "Case for Facilitating", *supra* note 299; Bernard S. Black & Reinier H. Kraakman, "Delaware's Takeover Law: The Uncertain Search for Hidden Value" (2002) 96 Nw. U. L. Rev. 521; Easterbrook & Fischel, "Proper Role", *supra* note 299.
[662] Arlen & Talley, "Precommitment and Managerial Incentives", *supra* note 121.
[663] Marcel Kahan & Michael Klausner, "Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment" (1993) 40 UCLA L. Rev. 931.

result in the potential purchaser also attempting to "buy management". The result would appear to pit the *self-interest* of management against corporate (shareholder) interests. Notwithstanding putative attempts to deal with this matter, leaving the resolution in the hands of management (or even a board constrained by the *funneling syndrome*) does not effectively address the ostensible conflict of interests. The existence of both latent and apparent anti-takeover devices would seem to proscribe takeovers as a check and balance on management. Despite the clearly identified conflicts of management, getting shareholders involved in the decision-making process lacks clear support.[664]

However, even if one sought to engage shareholders in this process, the application of the *funneling syndrome* and the related lack of transparency in terms of anti-takeover devices serve to minimize potential shareholder involvement and optimize the position of management. If this aspect is to be addressed, tools of more effective corporate governance are required. Latent constraints on takeovers must therefore be made apparent and be subject to investor (actual and potential), institutional and broad public review. To deal with this conundrum, it may be necessary to legally mandate that all forms of anti-takeover devices, both express and unapparent,[665] should be publicly disclosed annually (and updated whenever a material change occurs) and that the accuracy of all such disclosures be certified by the CEO and CFO annually, at the same time as the review and approval of the annual financial statements is undertaken. As well, to ensure accountability to the owners, the shareholders should have the right to override the recommendations of management (including the board of directors) and a shareholder vote to accept or reject a takeover bid (or to remove anti-takeover devices, both direct and indirect) should continue to be imposed by the regulator.[666]

Tools of more effective corporate governance could therefore require **specific transparent annual public disclosure of all corporate anti-takeover constraints** (both

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[664] Lucian Arye Bebchuk, "The Case for Empowering Shareholders" (2003), online: Social Science Research Network Electronic Library <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=387940>.
[665] Elaine Ziff, "The Effect of Corproate Acquisitions on the Target Company's License Rights" (2002) 57 Bus. Law. 767.
[666] See *OSCR 61-501*, *supra* note 384.

latent and apparent) **updated with material change reports**[667] **for any modifications having occurred over the course of a year.** Such tools could require that such disclosure be certified as being complete and accurate by the CEO and the CFO, with the statutory right of shareholders requiring the removal of these constraints; this could serve to address management and board of director self-interest. As well, leaving the final right to determine the acceptability of an offer to the shareholders (that is, allowing the owners of the shares to decide how they wish to deal with their property (the shares)) would assist in repatriating ownership rights and in avoiding the inherent conflicts of interests faced by management and the board of directors in dealing with this matter. The introduction of these tools, by statute so as to make them mandatory, could help address the problems raised by *self-interest* and the impact of the *funneling syndrome* and render management and the board of directors more accountable to their shareholders.

9.4.1.4. Structural Changes: Shareholder Access to the Ballot

Accountability requires the prospect of being able to enforce compliance; meaningful sanctions provide an element of enforceability. Corporations that introduce corporate practices and internal controls make it clear that a failure to comply will result in disciplinary action up to and including dismissal; there is accountability to a higher authority. However, in the case of the CEO and directors of a corporation, accountability to a higher authority, barring very exceptional circumstances, is often questionable. Barring a potential takeover bid (which for the reasons outlined herein is not always a meaningful concern) officers and board members are generally reasonably well entrenched. Accordingly, a process that allows shareholders to initiate action with the prospect of electing their own slate(s),[668] given that such action to be successful would require clear disaffection by a majority of the "owners", who would be required to

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[667] See *Form 27 – Material Change Report Under Section 75(2) of the Act*, Ont. Reg. 1015, R.R.O. 1990, Regulation 1015, Forms [Form 27].

[668] Securities and Exchange Commission, "Proposed Rule: Security Holder Director Nominations", 17 C.F.R. Parts 240, 249 & 274, Release Nos. 34-48626; IC-26206; File No. S7-19-03, online: Securities and Exchange Commission <http://www.sec.gov/rules/proposed/34-48626.htm> is an attempt to address this issue [Securities and Exchange Commission, "Proposed Rule"].

support the "opposition" for any such action to succeed, appears to merit consideration.[669] It warrants a closer examination, as has been suggested by the SEC[670] and academics.[671]

It is recognized that shareholder-proposed nominees or slates would be a change to the *status quo* and the perceived entrenched rights of the "directors and management". As a result, there clearly are and continue to be views to the contrary.[672] Concerns that dissident groups could hijack and abuse this process is however more theoretical than likely, given the holdings and therefore the required support of the institutional investors. As well, imposing regulatory hurdles such as "minimum threshold shareholder support" or "prior regulatory approval" to establish that a proposed slate is *"bona fide"* before a "non-management slate" can be submitted to an *annual general shareholders' meeting* or to a special meeting called for such purpose could address any valid concerns. Triggering events, such as a shareholder proposal that receives a specified percentage of support, before a shareholder slate is permitted could add an additional check and balance. However, such pre-conditions (such as a required shareholder proposal) in effect serve to entrench a board for the period required to allow a vote on a proposal to take place and would then require a subsequent shareholder meeting for the "shareholder slate" to be put before all shareholders.

The potential for alternative director slates could motivate incumbents to be more responsive to shareholder concerns, thereby achieving the objective of providing greater accountability to the shareholders. Conversely, it has been suggested during discussions relating to the *DSI* that "greater potential for shareholder democracy" may de-motivate individuals from seeking board positions at a time when such individuals may already be in relatively short supply. However, it is posited that the failure to seriously consider this

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[669] *DSI*, *supra* note 154, statement 99, that "[s]hareholders should be allowed to elect (as opposed to merely confirm the selection by management) of directors", was only supported by 47.5% (51.35% excluding the neutrals).

[670] This matter was the focus of review by the SEC in 1942, 1977, 1992, and 2003. See Securities and Exchange Commission, "Proposed Rule", *supra* note 679.

[671] See Lucian Arye Bebchuk, "The Case for Shareholder Access to the Ballot" (2003) 59 Bus. Law. 43.

[672] Martin Lipton & Steve Rosenblum, "Election Contests in the Company's Proxy: An Idea Whose Time has not come" (2003) 59 Bus. Law. 67.

option, especially when it would generally only be invoked where there may be investor disaffection and a loss of confidence in the incumbents managing a corporation, fails to recognize the inherent rights of shareholders "as owners". It fails to enable shareholders to hold those who manage their "interests" (limited though shareholders rights may now in fact be) accountable. It appears to rationalize the loss of individual rights, ostensibly to a reified entity, the corporation (but in fact to the committee, namely the board of directors, often controlled by the CEO) with a concomitant disenfranchisement of the individual shareholder. Such actions are more akin to a totalitarian than a democratic society: "It is an odd paradox that a corporate board of directors and a communist committee of commissars should so nearly meet in a common contention".[673] Whenever individual rights are sacrificed to seek to support a "common good" (without the individual playing (or being given a meaningful ability to participate in the determination of what should be done in his (her) best interests), there is potential for abuse, motivated by the *self-interest* of those in *de facto* control. The practical reality is that according to the *status quo*, management and the board of directors of a corporation can impose their views on the owners, but in practice the reverse is rarely true.

Abolishing a mandatory requirement to issue annual reports[674] (the cost of which appears to exceed the benefits for most shareholders and whose information could be made available on an as-required basis and/or with Internet access) and the savings that could thereby result from reduced printing and mailings could be used to offset the costs of supporting a meaningful shareholder election. There can be little rational justification for the individual or small group of shareholders being required to personally bear the costs of seeking to elect an alternative candidate or slate (with the inequity that the benefits of their actions if successful are to be shared by all shareholders). A relatively small investor is then better off voting with his (her) feet, with the result that, all other things being equal, unconstrained control rests with management and the board of directors.

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[673] Berle & Means, *supra* note 2 at 245.

[674] See *Ontario Securities Commission Policy 52-601 – Applications for Exemption from Preparation and Mailing of Interim Financial Statements, Annual Financial Statements and Proxy Solicitation Material*, 24 O.S.C.B. 2404. However, *CBCA*, *supra* note 37, s. 155 still requires the release to shareholders of annual financial statements, subject to a discretionary exception set out at s. 156

Tools of more effective corporate governance could, through requirements legally imposed by the regulator on all corporations, **seek to advance shareholder democracy**. This could be achieved by using a process enabling shareholders to put forward an individual or a slate of directors (subject to the occurrence of certain triggering events and/or the meeting of hurdles, as imposed based upon periodic review by the regulators) and could serve to help sever the perception (if not always the reality) of management control of the board of directors. While it is doubtful that alternative nominees or director slates would be used frequently, it could nevertheless engender greater accountability by those in control. Furthermore, if the process (under the circumstances outlined herein) were utilized, it would provide a potential check and balance on the problems of *self-interest* and the *funneling syndrome*. As well, if the annual report were not required to be delivered to shareholders unless expressly requested (although it could be made accessible to all via the Internet), the cost savings could be used to fund "greater shareholder democracy" in those limited cases where the need arose. Regulatory oversight and the *self-interest* of those in control would also serve as an immediate check and balance to ensure that this process is not abused.

9.4.1.5. Procedural Changes: More Effective Shareholder Proposals and Related Intervention

Shareholder proposals were not perceived to be very effective tools of corporate governance,[675] notwithstanding their increased use and the publicity that some of these actions served to generate.[676] It is also recognized that large shareholders can, given their leverage with management, use the process to extract benefits.[677] However, if the rules were modified to make the board of directors more accountable to the wishes of the proponents of shareholder proposals that had received meaningful support, then this could assist in creating greater accountability. This could be made to occur, for example, if shareholder proposals receiving twenty percent or greater shareholder support required

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[675] *DSI*, *supra* note 154, statement 97, that "[s]hareholder proposals are an effective way to exercise shareholder power", was only agreed to by less than half (41.5%) of those interviewed (47.27% excluding the neutral responses).

[676] *Michaud v. National Bank of Canada and Royal Bank of Canada*, [1997] R.J.Q. 547 (Que. Sup. Ct.).

the corporation to publicly indicate whether the board of directors intended to comply with the proposal. Where the board did not comply, the proponents of such proposals could be given the same rights as management to nominate individuals to the board of directors. Under such circumstances, the corporation could be prohibited from playing a proactive role in the election process, other than preparing a proxy with the names and descriptions of all the candidates and with equal space for management and the alternative slate, all in accordance with a format prescribed by the regulator. The shareholders at the next annual general meeting could then decide whom to elect, based on the description of their attributes (all certified as being true, full and plain disclosure in the manner previously outlined herein).

To ensure that this process could not be hijacked or abused (that is to prevent it from becoming a vehicle for special interests), checks and balances would be required. People acting "jointly or in concert" with management could be excluded from this process as this group already has a mechanism in place to have their views addressed, given their control of the proxy process and the corporation. As well, if there were more than one shareholder proposal, then only the one that had received the highest level of support (in excess of the minimum as pre-determined by the regulator) would be permitted to take advantage of this opportunity. This would focus attention on those issues perceived by the greatest number of shareholders to be of critical importance and would help to avoid diluting the efforts of smaller factions. As well, given the implications associated with "public policy" and the recognition that institutions are playing a central role in the evolution of corporate governance (with all the risks that this re-allocation of power and potential control entails), steps need to be taken to help ensure that this does not inadvertently shift power to a major institutional shareholder. To attempt to address this concern, the twenty percent (or greater or lesser support, as set from time to time by the regulator) could also require the support of a majority of the institutions that vote with respect to such a proposal, voting in favor. This should avoid having institutions take

[677] Stephen J. Choi & Andrew Guzman, "Choice and Federal Intervention in Corporate Law" (2001) 87 Va. L. Rev. 961.

control of this process, while at the same time recognizing their importance and the potential influence in affecting (and seeking to improve) corporate governance.

9.5. STRUCTURAL AND PROCEDURAL CHANGES: ACCOUNTING

Accounting and proper disclosure appears to be one of the essential building blocks for the foundation of the "efficient market theory". As a result, efforts are expended by regulators so as to ensure that material information, focusing specifically but not exclusively on financial data, is disclosed to all at the same time and that the market is able to operate efficiently. However, accounting provides great flexibility and enables one to "manipulate and manage earnings", all within the confines of the law.[678] There is therefore a recognized need to distinguish recurring income from "one-time items".[679] As well, related party transactions need to be specifically reported on and not buried in notes to the financial statements.[680] In addition, external auditors, the putative shareholders' gatekeeper, have their interests aligned with management (as at least historically, management played a key role in their appointment)[681] and are loyal primarily to management,[682] and their report to the shareholders is perceived to have relatively little value.[683] Given the foregoing observations, the foundation upon which the efficient

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[678] *DSI*, *supra* note 154, statement 105, that "[a]ccounting provides great flexibility and enables you to 'manipulate and manage earnings' all within the confines of the law", was supported by 80.5% of the interviewees (91.69% when the neutrals were excluded form the count). See also e.g. Jennifer Bayot, "Vivendi Pays $50 Million in Settlement with SEC" *The New York Times* (24 December 2003) C1. It is worthy of note that Vivendi International, which was reported to have misled its investors in news releases and financial statements and paid a fine of $50 million to the SEC, was not required to revise its financial statements.

[679] *DSI*, *ibid.*, statement 106, that "[a]ccounting needs to identify 'recurring income' and distinguish it from one items", was agreed to by 95.1% (100% when the neutrals were excluded).

[680] *Ibid.*, statement 109, that "[r]elated party transactions (that is, transactions with people or companies that have a close relationship with a corporation) should be specifically reported on by the external auditors to the shareholders as a specific item of disclosure and not buried in the notes to the financial statements", was supported by a 77.5% (81.58% when the neutrals were excluded).

[681] *Ibid.*, statement 46, that "[m]anagement if fact appoints the external auditors", was strongly supported by 66.7% (69.99 % when the neutrals were excluded).

[682] *Ibid.*, statement 49, that "[e]xternal auditors are primarily loyal to management", was also strongly supported by 75.6% (83.81 when the neutrals were excluded).

[683] *Ibid.*, statement 108, that "[t]he auditors' Annual Report, in fact, adds value for the shareholders", was only supported 35% (38.89% when the neutrals were excluded).

market rests and the value of this safeguard would appear, at least in the short term,[684] to be suspect.

In seeking to address these issues, the following could be considered. First, external auditors should be prevented from performing any non-audit functions for an audit client.[685] It was frequently suggested during the *DSI* that work on taxation matters should continue to be performed by external auditors as they know the corporation, their client, and are in the best position to assist with the tax planning, reporting and compliance. Furthermore, it was noted that an external check and balance exists in the form of government audits and that the interests of external auditors, management and shareholders are, at least insofar as taxation is concerned, aligned. It has however also been suggested that aggressive tax planning[686] can work to align the interests of the auditors with that of management. However, when coupled with the suggestion that **for "material errors and restatements", external auditors should be held accountable** in the manner advocated in this thesis, **and that personal accountability and responsibility (*PAR*[687]) should apply,** then allowing external auditors, with audit committee approval, to also perform the tax function can be rationalized and defended, at least until there is empirical evidence that suggests that it will not work as anticipated.

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[684] In the long term corrected information does find its way into the market and a correction does take place as is evidenced by events such as those relating to Enron, WorldCom and BreX. However, this does little for those who relied on market efficiency in making their decisions prior to the correction taking place. See Floyd Norris, "The Auditors Never Noticed" *The New York Times* (24 December 2003) C1. According to Italian investigators, Parmalat was engaged in a fraud that began ten years ago and was apparently picked up by the new auditors, Deloitte and Touche that had replaced Grant Thorton in 1999 under Italian rules that require one to change auditors every nine years. (However, it is to be noted that D & T only picked this up into the 4th year of their audit, when Deloitte began questioning a transaction involving derivatives.) On 30 December 2003, the SEC announced it had initiated legal proceedings against Parmalat. See SEC, News Release, "SEC Charges Parmalat with Financial Fraud" (30 December 2003), online: <http://www.sec.gov/litigation/litreleases/lr18527.htm>; *Securities and Exchange Commission v. Parmalat Finanziaria S.p.A.*, Case No. 03 CV 10266 (PKC) (S.D.N.Y.).

[685] This is already required legislatively. See *SOX*, *supra* note 150, s. 206; *MI 52-110*, *supra* note 200; Securities and Exchange Commission, "Proposed Rule", *supra* note 667.

[686] Mark Rosen & L.S. Rosen, "Unraveling Tax Gimmicks: What Might be the Next Big Corporate Tax Concern for Investors" Accountability Research corporation (22 September 2003) 1 at 4, where they note: "Quite often, aggressive tax schemes go hand-in-hand with aggressive financial reporting".

[687] See Subsection 9.5.2., above.

To address the appearance (if not also the fact) that external auditors are aligned with management,[688] a board of directors could **be required to go to public tender**, no less than every five years **for a new external auditor** and explain the recommended choice when seeking shareholder approval. Should the new firm of external auditors successfully challenge the propriety of any previous accounting and require any material changes to the accounts (including prior period adjustments, which in effect suggest that decisions previously taken may well have been based on incorrect information), then *PAR*[689] should apply and any amounts paid or payable directly or indirectly to the CEO and the CFO during or relating to the period in question (other than a reasonable living allowance in the case of officers) as well as to the external auditors relating to the period(s) in question should be required, by law, to be disgorged and remitted to the corporation. Furthermore, such failure should constitute "just cause" for dismissal with the forfeiture to the corporation of all future amounts otherwise payable to these same individuals. Should the board of directors decide not to terminate the CEO and the CFO for deemed cause (as the CEO and the CFO should bear responsibility for such failures), their rationale for failing to do so should be submitted to and be subject to shareholder approval. This should help ensure that accounts are properly drawn up and that those who fail to do so are held accountable for their failure to meet their duties to the corporation, its investors and its shareholders.

The foregoing academic suggestion is nevertheless subject to a very real current practical limitation; today, only the "big four" accounting firms[690] have the resources and capability to perform many of the larger national and international audits. As a result, other mechanisms are a necessary precursor to being able to provide a more competitive auditing environment. The resolution of this very real challenge is beyond the scope of this thesis. Nevertheless it does serve to raise a practical constraint that has, through inadvertence or otherwise, been permitted to evolve and needs to be addressed.

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[688] See *DSI, supra* notes 154, statements 21 & 24.
[689] See Subsection 9.5.2., above.

9.5.1. The External Auditors

One of the basic challenges faced by external auditors is that they are not in fact, nor in law, the shareholders' auditors, nor are they gatekeepers to help protect the interests of investors. As mentioned before, they are in fact very much aligned with and, at least historically, have been controlled by management. Whether this will change dramatically as a result of recent events like SOX and Bill 198 is open to debate, although it was suggested during the *DSI* that it is in the process of changing. To seek to address this conundrum, legislative steps have been taken to constrain the role and mandates of external auditors.[691] However, this does not appear to be the only area of conflicts of interests.

There has been an epidemic of restatement of financial statements in recent years.[692] Notwithstanding that external auditors had issued unqualified opinions, restatements have nevertheless subsequently occurred; this appears to have become acceptable. Restated financial statements mean that all who had acted on the prior "erroneous audited statements" to make decisions, be they internal, such as salary treatment (bonuses and increases in salaries may have been improperly arrived at, options exercised), or external (shares bought and/or sold, corporate paper bought and/or sold or credit transactions entered into, or the corporation otherwise dealt with), would have been misled. This may not lead to litigation, as recoverable damage had not necessarily been suffered. However, even where damage had been suffered, the cost of initiating the litigation usually mitigates against legal initiatives in all but the most egregious of cases.

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[690] The "Big Four" comprise Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers.

[691] Initiatives to begin to address this issue are being introduced. See e.g. *MI 52-110, supra* note 200.

[692] A search of databases for mentions of restatements due to irregularities or errors found 224 results in 1977-1989 (17 a year on average), 392 in 1990-1997 (49 a year), and 464 in 1998-2000 (155 a year). See FEI Research Foundation, "Quantitative Measures of the Quality of Financial Reporting", online: <http://www.fei.org/download/QualFinRep-6-13-2k1.ppt>. Further, numerous other restatements took place thereafter. For instance, on 6 November 2001, Enron announced a massive restatement of its financial statements for the years 1997 to 2000. For more recent examples, see "Shareholder Value, Financial Conservatism, and Auditor Independence"; <http://papers ssrn.com/abstract=454080> (Bratton).

Restatements may be caused by numerous factors. However, management and the external auditors should be held primarily accountable, as they are not constrained by the *funneling syndrome.* Personal accountability and responsibility, or *PAR* (as discussed below), may provide a means of addressing this challenge.

9.5.2. Personal Accountability and Responsibility (*PAR*)

The restatement of audited financial statements[693] should be deemed unacceptable. Any restatement should be viewed for what it is: a public acknowledgement that what had previously been reported was materially incorrect. Error should bring with it accountability. Just as employees are held accountable for their actions, the external auditors who audited the financial statements (with respect to which they had previously issued an unqualified audit report) and the management that had prepared and released such incorrect data should pay the ultimate price for their "material failure" to help safeguard the interests of the owners.[694] *CIA* should be the hallmarks of our system of corporate governance. Restating audited financial statements questions the competence (why restate if the work was done properly in the first place?), integrity (the quality and soundness of what was issued internally and to the public and upon which decisions were made can raise questions as to why this has taken place, and what will one do to ensure that it will not recur) and accountability (the price paid for the errors made) of those involved. Unless we merely wish to pay lip service to *CIA*, then when a material breach occurs (and restating prior years audited financial statements should be included in the definition of material breach for these purposes), a price should be paid by those responsible.

To hold those responsible accountable in a very transparent way, *PAR* should apply. The CEO, the CFO, the external auditors and the members of the audit committee at the time that the error took place (if still on the board of directors) should be obliged to immediately tender their resignation (such terminations being treated as termination for

[693] Other than to restate prior years' financial statements, as a result of a change in generally accepted accounting principles (GAAP).

cause) and, barring board-of-director intervention and express shareholder approval in the case of the officers or the directors, be replaced. Deemed termination for cause should prevent the officers in question from accessing any termination arrangements by requiring them to disgorge (or waive) all such payments to the corporation (less a reasonable living allowance), failing which anyone, including the corporation, should have the right to sue the individual in question and if successful (anyone other than the corporation or anyone acting for or otherwise on its behalf, such as employees), should participate equally with the corporation in sharing the benefits of the disgorged funds (such as can occur in the case of the short swing profit rules in the United States[695]). To make the sanction immediate and visible, an offending external auditor should be required to refund all fees earned from the corporation with respect to the offending period (each material error relating to a year being deemed to cover the whole accounting year in question).[696]

The application of *PAR* to any financial restatements may prove to be a much more effective and immediate sanction than the threat of litigation, which is lengthy, drawn out and less than effective. As well, litigation is paid for by the shareholders (the owners of the corporation), either directly to settle a case or indirectly to contest it with the associated call on the time and resources of the corporation, as well as a longer-term negative impact, including through increased insurance premiums and audit fees. Introducing *PAR* should assist in aligning the interests of the officers, the audit committee members and the auditors with those of the shareholders.

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[694] Since non-material errors or omissions would not result in a restatement of audited financial statements, restatements, other than to comply with a change in GAAPby definition, involve items that are material.

[695] *Securities Exchange Act of 1934*, *supra* note 6, s. 16(b).

[696] Accountability could also be enforced by a mechanism (predicated on the process used in the case of failures to comply with the short swing profit rules in the United States. See *supra* notes 83 & 6, where an offending party must act on its own initative to disgorge the funds in question, failing which a third party may initiate proceedings to recover the amounts on behalf of the corporation. The third party and will receive a bounty from the external auditors if the suit is successful.

9.5.3. Procedural Changes: Shareholder Election of the External Auditors

Two suggestions were put forward in the *DSI,* namely that shareholders should elect, as opposed to merely confirm, the external auditors[697] and that a tender process should be used with pre-qualified auditing firms bidding based on price and deliverables and shareholders voting based on written submitted bids.[698] There was some support (although not a majority) for the abstract concept of giving shareholders the right to elect the auditors.[699] However, when a specific methodology was suggested, the concept was strongly opposed.[700] The rationale appeared to be based on both philosophical and practical considerations. Philosophically, it was argued by some that board of directors are charged with the responsibility and the authority to manage the corporation and that shareholders of widely held, publicly listed corporations should not be, nor are they qualified to be engaged in the running of such entities. Concern was also expressed that "fringe groups",[701] as opposed to the shareholder body, could seek to use this process for personal as opposed to shareholder objectives. Practically, it was suggested that this could lead to conflict, as accountability would be to a generic group the shareholders and if problems arose between management and the shareholders, there would not be any arbiter. This friction, it was noted, would have to be tolerated until the next AGM, where an attempt could then be made to replace the auditors. While the foregoing may raise valid concerns, it appears to intimate that there may be many latent issues of potential concern, under the *status quo*, that in the interests of maintaining "harmony" are not dealt with. If true, this should be a greater concern than the constructive friction that may arise as a result of trying to make accountability more focused.

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[697] *DSI*, *supra* note 154, statement 100, that "[s]hareholders should, in fact, elect the external auditors as opposed to merely confirming the selection by management", was supported by less than a majority 37.5% (41.67% when the neutrals wee excluded).

[698] *Ibid.*, statement 58, that "[a] tender process should be used with 'pre-qualified' auditing firms bidding based on price and deliverables and shareholder voting based on written submitted bids", was generally not supported (only 18.4% (19.98% when the neutrals were excluded) were in favor).

[699] *Ibid.*, statement 53, that "[e]xternal auditors should be elected by the shareholders based on a commitment as to what they will do", was generally not supported; only 35% (37.84% when the neutrals were excluded) supported that statement.

[700] *Ibid.*, statement 58, that "[a] tender process should be used with "prequalified" auditing firms bidding based on price and deliverables and shareholder voting based on written submitted bids", was only supported by 18.4% (19.98% when those who indicated that they were neutral were excluded from the count).

[701] The issue of fringe groups is a concern usually and frequently raised by those in management.

If the role of the auditor is that of a gatekeeper, acting as a check and balance on management and on the board of directors, and if one accepts that no one should be accountable unto oneself, then making the external auditors accountable to those whom they purport to audit creates conflicts of interests. It therefore follows that the external auditors should not be put into office by management, or by the board of directors, but in fact by the shareholders. While in most cases the recommendation submitted to the shareholders by management is accepted, a failure to provide alternatives pre-ordains the outcome. To provide options, the election of auditors could include a vote from a qualified list of firms established by the Public Company Accounting Oversight Board (PCAOB)[702] (given the role that is being attributed to the external auditors), enabling shareholders to have a choice.

The ability of shareholders to elect external auditors could help make the latter more accountable to the shareholders, as opposed to those who purport to act on behalf of the owners.[703] However, two basic pragmatic challenges impede such an initiative. First, as has been noted, there are only four major international accounting firms. The result is that unless you want to use the same accounting firm as a major competitor, the options of whom you can engage may be quite limited. A race where there are only one or two contestants may not be a real race, especially if to the loser go all the more profitable non-audit functions that the external auditor is prevented from providing. Second, only certain external auditors have developed the requisite expertise in auditing-specialized industries. The result is that for such corporations changing external auditors, given the oligopoly if not the monopoly that appears to exist for the audit of complex international corporations, effective choice many not be a realistic option. As well, even where choices exist, it is argued that enlisting the services of new, less expert auditing firm results in a learning curve that is expensive, both in terms of added risk and cost, given the lack of required expertise. As a result, one must question whether accounting firms will wish to take on the risk associated with doing an audit of a corporation, given the learning curve

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[702] *PCAOB*, *supra* note 129.
[703] Anita Indira Anand, "Shareholder Isolation and the Regulation of Auditors" U.T.L.J. [forthcoming in 2004].

and the possibility that they will only be engaged for a relatively short period of time. As well, one must examine the related increased costs.

Given that shareholders of widely held, publicly listed corporations are generally passive (especially if management appears to be reasonably effective and responsible), the ability to have shareholders elect the external auditors may be little more than a threat. Furthermore, if exercised, and if the new external auditors were to raise issues that were not appropriately addressed by its predecessors, then the use of this process may help to realign interests. On the basis that internal controls will not work as effectively if those who are being monitored in turn choose and in fact control the monitor, it is suggested that **the external auditors should in fact be elected by the shareholders (not by management and the board of directors whom they should monitor) and should, in law, be accountable to their appointees**. However, where there are reasons as to why an auditing firm cannot be rotated, this should be subject to review with and approval by the regulator and if the corporation's position is agreed with, the rationale for retaining the same external auditor, publicly disclosed in the audited financial statements.

