A Basic Primer on Organizational Governance

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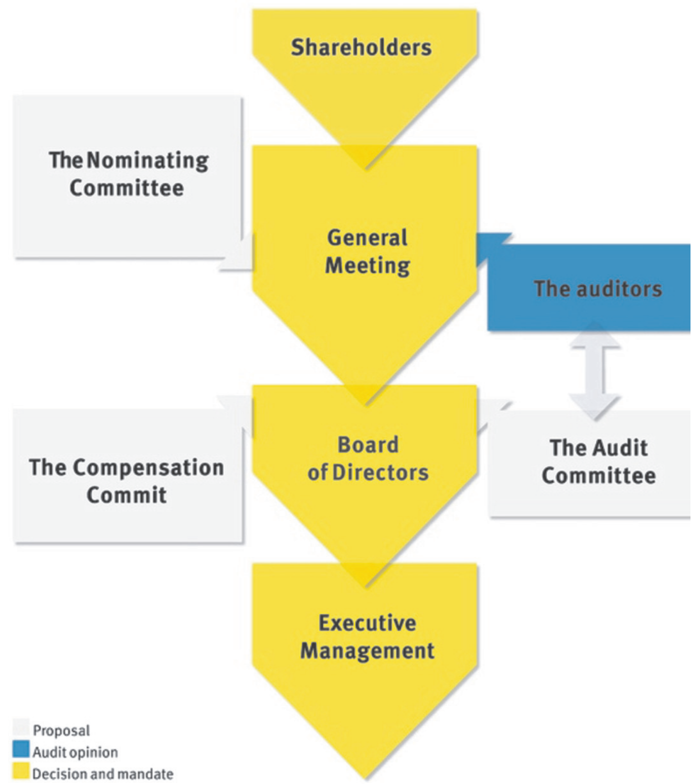
There has been a sea change in the attitude to corporate governance in the past decade. Perhaps it has been less of a revolution and more of a realization that the old back-scratching order of long lunches, rubber stamps, and incestuous intra/inter board relationships are not robust enough to fulfill the stewardship mandate that rests with boards of directors. This has been thrown up due to a number of grievous corporate failures over the past couple of decades which have spawned a number of reports including the Dey (1994), Cadbury (1992), and King (1994) reports. This is more a realization rather than a revolution because the basics have always been there but have been forgotten over the years. It took a number of dramatic corporate failures for the business community to remember the basics, and it is to these that this essay will turn. These failures of corporate governance and their aftermath are not restricted to large operations but occur at all levels of organizational endeavour. Hence an understanding of good corporate governance is germane to all organizations, big and small, as the author has discovered to his chagrin.

Robert Tricker (2009) noted that "if management is about running the business, governance is about seeing that it is run properly" or it is "the system by which organizations are directed and controlled" as Adrian Cabury (1992) noted. This suggests an oversight or stewardship role which is exactly at the heart of the governance function. Before elaborating further on the governance function itself, it might be useful to examine exactly where a board of directors fits in the broader arrangement of a corporate organization. To develop this understanding we will look to the agency theory of corporate organization.

AGENCY THEORY

The agency theory of corporate governance refers to the liaison function that a board of directors plays between the principals of an economic enterprise, i.e., shareholders, community or investors, and the management which has been charged with bringing the goals of the principals to fruition. Agency theory basically states that a board is there to arbitrate between the varying interests that develop between the principals of a company and the management. The board is seen as both the galvanizing force to affect the principals' interests through management and the arbitrator between the principals and management, both of

FIGURE 1
The Corporate Governance Process



whom may have different interests and strategies. This contrasts with management theory which suggests that management, and particularly the chief executive officer (CEO or ED), is in charge of corporate direction while the board and shareholders act as subservient or support players.

Agency theory suggests that a group's principals (entrepreneurs, shareholders, community, investors) come together to carry out some enterprise. The people who are charged with affecting the enterprise are management. The liaison or agent between the two is the board of directors. The principals inform the board of the raison d'être of the enterprise. The board then acts as the principals' agent in creating a strategic plan to affect the raison d'être which it hands to management who wrap a business plan around it for board approval. Once approved, management puts the plan into action and reports back periodically to the board on progress. The board in turn reports back to the shareholders on a less periodic basis: at least once a year and, at times, quarterly. So the direction of the enterprise flows from the principals through the board to management who report back on up the chain. Such is agency theory and the basis for our current corporate governance model.

