



Osgoode Hall Law School of York University
Osgoode Digital Commons

Articles & Book Chapters

Faculty Scholarship

2003

The Canadian Outside Director: Great Expectations

Warren Grover

Osgoode Hall Law School of York University

Follow this and additional works at: http://digitalcommons.osgoode.yorku.ca/scholarly_works



This work is licensed under a [Creative Commons Attribution-Noncommercial-No Derivative Works 4.0 License](https://creativecommons.org/licenses/by-nc-nd/4.0/).

Recommended Citation

Grover, Warren. "The Canadian Outside Director: Great Expectations." *Canadian Business Law Journal* 38.3 (2003): 349-366.

This Article is brought to you for free and open access by the Faculty Scholarship at Osgoode Digital Commons. It has been accepted for inclusion in Articles & Book Chapters by an authorized administrator of Osgoode Digital Commons.

THE CANADIAN OUTSIDE DIRECTOR: GREAT EXPECTATIONS

Warren Grover*

I. INTRODUCTION

The Final Report of the Joint Committee on Corporate Governance,¹ following the Dey Report,² recommended that the Canada Business Corporations Act (CBCA) should be amended to make it clear that directors do not need to manage the business and affairs of the corporation, as the CBCA used to provide, but should be responsible to supervise the management of the business and affairs of the corporation, which is now the wording of the relevant provision in the CBCA.³ The Saucier Report then went on to identify the five core functions that the board of directors should be explicitly responsible for:

- (1) Choosing the chief executive officer and ensuring that the senior management team can successfully manage the corporation.
- (2) Setting the parameters within which the management team operates.
- (3) Coaching the management team.
- (4) Monitoring the performance of the CEO and setting the CEO's compensation.
- (5) Providing assurance to stakeholders of the integrity of the reported financial performance.

* Falconbridge Professor in Commercial Law at Osgoode Hall Law School, Toronto and partner emeritus at Blake, Cassels & Graydon LLP. This is the revised version of comments on Chris Nicholls' paper "The Outside Director: Policeman or Policebo?" delivered at the 32nd Annual Workshop on Commercial and Consumer Law, held at the Faculty of Law of the University of Toronto on October 18 and 19, 2002. The revised version of the Nicholls paper precedes this article.

1. Joint Committee on Corporate Governance, Final Report, *Beyond Compliance: Building a Corporate Governance Culture* (TSX, CICA, November 2001) (hereafter Saucier Report).

2. 1994 Toronto Stock Exchange Committee on Corporate Governance in Canada entitled "Where Were the Directors? Guidelines for Improved Corporate Governance in Canada".

3. Canada Business Corporations Act, R.S.C. 1985, c. C-44, s. 102(1).

According to the Saucier Report, boards must have the capacity, independent of management, to fulfil these responsibilities. To accomplish this, boards need strong members independent of management with an appropriately diverse set of skills. These directors are defined as "outside directors".⁴

In this article I will assume that such individuals can be found in sufficient abundance to fill the majority of the seats on the boards of Canadian corporations traded on the Toronto Stock Exchange (TSE), as mandated by the Saucier Report. I will comment on five concepts that I consider most important, namely disclosure, liability, the audit committee, remuneration and insider trading. Before proceeding with those five matters I touch on two concepts that I believe drive Canadian considerations of these problems.

The first concept is that it is generally agreed that publicly traded Canadian corporations are mainly controlled by one person or a small group of persons. In 1991 Ron Daniels and Jeffrey MacIntosh stated that only 14% of the companies listed on the TSE 300 were widely held; 60.3% were controlled by a single shareholder or group of shareholders with legal control and 25.4% were controlled by a single shareholder or group of shareholders with effective control. This contrasts with the Fortune 500 where 63% were widely held.⁵ At a rhetorical level, when considering directors' duties of loyalty and care, Ed Iacobucci opines that "negligence seems unlikely, but violations of the fiduciary duty do not, where there is a controlling shareholder".⁶ On the other hand Daniels and Ed Waitzer stated that "the long-standing American concern with shareholder capacity to discipline managers for self-indulgent conduct is less relevant in a Canadian setting".⁷ Whatever the theory, the CBCA says that shareholders elect the board of directors⁸ and

4. Saucier Report, *supra*, footnote 1, at p. 5.

5. R. Daniels and J. MacIntosh, "Towards A Distinctive Canadian Corporate Law Regime" (1991), 29 Osgoode Hall L.J. 863, repeated in R. Daniels and E. Waitzer, "Challenges to the Citadel: A Brief Overview of Recent Trends in Canadian Corporate Governance" (1994), 23 C.B.L.J. 23 at p. 26. See also E. Iacobucci, "A Wise Decision? An Analysis of the Relationship Between Corporate Ownership Structure and Directors' and Officers' Duties" (2002), 36 C.B.L.J. 337 at p. 356.

6. Iacobucci, *ibid.*, at p. 367.

7. Daniels and Waitzer, *supra*, footnote 5, at p. 26. Put another way, a controlling shareholder will make sure management takes care of the majority shareholder and therefore the conflict is fairness between controlling and minority shareholders, not accountability of the management to shareholders generally.