9.5.4. Procedural Changes: Mandatory Rotation of the External Auditors

The challenges created by the unique position of the external auditors and the historical relationship of certain firms to management suggest the need for the mandatory rotation of the external auditors of the firm. However, for such a change to be effective, meaningful competition for the provisioning of such services would need to exist. Where competition exists, it could assist by providing a potentially different, less-biased perspective in reviewing the affairs of the corporation. Nevertheless, the existence of only four major external accounting firms may effectively prevent any meaningful competition in the cases of widely held, publicly listed national and international corporations. In the latter cases, rotation may be nothing more than a game of musical chairs; that is, the "major four" may in effect end up rotating the audits of corporations amongst themselves. The limited number of meaningful competitors in a world that has seen international business grow while the number of firms able to perform the required audit have been reduced from the big eight of a few years ago to the current big four, suggests that

mandatory rotation for the international corporations, unless greater competition is engendered in some other manner, may not be a viable short-term alternative for such corporations. Partner rotation, while viable and generally accepted (and already in practice in many accounting firms) is still less effective. Internal transfers usually entail an orderly transition, a handoff from the incumbent partner to the new one; in such an environment, it is less likely (but not impossible) that there will be any meaningful deviation in how the client is handled. While having partner rotation means that clearer cases of abuse may be made more difficult (as the corporation in question will be required to get more people to agree with an accounting position that the management of the corporation might wish to take) auditor self-interest would attempt to ensure that other than in clearest of cases, firm loyalty would be maintained. As a result, notwithstanding the challenges it is suggested that **it should be mandatory for auditing firms of corporations to be rotated on a periodic basis** (say every five years), with the basis for the selection of the replacement firm being clearly disclosed.[704] When coupled with *PAR* and the potentially greater importance of reputation in a more competitive environment, this should help ensure greater accountability. Where auditing firms cannot be rotated (and this is agreed with by the regulator), partner rotation within the same accounting firm, although potentially of limited value, should be mandatory.

9.5.5. Structural Change: The Audit Committee

The audit committee of the board of directors is now required to play a pivotal role in dealing with auditors and in decisions relating to their hiring and firing.[705] However, notwithstanding the rhetoric and apparent support for this suggestion, if divorced from the board of directors as a whole,[706] this approach serves to weaken the role of the board of directors. Therefore, unless academic or empirical justification can be advanced for creating boards within boards (given the reduction in the size of the boards and the supposition that there should be greater wisdom in the collectivity of a small board then in a subcommittee thereof), the justification for the action taken appears suspect at best

[704] Whether it is on the basis of a competitive bid, acknowledged expertise, or some other criteria, the basis should be clearly disclosed in the material requesting "approval" of the auditors.
[705] *SOX*, *supra* note 150, s. 203.

and politically motivated at worst. **Committees,** including specifically the audit committee, should be tools of the board of directors to help achieve more effective governance. They **should not** however be permitted to **become "special super boards",** as the rights and powers of a part should not be permitted to exceed the whole.

9.6. WHISTLE BLOWING

There appeared to be support for the concept of whistle blowing[707] as a means to seek to counter the loss of confidence in the efficiency of the stock markets and to provide a check and balance on the *funneling syndrome* and employee *self-interest.* However, the issue was and continues to be how to seek to do this effectively. To help meet the identified need, *there appears to be a consensus that an independent body*[708] *needs to oversee its operation,* staffed by individuals recognized as having the highest and recognized integrity.[709] Each *corporation should* legally be *required to establish and publicly disclose its whistle blowing program*; it should be designed to encourage substantiated whistle blowing[710] where an individual believes that a corporation is not complying with the law (as well as its own internal published practices) and is not comfortable that it can be resolved internally by dealing with his (her) superiors. The law should merely establish the minimum requirements, leaving it up to corporations to, at

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[706] *Ibid.*, ss. 101 & 103.

[707] *DSI, supra* note 154, statement 83, that "[w]histle blowing should be encouraged", was supported by 72.5% (87.14% excluding those that were neutral). Note that *MI 52-110, supra* note 200, s. 2.3(7) provides that "[a]n audit committee must establish procedures for: (a) the receipt, retention and treatment of complaints received by the issuer regarding accounting, internal controls, or auditing matters; and (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."

[708] Whether this should be handled internally or externally continues to be a subject of debate. While the use of an external body suggests greater independence, there appears to be a concern about "leakage" of perhaps maliciously initiated allegations, that could be damaging to individuals and to the corporation could be better handled and controlled internally. Conversely, those supportive of an external process suggest that it is more difficult to get individuals to come forward where they are dealing internally.

[709] Integrity, as used in statutes, is defined in *Black's Law Dictionary, supra* note 127 at 947 as meaning "soundness or moral principle and character, as shown by one person dealing with others in making and performance of contracts, and fidelity and honesty in the discharge of trusts". It is synonymous with "probity", "honesty" and "uprightness". Jean L. McKechnie, ed., *Webster's New Twentieth Century Dictionary* (Unabridged), 2d ed. (New York: World Publishing Co, 1974) at 953, includes similar wording in the definition, namely the quality or state of being of sound moral principle; uprightness, honesty and sincerity".

least initially, establish the methodologies and require public disclosure thereof, with legislation only intervening to address recognized shortcomings.

9.7. PROCEDURAL CHANGES: STOCK OPTION GRANTS

Stock options were and continue to be advanced as a means of aligning the interests of management (and directors) and the shareholders and assisting in getting them to think as owners. However, anecdotal evidence and the *DSI* suggest that this is not the case.[711] Stock options encourage management to think as speculators, to take short-term risks to maximize stock price gyrations at the expense of longer-term value creation as this enables them to benefit by exercising options at the height of a "generated cycle" and to be replenished with new options should the price of the stock fall. It encourages earnings and expectation management,[712] as unexpected increases in reported or anticipated earning with shares trading at high multiples enables management to lever their gains and earn sums of money that are otherwise not attainable. It distorts the role of the managers from acting to maximize shareholder value to engaging in personal gratification often at the expense of the shareholders.

To seek to address this anomaly, a number of mechanisms are being posited. First, options should not be granted to board members of corporations.[713] Second, where

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[710] Allegations have to be capable of being substantiated (by specific events, actions, testimony or other evidence). Otherwise, there is concern that such a process can lead to character assassination(s) and other abuse.

[711] For example, *DSI*, *supra* note 154, statement 78, supported by 82.9% (87.17% when the neutrals were excluded), agreed that stock options encourage management to take "short term risks to maximize 'potential upside' at the expense of longer term value creation".

[712] *Ibid.*, statement 59, that "[c]orporate earnings are managed", was agreed to by 90.5% (92.73% when the neutrals were excluded).

[713] *Ibid.*, statement 38, that "[d]irectors should get stock options", was only supported by relatively few, of those who responded: 9.8% (11.48% when the neutrals were excluded). A similar statement (asked to cross check the initial one at 74(b), that "[s]tock options should be granted to the board", was also only supported by the minority of 17.10% (19.48% excluding neutrals). The general view was that directors should not get options, although the differences in the results suggest that certain interviewees (not sufficient to change the general perspective) had mixed views and were of two minds on this issue. If one were consistent, then members of management on the board of directors should also not get stock options; however, such view was not generally supported.

options are granted to the officer group[714] (although a case can be made that officers of corporations should not be recipients of options, given their positions and their ability to have an impact on the value of their options), restrictions to prevent abuse should apply. Management should not be capable of exercising options or of otherwise monetizing them (directly or indirectly) while in office[715] (or while otherwise engaged with the corporation in any manner, including while acting as a consultant or an advisor) until one complete accounting cycle (that is, after audited financial statements have been released for a complete year), after the person in question has severed his (her) relationships with the corporation. To ensure that this is not done directly or indirectly, any attempt to monetize these options through puts, calls or other creative financial vehicles[716] should be subject to the same constraints.

Furthermore, to the extent that senior executives have been *circumventing the intent and spirit of the current disclosure* requirements by using derivatives to allow for the economic benefit to be realized but the related disclosure to be deferred, reporting for a five-year historical period, to disclose any options that have been exercised in an ostensibly legal (albeit potentially unethical) circumvention of the intent and spirit of the law should be legally required.[717] That should help to focus greater public and executive attention on the spirit, in addition to the letter of the law, make those who have abused the system disclose and accept the public's reaction and perchance help to instill greater

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[714] *Ibid.*, statement 72(a), that "[s]tock options should be granted to management", was supported by a very strong majority 70.7% (82.69% when the neutrals were excluded), even though some suggested that one should do away completely with stock options, if one could.

[715] *Ibid.*, statement(s) 74, that "[e]mployees, officers and directors should (a) be prevented from exercising options for a specified period of time (no immediate vesting)", was supported by 95.1% (97.94 %excluding the neutrals); that they should "(b) have to hold shares for a period of time after the exercise [of the options]" was supported by 68.3% (69.98% excluding neutrals); and that they should "(c) be prevented from exercising options until a period of time, after their retirement" generated substantial discussion and got only 30% (32.43% excluding neutrals).

[716] See Howlett, *supra* note 335, which notes that "Canadian securities regulators will soon clamp down on corporate executives and directors who use a loophole that allows them to circumvent insider trading rules and receive cash for their stock without declaring their transaction". The article goes on to state: "Such transactions were particularly popular during the stock market bubble in the late 1990's when many companies' shares were overvalued. They were widely used by company insiders, the sources said."

[717] See Adams, *et al.*, "Investors Sold Millions", *supra* note 335, which suggests that this recommendation, raised at the outset of the effort on this thesis, now appears to be happening.

confidence that those that skirt the law will be held accountable to both the spirit and the wording of the law, even if only on an after-the-fact basis.

Options should not be a license to obtain value by default, even when none, relatively speaking, has been created.[718] For example, if the industry is growing by 20 percent, but the corporation in question is only growing by 10 percent, no benefits should accrue to the holders of the stock options; after all, relative to their peers, management is not performing. Stock appreciation should be a payment for performance, not in spite of it. As well, since shareholders are being asked to dilute their equity holdings in an undetermined amount, caps could be put on the maximum upside that can accrue under stock option grants, and annual grants could be subject to an annual pre-approval by the shareholders.[719] Finally, the cost of the stock options (that is, the dilution factor) should be recorded[720] in a manner that shareholders will be able to understand (using "provisions pending exercise" and then being reflected in both the income statement and statements of equity).[721]

Certain practical problems can serve to frustrate the foregoing. For example, most option plans do not provide for the granting of stock options beyond ten years. Accordingly, the maximum terms of stock option grants under existing plans may not be able to accommodate such suggestions; amending the plans in question may be a necessary pre-condition to being able to make the proffered changes. As well, executives may require access to some of the "value created" while in office; not all will be prepared to await retirement before being able to access the results of their efforts. It has therefore been argued during the *DSI* that it could result in the premature departure of key executives to

[718] *DSI*, *supra* note 154, statement 76, that "[s]tock options should be long term in nature and related to the performance of the corporation (adjusted to take out normal growth) so that payment is made for above normal growth (i.e. for value above the norm)", was supported by a strong majority 68.4% (70.73% when the neutrals are excluded).
[719] *Ibid.*, statement 75, that "[a]nnual grants of stock options should be subject to shareholder approval", was supported by 65.9% (69.22% when the neutrals were excluded).
[720] *Ibid.*, statement 73, that "[T]he cost of stock options should be recorded as a cost of doing business in the Company's income statement", was supported by 82.9% (87.17% when the neutrals were excluded). Furthermore, at the time of the DSI, most saw this change as being inevitable.
[721] Regarding how this could be dealt with, and the rationale, see Appendix C, below.

allow them access to their accrued but locked-in gains. To address these real and very practical concerns (while at the same time seeking to provide tools of more effective governance), two suggestions are advanced. First, the time limit in current stock option plans should be modified to allow for longer periods for a grant (to enable them to be exercised post-retirement and after the waiting period has expired). As well, the value attributed to the options would have to account for and deal with the longer grant period. Second, under exceptional circumstances, where an exercise of options and a disposition of shares is required by an officer for personal reasons (or because they may otherwise expire), it should, subject to safeguards, be permitted. Prior agreement by the board of directors and prior public disclosure (before the options in question are to be exercised and related shares disposed of)[722] by senior executives should be required by regulation. The *required public disclosure* should take place within a prescribed number of days in advance of the "intent to exercise and dispose of the shares acquired pursuant to the options" and should be certified as being correct by the officer in question. Once announced, the officer in question would be obliged to exercise the options and dispose of the shares on the designated date. This would help ensure that all are aware, *ex ante*, as opposed to after the fact that a sale had taken place. Conversely, **realizing the economic value of options and doing indirectly that which cannot be done directly should be expressly, legislatively prohibited,**[723] with the forfeiture of any proceeds realized in such a manner being made to apply (similar to the short swing profit rules in the United States[724]). Only by ensuring that management will not be permitted, in their *self-interest*, to abuse the system should stock options for management be permitted to continue.

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[722] This mechanism is similar to the OSC rules dealing with the sale from a "control block". See *Multilateral Instrument 45-102 – Resale of Securities*, 24 O.S.C.B. 7029 (23 November 2001).

[723] See *MI 55-103*, *supra* note 335, which seeks to require reporting of transactions that provide a director or officer (or others who are required to file insider reports) with the economic value of securities without a concomitant legal disposition, that prior to this change did not require such transactions to be publicly reported.

[724] *Securities and Exchange Act of 1934*, *supra* note 6, s. 16(b).

9.8. PROCEDURAL CHANGES: SEEKING INDEPENDENT INPUT FROM EMPLOYEES, CUSTOMERS, SUPPLIERS AND SHAREHOLDERS ON A STATISTICALLY VALID BASIS AND REPORTING INTERNALLY AND EXTERNALLY ON THESE MEASURES

If a board of directors is to seek to be responsive to the needs of its constituents, it must endeavor to stay in contact with them. Consistent with the foregoing, it has been suggested that representatives of employees, customers and suppliers should sit on the board of directors.[725] Accessing such constituents (whether one agrees or disagrees with having them on a board of directors), given the important role that each plays in the success of a corporation, could assist in the circumvention of the *funneling syndrome.* Accordingly, factual information and the subjective views of these groups should be obtained in a meaningful manner, so as to assist the board of directors to achieve more effective governance. Knowing what management and labor think on issues of importance to the corporation, as well as obtaining an appreciation of the satisfaction levels of customers and the state of relations with suppliers, may constitute tools of more effective governance as they can assist in bestowing on the board of directors additional knowledge and information (that has not been screened by management) to act more effectively and to bypass the *funneling syndrome.* The structuring of such tools is beyond the scope of this thesis; however, this suggested approach is neither unique nor novel. Progressive corporations are undertaking initiatives seeking to access such information.[726] However, these generally continue to be management as opposed to board (or independent third party) driven. How these tools are used will dictate corporate action and reaction. Accordingly, time and effort must be expended in their development and they must by publicly exposed and tested to establish their credibility and worth. It should be noted that management may well view such board intervention as a threat and this could, as has been suggested, lead to *"constructive friction".* Nevertheless, if management is an integral part of the process, shares in the results, uses the information to manage more effectively and accepts the data as having integrity and validity, then

[725] Blair, *Ownership and Control, supra* note 103.
[726] See DiPiazza & Eccles, *supra* note 319 at 123-27.

notwithstanding some reluctance and even potential friction, this should (and does) help achieve more effective corporate governance by bypassing the *funneling syndrome* and by providing for greater accountability.

An anecdotal example serves to reinforce this point. At one time in the regulation of telecommunications, certain measures were used to determine the relative "productivity" of telephone companies. A "mechanical counting device" recorded the number of calls that were received by each operator per hour; the higher the number, the more productive the operator (or so the theory went). In fact, the company with the highest level of calls per hour was also experiencing the highest level of customer complaints, as customers indicated that they could not get through to the operators (even though the internal counts suggested that this company was the best in the system). A detailed investigation revealed that the operators were aware that they were being scored on the basis of the number of calls that they handled per hour. As a result, to improve their scores, when they were not busy they called one another, thereby increasing the mechanically counted calls per hour. What started quite "innocently" mushroomed, as once you started, you had to increase the number of "artificial calls", as a failure to do so would "decrease your reported productivity". It was only when external third parties pointed out that the internal reports were inconsistent with what was happening in practice, that the problem was uncovered. The corporation turned to independently surveying customers (that is, a third party unrelated to the corporation contacted and surveyed the customers) and only then did the "quality of service" and the reporting thereof coincide and improve. This is not cited to suggest that this case is unusual, but rather to note that *self-interest* is a strong motivator and the *funneling syndrome* an effective tool to enable goals to be achieved. Unless *self-interest* is constrained and the *funneling syndrome* subject to checks and balances from unrelated and disinterested third parties, individuals can be given incentives and end up doing the wrong thing, perhaps for what they perceive to be, or at least can self-rationalize are, the right reasons.

9.9. STRUCTURAL CHANGES: RESPONDING TO THE INFORMATION NEEDS OF SHAREHOLDERS

Anecdotal information and the *DSI* lead one to question the value of much of the information made available to shareholders.[727] As well, most do not believe that the Annual Report adds value for shareholders.[728] To seek to address this conundrum, change is required. There is a need to ensure that the information prepared to inform shareholders and to help ensure the efficiency of the market (which few shareholders, other then institutions, analysts, academics and competitors appear to study in any detail, if indeed they refer to it at all) is more than just bureaucracy and a make work exercise for professional advisors. There is a need to make financial information more meaningful, relevant, comparable and consumer-friendly (both for investors and potential investors).

To be useful to consumers, summarized relevant information in a "standardized format" and of limited length to allow for ease of reference, review and comparability should be mandated. Furthermore, to be meaningful to the consumer, *mandated macro and micro information should be provided in a chart format*, indicating the information in the following way: macro in the sense of reporting how the industry is performing relative to others in the market and micro by indicating how the corporation is performing relative to its peers. Management should be obliged to indicate who they consider their peers to be and why (and if changes are being made to the comparator group, the rationale for the changes and what the results of comparisons would have been in the absence of the changes). However, developing a reporting system that is responsive to the needs of investors is beyond the scope of this thesis; nevertheless, meaningful information in a reader friendly and understandable format is essential and may assist in providing investors (actual and potential) with more meaningful information.

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[727] *DSI*, *supra* note 154, statement 107, that "[a]ccountants respond to the informational needs of shareholders in a clear and concise manner", was only agreed to by 10% (12.12% when the neutral were excluded).

[728] *Ibid.*, statement 108, that "[t]he Auditors' Annual Report, in fact, adds value for the shareholders", was only agreed with 35% (38.89% when the neutrals were excluded). However, some of the respondents who thought that it did add value asked rhetorically, which one they would attach greater credibility to, an audited or an un-audited financial statement, and on that basis a number attached value to the auditor's report.

Corporations should therefore be required, by regulation, to provide data quarterly in a prescribed format, comparable to one's peers. This could include information such as earnings per share, how a corporation's stock has performed over a prescribed period of time relative to its peers and how the market as a whole has performed (say, during the last quarter and on a rolling-forward basis over the last eight quarters). The objective would be to assist shareholders (as well as potential investors) and for corporations to produce more meaningful and relevant information. To assist with consistency, comparability and uniformity of approach and to make this dynamic as opposed to anchored in past practice, the regulator should formalize the formatting of the material to be disclosed and it should be reviewed and modified periodically, based upon practical experience.

As well, compensation should also be publicly highlighted, given that there is concern that it is out of control.[729] While one can argue that the compensation paid to directors and officers is "relatively insignificant" when juxtaposed against the other expenses and costs incurred in widely held, publicly listed corporations, it is nevertheless a factor that affects not only what happens in a corporation (as this helps to establish norms) but also impacts public and investor confidence. As a result, the total cost of compensation and other benefits (rather than just salary increases) in both absolute terms (that is, the amount of the increase and percentage increases) and relative terms (that is, in comparison to one's peers, previously referred to, as well as industry as a whole), as well as comparisons for the five most highly paid officers, the officer group as a whole, management as a whole (excluding the officer group) and the corporation as a whole, yearly, over a specified period of time, should be provided. This should help to develop an appreciation of the mindset and approaches of those upon whom investors (actual and potential) are relying to manage the corporation.

As well, since managers are in the best position to know the corporation and its prospects, it would be worthwhile to ascertain from those in control why they believe that

[729] *Ibid.*, statement 65, that "[e]xecutive compensation is out of control", was supported by 68.3% (71.82% when the neutrals were excluded).

investors should invest or continue to stay invested in the corporation they are managing and to report annually against what they had suggested the prior year.

Shareholder proposals appear to be designed as a means of providing shareholders with a *forum to try to play a proactive role in seeking more responsible representation. To help ensure that this is not lost to the reader of the annual report, shareholder proposals should be dealt with in the summary, with a specific reference to where these matters are addressed in the detailed document.*

Ongoing research is required, and should be undertaken, to see how reporting to shareholders could be made more meaningful and effective. The preservation of the *status quo*, in a world that is anything but static, is a recognition that the needs of investors have not been taken into account in the development of contemporary reporting. Proactive as opposed to reactive steps may help to address the challenges faced by investors, and to improve investor confidence and market efficiency.[730]

9.10. LIABILITY

It is not the objective of this thesis to undertake a detailed review of director and officer (D & O) liability other than to comment on it as a tool of more effective governance. While most of those interviewed did not see D & O liability as being a personal "concern", they did agree that potential director liability created a "chill" in the ability to attract directors to serve on boards.[731] In the case of corporations, it was noted that two factors serve to make D & O liability a moot point. Most corporations not only carry what is perceived to be adequate D & O liability insurance coverage but also indemnify the D & O. It is the corporation and not the individual that is therefore required to bear the cost of any potential liability

[730] For a discussion of market efficiency, see Chapter 2, Section 2.2.1., above.
[731] *DSI*, *supra* note 154, statement 30, that "[d]irector liability (or potential) liability is a factor in getting people to accept a directorship", was agreed to by 62.5% (78.38% when the neutrals were excluded).

As a result, unlimited D & O liability, while conceptually appealing, does not serve as an effective check and balance; *PAR* under the existing system rarely applies. In order to address this issue, *PAR*, it was suggested, should be introduced. It was posited that rather than holding the corporation liable to its shareholders for the acts of its directors and officers, personal D & O liability (or *PAR*) should be applicable. Under *PAR*, directors and officers would be held personally liable for malfeasance (as opposed to negligence) for up to the amount that they had received from the corporation.[732] This liability would be borne personally and would not be capable of being indemnified or covered by the corporation. As a result, the risk would be borne by the individual and even if covered by insurance (borne by the individual and paid for, as compensation, by the corporation), it would be personally linked to the individual. As well, if wrongdoing were uncovered under *PAR*, all benefits (including the cost of insurance) less a reasonable living allowance would have to be disgorged to the corporation. This approach might result in directors and officers moving more frequently[733] (to lock in gains and to reduce risk that if they run into a problem they could be forced to disgorge their gains). Conversely, for those running an organization effectively, this would not be a concern. *PAR* would be consistent with providing incentives for directors and officers to act in the best interests of the corporation and this warrants greater examination.

9.11. Mandatory Disclosure of Reasons for Departures

To assist in ensuring that directors, officers and external auditors who leave or cease to be associated with a corporation publicly share the reasons for the departure (as opposed to merely providing a "spin") consideration should be given to imposing **a legal requirement to ensure true, full and plain disclosure of such reasons, with a legal sanction for a failure to comply**. Such required disclosure could be deemed to be a "material fact",[734] and could be legally mandated. This obligation and related sanction

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[732] *Ibid.*, statements 79 (re directors) & 80 (re officers), that they "should be held personally liable for things that they do wrong (malfeasance, not negligence per se) up to the amount of what they had received from the corporation", was supported by 61% (64.14% excluding the neutrals) and 55% (59.46% excluding the neutrals), respectively.

[733] However, it is being suggested that any officer or director who leaves a corporation would be obliged to provide true full and plain disclosure for the reasons for any departure.

[734] The term "material fact" is defined in *OSA*, *supra* note 6, s. 1(1).

should, it is postulated, then be applicable to all who knew (or should have known) the reasons for such departure and failed to disclose it or correct the said erroneous disclosure. This would help to ensure transparency, provide some support for directors who take a less than favorable position and who may otherwise be forced out and may encourage non-performing officers or directors to voluntarily pursue alternative careers rather than running the risk of being terminated for a lack of performance. This may also help constrain the traditional sizable economic rewards from being granted to departing CEOs who have performed in a less than satisfactory manner; where a senior executive knows that it may not be working out, he (she) may be encouraged to leave to pursue "other opportunities" rather than being faced with a termination and a required public disclosure that can at best, not be perceived as being career enhancing. Conversely, it has been suggested that this may also provide a "chill factor" and may make it even more difficult to attract directors (especially when coupled with *PAR*). Again, greater research is required to pursue its efficacy as a tool of more effective governance.

9.12. PROFESSIONAL DIRECTORS

The creation of a "director databank", under the purview of the regulator, where individuals appropriately prescreened (to ensure that the information provided in the "databank" is accurate) can be registered as being available to sit on corporate boards, may assist in helping to address the concerns expressed as to the availability of competent directors to serve on boards.[735] It can also serve as a check and balance and assist in assessing the validity of concerns that the changes brought on by the requirements of more effective corporate governance are making it difficult if not impossible to obtain "competent and qualified" directors. Therefore, it may be worth pursuing **the establishment of a "director databank"** (where all qualified could be registered, screened and certified and become available as a resource to corporations in search of directors) under the ambit of the regulator (or of a private body with regulatory oversight) as a tool of more effective governance. A certified "director databank" could serve as a tool to be re-examined annually to assess whether the desired effect, namely helping to improve the supply of directors with competence and integrity, is in fact being achieved.

An alternative (yet complementary) approach to deal with the supposed lack of directors has been advanced by Professors Gibson and Kraakman, who have suggested the establishment of a professional corps of directors, which (unlike the central registry referred to above) would not be dependant on the voluntary self-motivation of potential directors but rather would be created by institutional investors. As initially conceived, these individuals, who would be economically dependant on the institutional investors, would work full time at this task and would be specialists in monitoring. They could serve on a number of boards (much as professional directors do today) on a full-time basis and earn compensation equivalent to that of a partner in an accounting or legal firm. Given the current compensation scales for directors, these individuals could sit as "independents" on the boards of a number of corporations and earn sufficient amounts so as not to be financially dependent on their sponsors. However, since they would, in effect, be installed by institutional investors and could therefore be dependent on them to stay in office, they could harbor loyalties to these institutions. Nevertheless, such an approach could help to ensure that such directors would be at least be one step removed from being intimately tied to management and would have, all other things being equal, a higher degree of potential independence.

Professor Coffee has argued that Professors Gilson and Kraakman have discarded the model of the outside director being an independent referee in favor of one under which the director becomes a full-time agent of an identifiable class of shareholders.[736] However, that may well be an oversimplification; no one can successfully achieve election to a board of a corporation without a constituency of support, be it management, institutions or the board itself. As well, even directors who are "technically independent" at the outset of their mandate tend to align with the board and management over time and be reactive[737] rather than proactive.[738] As a result, sponsorship should not serve to automatically disqualify the able. As long as the terms of their support and any potential

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[735] Lipton, *supra* notes 641.
[736] See generally John C. Coffee, Jr., "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 Colum. Law. Rev. 277.
[737] *Ibid.*, statement 25: supported by 88.4% (92.46% if the neutrals were excluded).
[738] *DSI*, *supra* note 154, statement 24: supported by only 7.3% (7.87% if the neutrals were excluded).

conflicts have been clearly and transparently disclosed (as suggested herein, they should be for all candidates) prior to the election, it is hard to appreciate why assuming transparency and *CIA,* the institutionally (or for that matter any other) supported nominee to a board of directors would not be an improvement. As well, to be elected, support from more than just the institution would usually be required. Allowing for an election as opposed to a confirmation of a management slate appears to be an improvement to the tools of corporate governance, notwithstanding the source of the candidate. At the very least, this initiative could serve to bypass the *funneling syndrome* and management control, insofar as it relates to directorships. The appointment of such directors and their dependence on institutional support could justifiably raise concerns as to their independence. However, there is nothing to suggest that they would be any less independent referees than many of the other directors who sit on boards of directors of corporations.

A fundamental question raised by this approach is why institutions should initiate actions that benefit free riders, when alternative approaches are available that will benefit their constituents without free-rider issues coming into play. As well, a concomitant concern (not unique to any such appointees) is that the director may seek to act in a manner that benefits his (her) sponsor (be it the CEO or the institutional investors and be it covert or subliminal) to the disadvantage of others. How the individual will be positioned more effectively than other directors in order to deal with the *funneling syndrome* is a further issue. At best, a director appointed by an institutional investor could have greater independence (from management), could have access to greater resources to test information being provided by management and could provide a more balanced position at board meetings; at worst, such a director could be used to advance *self-interests.* However, if this serves to increase the availability of competent directors and counterbalances the challenges raised by what at times appears to be unfettered *self-interest* and the *funneling syndrome*, then it is an idea worth pursuing, monitoring and empirically testing. Furthermore, if it can be demonstrated that greater value accrues as a result of such an initiative, it should be more proactively pursued, monitored and reported upon.

While different structures can be considered, what is ultimately being sought is directors acting in the best interests of shareholders. It is the need to link the actions of the directors to those interests that to date have not been effectively fulfilled. Rather, given the very nature of how directors have traditionally been placed in and hold on to their offices, their loyalties are to management in general and the CEO in particular.[739] The manner in which they have historically been invited to serve on boards,[740] the fact that they are reactive and not proactive,[741] the fact that they generally do not ask the tough questions,[742] the fact that not all of them do their homework[743] and the application of the *funneling syndrome* all serve to ensure that the interests of the shareholders have not traditionally been a prime source of concern for directors. There is therefore a need to try new alternatives, test them and retain what works and alter what does not. Only by being proactive can we make inroads into understanding and trying to address the weaknesses in corporate governance.

9.13. CONCLUSION

Tools and other mechanisms for more effective corporate governance are constrained by practical realities. Change and evolution are essential. However, in order to complement suggested improvements, an effective methodology of periodic review, to enable modification or abandonment to take place if the alterations prove to be of relatively little practical value, is also required. Change can be initiated by voluntary corporate or legislative action (the former usually being motivated by *self-interest,* which can include good business practices, peer pressure and a fear that inaction may lead to mandatory as opposed to voluntary governance requirements).