The board then acts in a stewardship role in the agency model. In making their decisions in this model the board may have divided responsibilities. Should it be acting in the best interests of the corporation or those of the principals? In this matter Canada and United States diverge. In the U.S. model, the board is responsible to the principals or shareholders. In Canada, however, the board is primarily responsible to the corporation and this responsibility is enshrined in the Canada Business Corporations Act, R.S.C. 1985, c. C-44, ss. 122(1): "act honestly and in good faith with a view to the best interests of the corporation". It seems odd to make this distinction. Common sense would suggest that the interests of the corporation would be the same as those of the principals. In general this is true, but not always. There are more occasions than you might think where acting in the best interests of the principals may not be in the best interests of the corporation. This can happen when a dominant principal wishes the corporation to embark on a course which would benefit that principal but may be a detriment to or at least not be in the interests of the corporation. This most often happens in closely held companies. This can place directors in an uncomfortable situation when they are asked to decide on a matter in the interests of the corporation and against those of the principals who appointed them in the first place. Directorships can be uncomfortable.

THE ROLE OF THE BOARD

The role of the board of directors as agent between the principals and management is at once simple and complex: simple in that the responsibilities are few, complex in that the responsibilities, particularly monitoring, are complex. A board has three functions as follows:

- Strategic planning
- Hiring, firing, compensating, and evaluating the chief executive officer (CEO) or executive director (ED)
- Monitoring management in their accomplishment of the strategic plan

In attending to these responsibilities, the board has one employee, the CEO/ED.

Strategic planning

Strategic planning is undertaken by the board to provide the broad brush strokes of direction to management. Do not confuse a strategic plan with a business plan. The strategic plan is a simple document — the primary meat of which is the vision and the mission of the enterprise. The vision is the "blue sky" but not unrealistic place where the corporation would like to be or what it would like to accomplish in the long run. The mission is shorter term, and its realization should move the corporation towards the vision over a period of up to five years. Attached to the plan can be specific objectives and goals. These can come from either the board or from management when it wraps a business plan around the strategic plan. An important aside to the strategic planning process is the ethical framework by which it is to be accomplished. It is the board's responsibility to set the ethical tone from the top as a guide to management so that it does not wander into areas of questionable social responsibility. This tone can be hard-wired with a code of ethics document supplemented further with a statement of values. The code and the values documents should be widely circulated in the organization so there is no mistake as to the framework in which the strategic plan is to be consummated. With the strategic planning function completed the CEO/ED then prepares a business plan to see the strategy implemented. This plan, together with relevant budgets, capital expenditures, and other significant plans of action must be approved by the board. After approval, any significant deviation should be brought to the board. The rigorous function of strategic planning is only undertaken every five years or so, but it should be subject to annual reviews as to its continuing relevancy.

The CEO/ED Function

With a strategic plan in place it then becomes necessary to hire a CEO/ED to implement the plan if one is not already in place. This needs to be done with due care and great reflection as a bad hire can be devastating for a corporation. The CEO/ED is the only employee of the board. Along with the hiring function comes the firing function should the CEO/ED not be meeting the standards of the board. This necessarily means that there needs to be a formal evaluation process in place. If the board feels uncomfortable doing so or lacks the necessary skills then it should hire an appropriate consultant. Finally, a fair compensation package needs to be negotiated which encourages performance in the direction of the strategic plan. The details of the compensation package should be carefully designed to align with the strategic plan. A compensation consultant can be of value here.

Monitoring

The monitoring role of the board is the most time consuming and complex function it has to perform. In order to maintain maximum effectiveness in this area the board should be ruled by the maxim NIFO or the "nose in, fingers out" rule. In other words, monitoring is done at a polite distance. Although it is incumbent on the directors to be asking questions that does not mean disrupting operations or lines of authority through micro-management. Queries should go through the chair and thence to the CEO/ED. While it is appropriate for directors to familiarize themselves directly with operations, it should be done with knowledge of the CEO/ED, and with any critical observations shared with the board and CEO/ED and not more generally.

The most powerful tool that a director has is asking questions, and questions need to be followed up until satisfactorily answered. New directors are often told that they should keep quiet for the first year or so until they get their feet wet. This is not so. New directors should feel comfortable to make as many inquiries as they feel necessary, and the chair should encourage this. New directors mean a fresh outlook and that outlook is best utilized by the board through the questions they raise.