8. CBCA, s. 106(3).

shareholders, by a simple majority, may remove any director.⁹ Controlling the board of directors implies control of officers, since directors appoint the officers.¹⁰ Coupled with this concept of concentrated control is an abundance of subordinate voting shares¹¹ so that the controlling group may, in fact, have a relatively small percentage of the market capital.¹² Subordinated voting shares impact the ability to oust inefficient management.¹³

The second phenomenon that I believe exists, but is harder to prove, is that Canadian regulators make a lot of rules but seldom appear able to enforce them. Making the rules will likely result in a majority of those affected obeying the rules, although excessive speeding on Ontario highways seems to be the norm, in sharp contrast to jurisdictions where effective enforcement is practised. The CBCA provides that every person who contravenes its provisions or regulations for which no punishment is provided is guilty of an offence punishable on summary conviction.¹⁴ Similarly a person who makes an untrue statement of a material fact in any document required by the Act or regulations to be sent to the director or any other person is liable to a fine or imprisonment.¹⁵ No attempt to enforce these sections has ever been made. The lack of effective enforcement by the Securities Commissions is also apparent, as the Livent, Bre-X and YBM scandals demonstrated. Insider trading is not

9. CBCA, s. 109(1). Note that s. 6(4) does not allow for a greater number of votes to be put in the articles of incorporation.

10. CBCA, s. 121 — Often the controlling shareholder is herself the chief executive officer and may well pass the position down to the next generation when the controlling shareholder retires. For example, Belinda Stronach has succeeded her father, Frank, as head of Magna International Inc. and Edward Rogers Jr. will now head the cable company named after his father. It is not clear if provincial securities law can require independent directors in light of the clear provision of the CBCA, as the selection of directors is corporate law and not related to buying and selling of securities: see *Multiple Access Ltd. v. McCutcheon* (1982), 138 D.L.R. (3d) 1, [1982] 2 S.C.R. 161.

11. The Toronto Stock Exchange differentiates multiple voting, subordinate voting, restricted voting and non-voting.

12. For example, Rogers Communications Inc. has about three times as many non-voting as voting shares whereas at Magna International Inc. the ratio of subordinate voting to voting shares is about 80:1.

13. See for example, *Pente Investment Management Ltd. v. Schneider Corp.* (1998), 113 O.A.C. 253, 42 O.R. (3d) 177 *sub nom. Maple Leaf Foods Inc. v. Schneider Corp.* (C.A.); *Bowater Canadian Ltd. v. R.L. Crain Ltd.* (1988), 62 O.R. (2d) 752, 46 D.L.R. (4th) 161 (C.A.).

14. CBCA, s. 251.

15. CBCA, s. 250.

dealt with effectively by either the regulators¹⁶ or through civil actions.¹⁷

II. DISCLOSURE

One of the key corporate functions where an outside director can assist both management and stakeholders is by trying to ensure that all disclosure by the corporation reflects good communication skills. Disclosure is seen as an essential touchstone of appropriate corporate governance.¹⁸ Yet the concept of how to disclose as opposed to what to disclose is seldom discussed, other than to say disclosure must be "full, true and plain".¹⁹ It is at least arguable that the present disclosure by corporations is inadequate as a meaningful communication to shareholders. The ability of most investors to read and understand the financial statements is scant, yet such statements are a mainstay of corporate disclosure.²⁰ In order to enhance investor understanding of the issuer's business the regulators have required the issuers to provide a supplemental disclosure known as the Management Discussion and Analysis (MD&A) to accompany

-
16. The recent criminal fine paid by way of plea bargain by Michael Cowpland and the subsequent Ontario Securities Commission decision, *In the Matter of M.C.J.C. Holdings Inc. and Michael Cowpland*, Feb. 12, 2002, are much in point.
 17. *Green v. Charterhouse Group Canada Ltd.* (1973), 35 D.L.R. (3d) 161, [1973] 2 O.R. 677, affd 68 D.L.R. (3d) 592, 12 O.R. (2d) 280 (C.A.); *McIntyre Porcupine Mines Ltd. v. Hammond* (1975), 119 D.L.R. (3d) 139, 31 O.R. (2d) 452 (H.C.J.) (U.S. statute of no effect in Canada); *Bell v. Source Data Control Ltd.* (1988), 53 D.L.R. (4th) 580, 66 O.R. (2d) 78 (C.A.); *Dusik v. Newton* (1983), 1 D.L.R. (4th) 568, 48 B.C.L.R. 111 (C.A.). One of the few successful civil prosecutions was *Tongue v. Vencap Equities Alberta Ltd.*, [1996] 6 W.W.R. 761, 39 Alta. L.R. (3d) 29 (C.A.), which was a suit under the CBCA, not the securities legislation. There is also a successful civil suit under the Alberta Securities Act, *Nir Oil Ltd. v. Bodrug* (1985), 18 D.L.R. (4th) 608, 38 Alta. L.R. (2d) 321 (C.A.), and a partial victory in British Columbia, *Pelling v. Pelling* (1981), 130 D.L.R. (3d) 761, [1982] 2 W.W.R. 185 (B.C.S.C.).
 18. OSC Staff Notice 51-703 (June 16, 2000) says "The quality and timeliness of information disclosed to the capital markets by reporting issuers pursuant to the continuous disclosure obligations has always been a focus of the OSC".
 19. Securities Act, R.S.O. 1990, c. S.5, s. 56, is an example.
 20. The Saucier Report, *supra*, footnote 1, says the directors should provide assurance to stakeholders about the integrity of the corporation's reported financial performance. OSC Rule 52-501 (December 15, 2000) sets out the requirements for financial disclosure of issuers and adds some OSC requirements in addition to Canadian Generally Accepted Accounting Practice (GAAP). It is interesting that the additional OSC requirements relate to balance sheet items and comparative statements. Quarterly statements are not required to be audited but Companion Policy 52-501 CP item 2.1 sets out the OSC view that an external auditor should carry out a review of such statements.