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[739] *Ibid.*, statement 20, that "[d]irectors most closely align with the CEO", was supported by 90.5% (There were no neutrals).
[740] *Ibid.*, statement 18, that "CEOs play a pivotal role in the appointment of new directors", was supported by 83.3% (There were no neutrals).
[741] See *ibid.*, statements 24 & 25. Interestingly, only 7.3% (7.87% excluding neutrals) believe that directors are proactive and 88.4% (92.66% excluding neutrals) believe that they are reactive.
[742] *Ibid.*, statement 23, that "[d]irectors are not prepared to make the tough decisions, other than when they have no alternative", was supported 71.4% (81.04% when the neutrals were excluded).
[743] *Ibid.*, statement 26: only supported by 36.6% (45.47% when the neutrals were excluded).

Where there is an underlying perspective that certain change is desirable (but is not yet "generally acceptable", such as removing chairmen from office after a prescribed period of time, or not having CEOs or management sit on boards of directors), these can be recommended and discussion initiated. To the extent that this is discussed and found to be acceptable, it can over time become the norm. Separating the position of chairman and CEO as well as the voluntary retirement of directors at a pre-determined age has effectively been implemented in this manner (notwithstanding the submission herein that forced "age retirement" is not in the best interest of shareholders and suggests a compromise that is sourced in an inability to act more effectively and proactively). While the author may not share the view that age (as opposed to *CIA*) should be the criterion for determining whether one can or should continue to sit on aboard, it nevertheless was conceived of as a "practical" and "humane way" to provide for board change, is consistent with what were perceived to be the "rules of the game" and reflects compromise.

Voluntary change therefore can and does take place. However, to succeed it would be necessary to convince business leaders that it is in their *self-interest* to initiate action and comply. It nevertheless must be recognized that time, compromise and peer pressure are usually necessary pre-conditions to achieving a consensus voluntarily, given divergent *self-interests*. As well, there is a lack of effective enforceability, which is unfortunately the innate flaw of voluntary systems of corporate governance. They are a product of volition, not compulsion, and therefore fail to encompass those that may most need to be subjected to its application.

Uniformity to ensure that all play by the same basic rules (the concept of a level playing field) also facilitates comparability and would appear desirable. To achieve the foregoing and to assist in ensuring that information flowing into the financial markets (which, it is postulated is only as efficient as the data that enters it), a minimum degree of legally imposed regulation, with sanctions to support the operation of a "more" effective market,

would appear to be required.[744] The traditional approach is still the operating model (for example, the provincial regulatory bodies in Canada, most notably the Ontario Securities Commission and in the United States, most importantly the Securities and Exchange Commission, and state regulatory bodies). It is designed, through enforceable rules of general application, to assist but not supplant the supposedly effective operation of the market. The input for the effectiveness of the market is the accuracy, quality, timeliness and transparency of the information upon which it operates; the output is the market price of the shares that trade thereon. However, the ability to manipulate (at least in the short run) the input (data provided) and impact the output (the price of the shares) appears to be the innate weakness of the efficient market theory and helps to explain the breakdown in effective corporate governance.

Initiatives aimed at improving corporate governance cannot be undertaken in isolation. Given the liquidity of today's capital markets and the fact that *de facto* control is still exercised by management and boards of directors, the practical implications of proposed changes must be considered as well. Introducing changes that may cause corporations and business to flee to less demanding jurisdictions is a practical reality that one can only choose to ignore at one's peril. As a result, effective corporate governance needs to recognize that the Canadian regulatory system is constrained by such practical realities. Should our system be viewed as being less corporate friendly than that of our closest neighbor and economic powerhouse, the United States, then all other things being equal, we may well see more of our capital market (which already has many major corporations listed in both Canada and the United States) head south of the border. Competition for listings and related business act as a real and effective constraint against overly aggressive and demanding tools and processes of corporate governance. In the international world of business where capital knows no real borders, this reality must be included in any pragmatic assessment. Flight to jurisdictions that enable management to operate with the fewest restrictions is, for those whose interests conflict with that of the owner's, rational, logical and spurred on by *self-interest*. As a result, effective corporate

[744] R.H. Coase, *The Firm, The Market and the Law* (Chicago: University of Chicago Press, 1990) at 10.

governance requires an appreciation of the practical limitations, national as well as international.

If one does not give shareholders more meaningful powers and impose accountability (with sanctions, when required), it could be argued that one has in effect created an "institution" that is no longer a corporation but rather an investment vehicle that, once established, takes on a life of its own. Barring government or regulatory intervention, it can in fact become independent of the providers of capital and responsible to no one but itself. Failure to ensure accountability merely provides the scope for the untrammeled pursuit of *self-interest* and the *funneling syndrome* the means, unless constrained, to achieve it.

Given the shortcomings of both voluntary and legally imposed rules of governance, one must strive for the academic ideal but appreciate that the business community and investors will have to settle for the practical reality.

Chapter 10

Testing the Tools of "More Effective Governance"

10.1. INTRODUCTION

Tools that were the focus of the previous chapter, and the premises and principles upon which they were based (briefly addressed below), should in theory begin to address the issues raised in earlier chapters. To determine whether in practice they are likely to produce such results, an instrument setting out thirty-eight RAMs was developed. This was then administered to nineteen knowledgeable respondents and the findings summarized.

10.2. PREMISES

First, to be effective the internal governance of corporations needs to be supported by a properly balanced institutional foundation, analogous to a "three-legged stool", comprising directors, management and shareholders. Each should have an independent and complementary role to play, including acting as a check and balance on the other(s)[745] failing which internal corporate governance can be negatively impacted. Simply put, directors should govern, management should manage the affairs of the corporation subject to overview and monitoring by the board of directors, and shareholders as the owners of the corporation should have a clear right (an ability but not an obligation) to decide who should act on their behalf. As well, shareholders should be able to focus on and address, if not resolve, conflicts of interest(s) (when all directors are in a conflict of interests). Shareholders, in deciding (as owners) when and how to dispose of their asset (their shares), should also be unencumbered by the actions of their representatives (who may well be in a conflict of interests in such instances). Other than playing a role in the resolution of conflicts of interests, shareholders should not become directly involved in the internal business affairs of a corporation.

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[745] See by analogy LaPorta, *et al.*, "Judicial Checks and Balances", *supra* note 204.

Second, director and officer *CIA* are the *sine qua non* of more effective governance. Director competence[746] however has both an internal and external dimension. Internal competence relates to the individual and can be assessed based on historical information, be it academic, civic, political, business or professional. Detailed research can assist one in ensuring that prospective directors have the required credentials.[747] Failure to do so and the acceptance of funneled information (without independent verification) can result in individuals lacking competence and integrity, abusing the process.[748]

External competence, in contrast, relates to factors beyond the personal knowledge or experience of an individual director and is often transaction or event specific, as opposed to generic. It requires directors to understand and assess information, pre-conditions for effective and rational decisions. To assist them in such endeavors, opinions of lawyers, investment bankers and other professionals often backstop the recommendations(s) of management. Unless the board of directors has the ability to bypass the funneling and the screening of information, external competence is constrained by information fed to board members (the final decision makers) by management and/or their proxies. External competence recognizes that information (outside the experience or knowledge of directors) is required to enable intelligent and effective decisions to be made. If data to support action to be taken is constrained, then directors are by default required to rely on "internal competence and the information provided by management". Should the CEO seek to pursue a direction, a board is generally not, *all other things being equal,* well positioned to effectively challenge *ex ante* such actions of management. The applicability of "bounded rationality"[749] (a function of time available to generate, accumulate and absorb information before a decision must be made) and the *funneling syndrome* (control of information required by the board of directors to make decisions) suggest that external competence is an innate weakness of effective corporate governance.

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[746] The same is equally applicable to officers.
[747] A review of the composition of the board of directors of Enron, for example, would appear to support the belief that directors possessed "internal competence". See Gillan & Martin, "Enron", *supra* note 234. In Canada, the same would appear to have been true for the members of the board of directors of Ontario Power Generation. See *supra* note 375.
[748] See *Carom v. Bre-X Minerals Limited*, [1998] O.J. No. 1428.
[749] Michael P. Dooley, "Two Models of Corporate Governance" (1992) 47 Bus. Law. 461 at 467-71.

Integrity (moral uprightness; honesty[750]) is also an essential ingredient to more effective corporate governance. However, integrity would appear to be a function of individual character, opportunity for personal gain (*self-interest*) challenging a person, and the ability to rationalize the actions being taken in the context of potential risks and rewards.

If competence and integrity are essential pre-conditions to more effective corporate governance, then meaningful mechanisms to hold directors, officers and corporate advisors accountable are also required. Failure to implement effective accountability measures would reward "those few" who opt to bypass and sometimes even to abandon the interests of their constituents in pursuit of *self-interests*. It is this latter requirement, the need for greater accountability (limited though the options might be in practice), that more effective corporate governance needs to pursue.

Accountability on the part of management, directors and corporate advisors may be capable of being more effectively achieved by applying a three-fold test, namely (i) transparency on all issues related to a conflict or potential conflict of interests; (ii) the meaningful alignment of the interests of management, the directors and the advisors with those of the shareholders; and (iii) mandatory disgorgement of amounts received (or receivable, directly or indirectly) when the interests are not aligned and management benefits inappropriately, at the expense of the shareholders. These are the issues that the postulated principles and the tools of more effective governance seek to address.

10.3. PRINCIPLES AND APPROACH

In order to assess postulated tools of more effective corporate governance, the following approach was undertaken. First, three basic principles were enunciated that had their foundation in seeking to address the concerns that were the focus of this thesis and in the pursuit of director and officer *CIA*. These principles are as follows: First, conflicts of interest need to be effectively and transparently deal with. Second, the *funneling syndrome* needs to be circumvented so as to enable members of the board of directors to

[750] *Supra* notes 135 & 709.

have access to unfiltered information. Third, *PAR* should be applicable where *self-interest* benefits the individual (be it the directors, officers or external auditors) at the expense of the investing public (including shareholders of the corporation).

These principles were reviewed with individuals who had participated in the *DSI*. The initial phase of this latter interview was to ascertain whether they agreed (or disagreed) with these principles. All except two interviewed agreed (the first of the two is a lawyer who preferred the *status quo*; the second is an individual who agreed in principle, but wanted to understand how this would all work before providing unequivocal support). In addition, they were requested to agree (or disagree) with the statement that competence, integrity and accountability (*CIA*) are essential pre-conditions to effective corporate governance". All agreed.

The next phase, though the use of a matrix,[751] was to obtain their views on thirty-eight (what it was advanced should be) legally mandated tools of more effective corporate governance. They were asked to indicate the degree of importance that they would attach to each tool ("10" being the most important, and "0" having no importance). Finally, they were asked to respond to the following question: "In your opinion, what percent of current abuse is curtailed by tools of corporate governance that are currently legislated in Corporate and Securities law?" The average of the responses from the *DSI* interviewees to this question is referred to as the Legislative Risk Abuse Mitigation (or the LRAM%).

The thirty-eight tools of governance were ranked based on the cumulative scores obtained from the interviews. Each score was then attributed a weighting that reflected the percent of overall impact that such tool was expected to have in reducing the risk of abuse. In order to establish this weighting (referred to as the abuse mitigation percentage or "RAM%"), two assumptions were made, namely:

1. The risk of abuse (RA) is 100% without legislative restrictions and tools of corporate governance in place to curtail abuse; and

[751] Nineteen individuals were interviewed; a copy of the matrix used is included in Appendix M, below.

2. If all (thirty-eight) tools of corporate governance were implemented, the combination of existing legislation and tools of corporate governance should reduce the risk of abuse to an "optimum" norm (derived from interviews of Canadian business leaders and equated to 100% for purposes of this exercise).[752]

It follows that:

$$\sum RAM\% + LRAM\% = 100\%$$

The *RAM%* for each tool of corporate governance was calculated in the following manner:

1. Interviewees were asked to rank each tool of corporate governance on a scale of 0 to 10 (10 being the most important);
2. For each tool, the total points attributed by all *DSI* interviewees were summed, giving a total score.
3. The total score was then converted into a percentage (as a fraction of the aggregate points attributed to all thirty-eight tools of corporate governance).
4. This percentage was then scaled down to reflect the impact of legislation on reducing the risk of abuse.

The list of the thirty-eight tools of governance by ranking and their corresponding *RAM%* are set out in Table VI, below.[753]

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[752] This is merely included for illustrative purposes. The introduction of all the RAM's outlined herein would not serve to reduce the PA to 0. Much more detailed work is required to derive the appropriate correlation between the PA and the RAM's; however such an exercise if beyond the scope of this thesis.

[753] It is to be noted that low rankings were given to certain proposed tools, notwithstanding support for the direction, as the interviewees in question agreed with the direction but did not want to see them introduced into the law. Voluntary (as opposed to mandatory) compliance was still advocated by some. To seek to improve corporate governance (pending legislative action, if any such additional action is to take place) and to respond to those who would support voluntary, as opposed to legislative action, the following is posited: (i) a group of business leaders should meet (to be initiated by the regulator, such as the OSC in Canada, or the SEC is the United States) and review the RAMs advanced herein (and by any others) and seek to agree, annually, as to which should be implemented to assist in achieving more effective governance; (ii) a list of the agreed to critical RAMs should be compiled; (iii) a rating system should be developed for corporations based upon the number of RAMs (on the agreed to list based upon "best practices") that had been complied with; and (iv) corporations should be required to report their ratings and any changes thereto, year over

Table VI

Ranking	RAM%	Tool of Corporate Governance
1	3.4%	The Board of Directors and not management should control the Director appointment process.
2	3.4%	Directors and officers should be precluded from deciding matters when they are in an actual or potential conflict of interest.
3	3.2%	Officer compensation should be determined by, and under the supervision of, the compensation committee of the board with the Board of directors (as opposed to management) retaining the "independent outside advisors" and all decisions and process should be reported to shareholders.
4	3.1%	The CEO and the Chairman should not be the same individual.
5	3.0%	Directors should have access to independent advisors who do not otherwise act for management of the corporation and the use thereof publicly disclosed (at least annually).
6	3.0%	Corporations should be required to meet minimum standards to facilitate "whistle blowing".
7	2.9%	There should be a limit, established by the Board of Directors, as to the number of boards that each director should be permitted to sit on (whether private, public, government or other); the rationale for such limit should be reported to the shareholders on an annual basis, prior to the election of directors.
8	2.9%	AGM should require directors and management to report ex ante to the shareholders in person and through the disclosure material whether management achieved prior year's objectives.
9	2.8%	Where all directors are in a conflict of interest, any such proposed actions should be subject to shareholder approval.
10	2.8%	Public disclosure should be required if a professional director is supported by any institution, vested interest group or other shareholders.
11	2.7%	AGM should require directors and management to report ex ante to the shareholders in person and through the disclosure material objectives for the upcoming year.
12	2.7%	All conflicts of interest affecting directors (and officers) should be publicly disclosed including how they have been resolved and on a prescribed form, *ex ante,* whenever possible, and the accuracy thereof certified by the affected directors (and officers).
13	2.7%	External auditor's role should be changed to provide more meaningful information to investors/shareholders.
14	2.7%	Directors and officers should be required to provide and certify that self-descriptions included annually in the proxy statement provides true full and plain disclosure, of all personal information that may be relevant to a shareholder, objectively determined.
15	2.7%	AGM should require directors and management to report ex ante to the shareholders in person and through the disclosure material any conflict of interest and how they were resolved.
16	2.6%	Directors should be required to hold a meaningful number of shares in the corporation.
17	2.6%	Advisors to the Board of Directors should not be permitted to also serve management except in very exceptional circumstances, with prior Board of Director, approval and

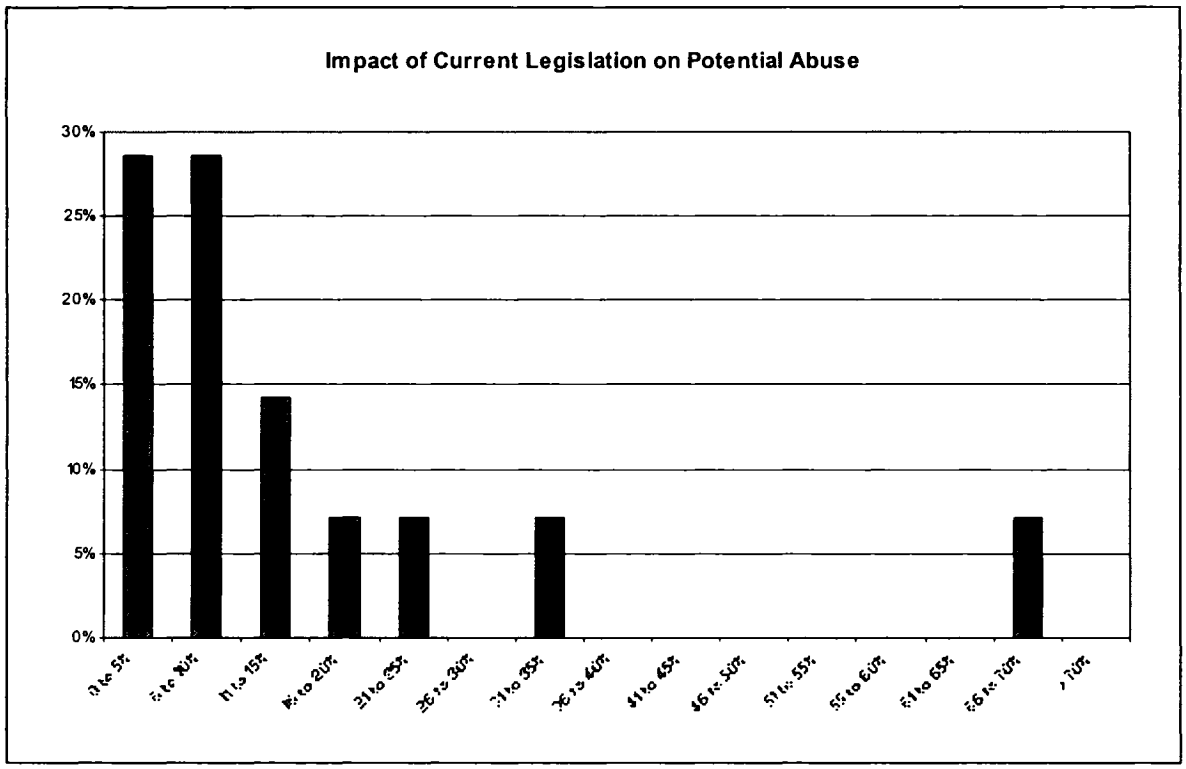
year. This would enable absolute as well as relative comparisons to take place and help ensure compliance; reporting accurately on the agreed to basis could be defined by regulation as being "material information". While the development of the specific rating system is beyond the scope of this thesis, this matter should be proactively pursued to help achieve the objective of more effective corporate governance.

Ranking	RAM%	Tool of Corporate Governance
		with public disclosure of the fact that this is taking place and the reasons for such actions.
18	2.5%	AGM should require directors and management to report ex ante to the shareholders in person and through the disclosure material proposed increases in director compensation.
19	2.5%	Any action that can serve to prevent takeovers should be subject to clear disclosure (as entered into and on an annual basis) and should be capable of being set aside promptly and unequivocally by the shareholders.
20	2.5%	External auditors should be accountable to the shareholders.
21	2.5%	Individuals in a potential conflict of interest should be disqualified from accepting a board position until the potential conflicts are no longer applicable.
22	2.5%	Directors should have direct access to alternative sources of information (other than as obtained from management) by meeting with key suppliers, customers, analysts, etc. and this information should be reported to shareholders at least annually.
23	2.2%	Management should not be members of the Board of Directors of the corporation post retirement from the corporation.
24	2.1%	Information when certified personally by directors or officers should, if erroneous, result in the applicability of PAR*
25	2.1%	Stock options (or any successor thereto) should not be capable of being exercised or realized until one complete accounting cycle after the retirement of an officer unless expressly approved by the Board of Directors and prior public announcement is made highlighting the reason for the exception.
26	2.0%	Board membership should be time, as opposed to age limited (e.g. to a maximum of 10 years) - Any deviation from the limit must be subject to public disclosure and receive board approval.
27	2.0%	Investment analysts should be accountable to shareholders/investors.
28	1.8%	CEOs of other corporations should not sit on compensation committees.
29	1.8%	The position of Chairman of the Board should be limited to no more than five, one-year terms.
30	1.6%	Restatement of financial statements should result in the automatic applicability of PAR to the CEO and CFO, the external auditors and members of the audit committee unless their continued retention is recommended by the Board of Directors (excluding those in a conflict of interest) and approved by the shareholders.
31	1.5%	Shareholders should elect (as opposed to confirm) the directors.
32	1.5%	Management should not be members of the Board of Directors of the corporation while employed by the corporation.
33	1.4%	Mandatory rotation of the firm of external auditors should be required; exceptions should be subject to regulatory approval and a public process.
34	1.4%	A professional corps of directors should be created with the assistance of institutional investors and the overview of the regulator?
35	1.4%	Shareholders should elect (as opposed to confirm) the auditors.
36	1.2%	Resignation or failure to reappoint a director should be accompanied by a press release highlighting the reasons for the resignation with PAR applying to the director and the board for a failure to provide true, full and plain disclosure.
37	0.7%	Shareholders should be permitted to cap individual total executive compensation to a maximum dollar amount.
38	0.6%	Proposed cap for total maximum individual compensation for officers of the corporation for the upcoming year.
	87%*	

* The $\sum$AM% = 87%, accounting for the fact that legislation is expected to reduce the risk of abuse by 13% (discussed below)

In response to the question as to what percent of current abuse is curtailed by the tools of corporate governance currently legislated in Corporate and Securities law, the *DSI* interviewees responded on average that only 13% of potential abuse was successfully limited by existing laws and regulations, as per Table VII below.

Table VII



The results of this effort can be used to quantify the ability to reduce *PA*.[754] Since the interviewees were of the view that the tools were important factors (albeit of varying importance) in improving corporate governance, their absence must, *a priori,* increase the *PA* (as the tools are in effect *RAMs*[755]).

Applying the data derived from these interviews to the formula advanced in Chapter 8, that $PA = A \times (1 - RAM)$, then in addition to *RAMs*, *A* must also be addressed. Returning to

[754] "PA" stands for "potential for abuse". For a discussion, see Chapter 8, above.
[755] "RAMs" stands for "risk of abuse mitigators". For a disccusion, see Chapter 8, above.

the table set out in Chapter 1[756] it is proffered that the *A* (authority) allocated to an owner (quadrant 4) should be 1; to an officer (quadrant 3) it should be 0.75; to a partner (quadrant 2) it should be half way between an owner and a officer, namely 0.875 and to a shareholder it should be less than 0.5. To the extent that the introduction of *RAMs* result in a shift in shareholders towards quadrant 1 and in directors and officers away from quadrant 4 (towards any of the other quadrants), then there would be more effective checks and balances and less risk of abuse *(PA)* taking place.

One can debate whether the *A* factors assigned should be modified or whether the weighting of the *RAMs* is appropriate (that initiative would be welcomed). As well, it is recognized that the higher the value attributed by a corporation to their *LRAM%* (relative to the "average" included herein), the lower the weighting and importance that would be attributed to the *RAMs* (and *vice versa*). However, such a focus would once again miss the point. The objective and challenge is at least two-fold. First, it is to take complex issues and frame them in relatively simple terms, not in the theoretical world of *ceteris paribus* but in the context of real life experience. Second, it is to attempt to get individuals to think in terms of the variables that *de facto* impact (or could impact) effective corporate governance in their own corporation. It is recognized that different inputs can and will impact the outputs. However, thinking in terms of the inter-relationship between the issues that impact effective corporate governance and having an understanding of and continually updating *RAMs* and *LRAMs* based on experience should assist in driving action in the direction of more effective corporate governance. Focusing on the thirty-eight items in Table VI, it is clear that some of the *RAMs* are outside the immediate short-term control of a corporation. Where such is the case, the *PA* increases. The result is that corporations are unlikely to achieve 100%. However, how they score on an absolute and relative basis will help boards of directors determine what their *PA* factor is and how effectively they are responding to the potential for abuse, both within their corporation and compared to others.

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[756] Chapter 1, above at 11.

10.4. CONCLUSION

Tools of governance, to be more effective, must seek to address the issues raised by those that intentionally or inadvertently seek to advance *self-interest* at the expense of shareholder interests. Those who have the confidence of the board (and the concomitant authority) have the potential to abuse. The greater the confidence and discretion, the greater the PA factor, the greater the checks, balances and accountability, the less likely (even though there is always the possibility) that abuse will take place. Accordingly, a board of directors, in fulfilling its fiduciary duties to the corporation (and the shareholders), needs tools (always supported by its judgment) to be able to assess the likelihood of abuse taking place. A "scorecard" designed to enable board members to assess and to attempt to deal with such likelihood, anchored in practical experience and dynamic tools, as opposed to being static, can assist in such an endeavor. If a board of directors approached PA in terms of the formula outlined herein (namely that $PA = A \times (1 - RAM)$) and candidly and objectively assessed the components, then it could assist in the following manners. First, the assessment would specifically require board members to think in terms of *PA* and appreciate that it is a factor that they must focus on (a matter that is otherwise often addressed in the abstract, but not as a subject of specific board focus). Second, the determination of the *PA* as a "factor" (percent) would enable relative and absolute comparisons to take place; relative by comparing oneself to one's peer's and absolute by comparing internal results on a year-over-year basis. A board of directors would be able to assess and report its *PA* (including the components that it considered and how these were weighted year over year, with changes, if, as and when required in the components) to the shareholders, at least annually, and advise as to whether, in the view of the board of directors, the corporation was making progress in addressing *PA*, or how and why it was losing ground and what action, if any, was being taken and/or contemplated.

Focus, transparency, dynamic as opposed to static tools and accountability could serve to improve effective corporate governance and help address the challenges that *self-interest* and the *funneling syndrome* continue to perpetuate.

Chapter 11
Conclusion

11.1. INTRODUCTION

Undertaking this dissertation has been a journey, originating in practical experience and propelled forward by an excursion into academic concepts and thoughts. While its focus has been on the two integral factors that it was postulated are at the core of the search for more effective corporate governance, namely *self-interest* and the *funneling syndrome*, it has also sought to address and respond to the research hypotheses outlined at the outset.[757] Numerous ancillary and related issues have also been raised, but not addressed in any detail, as each could easily have been the focus of a separate thesis.

11.2. RESEARCH HYPOTHESES

The fourteen research hypotheses advanced in Chapter 1[758] were anchored in experience, including taking into account the input received during the *DSI*, at the initial stages of this study. The conclusions, based on the work undertaken to date, are as follows.

An attempt to uncover a direct correlation between the rights of shareholders and the obligations of management[759] was pursued through the use of the matrix and the *DSI* questionnaire and interviews. However, one was not to be found. While in certain cases they appeared to be aligned (where there was a commonality of interests), there did not appear to be any symmetrical correlation. At best, such obligations appeared to be to the "corporation", an artificial legal creation in "man's (or woman's) own image", with rights and obligations. As a result, any alignment with the shareholders would appear, given the interposition of the corporation, to be more haphazard than symmetrical. As well, while checks and balances were ostensibly designed to help protect the interests of the

[757] Chapter 1, Section 1.4., above.
[758] *Ibid.*
[759] Hypothesis number 1.

corporation (and therefore, *a priori*, the shareholders), it is clear, as has been described herein,[760] that it can be and in fact often is neutralized by the "*funneling syndrome.*[761]

Shareholders are constrained by both external and personal factors from becoming more proactively engaged (even by exception in areas of potential conflict) in shareholder democracy or in what are viewed as the day-to-day activities of a corporation.[762] As well, skepticism appears to be expressed by those within or advising the business community, as to the viability of greater shareholder involvement. Putative attempts at the democratization of the corporation continue to suffer from many of the same challenges that inhibit (or historically had inhibited) the attempted democratization of other institutions, such as government. An opening for greater shareholder intervention exists and has been considered as a potential response to the need for more effective checks and balances. However, public choice, free-rider concerns, inertia and the complexity of seeking to get shareholders more actively involved (other than institutional investors or those with specific vested interests that warrant the expenditure of time, effort and financial resources) limits the probable success of achieving very proactive intervention from shareholders holding relatively few shares of widely held, public corporations.

Anthropomorphism appears to have clearly resulted in the attribution of legal rights to the "corporation" and concomitant greater rights to management (as the corporation can only act through others) at the expense of the rights of shareholders.[763] There is nothing to suggest that this will change dramatically, as the corporation, at the foundation of our system of capitalistic enterprise, continues to evolve to meet the needs of those who control it.

There appears to be an alignment of shareholder and management interests,[764] where both indicate a desire to seek the maximization of shareholder value. However, the "devil is in

[760] See Chapter 6, above.
[761] Hypothesis number 2.
[762] Hypothesis number 3.
[763] Hypothesis number 4.
[764] Hypothesis number 5.

the detail". Where management can benefit materially, even as long-term shareholders (as opposed to speculators) see their investments decimated, if not totally destroyed, their respective interests are not aligned. Unless a "proxy" for such "common interests" with related "sanctions", such as *PAR*, advanced herein (which is relatively easy to understand, quantifiable, measurable and subject to "independent challenge and determination" with the ability to ensure accountability), can be implemented legally, the alignment of interests will often continue to be a matter of spin, devoid of substance.