Beyond the caution of maintaining a polite distance and the encouragement of questions, boards can fulfill their monitoring function with a number of tools including:

- The board package: This is the primary information source for the board and is requisite for all meetings. It provides relevant briefings and background information on the agenda items. These materials need to be in the directors' hands in sufficient time to allow the directors to properly review and comprehend the essence of each agenda item. If this package is consistently late or incomplete, that is a danger signal in itself.

- The orientation package: This should provide new directors with a comprehensive review of the corporation, its values, ethics, operations, finances, policies, individual and broader responsibilities, and so on. Although it is permissible for management to prepare this orientation package, it is important that it be reviewed by the board to ensure that the orientation indeed aligns with the strategic plan and the wishes of the principals. When considering joining a board, look at this package. If it is lightweight or, worse still, non-existent, this is a danger signal and you may want to think twice before joining. The same is true of the board packages. If these are lightweight, you may want to move on to a better managed board.

- Risk assessment: The board needs to understand the risks that the corporation faces, and, in particular, what are the mitigating strategies should one of the risks materialize or increase to the point where there is a negative impact on the corporation. This is a document that should be reviewed and updated annually. The risks so noted should form part of the directors' peripheral vision so they remain aware of them and can report back any relevant intelligence gleaned from non-board activities. Risks include financial, reputational, operational, environmental, legal, regulatory, and so on.

- A two-year rolling agenda of board meetings: This provides directors with relatively fixed dates to allow them to make time on their personal agendas and so be able to attend meetings. More importantly, it ensures that items which are only addressed periodically (annual risk assessment review, strategic plan review, CEO/ED evaluation, business plan and budget, board self-evaluations, and so on) don't get missed. This also allows both directors and management to begin thinking about relevant topics in a timely fashion.

- Reports: The reports contained in the board package form an important source of information.

- Internal audit function: Given a critical mass in size, there needs to be an internal audit function. In this case the staff head of the function reports to the board with, at best, a dotted line relationship to the CEO/ED and never to the chief financial officer (CFO).

- Audited financial statements: A prime source of information and comfort for the directors. The directors should supplement these statements with a management letter from the auditors as they can often spot practices needing improvement or areas of risk which may escape management. In order to ensure the independence of the auditors, their non-audit work for the corporation should be kept to a minimum. If the board has no other committees, an indispensable one is the audit committee. It needs to be populated by financially literate members who are independent of potential biases. A member of management, for example, would not be appropriate to serve on the audit committee however skilled she may be.

- Self-assessment and individual director peer evaluation: A valuable tool to remind directors of their responsibilities to the group and encourage those on snooze control to participate in a more robust fashion.

- Ongoing professional education: Such in matters of governance, finance, operational, economic, and similar topics further enhances the ability of boards to properly fulfill their monitoring obligation.

Standards of Performance

According to the Canada Business Corporations Act, and common ethical practice, the board is to "act honestly and in good faith in the best interests of the corporation". There is also a duty of loyalty. Any conflicts or potential conflicts of interest need to be stated with the relevant board members recusing themselves accordingly. There is also a duty of confidentiality. Finally, where irreconcilable differences occur, there is a duty to resign.

THE BOARD STRUCTURE AND HOW IT WORKS

The members of the board are selected by the principals pursuant to the recommendations of a nominating committee. In smaller organizations they are often simply shareholder or stakeholder representatives. In larger organizations they can include members of management providing that their number does not overwhelm the principals' representatives. In boards where there may be potential for unhealthy bias it is recommended that directors independent of either management or the principals be appointed. This is important to provide a balance of unfettered opinion, and their role on the audit committee is particularly important.

The board should be large enough to provide the cross section of skills necessary to fully fulfill the monitoring function of the board. It should also be large enough to populate the committees without over-burdening particular individuals. Finally, in the case of some corporations which have a large number of partnerships, there need to be enough board members to allow population of joint venture boards.

As far as officers are concerned it is generally best if members of management, who are board members, are not also officers of the board. A possible exception would be the position of secretary which can be occupied by the corporate council. Beyond the secretary, there is the chair and the treasurer, as would be expected.

Minimum Committee Structure

A board should have a committee structure to bring recommendations to the board and so economize on board time. Committees are useful in other ways as well. A smaller group with a focused mandate can be very effective. Committees can also ensure independence that may be harder to obtain at the board level. Any committee should be governed by a committee charter which delineates its structure, its specific mandate, accountability, responsibilities, how it is to operate, a decision making process, and an obligation to take minutes and report. There should be a minimum of two committees, Audit and Finance as well as Nominating and Succession.