both annual financial statements and quarterly financial statements.²¹ It is difficult to believe that these turgid disclosures add to any investor's understanding.

For example, in the Coca-Cola Company 2001 Annual Report, the Financial Review Incorporating Management's Discussion and Analysis runs for 20 pages and precedes the five pages of financial statements and the 20 pages of notes to the financial statements. The MD&A contains such informative disclosure as:

Our international operations are subject to certain opportunities and risks, including currency fluctuations and government actions. We closely monitor our operations in each country and seek to adopt appropriate strategies that are responsive to changing economic and political environments and to fluctuations in foreign currencies.²²

There is a much more upbeat, user-friendly part of the Report in the Coca-Cola Chairman's remarks headed "Dear fellow share owners", which supplies the important data in four readily readable pages. The dichotomy between the positive communication in the Chairman's remarks and the miscommunication in the MD&A shows the impact regulatory rules have on useful disclosure. This impact is further exacerbated by the rules relating to financial disclosure.²³ The recent problems with Enron and its Special Purpose Vehicles (SPV) has resulted in a complex set of rules, designed by the Canadian Institute of Chartered Accountants (CICA) in Canada but following the Financial Accounting Standards Board (FASB) rules in the United States, relating to asset securitization.

Asset securitization is a simple concept but may be difficult for a corporation seeking financial assistance to achieve. Often asset securitization is used with respect to accounts receivable, which traditionally were pledged or assigned to a bank as security for a loan.²⁴ Such a loan would be shown on the balance sheet as a liability. Under an asset securitization transaction, the accounts receivable of the corporation (the Originator) are sold to a third party constructed for the purpose and known as a Special Purpose Entity

21. OSC Rule 51-501. The extension to quarterly statements started in 2001. The audit committee, which is composed of outside directors, in the Commission's view, should carefully review and consider the MD&A — OSC 51-501 CP item 2.4.

22. Coca-Cola 2001 Annual Report, p. 53. I used Coca Cola just to indicate that disclosure in the United States is as arcane as in Canada.

23. Found in s. 5-2 of the OSC Rules, which occupies over 30 pages in the compilation by Thomson Carswell, 33rd ed.

24. D. Sullivan, "Current Methods of Corporate Financing", 1974 Corp. Man. Tax Conf. 1.

(SPE) or SPV. That SPV in turn raises funds based only on the strength of the assets sold. Normally the Originator continues to service the accounts receivable, with the result that the financial transaction is opaque to the customers whose accounts have been sold.²⁵ The result of the sale, in terms of the balance sheet, is to show a diminution in accounts receivable and an increase in cash, with no provision in the liabilities section. This is a very positive financial advantage for the Originator, and if the SPV is owned largely by a bank or its subsidiaries then the bank will not have increased its loan portfolio, which is a positive result from the bank's perspective. But the essence of the transaction requires a "true sale" of the assets securitized. It is to that essence that the CICA has promulgated a set of rules that are difficult for all but the cognoscenti to comprehend.²⁶

There is an interesting case recently decided by an Ontario court in an action against BC Tel by several major financial institutions including SunLife.²⁷ The facts of the case show the many benefits SPVs may bring. The undisputed facts are that in 1985 BC Tel issued a series of 11.35% bonds with a 2005 maturity date. These bonds contained what was then a standard no financial advantage clause (NFAC) that provided that BC Tel could not redeem the bonds pursuant to the redemption clause prior to November 2000 by the application of funds obtained through borrowings having an interest cost to the company of less than 11.35% per annum. SunLife bought over \$6 million face value of the bonds between 1991 and 1997 at the market price, which did not reflect any reduction for the possibility of early redemption. In October 1997 BC Tel decided to do an accounts receivable securitization with CIBC as the SPV, the proceeds to be used to redeem the 1985 bonds. The concept that this was a sale and not a "borrowing" meant that the NFAC did not operate, so the redemption took place at a value that was approximately \$12 per \$100 of bonds redeemed below the then market value. SunLife alleged that this was simply a borrowing disguised as a sale. The court found that there was a true sale so the NFAC was not operative and the bondholders lost money. There was no oppression action

25. The whole concept with respect to accounts receivables is discussed in L. Friedlander, "Securitization of Divisible Interests: A Canadian Response to Steven Schwarcz" (1998), 29 C.B.L.J. 323.