A more effective way of seeking to align the interests of management and shareholders may be to only allow officers to participate in long-term share appreciation,[765] to the extent that the market price of a share of the corporation increases during their period with the corporation, at a rate that exceeds the average rate of increase for their peers. Such an approach is relatively simple to explain and understand, is easily measurable (or should be) and has checks and balances (with appropriate sanctions) that can be put into place to help ensure that it works effectively. Stock options (or a derivation thereof), at least for management, seem to be embedded into the concept of executive (if not also, more broadly, management) compensation and appear (until a better mechanism for capital accumulation for a CEO and management surfaces) to be here to stay. While the challenges raised by stock options are recognized, attempts to move away from such a widely accepted and recognized vehicle for management capital accumulation (even given potentially longer-term negative impacts on shareholders) will be difficult and time-consuming at best, notwithstanding tools that are available to enable a corporation to deal more effectively with many of its shortcomings.[766] Clearly this is an area that requires much more detailed research, analysis and recommendations as to how best to address and seek to resolve the apparent innate structural flaws. Alternatively, academic analysis and review is required to help determine whether stock options in any current

[765] Hypothesis number 6.

[766] *DSI*, *supra* note 154, statement 72(a), that "stock options should be granted to management", was supported by 70.7% of respondents (82.69% when the neutrals were eliminated). However although only 54.5% the *PS* of Chartered Accountants believed that management compensation should include stock options and 52.6% in the *PS* of graduates of the McGill Faculty of Law.

form should continue as a vehicle of executive compensation, or be statutorily prohibited and replaced by other methods of management capital accumulation.

Management *self-interest*, unless effectively subjected to meaningful checks and balances, has and will continue to push the limits of personal gratification, including the introduction of new methods or vehicles that will further expand the rights of management at the expense of investor rights. The monetization of stock options, bypassing potentially embarrassing disclosure requirements, is merely another, more recent indication of these types of challenges. Rather than dealing with them on a case-by-case basis (the current, less-than-effective practice), principles may need to be embodied into the law.[767] As well, incentives to encourage disclosure and enforceability need to be introduced. Whistle blowing,[768] which was generally supported by the *DSI*, was introduced into the law in Canada even though it could have been kept voluntary.[769] Only by making minimum standards, such as whistle blowing, legally mandatory, with effective sanctions for a failure to comply, can one seek to reduce the risk that those most in need of being subject to checks and balances allow personal *self-interest* to override broader corporate interests.

Guidelines, codes, best practices and other "voluntary" actions are ineffective[770] in achieving the desired or required results if those that one wants to constrain are the very ones most likely to circumvent even ostensibly mandatory requirements. If corporate governance were a means to an end,[771] certain minimum steps would have to be taken. Accountability[772] for failure to provide competence and integrity must be pursued. "Minimum standards" of corporate governance must be imposed at a common point[773]

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[767] Hypothesis number 10.
[768] *DSI*, *supra* note 154, statement 83, that "[w]histle blowing should be encouraged", was supported by 72.5 % (87.44% when those who were neutral were excluded).
[769] On 16 January 2004, effective March 2004, see *MI 52-110*, *supra* note 200.
[770] Hypothesis number 7.
[771] Hypothesis number 12.
[772] Hypothesis number 13.
[773] Hypothesis number 14

(such as by the regulator) with meaningful sanctions[774] (such as *PAR*) legally imposed rather than being left to voluntary compliance.[775]

11.3. ANCILLARY AND RELATED ISSUES

An effort of this nature is a rather humbling experience. One is impressed not with the incremental value that one may be able to add, but rather with the number of issues needing to be addressed. Unfortunately, many could only be highlighted, due to the scope of this thesis.

It was recognized at the outset that corporate governance had both an external and an internal dimension. However, given the practical constraints and the area of chosen focus, only the internal aspect was the subject of this thesis. Still, as one moved forward, numerous other issues surfaced, each of which could, if pursued, have been the focus of additional theses.

The role of "control groups" and the potentially analogous situation of "institutional investors"[776] (notwithstanding that the latter are often perceived to be a more effective check and balance on management and a solution to certain of the corporate governance challenges faced) was highlighted, but not pursued, as the focus of this thesis was widely held, publicly listed corporations. Whether institutional investors will be able to fulfill a more effective gatekeeper role and what will serve to counter *self-interest* and encourage them to act in a broader public interest, notwithstanding free-rider concerns, warrants greater detailed research and investigation. Is this merely a function of the individuals running these organizations or are there certain tangible (and intangible) drivers that will propel this action continually forward and serve to the benefit the broader investment community in general and individual investors in particular?

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[774] Hypothesis number 11.
[775] Hypothesis number 9.
[776] See Chapter 2, Section 2.5., "Institutional Guardians", above.

An understanding of why "rating agencies"[777] appear to have failed the public and what needs to be done to address this conundrum was merely a passing observation. It is unclear as to whether, like many others, they were duped or whether *self-interest*, including a benign acceptance of the application of the *funneling syndrome* resulted in their having become accomplices of management. This matter needs to be examined. The accumulation of factual data, the need to address the results of such research and a determination of the causes of the problems and how to respond most effectively are areas that required and still require detailed research, analysis, conclusions and recommendations.

Similarly, the ongoing debate as to the effectiveness and the value of "class action lawsuits",[778] if and how they help to improve corporate governance and who benefits most from such initiatives (the shareholders, more effective governance and therefore the public at large, or the lawyers) is part of an ongoing debate that was merely alluded to herein.

As well, the role and effectiveness of voluntary guidelines,[779] and whether there is any empirical evidence that can help assess whether the benefits generated (such as in response to the initiative by the TSX) are greater than the costs incurred is an outstanding question. For example, is the response to the TSX initiative (an example of voluntary guidelines) merely an exercise in expensive "check box" compliance, that does not address the core issues; this warrants investigation.

The role of the media[780] as an instrument to help achieve more effective corporate governance, and why they are negatively perceived[781] by those most closely connected with business (especially when one recognizes that they are often controlled by and an integral part of "big business") is also worthy of detailed research.

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[777] Chapter 4, Section 4.3., above.
[778] *Ibid.* at 140.
[779] *Ibid.*
[780] *Ibid.*
[781] See the responses to *DSI*, *supra* note 154, statements 111-115.

The area of CEO compensation[782] (integrally tied to *self-interest* and the *funneling syndrome*) and what happens to the compensation of newly hired CEOs (whose compensation, given their status, should already reflect the market, as it was sufficient to entice them to join the new employer) should be the subject of detailed research. Such effort could assess what happens in the first year, after a new CEO is appointed, and within a relatively short number of years thereafter. Are subsequent increases in line with what is paid to management generally, or are "new studies undertaken" that result in compensation increases (measuring "total compensation in all cases") that exceed that which is generally available to management and/or employees? If so, why does this happen? Is this "market driven" or is this the result, as was posited herein, of *self-interest* and the *funneling syndrome*? And does this apply to only the CEO, or also to his (her) direct reports as well?

Director compensation[783] and self-assessment[784] also merits more detailed research. Are directors merely being paid more as a result of the increased focus on corporate governance, without any identifiable changes in the composition and/or activities and related performance of the board of directors? Or has increased director compensation assisted in attracting "more and better" directors and can one demonstrate that the makeup (composition) and contribution of boards of directors has changed? Alternatively, are the same players being paid more for doing what directors should have been doing all along under best practices (as many best practices have been incorporated into the law)? If voluntary guidelines are as effective as mandatory requirements (except that mandatory requirements attempt to catch those that would otherwise fail to voluntarily comply) and if most complied voluntarily, why is one paying substantially more for what all were supposedly doing voluntarily under guidelines and best practices?

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[782] Chapter 3, Section 3.2., above.
[783] *Ibid.*
[784] See Bank of Montreal, *supra* note 638.

The conflict between the economic returns of shareholders and the CEO[785] (and senior management), especially in light of the historical spin that stock options were designed to align the interests of management with those of shareholders, deserves more detailed review then the notoriety associated with cases like Enron and WorldCom. A detailed current review of the returns earned by CEOs (and the senior management team), excluding base salary set when hired (or some other rational base of comparison) compared to the returns earned over the same period by shareholders, should assist in providing current empirical evidence to assess the relative alignment of the returns of the two groups in question, and provide a more rational basis for attempting to address and deal with this matter.

The role of the board of directors in strategic planning,[786] given the TSX guidelines, would be worthy of detailed research. The annual reports issued by corporations report on compliance with these guidelines. However, what may be more relevant and worthy of detailed research and analysis is how strategic planning is addressed and dealt with by boards of directors.

The director appointment process[787] (notwithstanding their confirmation by the shareholders) and how this operates in practice, again warrants more detailed research. While the *DSI* has suggested that the process is changing, the key role of the CEO and management and how this is being effectively countered (if in fact that is the case) warrants detailed review, analysis and study.

A detailed taxonomy of anti-takeover devices[788] and an examination thereof, and an assessment of who benefits and what can or should be done to address identified areas of concern, from a corporate governance perspective, warrants detailed research. However, it is being beyond the scope of this initiative.

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[785] Chapter 3, Section 3.5., "Self-Interest", above.
[786] *Ibid.*, Section 3.2.1., "Business Judgment Rule", above.
[787] Chapter 6, Section 6.4.2., "Control of the Proxy Machinery", above.

The role of accounting and auditing[789] was and is recognized as being critical to more effective corporate governance. As well, the existence of competition in providing the external audit function to corporations (or the lack thereof, given the nature of the demands that are made and the relatively few who are able to meet those demands),[790] the auditors' ability to constrain liability[791] and the need for more effective accountability, not to management or the corporation but to the shareholders and potential investors, all require more detailed research. Nevertheless, it was recognized that the afore-mentioned areas, as well as a detailed examination of auditing standards, how they are arrived at, the role of the accounting profession and their apparent failure to effectively meet the needs of shareholders and investors, and how this should be addressed was beyond the scope of this thesis. A critical review, unencumbered by *self-interest,* is essential if the role currently played by the profession is not by default to be assumed by others more capable of meeting investor and shareholder needs and expectations.

11.4. CONCLUDING RESTATEMENT

It is acknowledged that there are many issues that need to be pursued and that this effort has done little more than scratch the surface. Nevertheless, it has focused on two core issues, unconstrained *self-interest* and the *funneling syndrome;* these empower and enable corporations to be hijacked for personal as opposed to shareholder purposes. Corporations are nothing more than creatures of statute, creations accepted by a state, and have no more of a life (notwithstanding their reification) than we are prepared to allow. However, given the innate tendency for shareholders to vote with their feet, unless more effective tools of governance are implemented, "vested interests" will dictate how the corporation will operate. As was postulated at the outset of this thesis: *"Corporate governance must seek to ensure, that "the obligations and interests of management" are, in law and in fact, "aligned" with "the rights and the interests of the shareholders" and that management is always "held accountable in an effective manner", if the interests of the shareholders of the corporation are to be protected from abuse and shareholder*

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[788] *Ibid.*, Section 6.5., "Takeover Bids and Related Matters", above.
[789] *Ibid.*, Section 6.6., "Role of the External Auditor (Shareholders' Auditor)", above.
[790] *Ibid.*

confidence sustained."[792] As a result, if one does not give shareholders more meaningful powers and impose accountability on management and directors with meaningful sanctions (such as *PAR*), one may, by default, have created an "institution" that is no longer an instrument of the shareholders with any real accountability to its owners. Rather, one will have transformed the corporation into an investment/gaming vehicle that, once established, takes on a life of its own. Barring government or regulatory intervention, it can in fact be independent of the providers of capital and responsible to no one but itself. Failure to address the *PA* and to ensure accountability merely provides the scope for the untrammeled pursuit of *self-interest* the *funneling syndrome,* and the means, unless constrained, to achieve it.

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[791] *Ibid.*
[792] Chapter 1, Section 1.3, above.

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Glossary of Acronyms and Terminology

A:

Authority

Abuse:

It is defined, for purposes of this thesis, as seeking to advance personal as opposed to, and sometimes at the expense of, corporate interests. (See malfeasance)

Agency Costs:

The costs incurred to help ensure that your interests are being looked after by someone ostensibly acting on your behalf ,(or to borrow from the terminology advanced by Frank H. Easterbrook and Daniel R. Fischel, in *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991) at 10 "the combination of monitoring, bonding and residual costs").

Business Judgment Rule (BJR):

The business judgment rule is described by Blair J. in *CW Shareholdings Inc. v. WIC Western International Communications Ltd.* 39 O.R. (3d) 755 at 774, 160 D.L.R. (4th) 131, 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 intervention business decisions which have been made honestly prudently, in good faith and on reasonable grounds. In such cases, the board's decisions will not be subject to microscopic examination and the Court will be reluctant to interfere and to usurp the board of directors' function in managing the corporation."

CEO:

Chief Executive Officer

CFO:

Chief Financial Officer

CIA:

Competence, integrity and accountability

CICA:

Canadian Institute of Chartered Accountants

CPAB:

Canadian Public Accountancy Board

D & O:

Director and officer

DSI:

Detailed Survey and Interview

Funneling Syndrome:

A concept that suggests that information required for decision-making by a board of directors is controlled by the chief executive officer. [More specifically, given the anthropomorphism of the corporation, the ***"funneling syndrome"*** posits that at the core

of any potential breakdown in corporate governance, are a number of "symptoms", including self interest (also sometimes referred to as "agency costs" or "greed***"), the control of all material information by the CEO of a corporation (and /or his/her delegates)***, as well as a concomitant lack of transparency, all of which when permitted to occur unchecked at the level of the CEO, results in the risk of failure ***(malfeasance*** as defined herein), unless there is an effective immune system ***(checks and balances)*** to help protect the interests of the corporation (and its shareholders) [emphasis added].

Gatekeeper(s):

Those on whom the public relies to help ensure the accuracy of information made available to them given the supposed 'reputations' they would stand to lose if they failed to deal honestly with the public.

GAAP:

Generally Accepted Accounting Principles

GAAS:

Generally Accepted Auditing Standards

Greenmail:

Ii is the amount paid to a holder of equity of a corporation, a potential purchaser of the corporation, (or a source of a challenge to management) by the corporation to reacquire that party's equity (at a premium sufficient to warrant the party selling the shares back to the Corporation), using assets of the corporation.

LLP:

Limited liability Partnership

LRAM%:

Legislative risk of abuse mitigation percentage

Malfeasance: (See abuse)

The term, for purposes of this thesis, includes actions benefiting the *CEO* and corporate officers directly and personally, but at the expense of the corporation and its shareholders.

Market Efficiency:

Market efficiency or the "efficient market theory "posits that the price at which a stock trades incorporates and reflects all material information released by a corporation, such that the market price accurately reflects all relevant public information.

O:

Opportunity

OSC:

Ontario Securities Commission

PA:

Potential to abuse

PCAOB:

Public Company Accounting Oversight Board

Poison Pill:

It is a defensive measure whereby the acquisition of more than a defined number of shares in contemplation of a potential takeover, without the support of management (that is, ostensibly, the board of directors) results in the automatic implementation of actions such as the issuance of additional voting shares to all current shareholders, other than to the party seeking control, which effectively operates to considerably lessen the chance of a takeover.

PS:

Public Survey

RAM:

Risk of Abuse Mitigator

RAM%:

Abuse mitigation percentage

SEC:

Securities and Exchange Commission, of U.S.A.

SOX:

Sarbanes Oxley Act of 2002

SRO:

Self Regulated Organization

TSX:

Toronto Stock Exchange

Appendix A

Detailed Questionnaire (DSI)
Detailed Focus Group Survey Form

The "DSI form" included in this appendix, formed the basis for the detailed interview (DSI) that took place with representatives of the business community, including chairmen and/or CEOs, lawyers from public and private practice, accountants, financial community representatives and investors, as well as academics.

The "quantitative data", derived from the DSIs, is included in Appendix E.

Corporate Governance Study
Detailed Focus Group Survey
Issues Addressed

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	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	No opinion
Chairman						
1 Chairman should be a separate position from that of CEO	O	O	O	O	O	O
2 Former CEO's should be precluded from occupying the post of Chairman	O	O	O	O	O	O
3 There are effective checks and balances between the CEO and Chairman	O	O	O	O	O	O
4 There is an appropriate mechanism in place to deal with conflicts between the Chairman and the CEO, where these positions are separate	O	O	O	O	O	O
5 The position of Chairman should be a full time job	O	O	O	O	O	O
6 A Chairman should have access to the information required to make decisions that are at odds with recommendations of Management	O	O	O	O	O	O
7 Compensation is realistically addressed, given what is expected of today's non-executive Chairman	O	O	O	O	O	O
8 Ineffective Chairmen are not tolerated and are replaced	O	O	O	O	O	O
9 There is a need to make changes to make the position of non-executive Chairman more effective	O	O	O	O	O	O
CEO						
10 CEO's are sometimes compared to Royalty, given their ability to achieve great things and their power to bestow favors	O	O	O	O	O	O
11 CEO's, in practice, play a prime role in the appointment of directors	O	O	O	O	O	O
12 CEO's, play a prime role in interacting with (on issues of major importance), the External Auditors	O	O	O	O	O	O
13 CEO's play a key role in the retention or the changing of the external auditors	O	O	O	O	O	O
14 Amounts spent on non audit functions, performed by the external auditors are:						
i. Generally less than the annual audit fees;	O	O	O	O	O	O
ii. Generally greater than the annual audit fees;	O	O	O	O	O	O
iii. Generally equal to the annual audit fees	O	O	O	O	O	O
15 CEO's play a key role in the appointment of outside Legal Counsel to the Company	O	O	O	O	O	O
16 CEO's normally participate in (Board Committee) meetings of:						
a) The Audit Committee;	O	O	O	O	O	O
b) The Corporate Governance Committee;	O	O	O	O	O	O
c) The Compensation Committee; and	O	O	O	O	O	O
d) Other Committees	O	O	O	O	O	O
17 CEO's play a proactive role in the determination of Compensation:						
a) Of the Chairman	O	O	O	O	O	O
b) Of Board members	O	O	O	O	O	O
c) Their own Compensation	O	O	O	O	O	O
d) Officer compensation	O	O	O	O	O	O
e) Others	O	O	O	O	O	O
Directors						
18 The CEO plays a pivotal role in the appointment of new directors	O	O	O	O	O	O
19 The CEO plays a pivotal role in the removal of directors	O	O	O	O	O	O

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	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	No opinion
20 Directors generally most closely align with the CEO	O	O	O	O	O	O
21 Directors are generally supportive of the CEO	O	O	O	O	O	O
22 Directors are prepared to ask the "tough" questions	O	O	O	O	O	O
23 Directors are not prepared to make the tough decisions, other when they have no alternative	O	O	O	O	O	O
24 Directors are generally proactive	O	O	O	O	O	O
25 Directors are generally reactive	O	O	O	O	O	O
26 Directors generally spend the time required to "really understand the issues' and make a "meaningful contribution"	O	O	O	O	O	O
27 Prestige is a key factor in the acceptance of some directorial positions	O	O	O	O	O	O
28 Director compensation is a key factor in directors staying on a Board	O	O	O	O	O	O
29 Directors are being adequately compensated given the demands on them	O	O	O	O	O	O
30 Director liability (or potential liability) is a factor in getting people to accept a directorship	O	O	O	O	O	O
31 There should be a limit on:						
i. The number of directors	O	O	O	O	O	O
ii.The minimum and the maximum term	O	O	O	O	O	O
iii. Directors being elected to sit on boards for more than one year at a time	O	O	O	O	O	O
iv. Staggered boards (I.e. only 1/3 of the Board stands for re-election annually)	O	O	O	O	O	O
v.The number of boards a director can sit on	O	O	O	O	O	O
32 Former CEO's should be allowed to sit on the Board post retirement	O	O	O	O	O	O
33 Other former employees should be allowed to sit on Boards of companies, from which they retired, post retirement	O	O	O	O	O	O
34 Current professional advisors should be allowed to sit on Boards	O	O	O	O	O	O
35 Former professional advisors should be allowed to sit on Boards	O	O	O	O	O	O
36 Employees should be allowed to sit on boards of wholly owned subsidiaries						
i.There should also be external independent directors on these boards	O	O	O	O	O	O
ii.There should there be a limit as to the number of employee directors	O	O	O	O	O	O
iii.The size (net worth/ sales/ etc) be a factor in making the determination	O	O	O	O	O	O
37 Directors of publicly traded companies should be required to own a meaningful number of shares in the Company on whose Board they serve	O	O	O	O	O	O
38 Directors should get stock options	O	O	O	O	O	O
39 Directors should be able to independently hire, at Company expense, outside advisors, to assist them in making decisions	O	O	O	O	O	O
40 Directors should be allowed to engage in consulting or other activities, with the Corporation, on whose Board they serve	O	O	O	O	O	O
41 Cross-Board directorships should be permitted ((that is, Board of Co.#2 allows the CEO of Co. #2 to sit on the Board of Co. #1 and vice versa)	O	O	O	O	O	O
42 Board members should be independent of management (that is, there should be no ties between, family business or social between Board Members and management)	O	O	O	O	O	O
43 Any ties between management and Board members should be fully disclosed to the public	O	O	O	O	O	O

Appointment of the External Auditors						
44 Shareholders, in fact, appoint the external auditors	O	O	O	O	O	O
45 Directors, in fact, appoint the external auditors	O	O	O	O	O	O
46 Management, in fact, appoint the external auditors	O	O	O	O	O	O
47 External auditors are primarily loyal to Shareholders	O	O	O	O	O	O
48 External auditors are primarily loyal to Directors	O	O	O	O	O	O
49 External auditors are primarily loyal to Management	O	O	O	O	O	O
50 External auditors should be allowed to engage in consulting as well as in the audit functions	O	O	O	O	O	O
51 External auditors make the 'tough calls" (other that in "black and white cases")	O	O	O	O	O	O

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	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	No opinion
52 The firm of external auditors should be rotated in a meaningful manner	O	O	O	O	O	O
53 External Auditors should be elected by the Shareholders, based on a commitment as to what they will do	O	O	O	O	O	O
54 There should be a split between the firms that performs the audit and those who do other work (consulting/tax/personnel/systems development/etc	O	O	O	O	O	O
55 Shareholders and "others who rely on the audited financial statements" should be allowed to sue the external auditors who purportedly fail in their duty	O	O	O	O	O	O
56 The Audit Committee should have the authority to hire and fire the External Auditors	O	O	O	O	O	O
57 The "independent accounting board" (a new overseer for CA firms), that is being introduced) merely adds another level of red tape	O	O	O	O	O	O
58 A tender process should be used wth "pre-qualified" auditing firms bidding based on price and deliverables and shareholder voting, based upon the written submitted bids	O	O	O	O	O	O
Disclosure						
59 Corporate earnings are managed (i.e. management tries to "smooth out earnings" to meet street expectations)	O	O	O	O	O	O
60 "Material Information" is disclosed to all at the same time	O	O	O	O	O	O
61 Executive officers should be held personally responsible for:						
a) Failing to release material information in a timely manner	O	O	O	O	O	O
b) For "selectively" releasing material information	O	O	O	O	O	O
62 There should be liability for the officer in question, as opposed to a fine against the corporation (i.e., liability of the officer without reimbursement by the corporation)	O	O	O	O	O	O
63 Meetings with analysts, are a way of selling a company's vision of the future and gaining stock support ;anaysts believe that they are getting "unique information"	O	O	O	O	O	O
64 Timing of disclosure is well managed by corporations in the interest of ensuring full and prompt disclosure of material information to all at the same time	O	O	O	O	O	O
Compensation						
65 Executive compensation is out of control	O	O	O	O	O	O
66 Management and the CEO play a key role in the determination of executive compensation, under the "supervision of the Compensation Committee of the Board"	O	O	O	O	O	O
67 The real checks and balances in the determination of "Executive Compensation", in addition to the work done by management, are the "independent reports produced by independent consultants such as Mercer or Towers Perrin which provide the Board with independent and credible information as to what management should be paid	O	O	O	O	O	O
68 Generally management selects the Consultants engaged to work with them on the compensation matters	O	O	O	O	O	O
69 Loans to management should be prohibited	O	O	O	O	O	O
70 Loans to management should only be allowed with shareholder approval	O	O	O	O	O	O
71 Officer compensation above a specified limit, should be approved by shareholders	O	O	O	O	O	O
Stock Options						
72 Stock options should be granted to:						
a) Management	O	O	O	O	O	O
b) The Board	O	O	O	O	O	O
73 The cost of the stock options should be recorded as a cost of doing business in the Company's Income Statement	O	O	O	O	O	O
74 Employees, officers and directors should:						
a) be prevented from exercising stock options for a specified period of time (i.e. no immediate vesting)	O	O	O	O	O	O
b) have to hold shares for a period of time after the exercise	O	O	O	O	O	O
c) unless approved by the Board and announced in advance of an exercise should not be	O	O	O	O	O	O

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	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	No opinion
able to be exercised until three years after retirement						
75 Annual total grants of stock options, should be subject to Shareholder approval	O	O	O	O	O	O
76 "Stock options should be long term in nature and related to the perormance of the corporation, (adjusted to take out normal growth),so the payment is only made for above normal growth (I.e. for value creation above the norm)	O	O	O	O	O	O
77 Re-pricing of stock options should be disallowed, except with specific shareholder approval	O	O	O	O	O	O
78 The current system of stock options encourage management to take short term risks to maximize" potential upside" at the expense of longer term value creation	O	O	O	O	O	O
Liability						
79 Directors should be held personally liable for for the things that they do wrong, up to the amount of what they received from the Corporation	O	O	O	O	O	O
80 Officers should be held personally liable for the things that thery do wrong, up to the amount of what they have received from the Corporation	O	O	O	O	O	O
81 There should be no cap on director liability	O	O	O	O	O	O
82 There should be no cap on officer liability	O	O	O	O	O	O
83 Whistle blowing should be encouraged	O	O	O	O	O	O
84 Restrictions should be introduced on class action shareholder suits	O	O	O	O	O	O
85 Lawyers are the only real winners in class action suits	O	O	O	O	O	O
Proxy Solicitation						
86 Proxy solicitation is very much a tool of management	O	O	O	O	O	O
87 Management solicits proxies in a transparent and fair manner	O	O	O	O	O	O
88 Shareholders should be given more leeway in proxy solicitation	O	O	O	O	O	O
Role of the Investment Community & Analysts						
89 The investment community and analysts act in a fair and reasonable manner,	O	O	O	O	O	O
90 The investment community and analysts act in the investing publics best interests	O	O	O	O	O	O
91 The analysts operate independently of the Investment Banking and Underwriting parts of their business	O	O	O	O	O	O
92 Bankers avoid conflicts of interests	O	O	O	O	O	O
93 The investment community and analysts should be liable for their actions and should not be permitted to be indemnified by the firms for whom they act	O	O	O	O	O	O
94 Investment analysts should be liable to the public for misleading information	O	O	O	O	O	O
Role of Shareholders						
95 Shareholder approval is generally nothing more than a rubber stamp of what management wants to do	O	O	O	O	O	O
96 Shareholders have no real power	O	O	O	O	O	O
97 "Shareholder proposals" are an effective way toexercise of shareholder power	O	O	O	O	O	O
98 Shareholders should generally be given greater flexibility to be able to get together on issues	O	O	O	O	O	O
99 Shareholders should elect (as opposed to merely confirm the selection by management) of directors	O	O	O	O	O	O
100 Shareholder should, in fact, elect the external Auditors as opposed to merely confirming the selection by management	O	O	O	O	O	O
101 The policy for stock option grants should be approved by shareholders, before grants have any force or effect	O	O	O	O	O	O
102 Executive compensation should be subject to shareholder approval						
a) Based on overall limits established by the Board at the initial hiring	O	O	O	O	O	O
b) Only for increases above specific limits (ranges) that had been agreed to in	O	O	O	O	O	O

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	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	No opinion
advance by the shareholders						
Role of the Regulator						
103 The regulator should only be involved as a last resort, on an exception basis, rather than bringing in another level of "red tape" to deal with the current issues facing the business community	O	O	O	O	O	O
Role of Government						
104 The governments' role should be limited to bringing in legislation to deal with the issues that need to be addressed (if that is the only realistic option)	O	O	O	O	O	O
Accounting						
105 Accounting provides great flexibility and enables you to "manipulate and manage earnings" all within the confines of the law.	O	O	O	O	O	O
106 Accounting needs to identify the "recurring income" and distinguish it from the one time items	O	O	O	O	O	O
107 Accountants respond to the information needs of the shareholders in a clear and concise manner	O	O	O	O	O	O
108 The Auditors Annual Report, in fact, adds value for the shareholders	O	O	O	O	O	O
109 Related party transactions (that is, transactions with people or companies that have close relationships with a corporation) should be specifically reported on by the External Auditors to the Shareholders, as a specific item of disclosure, and not burried in the notes to the financial statements	O	O	O	O	O	O
110 I am happy with the work done for the shareholders by the external auditors	O	O	O	O	O	O
Media						
111 The media accurately reflects the state of corporate governance	O	O	O	O	O	O
112 The media is an ally of the shareholder in dealing with Corporate Governance problems	O	O	O	O	O	O
113 The media is an ally of business and reflects their viewpoint	O	O	O	O	O	O
114 The press is being responsible in dealing with the issue of corporate wrong doing	O	O	O	O	O	O
115 The press is being responsible in dealing with the issue of corporate governance	O	O	O	O	O	O
The Sarbones-Oxley Act of 2002						
116 I am familiar with this new US legislation	O	O	O	O	O	O
117 This legislation will improve corporate governance by holding corporate executives and accountants responsible to public shareholders	O	O	O	O	O	O
118 Expanding criminal and civil liability in the Securities area should be encouraged	O	O	O	O	O	O
119 Similar legislation should be enacted in Canada	O	O	O	O	O	O

NOTE:

1. Please feel free to add any comments that you wish, concerning corporate governance, on a separate piece of paper, and return it, with this

2. Thank you for taking the time to fill out this survey

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	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree	No opinion
3. All individual replies will be treated as confidential and your identity, or individual reply, will not be publicly disclosed.						