To the extent possible, the Audit and Finance committee needs to have at the minimum financially literate members and, ideally, at least one professional accountant among them. This committee should also be populated by independent directors to the extent possible, and certainly never have any directors as members who are also part of management. This group of the board has the highest profile as far as reporting and potential liability is concerned; therefore, members need to be well schooled as to their obligations. The internal audit function, if one exists in the organization, reports to the audit committee. This committee also works closely with the external auditors for both the publishing of the year end results as well as any interim financial reports which may be necessary.

The Nominating and Succession committee is tasked with the recruiting of appropriate board members to fill board vacancies as they arise. You will note that it is called the Nominating and Succession committee to underline the fact that this not just a last minute duty before the annual general meeting (AGM) but really deserves on-going attention from the committee members as the success of any board depends on carefully planned succession. To fulfill its mandate, this team needs to pay attention to the following areas throughout its term in office:

- Take inventory of the board skills and compare them against an ideal skill set which will be discussed later under board characteristics and competencies.
- Strategize on how any current and future gaps can be filled. Review the strategic and business plans to determine if any special skills of oversight may be required.
- Put together a board succession plan.

This committee can sometimes be tasked with arranging for a CEO/ED succession plan in the absence of a formal human resource (HR) and Compensation committee. Within the bailiwick of this group is the orientation process for new board members. Although management plays a significant role in board orientation, the orientation should be controlled by the board to ensure that management biases do not creep in.

Other committees which you may find attached to the board include Personnel, Planning and Policy, Environment, Compensation, Governance, Risk, Information Technology, various ad hoc committees, and others as the particular circumstances of the corporation require.

Board Characteristics and Competencies

A well-balanced board is crucial to its success in strategizing and monitoring the activities of a corporation on behalf of its principals. As such, the officers and the nominating committee need to pay particular attention to the following attributes to ensure a well-functioning board:

- Integrity and accountability. As mentioned earlier, the board needs to set the ethical tone for the corporation, and these attributes are crucial in this regard.

- Informed judgment. Board members need to be able to exercise good judgment in an informed way. This means the ability to put aside old prejudices and exercise informed judgments based on existing circumstances and information. The old way of doing things is not necessarily the best way. You need broad-minded board members who are well rounded.

- Financial literacy. Financial literacy does not mean a professional accounting designation, but it does mean the ability to read a set of financial statements and particularly the notes attached thereto. Not every board member needs to be financially literate, but a good balance of them should be.

- Mature confidence. This is a difficult one to gauge. What this means is that the board member should be confident enough in his/her own self to ask questions that need to be asked and tough enough to see that they are answered satisfactorily. The mature aspect means being able to work in tough situations in a mature way, always respectful and not prone to flying off the handle. Confidence also means the ability to say no in appropriate situations. We might illustrate mature confidence by a quote from Mahatma Gandhi who said, "A 'no' uttered from deepest conviction is better and greater than 'yes' merely uttered to please, or what is worse, to avoid trouble." That is mature confidence.

- High performance standards.

- Experience in at least one of the following domains: accounting, finance, business judgment, management, crisis response, industry knowledge, marketing, leadership, strategy and vision, and risk management, together with any particular skills relevant to the corporation's operations.

Basic Governing Documents

The more clear that the responsibilities and requirements of individual board members and their committees are, the better functioning the board will be on an individual and aggregate level. Certain documentation beyond the strategic plan and the business plan helps in this regard:

- A board charter that clearly defines the board's roles and responsibilities and governance procedures by which the board's roles and responsibilities will be met.
- Job descriptions for the chair, secretary, treasurer, committee chairs, and directors at large.
- Committee charters outlining its structure, its specific mandate, accountability, responsibilities, how it is to operate, a decision making process, and an obligation to take minutes and report back.

The board charter differs from the by-laws of a firm in that the by-laws represent a legal document or set of rules. A charter on the other hand defines the board's roles and responsibilities as well as governance procedures by which the board's roles and responsibilities will be met, but it is not a legal document. The board charter will include at a minimum the strategic plan (mission, vision, values) along with the strategic planning function, decision making practice, performance monitoring and key indicators, individual member roles and responsibilities (chair, secretary, treasurer, committee heads, directors at large), commitment to professional development, committees, board evaluation, and other corporate specific elements of which the board needs to be aware.