26. Draft Guidelines on Consolidation of Special Purpose Entities <www.cica.ca>; the similar FASB document is found in Exposure Draft June 28, 2002 at <www.fasb.org>.

27. *Metropolitan Toronto Police Widows and Orphans Fund v. Telus Communications Inc.*, [2003] O.J. No. 128 (QL), 120 A.C.W.S. (3d) 60 (Ont. S.C.J.).

available to the bondholders, although clearly their expectations were ignored by the directors of Telus. Who should have disclosed the problem to the bondholders?

Given that OSC-required disclosure is incomprehensible, will outside directors contribute to more effective disclosure to shareholders, bondholders and other stakeholders? The glut of detailed requirements put out by the OSC and the CICA have resulted in the MD&A being largely vetted by outside legal counsel while the financial statements are carefully reviewed by the external auditors. The directors should get written opinions from both of these professionals that they have been prepared in accordance with regulatory requirements. This is the standard report of the auditor,²⁸ but lawyers generally shrink from giving a similar opinion regarding the MD&A, despite the succour this would provide to directors under the CBCA.²⁹

However, the outside directors could be useful in ensuring that the Chairman's remarks as well as the financial highlights are helpful to shareholders.³⁰ While the current regulatory regime is not conducive to innovative communications concepts, communications models use both symmetrical and asymmetrical techniques that use research to develop messages that are likely to persuade strategic publics to behave as the organization wants.³¹ Other corporations use two-way communications models, which can be symmetrical or asymmetrical. In a two-way symmetrical model the corporation uses information gained from key relationships such as large institutional shareholders or analysts to shape the communications programs.³² For example, the corporation may ask analysts whether they want more focus on current operations or long-term goals. Then the corporation shapes its communications to reflect that feedback while still pushing the messages the corporation wants to advance.

The Coca-Cola Company is a very good marketer. In its 2001 Annual Report, Coca-Cola spends the first 35 pages marketing to its shareholders. In the rest of the report, covering an additional 53

28. Required by s. 169(1) of the CBCA.

29. CBCA, s. 123(4) and (5). For the ability of officers to rely on legal advice, however erroneous, see *Blair v. Consolidated Enfield Corp.*, [1995] 4 S.C.R. 5, 128 D.L.R. (4th) 73.

30. Page 1 of the Coca-Cola Company 2001 Annual Report, available online at <www.coca-cola.com>, is a great summary for investors of 2000 and 2001 financial numbers.

31. J. Grunig, "Implications of Public Relations for other Domains of Communication" (1993), 43 J. of Communications 164.

32. R. Barney and J. Black, "Ethics and Professional Persuasive Communications" (1994), 20 Public Relations Rev. 233.

pages, is the material required by the regulators — mainly MD&A plus financial statements. If a system could be developed in which the directors ensure that the auditors and the outside counsel vet the regulatory requirements, then the outside directors could concentrate on the marketing to shareholders, to ensure it was upbeat but not unrealistic. One hopes the regulators would allow the regulatory requirements, including MD&A and perhaps the financial statements, to be posted on the corporate website and not clutter the report to shareholders.

III. LIABILITY

The current CBCA pattern of monetary liability for outside directors is relatively clear. Directors are liable to restore to the corporation amounts they voted to pay out and which were paid out contrary to various provisions of the Act.³³ Similarly directors are responsible for the issue of shares at an undervalue.³⁴ They are also liable to employees for all debts not exceeding six months' wages for services performed for the corporation while they are directors.³⁵ And directors are required to comply with the statute, the corporation's constituting documents as well as the by-laws.³⁶ This group of potential liability provisions is erased if the director exercised the care that a reasonably prudent person would have exercised in the circumstances,³⁷ including good faith reliance on financial statements represented by an officer or reported on by the auditor of the corporation to fairly reflect the financial condition or the company, and any other report by a professional person who has expertise in the area.³⁸

The more general statutory duties of directors are twofold:

- (a) to act honestly and in good faith with a view to the best interests of the corporation (the fiduciary duty of loyalty to the corporation), and

33. CBCA, s. 118(2).

34. CBCA, s. 118(c).

35. CBCA, s. 119; *Proulx v. Sahelian Goldfields Inc.*, [2001] O.J. No. 3728 (QL), 204 D.L.R. (4th) 670 (C.A.).

36. CBCA, s. 122(2).

37. This duty of care is worded identically to the standard under s. 122(1)(b) discussed below.

38. CBCA, s. 123(4).

- (b) to exercise the care, diligence and skill that a reasonably prudent person would exercise in the circumstances (the duty of care).³⁹

Liability under those two provisions will be negated without any due diligence requirement if the director relied in good faith on the officer or auditor with respect to financial statements or on a report of a professional as noted above.⁴⁰

In addition, corporations may indemnify directors for breaches of the duty of care⁴¹ and may purchase insurance for directors against any liability incurred by the director in the individual's capacity as a director.⁴² While several authors have opined that such insurance is only available at an exorbitant cost,⁴³ the Aliant⁴⁴ information circular for the 2002 annual meeting said:

The directors and officers of Aliant and its subsidiaries, benefited from a group liability insurance in the amount of \$280 million (U.S.) purchased through the BCE group insurance program for the protection of all directors and officers of BCE and subsidiary corporations against liability incurred by them in their capacity as directors and officers.