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Appendix B

General Questionnaire Public Survey (PS)

The PS included in this addendum formed the basis for the survey of DSI representatives, of members of the Canadian Institute of Chartered Accountants (CICA) and of graduates of the McGill Faculty of Law.

Representatives of the DSI were canvassed in person; however, all other polling was conducted anonymously; the identity of the respondents was unknown to the author and all replies were on a confidential not for personal attribution basis.

The responses to the PS surveys (of members of the CICA and of the graduates of the McGill Faculty of Law) are included in Appendices G and H respectively, for information purposes; however, given the objective of this thesis, additional analysis of this data has not been undertaken at this time.

Details of the demographic information sought, (through a "drop down request" when respondents were approached via the internet), is included for the information of the reader (taken from a form that was used in the DSI "in person" interviews).

Demographic information is included in Appendix G for the CICA respondents and in Appendix J for graduates of the McGill Faculty of Law. As well, this information is displayed in graphic form, for respondents who were graduates of the McGill Faculty of Law, to enable the reader to gain a better appreciation of the demographics relating to this group of respondents.

Appendix B

General Questionnaire
Public Survey

Section 1: General	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
1. I currently own shares in one or more *publicly traded* corporations.		○		○	
2. I currently own mutual funds that include shares of *publicly traded* corporations.		○		○	
3. Over the next 12 months, I intend to purchase *shares of publicly traded corporations*, either directly or through the purchase of mutual funds.		○		○	
4. I have a good understanding of corporate governance.	○	○	○	○	○
5. I understand, the differences between the role of *management*, and the role of the *board of directors*.	○	○	○	○	○
6. Primary responsibility for how a corporation performs rests:					
a. With the shareholders;	○	○	○	○	○
b. With the directors; or	○	○	○	○	○
c. With management.	○	○	○	○	○

Section 2: Corporate Oversight	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	No Comment
7. I believe that *management of most publicly traded corporations* act in the best interests of their shareholders.	○	○	○	○	○	○
8. I believe that *management of most publicly traded corporations* act in their own	○	○	○	○	○	○

best interests.						
9. I believe that the *boards of directors of most publicly traded corporations* act in the best interests of their shareholders.	○	○	○	○	○	○
10. I believe that *boards of directors of publicly traded corporations*, should in fact be independent of management.	○	○	○	○	○	○
11. I believe that *boards of directors of most publicly traded corporations* are in fact independent of management.	○	○	○	○	○	○
12. I believe that the *external auditors of* a publicly traded corporation help protect the interests of shareholders.	○	○	○	○	○	○
13. I believe that *external auditors* of a publicly traded corporation help to give shareholders a fair picture of the true financial position of the corporation.	○	○	○	○	○	○
14. I believe that *external auditors of most publicly traded corporations* act independently of management to help protect the interests of the shareholders.	○	○	○	○	○	○
15. I believe that *the regulators of publicly traded corporations* (that is the governments, security commissions & stock exchanges) are doing an effective job in protecting the interests of investors.	○	○	○	○	○	○
16. I believe that *the media* are trustworthy in their reporting of the affairs of business.	○	○	○	○	○	○

Section 3: Executive Compensation	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	No Comment
17. I believe that *management of for profit publicly traded corporations* are compensated appropriately.	○	○	○	○	○	○
18. *Stock options* are a form of compensation, that I understand. (If you disagree, you may omit to answer, questions 19 and 20).		○		○		
19. I believe that *management compensation* should include "stock options".	○	○	○	○	○	○
20. I believe that *director compensation* should include stock options.	○	○	○	○	○	○

Section 4: Summary	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	No Comment
21. I believe that *Chief Executive Officers* of most for profit publicly traded corporations are honest and can be trusted.	○	○	○	○	○	○
22. I have confidence that *stock markets* generally operate effectively and fairly.	○	○	○	○	○	○
23. I believe that corporate governance *(that is the rules and processes that apply to how a "for profit corporation" should be managed)* serves to protect the shareholders.	○	○	○	○	○	○

Demographic Information (please, see the note below)
Age:
Education:

Gender:
Profession:
Marital Status:
Employment:
Residence:
Salary:

Your opinion:	
Personal comments:	

Demographic Information – Please tick ALL replies that are applicable. (Confidentiality-see note 3)	
Age: ❑ 18 to 25 ❑ 25 to 34 ❑ 35 to 44 ❑ 45 to 54 ❑ 55 and over	Profession ❑ Lawyer (or) ❑ Notary ❑ Chartered Accountant ❑ Business Executive ❑ Investment Counselor /Fund Manager ❑ Other
Gender: ❑ Male ❑ Female	
Marital Status: ❑ Single ❑ Married ❑ Other	Employment: ❑ Self-employed ❑ Partner in a professional firm that includes publicly traded companies as clients ❑ Employed in a professional firm that includes publicly traded companies as client ❑ Employed in industry ❑ Private company ❑ Publicly
Residence: ❑ Own ❑ Rent	
Education: ❑ High School ❑ College/Cegep ❑ University Undergrad ❑ University Post Grad. ❑ Other	

		traded company ❑ Employed in government ❑ Employed in academia ❑ Student ❑ Retired ❑ Other
	Salary: CAD CAD CAD	❑ < $20,000 CAD ❑ $20,001 to $49,999 ❑ $50,000 to $99,999 ❑ $100,000 to $149,999 ❑ over $150,000 CAD

Appendix C
Accounting for the cost of stock options

Accounting generally records and accounts for costs on a historical basis; current cost accounting is not yet an integral part of GAAP. However, stock options, even though they give rise to a "contingent liability" and "dilute" (that is reduce shareholder's equity per share, no less than losses incurred by a corporation) were nevertheless not included or accounted for as a "cost of doing business". That they were an integral part of executive compensation is readily apparent by the fact that stock options were often the key factor in being able to attract individuals to join corporations (especially if they were being enticed away from existing positions) or to retain "super stars". Accordingly, they were clearly a "cost of doing business".

A simple traditional way of dealing with stock options exists; however while easily understood and consistent with traditional accounting, it has a disadvantage in that it will "increase the cost" (as accounted for in the books of a corporation) of stock options, (as this approach will always be greater than the "discounted value"). Simply put, if one were to record the differences between the price at which options were granted and their market value as at the year end, annually, as a provision (that is as a cost or in effect, a reduction to retained earnings that could otherwise have been realized, had the stock in question been issued at fair market, as at year end) or as a reduction to previous amounts where the value of stock decreases (effectively increasing the provision that will affect retained earnings), the result would be that the contingent value transferred as a result of a stock option grant, could be reflected annually in the financial statements of a corporation. The foregone potential net upside, over the stock option grant price, is what has been incurred by the corporation as a contingent liability as a result of the grant of the options. The reporting of this cost factor (below the net income line, as impacting the retained earnings of a corporation), on an annual basis, could serve to provide a level of transparency and understanding of the implicit cost of the grant of options to the reader.

This can be demonstrated by the following simple example: the corporation grants 1,000, 000 options to its employees in April of year one, when the stock is trading at $10 per share, to

vest 33 1/3 percent a year over three years. At the end of year one, the stock is trading at $15 per share. The corporation would therefore record a cost of $5, 000,000 (and set up a provision of $5,000,000). It would therefore be clear to all shareholders that should the employees in question decide to exercise their options once they "vest", the cost incurred in the year would be the market value of the stock in question less the option price.
(It is noted that if the amounts in question were material, this computation could be carried out on a quarterly basis (or even a monthly basis), so as to ensure that expenses are appropriately charged).

Ignoring the impact of the grant of additional options in year two, if the market value of the stock at the end of year two were to drop to $13 per share, then income would be increased by $2,000,000 (namely the year end price of year two of $13, less the year end price in year one of $15) and income would in effect increase by $2,000,000 as the contingent liability and the provision would be reduced by a similar amount.
If in year three, the stock at year end increased to $20 per share, the increase in the expense and in the provision in year three would be $ 7,000,000 (namely the 1,000,000 shares at the year end price of $20 per share, less the prior year's year end price times the number of share options outstanding). In no event would the provision go below zero, as if the market value of the option fell below the option price, the options would not be exercised; they would at that point, have no value.

However, when the options were exercised, the market value of the stock would be included as a capital contribution, (that is added to the equity of the corporation) and the difference between the market value and the option price would be charged against the provision, (which had been accrued for on an annual basis). While some refinement may well be required to this oversimplification, it would at least serve to recognize that the value accretion associated with stock options is earned over time, the longer the outstanding period the greater the potential value. As well, it would ensure that the amount charged to income is done so on an annual basis, is reflective of the activities during each accounting period, and is not predicated on a formula, derived for another purpose. It also has another added feature; it ensures simplicity, ease of understanding and transparency.

Notwithstanding the foregoing "relative simplicity" an alternative methodology appears to have gained widespread use, namely the "Black Scholes" method of arriving at the value of stock options (using a methodology that few if any who are applying it, may really understand[1]). Black Scholes was not developed, for the use for which it is being applied, notwithstanding that its originator won the "1997 Nobel Prize in Economics" for its development).

It is to be noted that other contingencies, such as provisions for income taxes, which when actually paid, may be greater or less than the taxes provided for in a year, are not subjected to a "discounting process". Such treatment of accounting for income taxes has long been accepted as a part of GAAP. One can and therefore should question why similar methodology is not applicable in the case of accounting for stock options,

In addition to the challenges associated with accounting for stock options, it is noted that stock options are impacted not only by the performance of the company in question, but by the sector and the market as a whole. As a result, even if one firm's performance is the worst in its sector and the value of the stock of its peers has gone up by 30 percent, but the firm in question is swept along by its sector's performance, not by its own, (and its own goes up by only 10 percent), the value of the options of the firm with relatively poor performance will increase as well, in spite of its relatively poor performance. Accounting fails to address and report on this phenomenon; in such instances it is hard to appreciate how stock options align the interests of shareholders and management.

The challenge faced by accounting is to ensure that it provides meaningful information to those that it is charged to serve. How effectively his is being done is an issue that begs investigation. However, it is beyond the scope of this thesis.

[1] See generally http://www.ams.org/new-in-math/nobel1997econ.html; see also http://www.numa.com/cgi-bin/numa/calc_op.pl for an option calculator.

Appendix D

Rationale for the Legal Positioning of the Corporate Participants

Introduction

This appendix describes the rationale for the location attributed to each the individuals, categories of individuals, or other types of investors, as a matter of law.

Controlling Shareholder (# 9)

The "controlling shareholder" was located in the position suggesting that highest level of power and unfettered control. Since the board of directors is elected by a vote of the shareholders[1] and can be removed by similar action[2] the controlling shareholder has the ability to ensure that the board of directors is made up of directors whose views are aligned with its (his or her) own *self-interest*, (to the greatest extent permissible under the law). Directors are legally constrained by their fiduciary obligations and must legally act in the best interests of the corporation[3] [restrictions that apply to "all" directors]. However, the controlling shareholder, directly and indirectly, is nevertheless still in the best position to seek to ensure that its (his or her) interests are at the forefront of actions taken by the board of directors (subject to applicable legal constraints). Directors, who attempt to operate at cross-purposes with a controlling shareholder, do not in practice survive in their position. With ownership and control combined in the controlling shareholder, the ability to seek to ensure that its (his or her) *self-interests* prevail will, depending on the potential return, warrant the time, effort and expense that such action may require. The concern, given the effective power and control vested in a controlling shareholder, centers on the need to effectively guard against self dealing and the necessity of endeavoring to protect minority shareholder interests, matters of practical importance and interest. While a focus on the controlling shareholder is beyond the scope of this review, it is worthy to note that insofar as "institutional guardians" are perceived to be the

[1] See *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 [*CBCA*], section 106.
[2] Ibid. section 109
[3] Ibid. section 122

future potential gatekeepers to help achieve more "effective corporate governance", the aforementioned review could place them in about the same position as the Chairman and the CEO but with potentially more power. To the extent that one believes that self-interest and power serves to increase agency costs (that is power corrupts) this analysis suggests that the controlling shareholder (including institutions that are put into such a position) have even greater power than management to affect decisions of the Corporation. As a result, while they may serve as a check and balance on management and the board of directors, they are also positioned to facilitate potential abuse in their own *self-interest*.

Board of Directors (# 1)

The "board of directors" was viewed in law as having the next highest level of power and control. They are generally assigned power and authority to manage or supervise the management of the affairs of the Corporation[4] subject to matters that require the consent of the shareholders. However even when shareholder approval is required, this generally tends to be more process than substantively driven and is generally well managed and controlled by management.[5] This power however, is diffused as it resides in a body with varied views, interests, biases and objectives, namely a board of directors which is in fact a committee and not in individual members of the board unless delegated to such individual(s) by the board of directors.

Chairman & CEO (# 3)

The combined "chairman of the board of directors and the CEO" was viewed as being third in the hierarchy of power and control. The rational for this conclusion stems from the recognition that the chairman and CEO embodies a duality function, which if separated, could act as a check and balance on each other. Firstly, the chairman and CEO controls the agenda and the actual time allotted, pace and discussion at meetings of a board, what issues come up and how they will be addressed by the board of directors.

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[4] Supra (CBCA) section 102

[5] DSI question 95 confirms the view that: "Shareholder approval is nothing more than a rubber stamp for what management wants to do".

Secondly, when coupled with the duty of CEO, the chairman and CEO acts not only to help govern (including managing the meetings of the board of directors) but is also directly responsible for, and an advocate of positions that are submitted to, the board of directors for approval; as well, the key members of management report directly to, are accountable to and are managed by this position.

The combination of the advocacy function as well as responsibility and control of key management, information and data, what is addressed, how it is addressed and control over the pace and time allotted to have issues dealt with by the board, serves to put the chairman & CEO in a very powerful position and more notably and importantly, in a clear conflict of interest. As a member of management, it is his role to ensure that the recommendations of his staff under his leadership are submitted and approved by the board of directors. Given a personal *self-interest* and the *funneling syndrome*, a chairman & CEO serves to help entrench the position and views of management and operates to consolidate the "doing" and the "governance and monitoring" functions within the same persona. In terms of checks and balances, there is an inherent conflict. If a board of directors should be seeking to govern, monitor and control (in addition to counseling and advising management), then there is an innate conflict in the consolidation of the functions of the chairman with that of the CEO.

Non-Executive Chairman

(Chairman of the Board if different from the CEO) (# 2)

The non-executive chairman of the board was viewed as being next, in terms of the legally imposed power structure. The rationale was that this individual controlled the meetings of the board of directors, could play a proactive role in overall governance including in board appointments, the establishment of committee chairs and membership, board agenda, the handling of the meetings of the board of directors, as well as play a proactive role in what went into (or was taken out the control of) committee meetings. As well, this person is usually an *ad hoc* member of all committees and can therefore become engaged in issues of particular importance to that individual. While dependent

upon management and the CEO for information and the conduct of the day to day operations of the Corporation and while constrained by the *funneling syndrome*, an effective chairman is in a position of power (with the ability to be pivotal in the treatment of the CEO, who often reports not only to the board but more specifically to the chairman of the board). The chairmanship is a position of great latent power, more in what it is capable of making happen than what it may be achieving on a daily basis. Given the reporting relationship of the CEO to the non-executive chair and the potential that this position has in effectively removing and replacing a CEO, it was ranked ahead of the CEO (on the basis of potential as opposed to the actual impact).

Chief Executive Officer (CEO) (# 3a)

The appointment of officers is within the purview of a board of directors.[6] However, the paucity of specific statutory constraints provides great latitude for a board of directors. Subject to any limitations imposed by law,[7] the board of directors can delegate authority and responsibility to the CEO, (or to other officers of the Corporation). They usually do so in the bylaws or in an administrative resolution that outlines areas of authority and responsibility. Since the members of the board of directors lack the time and are generally not positioned (nor should they be) to be proactive in the day-to-day affairs of the Corporation, they of necessity rely on their delegate, the CEO, to coordinate and manage the affairs.

The CEO leads the Corporation under his (her) overall, essentially legally delegated, guidance and control. In effect the CEO has overall responsibility and authority for the day to day affairs of the Corporation, subject to the role retained by a board of directors by virtue of the law or of their own decision making process. When very broad personal powers transferred by the board of directors (a committee) to the CEO (an individual) are coupled with the *funneling syndrome*, it is easy to appreciate the very powerful and critical role played by a CEO in the affairs of a Corporation. However, the CEO is subject to the control of the board of directors and the chairman of the board. Therefore,

[6] Supra CBCA sections 104(1) and1 121(1)
[7] Ibid section 115 (3)

notwithstanding the proactive role played by the CEO and the importance of this position to the success or failure of a Corporation, it is nevertheless subordinate to the position of the chairman of the board of directors as it emanates from that body and its powers and control can be expanded or constrained as the board of directors, under the guidance of the chairman, dictates. As a result, this position is viewed in law, if not always in practice, as being subordinate to that of the chairman of the board of directors.

The Chief Financial Officer (CFO) (# 4)

The appointment of the CFO, like the CEO, is within the purview of a board of directors. However, unlike the CEO, the CFO reports to and in fact is usually selected by the CEO, even though the person filling this position is sometimes also interviewed by the chairs of the board and of the audit committee, (and sometimes the audit committee as a whole) before being submitted for confirmation to the board of directors. Given the importance of finance, the CFO plays a critical role in the decision making of a Corporation.

Business transactions, both current as well as prospective, will all have financial implications that will need to be assessed, addressed, acted and reported upon. The CFO therefore controls the financial information lifeline of the Corporation, not only for management, to enable then to reach future decisions and assess the results of prior ones, but also subject to *funneling syndrome,* to the board of directors and to the public at large. Given the importance of financial implications to any rational decision making process, as well as to monitoring results of actions taken (external and internal including acquisitions, dispositions and restructurings) the CFO, while subordinate to the CEO and the board of directors, plays a critical role in the decision making process; this is reflected by its location on the matrix.

Secured Creditors, Institutional Investors and the Speculators (#'s 5,6, & 8)

These groups are relatively experienced in their respective fields of endeavor. A detailed examination of their ability to affect decision-making within a widely held publicly listed corporation is outside the scope of this review. Suffice it to say that given the sophistication (generally) of these investors, their ability to impact decision making is

more a function of practical constraints such as not being involved or having direct access to the internal confidential information or the decision making process, or by being constrained by legal impediments, relationship concerns or other potential negative repercussions, (their own *self-interests*) that could result from taking on management and from playing a more proactive role, (in conflict with management and the board of directors) in the affairs of a Corporation.

In the case of the secured creditors, the status of the Corporation and its relative financial health has a direct impact the role of these constituents. In a financially robust Corporation where covenants are met, their role is passive; where the Corporation runs afoul of commitments or performs poorly, their role is much more proactive and depending upon the terms of their lending instruments or their leverage, can be much more demanding.

Similarly the role for the other constituents in Corporations that perform well is limited. While exceptions to the rule exist (and may well be a function of specific factors) the location of this group attempts to reflect where they would be perceived to be, all other things being equal, (that is, where a Corporation is in compliance with all of its financial covenants and is performing relatively well).

General Shareholders (# 7)

The shareholders of Corporations, the putative owners, have few substantive as opposed to procedural rights with respect to the operations and activities of the Corporation.[8] For example the Canada Business Corporations Act, in Part XII entitled "Shareholders" focuses primarily on the procedural aspects of meetings of shareholders. Other than the section dealing with shareholder proposals,[9] the Part in question focuses on purely administrative matters. It addresses matters of process, including place of meetings,[10]

[8] This was confirmed by DSI question 96, where a strong majority agreed that: "Shareholders have no real power".
[9] Supra CBCA section 137
[10] Ibid. section 132

calling meetings,[11] fixing record date,[12] notice of meeting,[13] waiver of notice,[14] shareholder list,[15] quorum,[16] right to vote,[17] voting,[18] resolution in lieu of meeting,[19] requisition of meeting,[20] meeting called by court,[21] court review of election,[22] and pooling agreement.[23] Furthermore, other than shareholder proposals,[24] derivative actions taken by a shareholder (or other complainant[25] in the name and on behalf of the corporation and any of its subsidiaries) or oppression remedies,[26] proactive as opposed to reactive actions on the part of shareholders is the exception as opposed to the rule. Policy of choice and free rider concerns may account for the innate passiveness of shareholders of Corporations. However, the corporate structure and limited legal rights help to arrive at an understanding of the positioning of shareholders in law insofar as their ability to impact corporate decision making is concerned. Their positioning as the group with a very limited ability in law to affect decision making within a widely held publicly traded Corporation, may help to explain why most such investors vote with their feet.

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[11] Ibid. section 133
[12] Ibid. section 134
[13] Ibid. section 135
[14] Ibid. section 136
[15] Ibid. section 138
[16] Ibid. section 139
[17] Ibid. section 140
[18] Ibid. section 141
[19] Ibid. section 142
[20] Ibid. section 143
[21] Ibid section 144
[22] Ibid section 145
[23] Ibid section 146
[24] ibid section 137
[25] Ibid section 238
[26] Ibid section 242

Appendix E

Detailed Breakdown of Responses to the DSI

This Appendix includes the detailed breakdown (in aggregate) of the responses to the DSI.

This information is viewed as being experiential and directional; it was not (other than the CA Magazine survey) based on a statistically valid sample.

Sixteen headings of information were canvassed, namely, "Chairmen, CEOs, Directors, Appointment of the External Auditors, Disclosure, Compensation, Stock Options, Liability, Proxy Solicitation, Role of the Investment Community and Analysts, Role of Shareholders, Role of the Regulator, Role of Government, Accounting, Media and the Sarbanes-Oxley Act of 2002"; the information is reported both including and excluding the views of those who were neutral, in the denominator.

CORPORATE GOVERNANCE - SURVEY RESULTS
DBI
SURVEY RESULTS

Characterization

		Agree	Neutral	Disagree	Excluding Neutrals Agree	Excluding Neutrals Disagree	Average	Median	Std Dev.
Chairman									
1	Chairman should be a separate position from that of CEO	86.00%	2.40%	11.60%	88.11%	11.89%	4.26	5	1.18
2	Former CEO's should be precluded from occupying the post of Chairman	61.90%	19.10%	19.00%	76.53%	23.47%	3.67	4	1.12
3	There are effective checks and balances between the CEO and Chairman	48.80%	10.80%	40.50%	54.59%	45.41%	3.03	3	1.04
4	There is an appropriate mechanism in place to deal with conflicts between the Chairman and the CEO, where these positions are separate	42.10%	10.50%	47.40%	47.04%	52.96%	2.89	3	1.05
5	The position of Chairman should be a full time job	25.50%	14.00%	60.50%	29.81%	70.74%	2.58	2	1.03
6	A Chairman should have access to the information required to make decisions that are at odds with recommendations of Management	58.40%	27.00%	14.60%	80.00%	20.00%	3.93	4	1.06
7	Compensation is realistically addressed, given what is expected of today's non-executive Chairman	43.60%	20.50%	35.90%	54.84%	45.16%	3.05	3	1.10
8	Ineffective Chairmen are not tolerated and are replaced	17.10%	12.20%	70.70%	19.48%	80.52%	2.39	2	0.95
9	There is a need to make changes to make the position of non-executive Chairman more effective	75.60%	9.80%	14.60%	83.81%	16.19%	3.73	4	0.97
CEO		**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
10	CEO's are sometimes compared to Royalty, given their ability to achieve great things and their power to bestow favors	89.40%	3.60%	7.00%	92.68%	7.32%	3.88	4	0.82
11	CEO's, in practice, play a prime role in the appointment of directors	92.70%	0.00%	7.30%	92.70%	7.30%	3.90	4	0.56
12	CEO's, play a prime role in interacting with (on issues of major importance), the External Auditors	77.60%	7.50%	15.00%	83.78%	16.22%	3.73	4	0.93
13	CEO's play a key role in the retention or the changing of the external auditors	75.60%	7.30%	17.10%	81.58%	18.42%	3.78	4	0.94
14	Amounts spent on non audit functions, performed by the external auditors are:								
	I. Generally less than the annual audit fees;	31.40%	5.10%	63.40%	33.16%	66.84%	2.56	2	1.02
	II. Generally greater than the annual audit fees;	53.70%	7.30%	39.00%	57.94%	42.06%	3.22	4	1.06
	III. Generally equal to the annual audit fees	12.20%	4.90%	82.90%	12.84%	87.16%	2.24	2	0.73
15	CEO's play a key role in the appointment of outside Legal Counsel to the Company	67.50%	10.00%	22.50%	75.00%	25.00%	3.58	4	1.06
16	CEO's normally participate in (Board Committee) meetings of:								
	a) The Audit Committee;	69.40%	7.30%	23.70%	74.97%	25.73%	3.50	4	1.01
	b) The Corporate Governance Committee;	73.70%	19.30%	7.90%	90.32%	9.68%	3.68	4	0.68
	c) The Compensation Committee; and	87.20%	7.70%	5.10%	94.47%	5.53%	3.98	4	0.80
	d) Other Committees	82.10%	15.30%	2.60%	96.93%	3.07%	3.82	4	0.51
17	CEO's play a proactive role in the determination of Compensation:								
	a) Of the Chairman	78.90%	2.60%	20.50%	79.80%	20.20%	3.82	4	0.88
	b) Of Board members	77.50%	5.00%	17.50%	81.58%	18.42%	3.88	4	0.86
	c) Their own Compensation	87.20%	2.50%	10.30%	89.44%	10.56%	3.87	4	0.93
	d) Officer compensation	100.00%	0.00%	0.00%	100.00%	0.00%	4.33	4	0.47
	e) Others	95.00%	5.00%	0.00%	100.00%	0.00%	4.10	4	0.44
Directors		**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
18	The CEO plays a pivotal role in the appointment of new directors	83.30%	0.00%	16.70%	83.30%	16.70%	3.74	4	0.83
19	The CEO plays a pivotal role in the removal of directors	71.80%	5.10%	23.10%	75.68%	24.32%	3.56	4	0.94
20	Directors generally most closely align with the CEO	90.50%	0.00%	9.50%	90.50%	9.50%	3.85	4	0.82
21	Directors are generally supportive of the CEO	100.00%	0.00%	0.00%	100.00%	0.00%	4.07	4	0.26
22	Directors are prepared to ask the "tough" questions	33.30%	16.70%	50.00%	39.98%	60.02%	2.86	3	1.03
23	Directors are not prepared to make the tough decisions, other when they have no alternative	71.40%	11.90%	16.70%	81.04%	18.96%	3.56	4	0.86
24	Directors are generally proactive	7.30%	7.30%	85.40%	7.87%	92.13%	2.22	2	0.57
25	Directors are generally reactive	88.40%	4.60%	7.00%	92.65%	7.35%	3.86	4	0.80
26	Directors generally spend the time required to "really understand the issues' and make a "meaningful contribution"	36.60%	19.50%	43.90%	46.47%	53.53%	2.95	3	0.95
27	Prestige is a key factor in the acceptance of some directorial positions	95.20%	2.40%	2.40%	97.55%	2.45%	4.10	4	0.53
28	Director compensation is a key factor in directors staying on a Board	19.50%	9.80%	70.70%	21.62%	78.38%	2.49	2	0.90
29	Directors are being adequately compensated given the demands on them	41.00%	12.80%	46.20%	47.01%	52.99%	2.90	3	1.23
30	Director liability (or potential liability) is a factor in getting people to accept a directorship	72.50%	7.50%	20.00%	78.38%	21.62%	3.68	4	0.97
31	There should be a limit on:								
	I. The number of directors	85.40%	0.00%	14.60%	85.40%	14.60%	3.73	4	0.84
	II The minimum and the maximum term	58.40%	3.00%	38.50%	60.24%	39.76%	3.15	4	1.16
	iii. Directors sitting on boards for more than one year	33.30%	5.60%	61.10%	35.29%	64.71%	2.67	2	1.17
	iv. Staggered boards (i.e. only 1/3 of the Board stands for re-election annually)	31.50%	14.40%	54.10%	36.82%	63.18%	2.81	2	1.10
	v.The number of boards a director can sit on	75.00%	7.50%	17.50%	81.08%	18.92%	3.83	4	0.93
32	Former CEO's should be allowed to sit on the Board post retirement	33.30%	9.50%	57.10%	36.84%	63.16%	2.71	2	1.07
33	Other former employees should be allowed to sit on Boards from which they retired, post retirement	23.80%	9.50%	66.70%	28.57%	71.43%	2.50	2	0.94
34	Current professional advisors should be allowed to sit on Boards	21.40%	9.50%	69.00%	23.67%	76.33%	2.29	2	1.07
35	Former professional advisors should be allowed to sit on Boards	63.40%	9.80%	26.80%	70.27%	29.73%	3.29	4	1.03
36	Employees should be allowed to sit on boards of wholly owned subsidiaries	87.80%	4.90%	7.30%	92.31%	7.69%	3.90	4	0.56
	I.There should also be external independent directors on these boards	57.50%	17.50%	25.00%	69.70%	30.30%	3.58	4	0.93
	II.There should there be a limit as to the number of employee directors	61.50%	15.40%	23.10%	72.73%	27.27%	3.44	4	0.91
	III.The size (net worth/ sales/ etc) be a factor in making the determination	58.40%	12.20%	29.20%	66.67%	33.33%	3.29	4	0.99
37	Directors of publicly traded companies should be required to own a meaningful number of shares in the Company on whose Board they serve	84.30%	15.70%	29.80%	84.30%	15.70%	3.80	4	1.15
38	Directors should get stock options	9.80%	14.60%	75.60%	10.26%	89.74%	2.22	2	0.79
39	Directors should be able to independently hire, at Company expense, outside	97.80%	2.40%	0.00%	100.00%	0.00%	4.24	4	0.49