What the Board Can and Can Not Do

Pursuant to 102(1), Part X of the Canada Business Corporations Act, the board has the "duty to manage or supervise management. Subject to any unanimous shareholder agreement, the directors shall manage, or supervise the management of, the business and affairs of a corporation." In practice the board delegates all operating matters to management and staff with the exception of the strategic plan and hiring/firing/evaluating/compensating the CEO/ED and monitors the results of this delegation. However, there are limitations on what the board can delegate and these follow:

- Issuing securities
- Declaring dividends
- Purchasing or acquiring shares in another corporation
- Recommending approval of annual audited financial statements
- Approving information circulars
- Approving take-over bids
- Adopting or amending by-laws which must later be approved by the shareholders or principals

Restrictions on board actions and reserved solely for the shareholders of a corporation are:

- Electing, appointing, and removal of directors
- Changes to the Articles of Incorporation
- Amalgamations
- Substantial disposal of corporate assets or outright dissolution

Where there are boards of partnerships or joint ventures, there are likely to be further restrictions on the actions of a board outlined in a unanimous shareholder agreement.

Liability Issues

The remit of this essay is not a detailed examination of director liability, but it would be negligent not to include an overview of this issue in any discussion on governance and boards of directors. Personal director liabilities vary from jurisdiction to jurisdiction, so it is best to seek legal counsel as to the specific liabilities which a director may face in a particular region. Although directors are not guarantors of corporate conduct, they nonetheless generally face liabilities in these broad areas:

- Unlawful act if they directed, authorized, acquiesced, permitted or concurred in the act
- Declared dividends when the corporation was insolvent
- Breach of occupational health and environmental regulations by the corporation
- Unpaid employee wages
- Creditor claims if the corporation continues to trade while insolvent
- Unpaid government obligations relating to payroll and GST/HST
- Possible derivative actions by stakeholders (though this requires the consent of the court)

The best protection to a director from personal liability is to clearly exercise the "duty of care" and due diligence. The best way directors can do this is to ask questions and satisfy themselves that the answers are reasonable. If the answers lack a ring of credibility then the board is entitled to bring in a second opinion from outside the corporation and board. As far as business judgment matters are concerned the courts will not hold directors liable for a mistake in business judgment so long as there is a clear record of them exercising due diligence. Make sure that minutes of the director meetings reflect the exercise of this "duty of care," particularly on subjects which may potentially blow up in the future. One way of ensuring that due diligence is undertaken in areas of specific director liability is to include as a regular agenda item an update from management on areas of possible liability as noted in the bullets above.

It is possible to purchase directors' and officers' (D&O) liability insurance, but this should not be seen as a universal panacea. For one thing, the directors have to continue to act honestly and in good faith. Liability insurance does not abrogate that duty. For another, the insurance may not cover what one might think it does. For this reason careful examination of the policy should be undertaken, particularly by new candidates for board appointment. Considerations in deciding on D&O insurance include:

- The cost
- Scope and deductibles
- Likelihood of a claim
- The need of insurance to attract good directors
- A severability clause that specifies individual rather than joint knowledge

There are certain areas which D&O insurance will not cover and you need to determine what these are. These deficiencies should then be covered off by indemnities from the corporation. In particular, the following items would likely need to be indemnified by the corporation:

- Blanket coverage of anything that insurance does not cover regardless of policy limits.
- Legal and other professional fees for defence of an action
- Cost of investigations, hearings, and inquiries.
- Cover hearings and similar events, whether compelled or simply asked to attend.
- Clarify who will engage any necessary counsel or professional help, i.e., the corporation or the director.
- All fees should be paid promptly without having to wait for sometimes lengthy insurance claims to be settled.
- In the event of a dispute the indemnity will cover all costs of determining indemnity before the courts.

Finally, D&O coverage and indemnification should not cease to cover you when you cease to be a director. Both the D&O insurance and indemnification should remain in force to cover you for the period you were with the board regardless of whether you have since left.

CONCLUSION

The foregoing should not intimidate aspirants and recruits to directorships. It will act as a good guide on how to make a directorship a fulfilling experience without getting tripped up in some of the potential problem areas. You don't have to be particularly skilled in any of the arts of business, but you do need to feel comfortable asking questions and satisfied that the answers being given are reasonable. If you feel uncomfortable with the information you are receiving or the actions being sanctioned by the board then you should resign. Otherwise, enjoy the wealth of the experience.

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