In 2001 the amount of premiums paid by the Aliant group for participating coverage in respect of directors and officers was \$40,300 (U.S.). In a case in which the corporation is not permitted by law to reimburse the insured, there is no deductible amount. Where the Corporation is permitted to reimburse the insured, the deductible is \$1 million (U.S.) for the Corporation.⁴⁵

Accordingly any outside director can expect to collect a full indemnity, either from the corporation itself or from the insurer under the directors' and officers' insurance policy. While there are provisions in other statutes, such as the Income Tax Act or the recent revisions to Ontario's Securities Act relating to the liability

39. CBCA, s. 122(1).

40. It may be noted that this type of reliance has been treated by the Supreme Court of Canada as a bar to any action: see *Blair v. Consolidated Enfield*, *supra*, footnote 29.

41. CBCA, s. 124(1).

42. CBCA, s. 124(6). This could cover all duties, including any breach of the duty of loyalty for which indemnity is not permitted under s. 124(3).

43. K. Ottenbreit and J. Walker, "Learning from the Delaware Experience: A Comparison of the Canada Business Corporations Act and the Delaware General Corporation Law" (1998), 29 C.B.L.J. 364 at p. 387, note 78

44. Aliant is a CBCA corporation that resulted from the amalgamation of the telephone companies operating in the four Atlantic provinces. Bell Canada owns a majority of the Aliant shares.

45. Aliant, "Notice of Annual and Special Meeting of Shareholders and Information Circular" dated March 4, 2002 at p. 13. A similar statement is found in the BCE Notice of 2002 Annual and Special Meeting and Management Proxy Circular dated March 30, 2002 at p. 25.

of directors for misrepresentations, it seems clear that indemnification is available.⁴⁶ Liability problems only arise for outside directors if the corporation is insolvent.⁴⁷ As a corporation drifts toward insolvency, directors now seem required to consider the interests of creditors.⁴⁸ But as insolvency looms, indemnification vanishes. Directors will therefore tend to resign or search for some method to limit liability. One possibility is the charter option provision now prevalent in the United States.⁴⁹ This permits firms to obtain charter amendments that insulate directors from monetary liability for breaches of the duty of care (but not the fiduciary duty of loyalty).⁵⁰

While various authors have suggested that Canadian courts are relatively lenient on directors in duty of care cases,⁵¹ an absolution from monetary liability would decrease D&O insurance premiums and decrease the ever increasing stipends paid to outside directors.⁵² Monetary liability on outside directors is a negative force that needs rethinking.

IV. THE AUDIT COMMITTEE

The CBCA requires every publicly traded corporation to have an audit committee composed of not less than three directors, a majority of whom are not officers or employees of the corporation or any of its affiliates.⁵³ The Saucier Report requires the audit committee to be composed solely of outside directors, all of whom should be "financially literate" and at least one member who has accounting

46. See *R. v. Bata Industries Ltd.* (1995), 25 O.R. (3d) 321, 127 D.L.R. (4th) 438 (C.A.), which involved two directors of Bata who were convicted of failing to take all reasonable care to prevent an unlawful discharge of industrial waste. The trial judge levied a fine on the directors and prohibited indemnification. The Court of Appeal said the corporation could indemnify the directors. Note also that corporations were held entitled to deduct fines in computing income for income tax purposes in *65302 British Columbia Ltd. v. Canada* (1999), 179 D.L.R. (4th) 577, [1999] 3 S.C.R. 804. Employees could not do so.

47. See *Proulx v. Sahelian Goldfields Inc.*, *supra*, footnote 35.

48. A. Keay, "The Duty of Directors to Take Account of Creditors' Interests: Has it Any Role to Play?", [2002] J.B.L. 379; Iacobucci, *supra*, footnote 5; J.S. Ziegel, "Creditors as Corporate Stakeholders: The Quiet Revolution — An Anglo-Canadian Perspective" (1993), 43 U. of T. L.J. 511.

49. Delaware Corporate Law, s. 102(b)(7) is the seminal provision.

50. J. Macey, "Displacing Delaware: Can the Feds Do a Better Job Than the States in Regulating Takeovers?" (2002), 57 Bus. L. 1025, at note 52.

51. See for example, Iacobucci, *supra*, footnote 5, at p. 353.

52. In the January 29, 2003 *Globe and Mail*, Report on Business, p. 5, Royal Bank of Canada has increased its annual stipend to outside directors to \$100,000: see below.

53. CBCA, s. 171.

or related financial expertise.⁵⁴ The basic role of the audit committee is to ensure that the external auditors are satisfied with the accounting estimates and judgments made by management and that these principles reflect an appropriate application of GAAP.⁵⁵ There are also requirements to oversee the internal audit function, *inter alia*. In this article, the focus will be on the central role with the outside auditor. As a result of the recent regulatory and statutory initiatives, it appears to be clear that the external auditor's interaction with the audit committee will increase dramatically. Indeed that committee, rather than management, will become its primary reporting focus.