advisors, to assist them in making decisions									
40 Directors should be allowed to engage in consulting or other activities, with the Corporation, on whose Board they serve	19.50%	7.30%	73.20%	21.04%	78.96%		2.32	2	0.96
41 Cross Board Relationships should be permitted (i.e., CEO of Co. #1 who sits on the Board of Co.#2 allows the CEO of Co. #2 to sit on the Board of Co. #1)	25.00%	12.50%	62.50%	28.57%	71.43%		2.60	2	1.06
42 Board members should be independent of management (that is, there should be no ties between family business or social between board members and management)	62.10%	6.90%	31.00%	66.67%	33.33%		3.41	4	1.05
43 Any ties between management and Board members should be fully disclosed to the public	93.10%	0.00%	6.90%	93.10%	6.90%		4.17	4	0.76
Appointment of the External Auditors	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**		**Average**	**Median**	**Std Dev.**
44 Shareholders, in fact, appoint the external auditors	11.90%	2.40%	85.70%	12.24%	87.76%		2.12	2	0.80
45 Directors, in fact, appoint the external auditors	35.70%	16.70%	47.60%	42.86%	57.14%		2.79	3	1.12
46 Management, in fact, appoint the external auditors	66.70%	4.70%	28.60%	69.93%	30.07%		3.43	4	1.04
47 External auditors are primarily loyal to Shareholders	12.20%	4.90%	82.90%	12.82%	87.18%		2.15	2	0.82
48 External auditors are primarily loyal to Directors	22.00%	13.10%	65.90%	25.00%	75.00%		2.49	2	0.93
49 External auditors are primarily loyal to Management	75.60%	9.80%	14.60%	83.78%	16.22%		3.66	4	0.79
50 External auditors should be allowed to engage in consulting as well as in the audit functions	33.30%	7.20%	59.50%	35.87%	64.13%		2.59	2	1.07
51 External auditors make the "tough calls" (other that in "black and white cases")	31.70%	9.80%	58.50%	35.14%	64.86%		2.71	2	1.03
52 External auditors should be rotated in a meaningful manner	40.50%	9.50%	50.00%	44.74%	55.26%		2.88	3	1.13
53 External Auditors should be elected by the Shareholders, based on a commitment as to what they will do	35.00%	7.50%	57.50%	37.84%	62.16%		2.75	2	1.13
54 There should be a split between those who perform the audit and those who do other work (consulting/taxbenconsel/systems development/etc	75.60%	4.90%	19.50%	79.49%	20.51%		3.66	4	0.99
55 Shareholders and "others who rely on the audited financial statements" should be allowed to sue the external auditors who purportedly fail in their duty	85.00%	2.50%	12.50%	87.18%	12.82%		3.85	4	0.89
56 The Audit Committee should have the authority to hire and fire the External Auditors	59.50%	4.80%	35.70%	62.50%	37.50%		3.29	4	1.22
57 The "independent accounting board" (a new overseer for CA firms), that is being introduced) merely adds another level of red tape	45.90%	10.90%	43.20%	51.51%	48.49%		3.00	3	1.00
58 A tender process should be used with "pre-qualified" auditing firms bidding based on price and deliverables and shareholder voting, based upon the written submitted bids	18.40%	7.90%	73.70%	19.96%	80.04%		2.37	2	0.88
Disclosure	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**		**Average**	**Median**	**Std Dev.**
59 Corporate earnings are managed (i.e. management tries to "smooth out earnings" to meet street expectations)	90.50%	2.40%	7.10%	92.73%	7.27%		3.90	4	0.82
60 "Material information" is disclosed to all at the same time	43.90%	9.80%	46.30%	48.67%	51.33%		2.99	3	1.04
61 Executive officers should be held personally responsible for:									
a) Failing to release material information in a timely manner	70.70%	4.90%	24.40%	74.36%	25.64%		3.54	4	0.95
b) For "selectively" releasing material information	75.60%	4.90%	19.50%	79.49%	20.51%		3.68	4	0.93
62 There should be liability for the officer in question, as opposed to a fine against the corporation (i.e., liability of the officer without reimbursement by the corporation)	65.90%	4.90%	29.30%	69.23%	30.77%		3.41	4	0.97
63 Meetings with analysts are a way of giving the analysts "confidential information" in return for their tacit agreement to "push" the stock	75.00%	8.30%	16.70%	81.82%	18.21%		3.81	4	0.80
64 Timing of disclosure is well managed by corporations in the interest of ensuring full and prompt disclosure of material information to all at the same time	63.40%	7.30%	29.30%	68.59%	31.41%		3.37	4	0.94
Compensation	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**		**Average**	**Median**	**Std Dev.**
65 Executive compensation is out of control	68.30%	4.90%	26.80%	71.82%	28.18%		3.54	4	1.03
66 Management and the CED play a key role in the determination of executive compensation, under the "supervision of the Compensation Committee of the Board"	90.20%	2.50%	7.30%	92.51%	7.49%		3.95	4	0.87
67 The real checks and balances in the determination of "Executive Compensation", in addition to the work done by management, are the "independent reports produced by independent consultants such as Mercer or Towers Perrin which provide the Board with independent and credible information as to what management should be paid	50.00%	2.50%	47.50%	51.28%	48.72%		3.08	4	1.07
68 Generally management selects the Consultants engaged to work with them on the compensation matters	79.50%	12.80%	7.70%	81.17%	8.83%		3.74	4	0.84
69 Loans to management should be prohibited	46.30%	9.80%	43.90%	51.35%	48.67%		3.10	3	1.07
70 Loans to management should only be allowed with shareholder approval	29.30%	12.20%	58.50%	33.87%	66.13%		2.68	2	1.01
71 There should be restrictions on insider sales and insider speculation	41.50%	4.97%	53.70%	43.59%	56.41%		2.90	2	1.22
Stock Options	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**		**Average**	**Median**	**Std Dev.**
72 Stock options should be granted to:									
a) Management	70.70%	14.60%	14.80%	82.69%	17.31%		3.56	4	0.84
b) The Board	17.10%	12.20%	70.70%	19.48%	80.52%		2.34	2	0.91
73 The cost of the stock options should be recorded as a cost of doing business in the Company's Income Statement	82.90%	4.90%	12.20%	87.17%	12.83%		3.80	4	0.78
74 Employees, officers and directors should:									
a) be prevented from exercising stock options for a specified period of time (i.e. no immediate vesting)	95.10%	2.50%	2.40%	97.54%	2.46%		4.02	4	0.47
b) have to hold shares for a period of time after the exercise	68.30%	2.40%	29.30%	69.96%	30.04%		3.44	4	1.05
c) be prevented from exercising options until a period of time after their retirement	30.00%	7.50%	62.50%	32.43%	67.57%		2.55	2	1.13
75 Annual grants of stock options should be subject to Shareholder approval	65.90%	4.90%	29.30%	69.23%	30.78%		3.44	4	1.07
76 Stock Options should be long term in nature and related to the performance of the corporation (adjusted to take out normal growth) so that payment is only made forabove normal growth(i.e., for value above the norm)	68.40%	3.35%	28.30%	70.73%	29.27%		3.53	4	1.01
77 Re-pricing of stock options should be disallowed, except with specific shareholder approval	90.20%	0.00%	9.80%	90.20%	9.80%		3.90	4	0.89
78 The current system of stock options encourage management to take short term risks to maximize" potential upside" at the expense of longer term value creation	82.90%	4.90%	12.20%	87.17%	12.83%		3.83	4	0.80
Liability	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**		**Average**	**Median**	**Std Dev.**
79 Directors should be held personally liable for for the things that they do wrong, up to the amount of what they received from the Corporation	61.00%	4.90%	34.10%	64.14%	35.86%		3.22	4	1.11

80 Officers should be held personally liable for the things that they do wrong, up to the amount of what they have received from the Corporation	55.00%	7.50%	37.50%	59.46%	40.54%	3.10	4	1.15
81 There should be no cap on director liability	23.10%	5.10%	71.80%	24.24%	75.76%	2.49	2	0.97
82 There should be no cap on officer liability	28.20%	3.10%	68.70%	29.12%	70.88%	2.64	2	1.11
83 Whistle blowing should be encouraged	72.50%	16.80%	10.70%	87.16%	12.84%	3.85	4	0.70
84 Restrictions should be introduced on class action shareholder suits	65.00%	17.50%	17.50%	78.79%	21.21%	3.53	4	0.93
85 Lawyers are the only real winners in class action suits	71.10%	7.90%	21.10%	77.14%	22.86%	3.58	4	0.92
Proxy Solicitation	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
86 Proxy solicitation is very much a tool of management	92.70%	0.00%	7.30%	92.70%	7.30%	4.00	4	0.87
87 Management solicits proxies in a transparent and fair manner	43.20%	20.90%	35.90%	54.61%	45.39%	3.06	3	1.00
88 Shareholders should be given more leeway in proxy solicitation	58.40%	21.10%	20.60%	73.54%	26.46%	3.44	4	0.91
Role of the Investment Community & Analysts	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
89 The investment community and analysts act in a fair and reasonable manner.	17.50%	2.50%	80.00%	17.95%	82.05%	2.33	2	0.92
90 The investment community and analysts act in the investing public best interests	10.00%	7.50%	82.50%	10.81%	89.19%	2.23	2	0.90
91 The analysts operate independently of the investment Banking and Underwriting parts of their business	9.80%	4.90%	85.40%	10.29%	89.71%	2.10	2	0.96
92 Bankers avoid conflicts of interests	7.50%	10.00%	82.50%	8.33%	91.67%	2.13	2	0.72
93 The investment community and analysts should be liable for their actions and should not be permitted to be indemnified by the firms for whom they act	70.70%	9.80%	19.50%	78.38%	21.62%	3.59	4	1.05
94 Investment analysts should be liable to the public for misleading information	77.80%	5.50%	16.70%	82.32%	17.87%	3.72	4	0.88
Role of Shareholders	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
95 Shareholder approval is nothing more than rubber stamps for what management wants to do	75.60%	4.90%	19.50%	79.50%	20.50%	3.83	4	0.97
96 Shareholders have no real power	70.70%	7.50%	22.00%	76.27%	23.73%	3.58	4	1.00
97 "Shareholder proposals" are an effective way to exercise of shareholder power	41.50%	12.20%	46.30%	47.27%	52.73%	3.00	3	1.02
98 Shareholders should be given a greater flexibility to be able to get together on issues	70.00%	15.00%	15.00%	82.35%	17.65%	3.80	4	0.81
99 Shareholders should elect (as opposed to merely confirm the selection by management) of directors	47.50%	7.50%	45.00%	51.35%	48.65%	3.08	3	1.05
100 Shareholder should, in fact, elect the external Auditors as opposed to merely confirming the selection by management	37.50%	10.00%	52.50%	41.67%	58.33%	2.95	2	1.11
101 Stock option grants should be approved by shareholders, before they have any force or effect	82.50%	5.00%	12.50%	86.84%	13.16%	3.83	4	0.91
102 Executive compensation should be subject to shareholder approval								
a) At the initial hiring	12.20%	4.90%	82.90%	12.83%	87.17%	2.27	2	0.90
b) Only for increases above specific limits which had been agreed to in advance by the shareholders	22.00%	4.90%	73.20%	25.11%	74.89%	2.48	2	0.95
Role of the Regulator	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
103 The regulator should only be involved as a last resort, on an exception basis, rather than bringing in another level of "red tape" to deal with the current issues facing the business community	62.50%	7.50%	30.00%	67.57%	32.43%	3.43	4	1.11
Role of Government	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
104 The governments' role should be limited to bringing in legislation to deal with the issues that need to be addressed (if that is the only realistic option)	80.50%	7.90%	12.20%	86.84%	13.16%	3.80	4	0.81
Accounting	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
105 Accounting provides great flexibility and enables you to "manipulate and manage earnings" all within the confines of the law.	80.50%	12.20%	7.30%	91.67%	8.33%	3.78	4	0.85
106 Accounting needs to identify the "recurring income" and distinguish it from the one time items	95.10%	4.90%	0.00%	100.00%	0.00%	4.05	4	0.38
107 Accountants respond to the information needs of the shareholders in a clear and concise manner	10.00%	17.50%	72.50%	12.12%	87.88%	2.33	2	0.73
108 The Auditors Annual Report, in fact, adds value for the shareholders	35.00%	10.00%	55.00%	38.89%	61.11%	2.78	2	0.97
Related party transactions (that is, transactions with people or companies that have close relationships with a corporation) should be specifically reported on by the External Auditors to the Shareholders, as a specific item of disclosure, and not buried in the notes to the financial statements.	77.50%	5.00%	17.50%	81.58%	18.42%	3.68	4	0.86
110 I am happy with the work done for the shareholders by the external auditors	44.70%	10.90%	44.70%	50.00%	50.00%	3.03	3	1.00
Media	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
111 The media accurately reflects the state of corporate governance	22.00%	9.70%	68.30%	24.39%	75.61%	2.49	2	0.90
112 The media is an ally of the shareholder in dealing with Corporate Governance problems	45.00%	17.50%	37.50%	54.55%	45.45%	3.05	3	0.98
113 The media is an ally of business and reflects their viewpoint	25.00%	7.50%	67.50%	27.03%	72.97%	2.50	2	0.96
114 The press is being responsible in dealing with the issue of corporate wrong doing	40.00%	17.50%	42.50%	48.48%	51.52%	2.95	3	0.96
115 The press is being responsible in dealing with the issue of corporate governance	34.20%	23.70%	42.10%	44.83%	55.17%	2.87	3	0.96
The Sarbanes-Oxley Act of 2002	**Agree**	**Neutral**	**Disagree**	**Agree**	**Disagree**	**Average**	**Median**	**Std Dev.**
116 I am familiar with this new US legislation	92.30%	2.60%	5.10%	94.74%	5.26%	3.95	4	0.56
117 This legislation will improve corporate governance by holding corporate executives and accountants responsible to public shareholders	58.60%	11.70%	29.70%	66.36%	33.64%	3.27	4	0.99
118 Expanding criminal and civil liability in the Securities area should be encouraged	69.20%	10.30%	20.50%	77.14%	22.86%	3.51	4	0.85
119 Similar legislation should be enacted in Canada	59.50%	13.50%	27.00%	68.79%	31.21%	3.35	4	0.92

Appendix F

Black Lined Version of the PS Survey

The following changes were made to the initial draft of the PS that had been used in the DSI:

Statement 1 had read "I own shares of a corporation that are listed on a stock exchange"; this was rewritten to state "I currently own shares in one or more *publicly traded corporations*".

Statement 2 that "I currently own mutual funds that include shares of publicly traded corporations" was added, to recognize that professional advisors (such as external auditors) may have restrictions on their ability to invest in shares of clients and that many, in fact, invest indirectly through mutual funds.

Statement 3 (old 2) which had stated that "I am a potential investor in shares of a corporation listed on a stock exchange" was changed to read that "Over the next 12 months, I intend to purchase shares of publicly traded corporations, either directly or through the purchase of mutual funds".

Statement 4 initially indicated that "I would rate my understanding of corporate governance as (a) excellent; (b) rudimentary (only what I learn through the media) and (c) non existent", was modified to read "I have a good understanding of corporate governance".

Statement 7 which stated that "Management acts in the best interests of its shareholders" was changed to read that "I believe that management of most publicly traded corporations act in the best interests of their shareholders".

Similar changes including the addition of the words "I believe that" were added to the beginning of sentences 8 through 23 (other than statement 18 that remained unchanged).

A new statement 10 was added which provided that "I believe that corporations of publicly traded corporations should in fact be independent of management"

The words "independent auditors" were changed to "external auditors" in statements 12 and in 13.

The predecessor to the current section 17 provided that "Management of for profit corporations are not overpaid": this was changed to "I believe that management of for profit publicly traded corporations are compensated appropriately"

Statement 20 had stated "Confidence in how the stock market operate is warranted"; this was changed to read that "I have confidence that stock markets generally operate effectively and fairly".

The revised form, (which reflected changes requested by CA Magazine), was used by members of the CICA (chartered accountants) and by the proactive respondents to the survey of graduates of the McGill Faculty of Law.

The black-lined copy of the PS included hereinafter in this Appendix, serves to highlight the described modifications.

Appendix F

Blacklined Version of The General Questionnaire Public Survey (PS)

Section 1: General	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
1. I currently own shares in one or more *publicly traded* corporations.		○		○	
2. I currently own mutual funds that include shares of *publicly traded* corporations.		○		○	
3. Over the next 12 months, I intend to purchase *shares of publicly traded corporations*, either directly or through the purchase of mutual funds.		○		○	
4. I have a good understanding of corporate governance.	○	○	○	○	○
5. I understand, the differences between the role of *management*, and the role of the *board of directors*.	○	○	○	○	○
6. Primary responsibility for how a corporation performs rests:					
a. With the shareholders;	○	○	○	○	○
b. With the directors; or	○	○	○	○	○
c. With management.	○	○	○	○	○

Section 2: Corporate Governance	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	No Comment
7. I believe that *management of most publicly traded corporations* act in the best interests of their shareholders.	○	○	○	○	○	○
8. I believe that *management of most publicly traded corporations* act in their own	○	○	○	○	○	○

best interests.						
9. I believe that the *boards of directors of most publicly traded corporations* act in the best interests of their shareholders.	○	○	○	○	○	○
10. I believe that *boards of directors of publicly traded corporations*, should in fact be independent of management.	○	○	○	○	○	○
11. I believe that *boards of directors of most publicly traded corporations* are in fact independent of management.	○	○	○	○	○	○
12. I believe that the *external auditors of* a publicly traded corporation help protect the interests of shareholders.	○	○	○	○	○	○
13. *I believe that* external auditors of a publicly traded corporation help to give shareholders a fair picture of the true financial position of the corporation.	○	○	○	○	○	○
14. I believe that *external auditors of most publicly traded corporations* act independently of management to help protect the interests of the shareholders.	○	○	○	○	○	○
15. I believe that *the regulators of publicly traded corporations* (that is the governments, security commissions & stock exchanges) are doing an effective job in protecting the interests of investors.	○	○	○	○	○	○
16. I believe that *the media* are trustworthy in their reporting of the affairs of business.	○	○	○	○	○	○

Section 3: Executive Compensation	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	No Comment
17. I believe that *management of for profit publicly traded corporations* are compensated appropriately.	○	○	○	○	○	○
18. *Stock options* are a form of compensation, that I understand. (If you disagree, you may omit to answer, questions 19 and 20).		○		○		
19. I believe that *management compensation* should include "stock options".	○	○	○	○	○	○
20. I believe that *director compensation* should include stock options.	○	○	○	○	○	○

Section 4: Summary	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	No Comment
21. I believe that *Chief Executive Officers* of most for profit publicly traded corporations are honest and can be trusted.	○	○	○	○	○	○
22. I have confidence that *stock markets* generally operate effectively and fairly.	○	○	○	○	○	○
23. I believe that corporate governance *(that is the rules and processes that apply to how a "for profit corporation" should be managed)* serves to protect the shareholders.	○	○	○	○	○	○

Demographic Information (please see the note below)
Age:
Education:

Gender:
Profession:
Marital Status:
Employment:
Residence:
Salary:

Your opinion:	
Personal comments:	

Notes:

1. *Please feel free to add any comments that you wish, concerning corporate governance, and return it, with this survey.*
2. *Thank you for taking the time to fill out this survey.*
3. *All individual replies will be treated as confidential and your identity, or individual reply, will not be publicly disclosed.*

Appendix G

Detailed Results of the Survey of CA's

This survey was conducted by Itracks, <itracks.com>, on behalf of CA Magazine using a questionnaire developed by the author (and modified at the request of CA Magazine). All information was obtained on a confidential, not for personal attribution basis, although the "consolidated" material, enclosed herein, was shared with the author.

The results of this initiative are included for reference purposes (and may be useful for further review and future detailed analysis). However, the objective of this effort, as it relates to this thesis, was to assess the responses of chartered accountants, compare them with those of graduates of the McGill Faculty of Law as well as those subject to the DSI, and to search for directional views, as opposed to very detailed consistency or differences.

CA Magazine- Corporate Governance Survey Results

Currently own shares

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	149	25.4	25.4	25.4
	Disagree	49	8.4	8.4	33.8
	Neutral	9	1.5	1.5	35.3
	Agree	110	18.8	18.8	54.1
	Strongly Agree	246	42.0	42.0	96.1
	No Comment	23	3.9	3.9	100.0
	Total	586	100.0	100.0	

Currently own mutual funds

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	97	16.6	16.6	16.6
	Disagree	33	5.6	5.6	22.2
	Neutral	4	0.7	0.7	22.9
	Agree	138	23.5	23.5	46.4
	Strongly Agree	301	51.4	51.4	97.8
	No Comment	13	2.2	2.2	100.0
	Total	586	100.0	100.0	

Intend to purchase shares

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	71	12.1	12.1	12.1
	Disagree	32	5.5	5.5	17.6
	Neutral	45	7.7	7.7	25.3
	Agree	172	29.4	29.4	54.6
	Strongly Agree	254	43.3	43.3	98.0
	No Comment	12	2.0	2.0	100.0
	Total	586	100.0	100.0	

Good understanding of corp. gov.

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	7	1.2	1.2	1.2
	Disagree	41	7.0	7.0	8.2
	Neutral	64	10.9	10.9	19.1
	Agree	285	48.6	48.6	67.7
	Strongly Agree	184	31.4	31.4	99.1
	No Comment	5	0.9	0.9	100.0
	Total	586	100.0	100.0	

Understand the differences

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	1	0.2	0.2	0.2
	Disagree	10	1.7	1.7	1.9
	Neutral	25	4.3	4.3	6.1
	Agree	274	46.8	46.8	52.9
	Strongly Agree	270	46.1	46.1	99.0
	No Comment	6	1.0	1.0	100.0
	Total	586	100.0	100.0	

CA Magazine- Corporate Governance Survey Results

Primary responsibility: shareholders

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	195	33.3	33.3	33.3
	Disagree	237	40.4	40.4	73.7
	Neutral	67	11.4	11.4	85.2
	Agree	63	10.8	10.8	95.9
	Strongly Agree	20	3.4	3.4	99.3
	No Comment	4	0.7	0.7	100.0
	Total	586	100.0	100.0	

Primary responsibility: directors

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	16	2.7	2.7	2.7
	Disagree	44	7.5	7.5	10.2
	Neutral	33	5.6	5.6	15.9
	Agree	252	43.0	43.0	58.9
	Strongly Agree	236	40.3	40.3	99.1
	No Comment	5	0.9	0.9	100.0
	Total	586	100.0	100.0	

Primary responsibility: management

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	4	0.7	0.7	0.7
	Disagree	9	1.5	1.5	2.2
	Neutral	12	2.0	2.0	4.3
	Agree	157	26.8	26.8	31.1
	Strongly Agree	394	67.2	67.2	98.3
	No Comment	10	1.7	1.7	100.0
	Total	586	100.0	100.0	

Management act in best interests of shareholders

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	16	2.7	2.7	2.7
	Disagree	141	24.1	24.1	26.8
	Neutral	135	23.0	23.0	49.8
	Agree	265	45.2	45.2	95.1
	Strongly Agree	25	4.3	4.3	99.3
	No Comment	4	0.7	0.7	100.0
	Total	586	100.0	100.0	

Management act in their own best interests

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	11	1.9	1.9	1.9
	Disagree	126	21.5	21.5	23.4
	Neutral	94	16.0	16.0	39.4
	Agree	262	44.7	44.7	84.1
	Strongly Agree	88	15.0	15.0	99.1
	No Comment	5	0.9	0.9	100.0
	Total	586	100.0	100.0	

Boards act in the best interests of shareholders

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	8	1.4	1.4	1.4

	Disagree	76	13.0	13.0	14.3
	Neutral	99	16.9	16.9	31.2
	Agree	341	58.2	58.2	89.4
	Strongly Agree	59	10.1	10.1	99.5
	No Comment	3	0.5	0.5	100.0
	Total	586	100.0	100.0	

Boards should be independent of management

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	3	0.5	0.5	0.5
	Disagree	18	3.1	3.1	3.6
	Neutral	24	4.1	4.1	7.7
	Agree	190	32.4	32.4	40.1
	Strongly Agree	346	59.0	59.0	99.1
	No Comment	5	0.9	0.9	100.0
	Total	586	100.0	100.0	

Boards are independent of management

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	29	4.9	4.9	4.9
	Disagree	273	46.6	46.6	51.5
	Neutral	153	26.1	26.1	77.6
	Agree	114	19.5	19.5	97.1
	Strongly Agree	8	1.4	1.4	98.5
	No Comment	9	1.5	1.5	100.0
	Total	586	100.0	100.0	

External auditors help protect shareholders

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	8	1.4	1.4	1.4
	Disagree	45	7.7	7.7	9.0
	Neutral	60	10.2	10.2	19.3
	Agree	277	47.3	47.3	66.6
	Strongly Agree	191	32.6	32.6	99.1
	No Comment	5	0.9	0.9	100.0
	Total	586	100.0	100.0	

External auditors give shareholders a fair picture

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	8	1.4	1.4	1.4
	Disagree	28	4.8	4.8	6.1
	Neutral	61	10.4	10.4	16.6
	Agree	321	54.8	54.8	71.3
	Strongly Agree	161	27.5	27.5	98.8
	No Comment	7	1.2	1.2	100.0
	Total	586	100.0	100.0	

CA Magazine- Corporate Governance Survey Results

External auditors act independently of management

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	9	1.5	1.5	1.5
	Disagree	78	13.3	13.3	14.8
	Neutral	84	14.3	14.3	29.2
	Agree	305	52.0	52.0	81.2
	Strongly Agree	106	18.1	18.1	99.3
	No Comment	4	0.7	0.7	100.0
	Total	586	100.0	100.0	

Regulators are doing an effective job

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	22	3.8	3.8	3.8
	Disagree	142	24.2	24.2	28.0
	Neutral	143	24.4	24.4	52.4
	Agree	239	40.8	40.8	93.2
	Strongly Agree	32	5.5	5.5	98.6
	No Comment	8	1.4	1.4	100.0
	Total	586	100.0	100.0	

Media are trustworthy

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	77	13.1	13.1	13.1
	Disagree	223	38.1	38.1	51.2
	Neutral	159	27.1	27.1	78.3
	Agree	107	18.3	18.3	96.6
	Strongly Agree	10	1.7	1.7	98.3
	No Comment	10	1.7	1.7	100.0
	Total	586	100.0	100.0	

Management are compensated appropriately

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	52	8.9	8.9	8.9
	Disagree	157	26.8	26.8	35.7
	Neutral	141	24.1	24.1	59.7
	Agree	168	28.7	28.7	88.4
	Strongly Agree	50	8.5	8.5	96.9
	No Comment	18	3.1	3.1	100.0
	Total	586	100.0	100.0	

I understand stock options

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	5	0.9	0.9	0.9
	Disagree	23	3.9	3.9	4.8
	Neutral	31	5.3	5.3	10.1
	Agree	333	56.8	56.8	66.9
	Strongly Agree	193	32.9	32.9	99.8
	No Comment	1	0.2	0.2	100.0
	Total	586	100.0	100.0	

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Management compensation should include stock options

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	39	6.7	7.0	7.0
	Disagree	119	20.3	21.3	28.3
	Neutral	90	15.4	16.1	44.4
	Agree	252	43.0	45.2	89.6
	Strongly Agree	52	8.9	9.3	98.9
	No Comment	6	1.0	1.1	100.0
	Total	558	95.2	100.0	
Missing	System	28	4.8		
Total		586	100.0		

Director compensation should include stock options

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	93	15.9	16.7	16.7
	Disagree	211	36.0	37.8	54.5
	Neutral	90	15.4	16.1	70.6
	Agree	127	21.7	22.8	93.4
	Strongly Agree	30	5.1	5.4	98.7
	No Comment	7	1.2	1.3	100.0
	Total	558	95.2	100.0	
Missing	System	28	4.8		
Total		586	100.0		

CEOs are honest and can be trusted

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	9	1.5	1.5	1.5
	Disagree	80	13.7	13.7	15.2
	Neutral	158	27.0	27.0	42.2
	Agree	294	50.2	50.2	92.3
	Strongly Agree	21	3.6	3.6	95.9
	No Comment	24	4.1	4.1	100.0
	Total	586	100.0	100.0	

Stock markets operate effectively and fairly

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	20	3.4	3.4	3.4
	Disagree	117	20.0	20.0	23.4
	Neutral	110	18.8	18.8	42.2
	Agree	313	53.4	53.4	95.6
	Strongly Agree	15	2.6	2.6	98.1
	No Comment	11	1.9	1.9	100.0
	Total	586	100.0	100.0	

Corporate governance protects the shareholders

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly Disagree	5	0.9	0.9	0.9
	Disagree	35	6.0	6.0	6.8
	Neutral	92	15.7	15.7	22.5
	Agree	369	63.0	63.0	85.5
	Strongly Agree	80	13.7	13.7	99.1
	No Comment	5	0.9	0.9	100.0
	Total	586	100.0	100.0	

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Age

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	18-25	32	5.5	5.5	5.5
	25-34	132	22.5	22.6	28.1
	35-44	176	30.0	30.1	58.2
	45-54	155	26.5	26.5	84.8
	55 and over	89	15.2	15.2	100.0
	Total	584	99.7	100.0	
Missing	System	2	0.3		
Total		586	100.0		

Gender

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Male	398	67.9	68.6	68.6
	Female	182	31.1	31.4	100.0
	Total	580	99.0	100.0	
Missing	System	6	1.0		
Total		586	100.0		

Marital Status

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Single	125	21.3	21.5	21.5
	Married	402	68.6	69.2	90.7
	Other	54	9.2	9.3	100.0
	Total	581	99.1	100.0	
Missing	System	5	0.9		
Total		586	100.0		

Residence

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Own	484	82.6	84.3	84.3
	Rent	90	15.4	15.7	100.0
	Total	574	98.0	100.0	
Missing	System	12	2.0		
Total		586	100.0		

Education

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	High School	6	1.0	1.0	1.0
	College/Cegep	9	1.5	1.5	2.6
	University Undergrad	303	51.7	52.1	54.6
	University Post Grad	236	40.3	40.5	95.2
	Other	28	4.8	4.8	100.0
	Total	582	99.3	100.0	
Missing	System	4	0.7		
Total		586	100.0		

Profession

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	582	99.3	99.3	99.3
	Lawyer	4	0.7	0.7	100.0
	Total	586	100.0	100.0	

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Profession

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	585	99.8	99.8	99.8
	Notary	1	0.2	0.2	100.0
	Total	586	100.0	100.0	

Profession

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	35	6.0	6.0	6.0
	CA	551	94.0	94.0	100.0
	Total	586	100.0	100.0	

Profession

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	565	96.4	96.4	96.4
	Business Executive	21	3.6	3.6	100.0
	Total	586	100.0	100.0	

Profession

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	580	99.0	99.0	99.0
	Investment Counselor/Fund Manager	6	1.0	1.0	100.0
	Total	586	100.0	100.0	

Profession

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	0	555	94.7	94.7	94.7
	Other	31	5.3	5.3	100.0
	Total	586	100.0	100.0	

Employment

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Self-employed	100	17.1	18.7	18.7
	Partner in prof firm	38	6.5	7.1	25.8
	Employed in prof firm	68	11.6	12.7	38.5
	Employed in Industry	160	27.3	29.9	68.4
	Employed in gov't	64	10.9	12.0	80.4
	Employed in academia	10	1.7	1.9	82.2
	Student	28	4.8	5.2	87.5
	Retired	25	4.3	4.7	92.1
	Other	42	7.2	7.9	100.0
	Total	535	91.3	100.0	
Missing	System	51	8.7		
Total		586	100.0		

Employed in Industry

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Private company	87	14.8	56.1	56.1
	Publicly traded company	68	11.6	43.9	100.0
	Total	155	26.5	100.0	
Missing	System	431	73.5		
Total		586	100.0		

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Salary

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Less than $20,000	24	4.1	4.5	4.5
	$20,001 to $49,999	40	6.8	7.4	11.9
	$50,000 to $99,999	243	41.5	45.3	57.2
	$100,000 to $149,999	128	21.8	23.8	81.0
	Over $150,000	102	17.4	19.0	100.0
	Total	537	91.6	100.0	
Missing	System	49	8.4		
Total		586	100.0		

Appendix H

Detailed Results of the Survey of the Graduates of the McGill Faculty of Law

Appendix H includes the compilation of the responses received to the survey of graduates of the McGill Faculty of Law. This survey was conducted without pretense to statistical validity. Graduates who had made their email addresses available "for public access" were contacted by McGill University (as the initial attempt at a reactive survey (that is asking individuals who visited the McGill Faculty of Law Alumnae site to fill out the survey) did not prove effective).