The real dilemma facing any audit committee is the enormous push to continuously show rising market prices for the corporation's shares, which satisfies every person connected to the corporation, be they management, investors, stakeholders or exogenous observers. These prices are seen to depend in large part on the profits as shown on the income statements released every quarter. Within the limits of the rules of GAAP, each person connected to the quarterly financials would like to see rising profits displayed. There is enormous latitude under accounting rules, in various areas of income and balance sheet reporting, that can be used to make those financial statements as positive as possible. So long as there is no fraud,⁵⁶ the maxim of making the best showing will prevail. There is little reason for the audit committee to question the financial statements prepared by management if the external auditors confirm that they properly comply with GAAP. And the statute mandates that the auditors so confirm when setting out their report.⁵⁷ To some extent this seems to make the role of the audit committee redundant, but the pressure by management on the auditor to put out a "clean" report may be somewhat tempered by the existence of another layer of supervision.⁵⁸

One problem for the audit committee are the various ways in which a person is entitled to recognize income and expenses for

54. Saucier Report, *supra*, footnote 1, at p. 29.

55. Saucier Report, *ibid.*, at p. 31.

56. See R. Sauer, "Financial Statement Fraud: The Boundaries of Liability Under the Federal Securities Law" (2002), 56 Bus. Lawyer 955.

57. CBCA, s. 169 and *Canada Business Corporation Regulations*, 2001, SOR/2001-512.

58. The function of the audit committee will involve an enhanced duty of care in order for the committee to live up to its formal mandate, which is now required. Without a formal mandate, Canadian outside directors sometimes seem to accept whatever is put before them by management, see *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, [2002] O.J. No. 2412 (QL), 214 D.L.R. (4th) 496 (S.C.J. (Comm. List)).

financial statement purposes. Vendor financing is a good example of increasing revenues by lending the purchaser of equipment the bulk of the purchase price.⁵⁹ Until 2001 companies who accounted for an acquisition by purchase accounting⁶⁰ were required to amortize any goodwill over a maximum of 40 years. This amortization, which is a charge to expenses, put a large drag on future earnings. When pooling accounting was outlawed in 2001 a change was made to amortization of goodwill, so it did not have to be immediately amortized at all. In fact, if the corporation is doing well, goodwill will never be amortized. This is an acceptable accounting treatment to reduce expenses and increase profits, compared with the previous situation.

Amortization of goodwill, or the lack thereof, is an obvious way legally to inflate the income statement. And goodwill is only one sort of amortization. If a company secures a five-year term loan from a bank at an interest rate of prime plus one, it is common for the bank to charge a significant initial fee for arranging the loan. Under accounting rules, that "fee" can be charged to expenses in the year incurred or it can be amortized over the five-year life of the loan. Obviously the different allowable techniques of expensing the fee result in different profits for the corporation, yet both are acceptable.

Accounting rules are not the only culprit. Lawyers often are able to structure a transaction so that it results in favourable accounting and tax treatment. Consider the use of a SPV to convert what would otherwise be a secured loan into a "true sale" asset securitization. Not only does the financial transaction not impact the liability side of the balance sheet, but there is no interest charge to expense on the income statement.⁶¹ Additionally if a bank is really the SPV, it will not increase its loan exposure as there is no loan in a true sale transaction. As OSFI has approved the use of SPVs for banks,⁶² can the audit committee object?⁶³

59. See A. Levitt and P. Dwyer, *Take on the Street* (New York, Pantheon, 2002), p. 166.

60. In which one allocates the amount paid to the assets acquired and recognizes the excess as goodwill. This contrasts with pooling accounting where no goodwill is recognized. See W. Grover and D. Ross, *Materials on Corporate Finance* (Toronto, De Boo, 1975).

61. *Supra*, footnote 26.

62. See speech of Mr. N. LePan, October 2002, available on the Office of the Superintendent of Financial Institutions website, <www.osfi-bsif.gc.ca>.

63. In the *Telus* case, *supra*, footnote 27, the judge noted that the transaction was very profitable for Telus and therefore something the board would sanction considering its fiduciary duty to the corporation. In the 2001 Coca-Cola Annual Report, *supra*, footnote 21, the MD&A says at p. 59: "The Company does not have transactions, arrangements or relationships with 'special purpose' entities and the Company does not have any off

V. REMUNERATION

Remuneration of outside directors is closely tied to accounting treatment for the corporation and income tax treatment for the recipient. It is also about to skyrocket as the emphasis on outside directors increases⁶⁴ and theoretical liability is also increased due to unfortunate regulatory⁶⁵ and legislative changes.⁶⁶ The Royal Bank of Canada is a good example.

For the year ending October 31, 2002 the annual retainer for an outside director was \$30,000 plus additional amounts for committee retainers and meeting fees. The non-executive chairman received an additional retainer of \$250,000. In light of the increased duties of members of the audit committee, the committee retainer for audit committee members was doubled in 2003 from \$3,000 to \$6,000 for members and to \$20,000 from \$10,000 for the audit committee chair. Starting in March 2003, in addition to the annual board retainer of \$30,000 there will be a "dedicated annual board retainer" of \$70,000, bringing the basic total to \$100,000. The \$70,000 dedicated retainer will be paid in Director Deferred Stock Units (DDSU) or in Bank Common Shares. These DDSUs or common shares must be retained until the director retires. Thus the basic retainer has jumped from \$30,000 to \$100,000.

Prior to 2003, the director when newly appointed got options to purchase shares equal to 6,000 shares and additional options to purchase 4,000 shares each year. The accounting treatment in 2002 would have shown no expense for the bank in 2002 as a result of the option grant. If an option for 4,000 shares were exercised on January 30, 2003, the bank would show an increase in cash on the balance sheet, and a similar increase against shares outstanding on the liability side of the balance sheet.

From the individual director's point of view, if an option is exercised and the shares so acquired are sold, then, for income tax

balance sheet debt." Could this indicate that the Coca-Cola board of directors is not fulfilling its duty of loyalty?

64. In January 2003 OSFI put out Corporate Governance Guidelines for federally regulated financial institutions. It says "Demonstrable board independence is at the core of effective governance . . . In selecting board members, the recruitment process and the development of a director profile should emphasize the independence of board members". See <www.osfi-bsif.gc.ca>.
65. This refers to the CSA proposal for secondary market liability, which is now being advanced into legislation in Ontario.
66. Keeping the Promise for a Strong Economy Act (Budget Measures) 2002, S.O. 2002, c. 22.

purposes, 50% of the difference between the sale price and the exercise price comes into the director's income as employment income. Thus the director effectively gets a capital gain treatment on the net proceeds. This makes the option concept very appealing, although it is only useful if the shares go up in value.

As set out above, Royal Bank this year has discontinued grants of options for outside directors and has instead instituted an additional annual board retainer of \$70,000, which the director must receive either in DDSUs or in Bank Common Shares. Each DDSU has an initial value equal to the market value of a common share at the time the DDSU is credited to the director. DDSUs attract dividends of additional DDSUs at the same rate as dividends on Bank Common Shares. Directors opt whether to choose DDSUs or Bank Common Shares. In either event, the directors are required to retain the common shares acquired with the dedicated annual retainer or the DDSUs until they retire. Upon conversion to cash after retirement the DDSUs are credited with the market value of the bank shares on the conversion date. Under the Income Tax Regulations⁶⁷ such deferred compensation will only attract tax when liquidated and there will only be the 50% inclusion in income like a capital gain. Unlike stock options, the outside director does not have any downside risk associated with the DDSU, but its value will vary with the price of the common shares. Clearly the annual cost to the bank for each outside director has risen enormously.

VI. INSIDER TRADING

Trading by individuals in the securities of corporations of which they are directors, senior officers or significant shareholders is commonly known as insider trading. Often it is seen to be unfair or offensive if the trading is done when the insider is aware of undisclosed material information that is likely to impact the market price of the corporation's stock. The principal basis for the unfairness theory is grounded in the concept that the insider has an informational advantage from which others are excluded and this advantage is used to the disadvantage of the person on the other end of the trade.⁶⁸ It is usually called the equal access theory and is based on the concept of informational parity. It therefore embraces

67. Income Tax Act, Regulation 6801(d).

68. V. Brudney, "Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws" (1979), 93 Harv. L. Rev. 322.

trades by persons other than insiders, such as those who have obtained confidential information from various sources that are not generally known in the market. The equal access theory was initially introduced in prosecutions by the SEC under Rule 10(b)-5,⁶⁹ and it was followed by the influential Second Circuit⁷⁰ until derailed by the United States Supreme Court in 1980.⁷¹ In that case the court introduced the fiduciary theory, which would only catch trading transactions where the informed trader owed a pre-existing relationship of trust and confidence to uninformed traders. This concept of a disclosure duty being dependent on a fiduciary relationship could extend to reach trading by tippees who, while initially owing no duty, assumed the tipper's fiduciary duty, but only if the tipper secures a personal benefit from the tippee.⁷² That limiting position in the United States has effectively slowed insider trading prosecutions by the SEC⁷³ although Reg FD (fair disclosure) has partly filled the void.⁷⁴

It has been said that "insider trading is unfair and immoral, the economics do not matter, and anyone who says they do is immoral".⁷⁵ If an economic foundation is sought, it should include how regulation increases welfare and it should be general in the sense that it can be used in any securities market.⁷⁶ Some commentators conclude there is no economic foundation for mandatory insider regulation.⁷⁷ Market makers and investors are the prime victims, but the whole trading history, once disclosed, undermines confidence in the morality and integrity of financial markets as well as of the

69. *Cady, Roberts & Co.*, 40 SEC 907 (1961).

70. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

71. *Chiarella v. United States*, 445 U.S. 222 (1980). In that case the impugned trades were made by a partner who acquired information from takeover bidders rather than the target companies.

72. *Dirks v. SEC*, 463 U.S. 646 (1983). In that case a former employee exposed a corporation's ongoing fraud to a security analyst who then informed his clients before knowledge of the fraud became public. See generally R. Kraakman, "The Legal Theory of Insider Trading Regulation in the United States" in K. Hept and E. Wymeersch, *European Insider Dealing* (London, Butterworths, 1991).

73. Levitt and Dwyer, *supra*, footnote 59, at pp. 92-93.

74. *Ibid.*, at pp. 94ff.