Where the respondent agreed to reply, the author received no indication via the email as to who the respondent was [unless the respondent volunteered to identify himself (or herself) in the email itself (which in fact was only done by one individual].

The actual response rate to the proactive (as opposed to reactive) survey was excellent (double what is normally considered to be a good response rate). Double the rate that is considered to be a good reply, was in fact achieved.

	Questions																							
	1	2	3	4a	4b	4c	5	6a	6b	6c	7	8	9	10	11	12	13	14	15	16	17	18	19	20
1 Student	4	4	4	2	4	2	4	2	4	2	3	4	4	2	2	4	4	4	3	2	2	4	4	3
2 Student	2	4	2	4	2	2	4	2	4	2	4	4	5	5	5	5	4	4	4	4	4	4	5	5
3 Student	4	4	4	2	4	2	4	2	2	4	3	3	3	3	5	4	3	3	3	4	2	4	4	2
4 Lawyer	4	4	4	4	2	2	4	2	2	4	4	4	4	4	5	5	4	4	4	4	3	4	3	3
5 Bus. Exec	4		4	3	3	2	5				3		4	4		4	3	4	3		4	4	3	4
6 CA	2	4	2	4	2	2	4	2	2	4	2	4	2	2	5				2	1	3	4	3	3
7 Bus. Exec	4	4	4	4	2	2	4	2	2	4	4	2	4	5	4	5	5	5	4	4	4	2	2	4
8 Fund Mgr	4	4	4	4	2	2	4	2	2	4	4	4	4	2	5	4	2	2	2	1	4	4	4	4
9 Bus. exec	4	4	4	2	4	2	4	2	2	4	3	4	4	2	5	4	4	3	2	3	1	4	4	2
10 Lawyer	2	4	4	4	2	2	4	2	4	2	4	4	4	2	5	5	4	4	2	1	3	4	3	3
11 Student	4	4	4	2	4	2	4	2	2	4	4	5	4	5	3	5	4	4	2	3	3	4	4	4
12 Consultant	4	4	4	2	4	2	4	2	2	4	3	4	4	3	4	2	3	2	3	4	4	4	4	1
13 Lawyer	2	2	2	5	2	2	5	2	4	5	3	4	3	4	2	3	3	3	2	2	2	4	2	2
14 Lawyer	4	4	4	4	2	2	5	1	3	5	3	5	4	5	4	4	3	3	2	1	1	4	4	1
15 Lawyer	4	4	4	5	2	2	5	4	5	5	2	4	2	5	2	4	4	3	2	1	2	4	2	2
16 Bus. Exec	4	4	3	4	2	2	4	5	3	5	4	4	4	5	2	5	4	4	2	3	5	4	5	1
17 Bus. Exec ****	4	4	4	4	2	2	4	2	2	4	4	2	4	5	4	5	5	5	4	4	4	2	2	4
18 Lawyer	4	2	4	3	3	3	4	2	4	5	3	4	3	5	4	4	3	4	2	1	5	4	4	3
19 lawyer	2	4	4	5	2	2	5	4	4	5	4	3	4	4	2	4	5	4	4	3	3	4	4	2
20 Lawyer	4	4	4	5	2	2	5	1	5	5	5	3	4	5	5	5	3	3	3	3	5	2	5	5
21 lawyer	4	4	4	5	2	2	5		3	4	2	5	3	5	2	2	2	2	2	2	2	4		
22 Lawyer	4	4	4	4	2	2	4	1	3	5	4	5	2	5	1	2	2	2	2	3	1	4	1	1
23 Lawyer	4	4	4	4	2	2	4	2	4	5	4	2	4	5	2	4	4	4	2	3	4	4	5	5
24 Lawyer	4	4	4	3	3	3	4	4	4	5	3	2	3	5	3	3	3	3	1	2	5	4	4	4
25 Other	4	4	4	4	2	2	4	2	5	4	4	5	3	5	2	4	4	4	4	4	2	4	4	2
26 Lawyer	4	4	4	4	2	2	4	1	3	4	4	3	4	3	3	4	4	4	3	3	3	4	4	4
27 Lawyer	4	4	4	5	2	2	5	2	3	5	2	4	3		4	3	3	3	2	3	1	4	2	2
28 Lawyer	4	4	4	5	2	2	5	3	4	5	4	2	4	3	2	4	5	4	4	4	4	4	4	2
29 Lawyer	4	4	4	4	2	2	4	2	4	5	4	3	4	5	3	3	3	3	2	3	2	4	2	2
30 Other	2	2	2	4	2	2	4	4	2	4	2	4	2	5	5	5	5	5	2	2	2	4	4	4
31 NA	2	2	2	3	3	3	5	4	5	5		4	4	4	2		4		4	3	2	4	2	2
32 Lawyer	2	2	2	3	3	3	4	2	3	4	2	3	2	4	3	4	4	4	3	2	3	4	3	3
33 Lawyer	4	4	4	4	2	2	5	5	5	5	2	5	3	5	2	3	3	2	2	3	2	4	2	2
34 Lawyer	2	2	2	5	2	2		5							1	4	4		2	2		4	2	2
35 Lawyer	2	2	2	5	2	2	5		5						1	4	4		2	2		4		
36 Lawyer	2	4	4	5	2	2	5			5	4	4	4	5	2	4	5	4	4	4	2	4	3	2
37 Lawyer	4	4	4	4	2	2	4	2	4	2	4	3	4	4	2	4	4	4	4	3	2	4	3	3
38 Other	4	4	2	4	2	2	4		4		3	3	4	4	2	5	4	4	2	2	2	4	2	2
39 Lawyer	2	2	4	4	2	2	4	5	3	5	1	5	2	5	2	3	3	3	2	2	1	2	1	1
40 Lawyer	4	4	2	4	2	2	4	1	5	4	3	3	4		1	2	2	1	1	1	4	4	4	4
41 Executive(ret.)	4	4	4	4	2	2	5		5		2	5	3		2		3	2	1	2	2	4	3	1
42 Lawyer	4		4	3	3	3	4		4	4	4	2	3	4	4	3	3	3	2	3	2	4	4	2
43 Lawyer	4	4	4	4	2	2	4			4	5	5	5	5	2	4	2		5	5	5	4	3	3
44 Lawyer	2	4	4	4	2	2	4	4	4	5	4	4	4	4	2	4	4	2	2	1	2	2		
45 Lawyer	4	4	4	4	2	2	5	1	5	5	4	3	4	5	5	3		3	4	3	2	4	3	4
46 Other	4	4	4	3	3	3	3	2	2	4	2	4	2	4	2	4	2	4	2	3	1	4	2	2
47 Other	2	4	4	4	2	2	4	3	4	5	4	2	3	3	3	4	4	5	4	5	4	4	4	4
48 Other	4	4	4	4	2	2	4		4		5	2	4	5	3	5	5	5	4	4	4	4	2	2
49 Other	4	4	4	4	2	2	4		4		3	5	3	3	2	3	3	2	2	2	1	4	4	4
50 Other	2	4	2	5	2	2	5	1	5	3	4	2	5		4	1	5	2	4	4	5	4	4	2
51 Lawyer	4	4	4	4	2	2	4	2	3	4	2	4	2	5	2	4	2	4	1	3	1	4	5	1
52 Lawyer	4	4	4	5	2	2	5		5		4	4	4	4	1	5	4	4	4	2	2	4	2	2
53 Lawyer	4	4	4	5	2	2	5	2	2	4	3	4	5	3	2	4	4	4	4	3	3	4	5	5
54 Lawyer	4	4	4	4	2	2	4			4	5	5	5	5	4	4	4	4	4	3	4	4	3	2
55 Lawyer	4	4	4	5	2	2	5	1	5	4	3	4	4	3	4	2	2	2	3	3	2	4	4	4
56 Lawyer	4	4	4	4	2	2	4		4	4	3	4	4	4	2	2	3	3	2	3	2	4	2	2
57 Other	4	4	4	4	2	2	4	3	4	3	3	3	4	4	2	2	2	2	2	3	3	4	4	4
58 Other	4	2	2	2			3			3	3	4	3	3	4	2	3	3	2	2	2	4	2	2
59 Lawyer	2	2	2	1			5	3	4	5	4	5	5	5	5		4	4		3	3	4	5	
60 Lawyer	2	4	4	4			4		4	4	4	2	4	4	2	3	3	3	2	3	2	4	2	2
61 Lawyer	4	4	4	5			5	2	4	5	4	5	4	5	1	4	4	4	4	4	4	4	4	2
62 Lawyer	2	4	4	4			5	2	4	3	4	4	4	4	2	5	5	3	2	2	3	4	4	4
63 Lawyer	2	4	2	5			5	1	4	3	2	4	4	5	2	2	2	2	2	4	2	4	4	2
64 Bus. Exec.	4	2	4	5			5	1	4	4	4	2	5	5	4	4	4	4	4	2	2	4	4	4
65 Lawyer	4	4	4	4			4	2	2	4	4	4	4	2	2	4	4	4	4	2	4	4	4	4
66 Lawyer	4	4	4	4			4	3	4	4	4	5	4	3	4	4	4	2	4	4	4	4	3	2
67 Lawyer	4	4	4	4			4			4	4	3	4	4	4	5	5	4	3	5	5	4	2	2
68 Lawyer	4	4	4	4					4	4	4	2	4	4	2	5	5	5	5	5	1	4	4	4
69 Lawyer	2	2	4	3			4	1	2	4	3	4	3	5	2	1	1	1	4	4	2	4	2	2
70 Lawyer	2	4	4	4			4	1	4	5	4	4	4	4	4	5	5	5	4	4	2	4	3	3
71 Other	2	2	2	1			1	3	4	4	4	4	4	3	3	3	4	4	4	4		4	4	4

	Questions																							
	1	2	3	4a	4b	4c	5	6a	6b	6c	7	8	9	10	11	12	13	14	15	16	17	18	19	20
72 Not Answered	2	2	4	4		4				4	4	2	4	5	2	5	5	4	4	4	5	4	4	2
73 Lawyer	4	4	4	3			5		5	5	3	5	5	5	5	3	5	4	3	3	2	3	3	2
74 Lawyer	2	4	2	3			4	1	4	5	4	4	3	4	2	4	4	4		4	1	4	2	2
75 Lawyer	4	2	4	4			5			4	4	4	4	4	2	4	4	4	4	4	2	4	2	2
76 Lawyer	4	4	4	5			5	3	5	4	4	4	4	5	2	4	4	4	1	3	3	4	4	1
77 Business Exec.	4	2	4	5			5	5	3	5			4	5		4	4	2	4	2	4	4	5	5
78 Lawyer	4	4	4	4			4	1	5	3	4	2	4	4	3	5	5	5	3	3	3	4	3	3
79 Other	4	4	4	5			5			5	2	5	5		2	2	2	3	1	1	1	4	5	5
80 Other	4	2	4	4			4	3	5	5	4	4	3	2	1	2	2	2	3	4	2	4	2	2
81 Lawyer	4	4	4	5			5			4	4	4	4	3	2	5	5	5	4	2	4	4	4	4
82 Lawyer	4	4	4	5			5	4	4	4	3	5	4	5	4	2	2	2	2	2	4	4	3	3
83 Lawyer	4	4	4	5			5	1	2	5	4	2	4	5	2				5	2	2	4	2	2
84 Lawyer	4	2	2	4			4		4		3	4	3	5	3	4	4	4	2	2	4	4	4	4
85 Lawyer	4	4	4	5			5	2	4	5	4	2	4	5	2	4	4	4	3	2	2	4	2	2
86 Other	2	2	2	3			5	2	3	4	4	3	4	5	2	5	4	5	3	2		4	3	3
87 Lawyer	4	2	4	4			4		5		4	2	4	5	1	4	4	4	3	3	2	4	3	3
88 Lawyer	4	4	2	5			5		5		4	2	4	4	2	4	4		2	3	2	2		
89 Bus. Exec.	4	4	4	4			4		5	5	4	3	4	5	4	3	3	4	4	4	4	4	3	3
90 Lawyer	2	2	2	3			3	2	5	4	4	4	5	4	4	4	4	4	4	4	4	4	2	2
91 Lawyer	2	2	4	5			5	3	5	4	3	4	4	2	2	5	4	4	4	3		4	3	4
92 Lawyer	4	4	4	4			4		4		4	2	4	5	3	3	3	4	3	4	3	4	3	3
93 Lawyer	4	4	4	3			4	2	5	2	2		3		2	3	3	2	1	3	2	4	1	1
94 Lawyer	4	4	4	4			5	1	4	5	2	5	4	5	2	4	4	4	2	3	4	4	4	1
95 Lawyer	4	4	4	5			5	3	5	4	3	5	3	5	3	3	3	2	1	2	3	4	1	1
96 Lawyer	4	2	4	4			4	4	4	4	2	5	5	5	2	5	5	3	5	3	4	4	1	3
97 Lawyer	2	2	4	4			4	2	4	5	4	2	4	5		5	5	5	2	3	2	4	4	1
98 Lawyer	4	4	4	4	4	5	5		3	4	4		4	4	3	5	4	4	2	2	3	4	3	3
99 Lawyer	4	4	4	5			4		4		2	5	2	2	5	4	3	3	1	3		4	2	2
100 Lawyer	4	4	4	4			5		5	5	4	4	4	5	4	5	5	5	4	4	3	4	4	4

1	0	0	0	2	0	0	1	16	0	0	1	0	0	0	8	2	1	2	9	9	11	0	5	12
2	28	24	20	6	45	51	0	31	15	5	16	20	9	9	44	12	13	18	37	26	35	6	25	37
3	0	0	1	13	7	6	3	10	12	6	23	14	19	12	13	16	23	19	16	35	17	1	22	17
4	72	74	79	51	6	1	53	8	38	42	52	39	59	25	19	40	41	42	32	25	23	93	35	23
5	0	0	0	28	0	1	40	5	24	34	4	21	11	46	13	25	19	12	4	4	8	0	9	6
6	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0

	1	2	3	4a	4b	4c	5	6a	6b	6c	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Total 4,5	72	74	79	79	6	2	93	13	62	76	56	60	70	71	32	65	60	54	36	29	31	93	44	29
Total 1,2	28	24	20	6	45	51	1	47	16	5	17	20	9	9	52	14	14	20	48	36	48	6	30	49
% 4 and 5	72.0%	76%	80%	91%	12%	4%	99%	22%	81%	94%	77%	75%	89%	89%	38%	82%	81%	73%	44%	45%	40%	94%	59%	37%
% 1 and 2	28.0%	24%	20%	9%	88%	96%	1%	78%	19%	6%	23%	25%	11%	11%	62%	18%	19%	27%	56%	55%	60%	6%	41%	63%
% 4 and 5 (incl 3)	72.0%	75.5%	79.0%	79.0%	10.3%	3.4%	95.9%	18.6%	69.7%	87.4%	58.3%	63.8%	71.4%	77.2%	33.0%	68.4%	61.9%	56.1%	36.7%	29.3%	33.0%	93.0%	45.8%	30.5%
% 1 and 2 (incl 3)	28.0%	24.5%	20.0%	8.0%	77.6%	86.4%	1.0%	67.1%	16.9%	5.7%	17.7%	21.3%	9.2%	9.8%	53.6%	14.7%	14.4%	21.5%	46.9%	35.4%	48.9%	6.0%	31.3%	51.6%
Average	3.43	3.18	3.39	3.49	2.26	2.20	4.36	2.38	3.84	4.27	3.44	3.84	3.72	4.31	2.71	3.74	3.66	3.46	2.97	2.96	2.90	3.86	3.16	2.69
Median	4.00	4.00	4.00	4.00	2.00	2.00	4.00	2.00	4.00	4.00	4.00	4.00	4.00	5.00	2.00	4.00	4.00	4.00	3.00	3.00	3.00	4.00	3.00	2.00
Standard Deviation	0.91	0.85	0.81	0.69	0.58	0.56	0.68	1.20	1.01	0.75	0.87	1.07	0.79	0.99	1.19	1.06	1.00	1.04	1.12	1.02	1.20	0.50	1.05	1.16

				Demographic Data										
	21	22	23	24	25	26	27	28	29	30	31			
1 Student	3	3	5	2	1	2	1	4	1	7	1			
2 Student	3	4	4	2	1	2	1	4	1	7	1			
3 Student	2	4	3	2	1	2	1	4	1	7	1			
4 Lawyer	3	5	5	2	1	2	1	4	1	7	1			
5 Bus. Exec	3		4	2	1	2	1	4	1	7	1			
6 CA	3	3	3	2	1	2	1	4	1	7	1			
7 Bus. Exec	4	4	4	2	1	2	1	4	1	7	1			
8 Fund Mgr	4	4	4	2	1	2	1	4	1	7	1			
9 Bus. exec	3	2	4	2	1	2	1	4	1	7	1			
10 Lawyer	3	4	4	2	1	2	1	4	1	7	1			
11 Student	4	4	4	2	1	2	1	4	1	7	1			
12 Consultant	4	4	3	2	1	2	1	4	1	7	1			
13 Lawyer	2	2	3	2	1	2	1	4	1	7	1			
14 Lawyer	4	3	2	2	1	2	1	4	1	7	1			
15 Lawyer	4	3	3	2	1	2	1	4	1	7	1			
16 Bus. Exec	3	4	3	2	1	2	1	4	1	7	1			
17 Bus. Exec ****	4	4	4	2	1	2	1	4	1	7	1			
18 Lawyer	2	3	4	2	1	2	1	4	1	7	1			
19 lawyer	4	4	5	2	1	2	1	4	1	7	1			
20 Lawyer	4	4	3	2	1	2	1	4	1	7	1			
21 lawyer	2	3	4	2	1	2	1	4	1	7	1			
22 Lawyer	3	4	4	2	1	2	1	4	1	7	1			
23 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
24 Lawyer	4	4	3	2	1	2	1	4	1	7	1			
25 Other	4	5	4	2	1	2	1	4	1	7	1			
26 Lawyer	4	3	4	2	1	2	1	4	1	7	1			
27 Lawyer	2	3	2	2	1	2	1	4	1	7	1			
28 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
29 Lawyer	3	3	4	2	1	2	1	4	1	7	1			
30 Other	2	2	2	2	1	2	1	4	1	7	1			
31 NA	3	3	4	2	1	2	1	4	1	7	1			
32 Lawyer	4	3	2	2	1	2	1	4	1	7	1			
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35 Lawyer			3	2	1	2	1	4	1	7	1			
36 Lawyer	4	3	4	2	1	2	1	4	1	7	1			
37 Lawyer	4	3	4	2	1	2	1	4	1	7	1			
38 Other	2	2	3	2	1	2	1	4	1	7	1			
39 Lawyer	1	2	2	2	1	2	1	4	1	7	1			
40 Lawyer	3	3	5	2	1	2	1	4	1	7	1			
41 Executive(ret.)	3	2	3	2	1	2	1	4	1	7	1			
42 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
43 Lawyer	2	1	3	2	1	2	1	4	1	7	1			
44 Lawyer	3	2	4	2	1	2	1	4	1	7	1			
45 Lawyer	4	2	2	2	1	2	1	4	1	7	1			
46 Other	2	2	2	2	1	2	1	4	1	7	1			
47 Other	4	2	3	2	1	2	1	4	1	7	1			
48 Other	4	4	4	2	1	2	1	4	1	7	1			
49 Other	4	4	3	2	1	2	1	4	1	7	1			
50 Other	4	4	4	2	1	2	1	4	1	7	1			
51 Lawyer	2	1	1	2	1	2	1	4	1	7	1			
52 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
53 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
54 Lawyer	5	5	4	2	1	2	1	4	1	7	1			
55 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
56 Lawyer	3	4	3	2	1	2	1	4	1	7	1			
57 Other	4	4	4	2	1	2	1	4	1	7	1			
58 Other	2	4	3	2	1	2	1	4	1	7	1			
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60 Lawyer	4	2	4	2	1	2	1	4	1	7	1			
61 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
62 Lawyer	4	3	4	2	1	2	1	4	1	7	1			
63 Lawyer	4	2	2	2	1	2	1	4	1	7	1			
64 Bus. Exec.	4	4	4	2	1	2	1	4	1	7	1			
65 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
66 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
67 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
68 Lawyer	4	4	4	2	1	2	1	4	1	7	1			
69 Lawyer	1	2	4	2	1	2	1	4	1	7	1			
70 Lawyer	4	4	5	2	1	2	1	4	1	7	1			
71 Other	4	4	4	2	1	2	1	4	1	7	1			

	21	22	23	Demographic Data 24	25	26	27	28	29	30	31
72 Not Answered	2	4	4								
73 Lawyer	3	2	1								
74 Lawyer	2	3	2								
75 Lawyer	4	4	2								
76 Lawyer	4	2	2								
77 Business Exec.		4	4								
78 Lawyer	3	3	3								
79 Other	5	5	1								
80 Other	4	4	2								
81 Lawyer	4	4	4								
82 Lawyer	3	2	5								
83 Lawyer	4	4	4								
84 Lawyer	3	3	4								
85 Lawyer	4	4	4								
86 Other	3	3	4								
87 Lawyer	4	4	5								
88 Lawyer		3									
89 Bus. Exec.	5	4	4								
90 Lawyer	4	3	4								
91 Lawyer		4	4								
92 Lawyer	4	4	5								
93 Lawyer	2	2	1								
94 Lawyer	2	1	4								
95 Lawyer	3	2	3								
96 Lawyer	4	5	5								
97 Lawyer	4	2	4								
98 Lawyer	3	4	4								
99 Lawyer	1	1	1								
100 Lawyer	3	4	4								

1	3	4	5								
2	16	21	12								
3	25	22	21								
4	49	46	52								
5	3	5	9								
6	0	0	0								

	21	22	23	24	25	26	27	28	29	30	31
Total 4,5	52	51	61								
Total 1,2	19	25	17								
% 4 and 5	73%	67%	78%								
% 1 and 2	27%	33%	22%								
% 4 and 5 (incl 3)	54.2%	52.0%	61.6%								
% 1 and 2 (incl 3)	19.8%	25.5%	17.2%								
Average	3.97	3.84	3.98								
Median	4.00	4.00	4.00								
Standard Deviation	0.91	0.96	0.95								

Percent	24	25	26	27	28	29	30	31
1	1%	72%	25%	72%	0%	73%	27%	6%
2	30%	28%	65%	28%	0%	0%	18%	10%
3	22%	0%	9%	0%	11%	2%	18%	23%
4	19%	0%	0%	0%	86%	8%	11%	22%
5	29%	0%	0%	0%	3%	1%	27%	39%
6	0%	0%	0%	0%	0%	15%		0%

Appendix I

Public Survey

The Rationale For Not Including The Data:

Given my inability to get a national newspaper to participate in this aspect of the survey effort, the rather meager response to my attempts to otherwise generate broad national participation, the inclusion (inadvertently in the public survey) of a number of individuals who were also captured by the DSI, the CA and the graduates of the McGill Faculty of Law PS (when the alternative approach was initiated), as well as the projected cost of seeking to do an "effective survey" of the general public and the limited direct value, (although of interest) of such a costly effort to the primary purpose of this initiative, I decided not to proceed with that aspect of the research.

While inclusion of the relatively "few" replies had been considered, the overlapping nature of a number of the respondents, as well as the conclusion that they had no probative value resulted in the decision to exclude that data from the thesis.

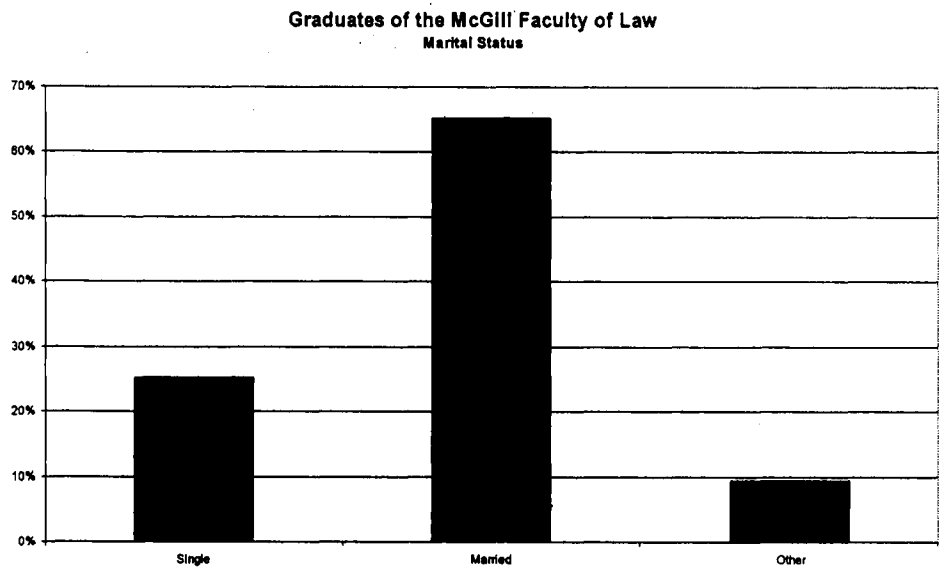
Appendix J

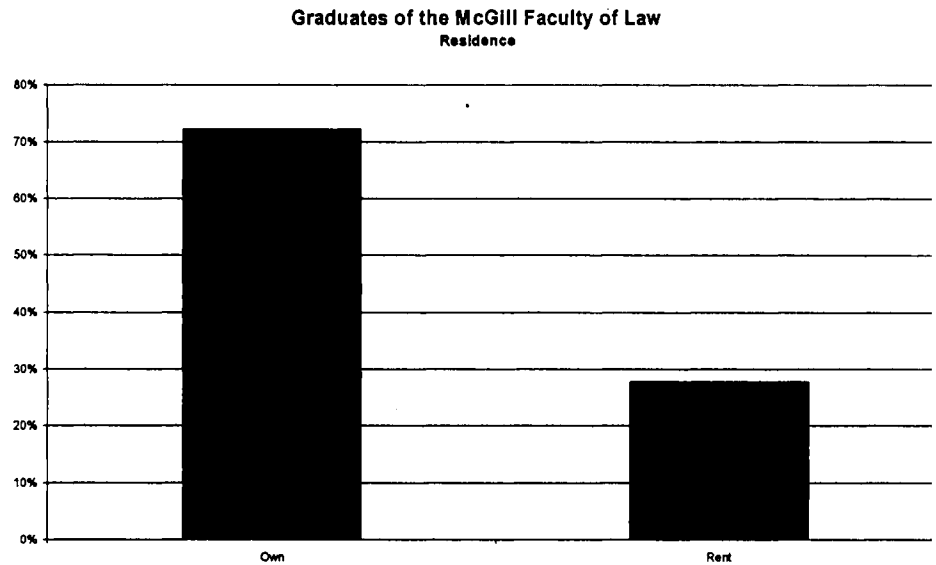
Demographic Information for Graduates of the McGill Faculty of Law

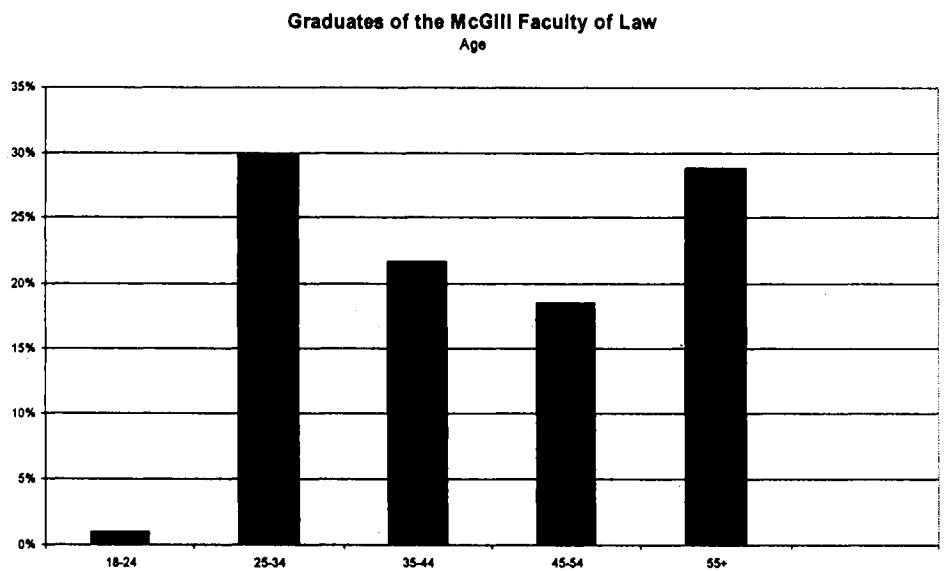
Appendix J seeks to provide, in visual form, an appreciation of the makeup of the respondents to the survey of the McGill Faculty of Law Graduates.