75. F. Easterbrook, "Insider Trading as an Agency Problem" in J. Pratt and R. Zeckhauser, eds., *Principals and Agents: The Structure of Business* (Boston, Harvard Business School Press, 1985), p. 83.

76. See H. Schmidt, "Insider Regulation and Economic Theory" in *European Insider Dealing*, *supra*, footnote 72.

77. *Ibid.*

public companies involved.⁷⁸ If this is true, then the public corporations themselves are in an excellent position to restrict insider trading.⁷⁹

In Canada, insider trading regulation initially arose from the Kimber Report⁸⁰ but has been embedded in the provincial securities acts⁸¹ and the incorporation statutes⁸² for several decades. There are also provisions in the Criminal Code dealing with fraud which proved to be effective in the early years.⁸³ The focus from a securities regulation viewpoint in Canada is on the unfairness created in the market place, which is analogous to the equal access theory rejected by the United States Supreme Court. However, since the reporting requirements are limited to insiders as defined, concentration on these market actors would be a rational use of resources and a policy that is most likely to pay enforcement and deterrence dividends.⁸⁴

The problem of enforcement of insider trading liability by the regulator or by the counter party in the market has proved to be very difficult. The words in the statute were sometimes the culprit,⁸⁵ but the evidence suggests that insider trading is pervasive and the number of cases brought is miniscule.⁸⁶ Insider trading offences are very difficult to detect. Neither the judiciary nor the trading public appear to view it as a serious offence. Normally the counterparty trades in the market without knowing that the trade is with an insider. And the volume traded by the counterparty is often quite small. While the corporation in theory can require the insider who proposes to disgorge the profits, that has not been the reality.

The 2002 Cowpland decision is a case in point. According to an agreed statement of facts, Cowpland or his holding company sold shares in August 1997 for \$20.4 million when he knew that losses

78. *Ibid.*

79. H. Manne, *Insider Trading and the Stock Market* (New York, Free Press, 1966), more recently succinctly set out by the same author in the *Wall Street Journal* in 2002.

80. Report by the Attorney General's Committee on Securities Regulation in Ontario (March 1965).

81. See for example Ontario's Securities Act, *supra*, footnote 19, Part XXI.

82. CBCA, Part XI.

83. See *R. v. Littler* (1974), 65 D.L.R. (3d) 443 and 467, 27 C.C.C. (2d) 216 (Que. C.A.); D. Johnston, Case Note (1977), 2 C.B.L.J. 234.

84. See S. Beck, "Of Secretaries, Analysts and Printers: Some Reflections on Insider Trading" (1984), 8 C.B.L.J. 385 at p. 409.

85. The words "make use of" plagued several cases: see *Green v. Charterhouse Group*, *supra*, footnote 17; J. Baillie and V. Alboini, "The National Sea Decision — Exploring the Parameters of Administrative Discretion" (1978), 2 C.B.L.J. 454.

86. See Beck, *supra*, footnote 84.

would be higher than anticipated. The shares fell considerably in September 1997. He pleaded guilty in criminal court and was fined \$1 million. Before the OSC,⁸⁷ Cowpland offered to pay another \$500,000 under a settlement agreement worked out with Commission staff. But the Commission refused to accept the settlement and said,

[i]llegal insider trading by its very nature is a cancer that erodes public confidence in the capital markets. It is one of the most serious diseases our capital markets face. If we do not act in the public interest by sending an appropriate message in appropriate circumstances, then we fail in doing our duty⁸⁸

Now the staff will have to relitigate without any agreed statement of facts and, given the prior track record, Mr. Cowpland is likely to win.

There are plenty of ways corporations could regulate their own insider trading. One could limit trading to buying on good news and even then set a limit. Selling on bad news could be prohibited. There is no reason to think Canadian corporations are incapable of designing workable and acceptable programs of insider trading. This could be a useful project for outside directors, including disclosure of the details of the insider trading rules the directors had adopted. There would not be many cases before the courts but if there was annual disclosure of all the insider trading and such trading was shown to be within the rules established by the outside directors, the OSC "cancer" would be cured, or at least be in remission.

VII. CONCLUSION

The pressure for the boards of Canadian publicly traded corporations to have more outside directors is increasing. This will result in significant costs, which should be commensurate with shareholder expectations, given the increased work quotient and the potential for increased liability. It is unlikely that the outside directors will detect fraud or be able to add much to the review of the financial statements by the external auditor, although having the auditor report directly to the outside directors would change the appearance of the auditor reporting mainly to management.

87. *In the Matter of M.C.J.C. Holdings Inc. and Michael Cowpland, supra*, footnote 16.

88. *Ibid.*

Whether the impact is likely to be more cosmetic than substantive remains to be seen. In the insider information area, however, the outside directors could perform a valuable function by setting up rules for insiders buying or selling securities, with a clear disclosure of the results to shareholders in the annual information proxy. They could also be useful in supervising the disclosure messages in documents sent to shareholders, other than the extensive disclosure required by the statutes and the regulators. If legal voting control rests largely within the management group, it will be difficult for outside directors to effectively serve investors who have insignificant voting rights, even if those investors have the major part of the market capitalization.