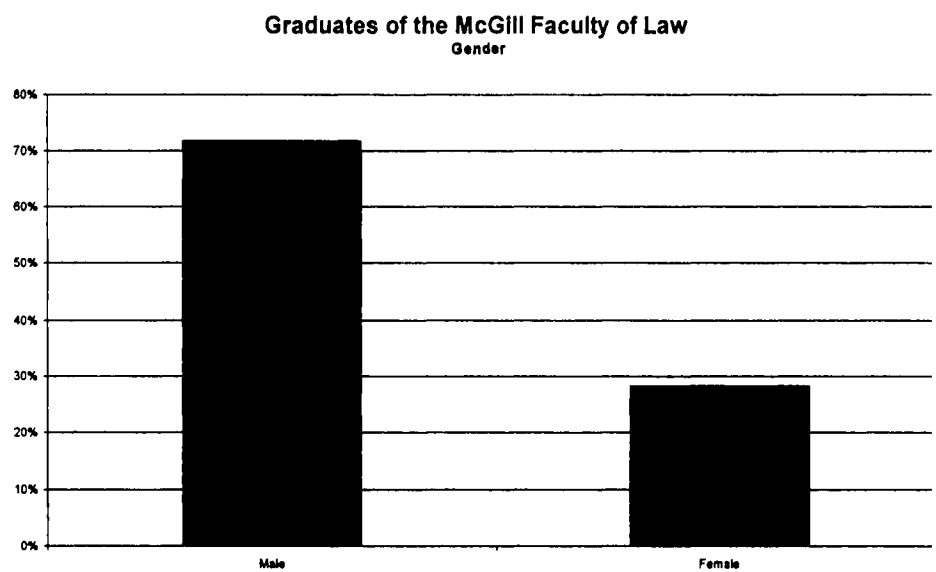
The largest number by group, own their own home, are male, are 25-34 years of age (with the second largest group being 55 and over), are self employed lawyers, have post graduate education and earn in excess of $150,000 a year. While a detailed analysis and attempted correlation of the views of respondents to the demographic data could serve to enlighten, it is nevertheless beyond the scope of the effort at this time.

APPENDIX I (1/2)

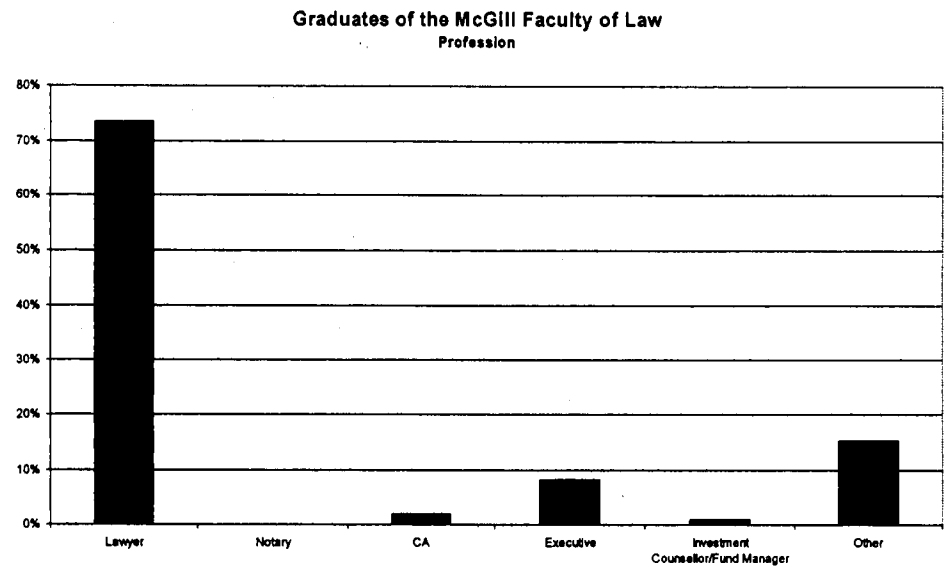


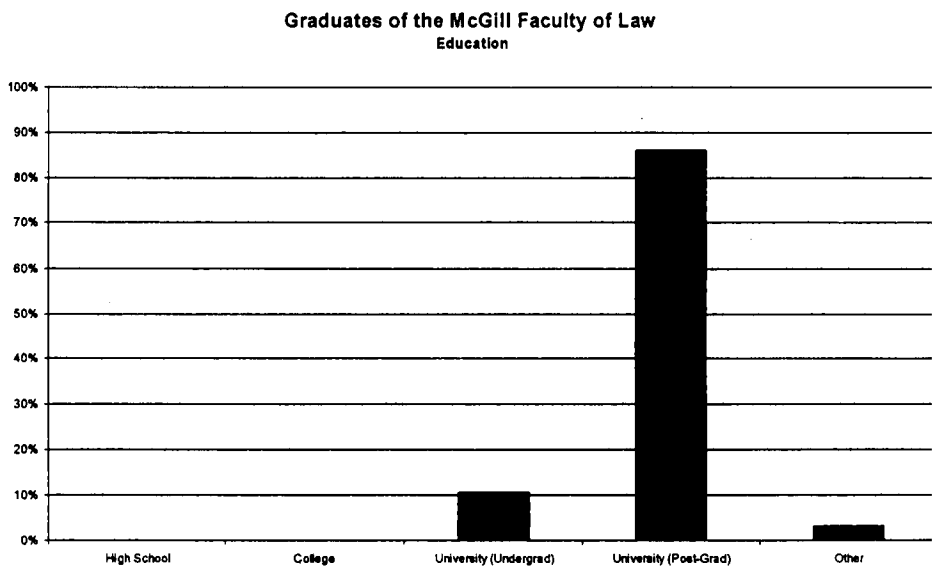


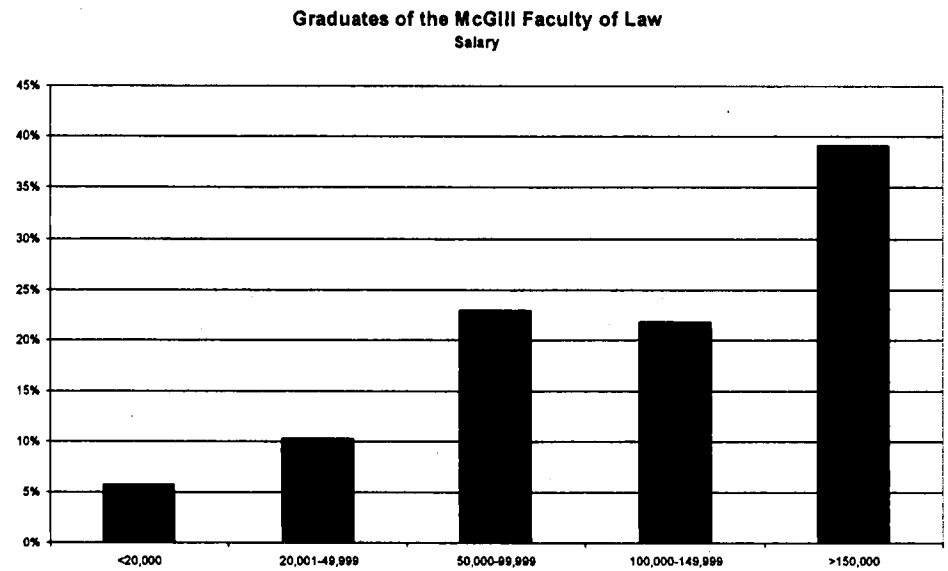


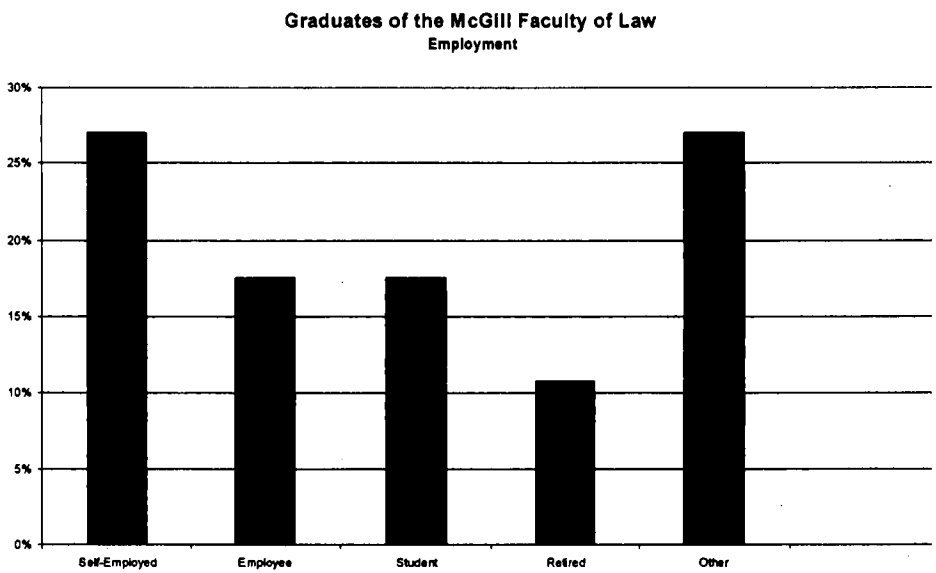


APPENDIX I (2/2)









Appendix K

Results of the DSI McGill Faculty of Law Graduates and CA Public Survey (PS)

Appendix K provides a pictorial overview of the results of the PS Survey of the three groups, the DSI, the graduates of the McGill Faculty of Law and Canadian Chartered Accountants (CAs). The numbers referred to at the bottom of the chart correspond to the statements, where the views of the interviewees were questioned.

The numerical information and the statements to which interviewees responded follows the chart in Appendix K.

Appendix K

Corporate Governance
Comparisons of Responses
(DSI, CAs and Graduates of the McGill Faculty of Law)
Public Survey (PS)

1. I currently own shares in one or more *publicly traded corporations.*	92.9	60.8	72.0
2. I currently own mutual funds that include shares of *publicly traded corporations.*	40.0	74.9	75.5
3. Over the next 12 months, I intend to purchase *shares of publicly traded corporations*, either directly or through the purchase of mutual funds.	92.9	72.7	79.0
4. I have a good understanding of corporate governance.	96.3	80.0	79.0
5. I understand, the differences between the role of *management*, and the role of the *board of directors.*	100.0	92.9	95.9
6. Primary responsibility for how a corporation performs rests with:			
- (a) the shareholders	7.0	14.2	18.6
- (b) the directors	35.7	83.3	69.7
- (c) management	67.9	94.9	87.4

*It is to be noted that if the neutrals (and no comments) had been excluded from the denominator in arriving at the percentage, the result would have been be marginally higher. Detailed information relating to the responses of the CA's and the graduates of the McGill Faculty of Law are included in appendices G and H, respectively.

2. Corporate Oversight			
7. I believe that *management of most publicly traded corporations* act in the best interests of their shareholders.	67.9	49.5	58.3
8. I believe that *management of most publicly traded corporations* act in their own best interests.	51.9	59.7	63.8
9. I believe that the *boards of directors of most publicly traded corporations* act in the best interests of their shareholders.	71.4	68.3	71.4
10. I believe *that boards of directors of publicly traded corporations*, should in fact be independent of management.	100.0	91.4	77.2
11. I believe *that boards of directors of most publicly traded corporations* are in fact independent of management.	38.5	20.9	33.0
12 I believe that the *external auditors* of a publicly traded corporation help protect the interests of shareholders.	57.1	79.9	68.4
13 I believe that *external auditors of a publicly traded corporation* help to give shareholders a fair picture of the true financial position of the corporation.	42.9	82.3	61.9
14 I believe that *external auditors of most publicly traded corporations* act independently of management to help protect the interests of the shareholders.	37.0	70.1	58.1
15 I believe that *the regulators of publicly traded corporations* (that is the governments, security commissions & stock exchanges) are doing an effective job in protecting the interests of investors.	32.1	46.3	36.7
16 I believe that *the media* are trustworthy in their reporting of the affairs of business.	25.0	20.0	29.3

	Executive Compensation			
17	I believe that *management of for profit publicly traded corporations* are compensated appropriately.	48.1	37.2	33.0
18	*Stock options* are a form of compensation, that I understand. (If you disagree, you may omit to answer, questions 19and 20)	96.4	89.7	93.0
19	I believe that m*anagement compensation* should include "stock options".	53.6	54.5	45.8
20	I believe that *director compensation* should include stock options.	11.1	28.2	30.5

	Stocks			
21	I believe that *Chief Executive Officers* of most for profit publicly traded corporations are honest and can be trusted.	67.9	53.8	54.2
22	I have confidence that *stock markets* generally operate effectively and fairly.	48.1	56.0	52.0
23	I believe that ***corporate governance*** (*that is the rules and processes that apply to how a "for profit corporation" should be managed*) serves to protect the shareholders.	57.7	76.7	61.6

Demographic Information – Please tick ALL replies that are applicable.		(Confidentiality-see note 3)
Age:	❑ 18 to 25 ❑ 25 to 34 ❑ 35 to 44 ❑ 45 to 54 ❑ 55 and over	
Gender:	❑ Male ❑ Female	
Marital Status:	❑ Single ❑ Married ❑ Other	
Residence:	❑ Own ❑ Rent	
Education:	❑ High School ❑ College/Cegep ❑ University Undergrad ❑ University Post Grad. ❑ Other	
Profession		❑ Lawyer (or) ❑ Notary ❑ Chartered Accountant ❑ Business Executive ❑ Investment Counselor /Fund Manager ❑ Other
Employment:		❑ Self-employed ❑ Partner in a professional firm that includes publicly traded companies as clients ❑ Employed in a professional firm that includes publicly traded companies as client ❑ Employed in industry ❑ Private company ❑ Publicly traded company ❑ Employed in government ❑ Employed in academia ❑ Student ❑ Retired ❑ Other
Salary:		❑ < $20,000 CAD ❑ $20,001 to $49,999 CAD ❑ $50,000 to $99,999 CAD ❑ $100,000 to $149,999 CAD ❑ over $150,000 CAD

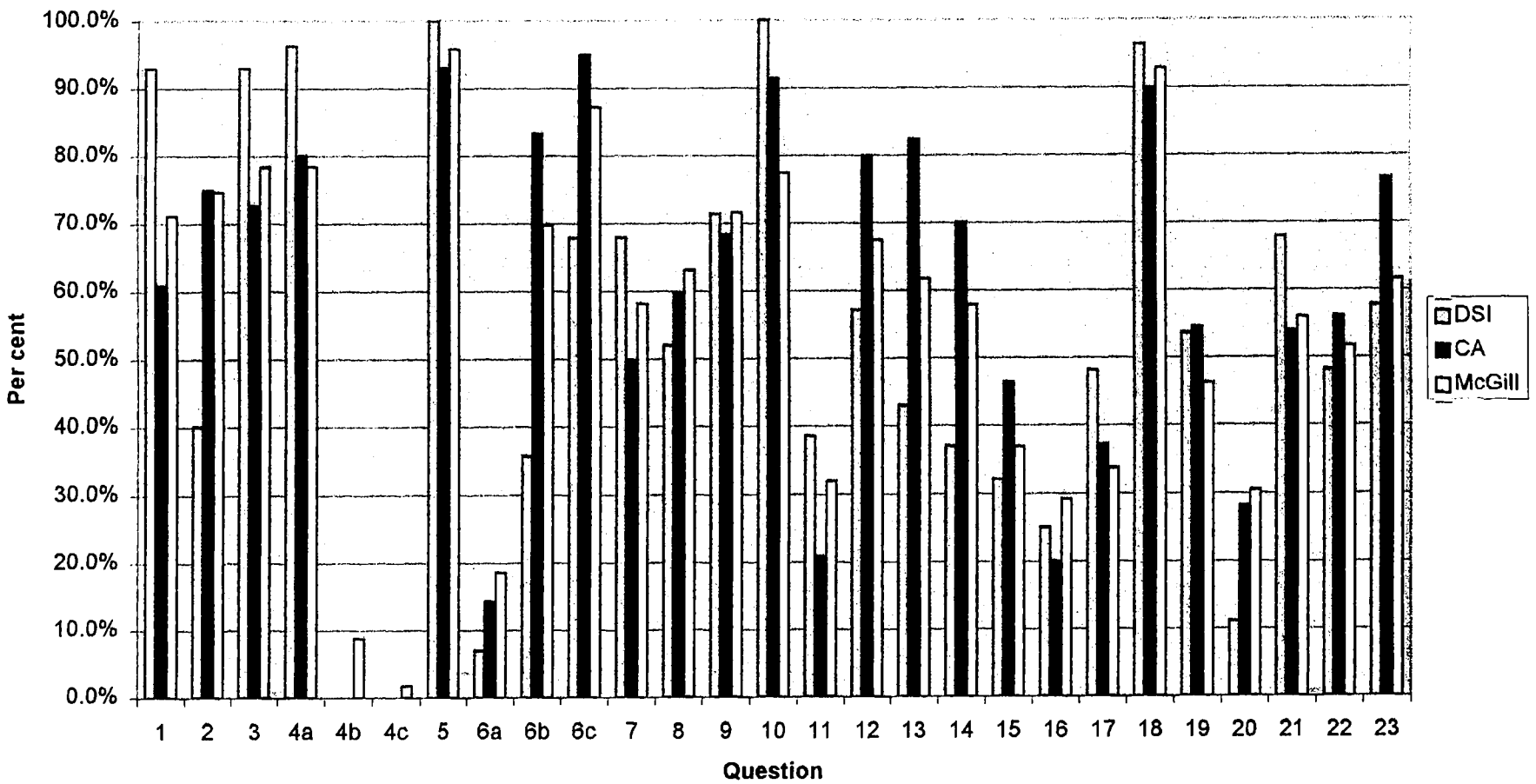
NOTE:

1. Please feel free to add any comments that you wish, concerning corporate governance, and return it, with this survey.
2. Thank you for taking the time to fill out this survey.
3. All individual replies will be treated as confidential and your identity, or individual reply, will not be publicly disclosed.

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TABLE K
PS Surveys
Consistency of Results
DSI, CAs & Graduates of the Mcgill Faculty of Law

[The Numbers above "Question" [below], correspond to the questions in the PS Survey]



Appendix L

Comparative and Competitive Rationality

Actions of boards of directors within widely held publicly listed corporations generally are bounded by the appearance of rationality. However, the *funneling syndrome* and *comparative* and *competitive rationality* enable board members to be directed, inadvertently or intentionally, in a desired, often irrational direction.

Constrained by time (both their own, given other commitments and that which is available to reach decisions at board meetings) as well as the information flow (constrained as it is by the *funneling syndrome*), directors react to what is before them. A case in point is compensation; comparative and competitive rationality serves to rationalize pay increases that on an absolute basis may well not be justified.

A simple example serves to illustrate the point. CEO of corporation A is paid 20 % less than CEO of Corporation B. With the required disclosure of compensation, it becomes readily apparent to CEO of corporation A, that even though his corporation is roughly equal in size to corporation B, he is being paid 20% less, which he argues is irrational. Convincing those who will have to decide his compensation that he is being unfairly treated (on a relative basis), CEO of company A indirectly assists in getting his compensation into line with corporation B. However, once this occurs and is made public, the CEO of corporation B takes the position that he has always been paid (and of course should be paid more than corporation A, for a variety of subjective reasons). To maintain the relative compensation scale, he should be kept at a 20% differential; the result is that to keep him whole, he should receive a 40% increase, as only by taking such action will his relative pay scale be preserved. (This of course becomes an ongoing repetitive process)

If corporation A, then goes out to hire a replacement CEO, the potential hire, other things being equal, will not leave his current employer (with all the certainty that being an incumbent entails) for the uncertainty of a new position, without being compensated

accordingly for the additional risk. As a result, company B may have to pay the new CEO 40 % more than the former CEO of corporation B, to attract the new CEO. Applying the former oversimplification, the CEO of corporation A will then seek a 40% increase, arguing comparative and competitive rationality (supported by "independent outside consultants") justifies such increases.

In a free market, one can argue that supply and demand should set the pay scales of corporations; however, given the absence of the competitive constraints that serve as checks and balances in the market place, alternative checks and balances are required as a proxy for the market. One such alternative is to require total compensation of the CEO (and board members) of a corporation (as well as annual increases) to be subject to prior shareholder approval. As a result, there would be a need to explain, justify and defend the compensation treatment of the CEO to the shareholders. Should the shareholders artificially constrain the compensation, then market forces could prevail and the corporation could end up losing the CEO; however, one must question whether it is really the CEO's that run the corporation or whether others within a corporation (or outsiders) could not rise to meet the challenges. While it is understood that this approach, based on the interviews carried out, does not engender great support, it is nevertheless suggested that effective checks and balances on the captains of ships of commerce are required, if we continue to believe that corporations represent private as opposed to public capital and, if as is postulated herein, being a shareholder is still being an owner of property.

Appendix M

Matrix to Assess Views on Proffered Legally Mandated Tools of More Effective Corporate Governance

Appendix M includes the matrix that was designed to assess the views of interviewees, on proffered legally mandated tools of more effective corporate governance.

Four steps were followed in this process (which was conducted in person and only with a limited number of interviewees).

Firstly, principles were advanced and the interviewees were asked to agree, disagree or to comment on the posited principles.

Secondly, a "postulate" was advanced and a similar reaction was requested.

Thirdly, interviewees were asked to consider the 38 "tools of more effective governance" that were being advanced (it being suggested that these be legally implemented) and to indicate whether in the respondent's view, they related to "competence, integrity or accountability" (or to more that one of the foregoing).

Lastly the interviewees were asked to indicate how important they believed each of the 38 matters were with 10 being assigned to those that were viewed as being most important and 0, being attributed to matters that were viewed as being of no importance. Where a 0 was assigned, no answer to the question relating to "competence, integrity or accountability" was required nor requested. The results of this exercise are reported upon in the thesis in Chapter 10.

DCL LEGALLY MANDATED TOOLS OF MORE EFFECTIVE CORPORATE GOVERNANCE

The tools outlined below relate to which of the following?

Degree of importance

Indicate the degree of importance that you would attribute to each tool.

	Competence	Integrity	Accountability	Highest ... No importance
1 The CEO and the Chairman should not be the same individual.				
2 Directors and officers should be required to to provide and certify that self-descriptiona included annually in the proxy statement provides true full and plain disclosure, of all personal information that may be relevant to a shareholder, objectively det				
3 Directors should have access to independent advisors who do not otherwise act for management of the Corporation and the use thereof publicly disclosed (at least annually).				
4 Directors should have direct access to alternative sources of information (other than as obtained from management) by meeting with key suppliers, customers, analysts, etc. and this information should be reported to shareholders at least annually.				
5 A professional corps of directors should be created with the assistance of institutional investors and the overview of the regulator?				
6 Public disclosure should be required if a professional director is supported by any institution, vested interest group or other shareholders.				
7 Board membership should be time, as opposed to age limited (e.g. to a maximum of 10 years) - Any deviation from the limit must be subject to public dislosure and receive board approval.				
8 The position of Chairman of the Board should be limited to no more than five, one year terms.				
9 Management should not be members of the Board of Directors of the Corporation while employed by the corporation				
10 Management should not be members of the Board of Directors of the Corporation post retirement from the Corporation				
11 The Director appointment process should be controlled by the Board of Directors and not management				
12 Individuals in a potential conflict of interest should be disqualified from accepting a board position until the potential conflicts are no longer applicable				
13 There should be a limit, established by the Board of Directors, as to the number of boards that each director should be permitted to sit on (whether private, public, government or other); the rationale for such limit should be reported to the shareholders				
14 Officer compensation should be determined by, and under the supervision of, the compensation committee of the board with the Board of directors (as opposed to management) retaining the "independent outside advisors" and all decisions and process should be				
15 CEOs of other corporations should not sit on compensation committees.				

16 Stock options (or any successor thereto) should not be capable of being exercised or realized until one complete accounting cycle after the retirement of an officer unless expressly approved by the Board of Directors and prior public announcement is made			
17 All conflicts of interest affecting directors (and officers) should be publicly disclosed including how they have been resolved and on a prescribed form, *ex ante*, whenever possible, and the accuracy thereof certified by the affected directors (and officer			
18 Directors and officers should be precluded from deciding matters when they are in an actual or potential conflict of interest.			
19 Where all directors are in a conflict of interest, any such proposed actions should be subject to shareholder approval.			
20 Any action that can serve to prevent takeovers should be subject to clear disclosure (as entered into and on an annual basis) and should be capable of being set aside promptly and unequivocally by the shareholders.			
21 Advisors to the Board of Directors should not be permitted to also serve management except in very exceptional circumstances, with prior Board of Director, approval and with public disclosure of the fact that this is taking place and the reasons for such			
22 Mandatory rotation of the firm of external auditors should be required; exceptions should be subject to regulatory approval and a public process.			
23 Shareholders should elect (as opposed to confirm) the auditors.			
24 Shareholders should elect (as opposed to confirm) the directors.			
25 Shareholders should be permitted to cap individual total executive compensation to a maximum dollar amount.			
26 Information when certified personally by directors or officers should, if erroneous, result in the applicability of PAR*			
27 External auditors should be accountable to the shareholders.			
28 Investment analysts should be accountable to shareholders/investors.			
29 Restatement of financial statements should result in the automatic applicability of PAR to the CEO and CFO, the external auditors and members of the audit committee unless their continued retention is recommended by the Board of Directors (excluding those			
30 AGM should require directors and management to report *ex ante* to the shareholders in person and through the disclosure material:			
a Objectives for the upcoming year.			
b Whether management achieved prior year's objectives.			
c Any conflict of interest and how they were resolved.			
d Proposed increases in director compensation.			

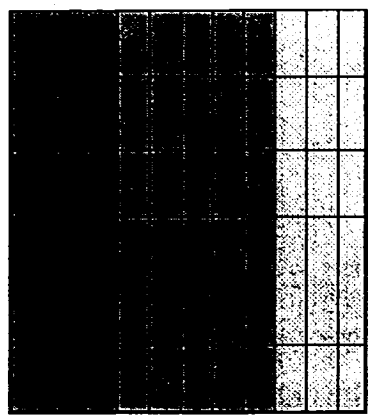
31 Proposed cap for total maximum individual compensation for officers of the Corporation for the upcoming year.

32 External auditor's role should be changed to provide more meaningful information to investors/shareholders.

33 Directors should be require to hold a meaningful number of shares in the corporation.

34 Resignation or failure to reappoint a director should be accompanied by a press release highlighting the reasons for the resignation with PAR applying to the director and the board for a failure to provide true, full and plain disclosure.

35 Corporations should be required to meet minimum standards to facilitate "whistle blowing"



In your opinion, what percent of current abuse is curtailed by tools of corporate governance that are currently legislated in Corporate and Securities law?	

* PAR should result in the disgorgement to the benefit of the Corporation when a directors or officer fails to meet a statutory obligation and/or allows himself (herself) to benefit inappropriately due to acting in self interest as opposed to Corporate inte

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DCL: Principles	Agree	Disagree	Comments
Conflicts of interest need to be effectively and transparently dealt with.	☐	☐	
The funnelling syndrome* needs to be circumvented to enable members of the Board of Directors to have access to unfiltered information.	☐	☐	
PAR** (personal accountability and responsibility) should be applicable where self interest benefits the individual (be it the directors, officers or external advisors) at the expense of the investing public (including shareholders of the Corporation).	☐	☐	
DCL Postulate:			
CIA (competence, integrity and accountabilty) on the part of directors and officers are necessary preconditions to more effective corporate governance.	☐	☐	