The Challenges of Being a Public Company: Where Things Stand on Corporate Governance and Executive Compensation

Prepared by:
Cornell Wright
Tel: (416) 865-7651• Fax: (416) 865-7380
E-mail: cwright@torys.com
&
Leslie McCallum
Tel: (416) 865-7993 • Fax: (416) 865-7380
E-mail: lmccallum@torys.com

Torys LLP
3000- 79 Wellington St W, TD Ctr, Box 270
Toronto, ON M5K 1N2
www.torys.com

Canadian companies and their directors and officers are facing intense scrutiny from regulators, stock exchanges, institutional investors, shareholders and the media. Regulators in both Canada and the United States have been very active in imposing new governance and disclosure requirements and are increasingly vigilant in enforcing those requirements, particularly in the wake of the recent financial market turmoil. In addition, directors' duties, conflicts of interests and processes of deliberation are being scrutinized more closely by investors and the courts, significantly increasing the exposure of directors to lawsuits and potential liability.

These developments, and others, have created new risks for Canadian public companies and their directors and officers.

CANADIAN INVESTOR CONFIDENCE RULES

Canadian securities laws include a number of rules to promote investor confidence in the public filings of companies. The Canadian rules are substantially similar to comparable provisions of the US *Sarbanes-Oxley Act of 2002* and US stock exchange requirements. Some of the measures were phased in over time, and certain companies (e.g., foreign and venture issuers) receive slightly different treatment. Highlights of some of the rules are discussed below.

CEO and CFO Certification Requirements

The CEO and CFO of every public company are required to personally stand behind financial statements and other documents. They must personally certify several aspects of the company's disclosure:

- integrity of interim and annual filings;
- design and evaluation, and disclosure of conclusions as to the effectiveness, of disclosure controls and procedures; and
- design of, and disclosure of material changes in, internal control over financial reporting.

Beginning in 2009, the CEO and CFO of every public company (except investment funds) are also required to provide expanded certifications with respect to its internal control over financial reporting (ICFR). Specifically, CEOs and CFOs are required to certify annually that they have

- evaluated, or caused to be evaluated under their supervision, the effectiveness of the company's ICFR; and
- disclosed in the annual management's discussion and analysis (MD&A) their conclusions about the effectiveness of the company's ICFR.

CEOs and CFOs must also certify annually that they have disclosed to the company's auditors and either the board of directors or the audit committee any fraud involving management or other employees with a significant role in ICFR.

Canadian companies are not required to obtain an auditor's attestation of the effectiveness of internal control over financial reporting, as is required of US and cross-border companies under SEC rules.

These certifications take on even greater significance given that the civil liability regime described below imposes personal liability for damages on directors and officers for disclosure violations.

Disclosure of Corporate Governance Practices

Canadian securities laws include a set of corporate governance guidelines that reflect best practices and an accompanying disclosure rule that requires public companies to describe specific aspects of their governance practices in relation to the guidelines.

The corporate governance guidelines deal with matters such as board composition; meetings of independent directors; board mandate; position descriptions of the CEO, board and committee chairs; orientation and continuing education;

code of business conduct and ethics; nomination of directors; compensation; and regular board assessments. The guidelines are substantially similar to the listing standards of the New York Stock Exchange (NYSE), although the "comply or explain" feature – voluntary compliance coupled with a disclosure requirement – distinguishes the Canadian approach from the mandatory nature of the US rules.

In December 2008, the Canadian securities regulators published a proposed overhaul of the corporate governance regime for Canadian public companies. The proposals feature a new policy that articulates nine high-level corporate governance principles. Each principle is accompanied by commentary that provides relevant background and explanation, together with examples of practices that could achieve its objectives. Companies would be required to disclose the practices they use to achieve the objectives of each principle. The regulators emphasize that the examples are not mandatory and should not be interpreted as best practices or minimum standards.

The policy explicitly recognizes that (i) other practices may achieve the same objectives; (ii) corporate governance practices will evolve as an issuer's circumstances change; and (iii) each issuer should have the flexibility to determine practices that are appropriate for its particular circumstances. This is a significant change from the current requirement to "comply or explain" against specific governance guidelines, which some issuers have criticized as overly prescriptive. The regulators are also proposing to introduce a more principles-based approach for determining whether a director is independent for audit committee and other board and committee purposes. The bright-line tests in the current definition of independence would be eliminated.

The Alberta Securities Commission has questioned whether the proposals will meaningfully enhance investor protection and whether their introduction so soon after implementation of the current regime is beneficial. Moreover, the regulators received many comment letters on the proposals reflecting a wide variety of views. It is unclear at this point whether the regulators will go forward with them (either as proposed or with substantial modifications), particularly in light of recent US developments (described below) that would, if implemented, move US standards in the opposite direction of Canada's more principles-based approach by imposing additional mandatory requirements. Generally speaking, the greater the divergence between Canadian and US governance standards, the more complicated compliance is for cross-border issuers.

EXECUTIVE COMPENSATION

New Disclosure Rules

Canadian securities regulators have overhauled the rules relating to executive compensation disclosure. The regulators believe that the new rules will result in better communication of what boards of directors intend to pay executives, and will also allow investors to assess how decisions about executive compensation are made. The new rules are similar – but not identical – to the US Securities and Exchange Commission's (SEC's) rules on executive compensation disclosure that came into effect in 2007.

When companies comply with the new rules for the first time, they are not required to restate, for comparative purposes, disclosure for prior financial years.

Highlights of the new rules are as follows:

- The most significant aspect of the new rules is the requirement to provide a "compensation discussion and analysis" (CD&A) that describes all significant elements of compensation and explains the rationale for specific compensation programs and decisions for each "named executive officer" (NEO). The regulators have long complained about the lack of meaningful analysis in companies' reports on executive compensation. Companies should be applying the same level of rigour to their CD&A as they do to their MD&A, taking into account the regulators' interpretative guidance for MD&A disclosure. We expect the regulators to focus on the CD&A in upcoming continuous disclosure reviews.
- Companies must disclose performance goals that are based on objective, identifiable measures, such as the company's stock price or earnings per share, if those goals are significant to compensation decisions. (If goals are subjective, the company may describe them without providing specific measures.) There is an exception if disclosure would seriously prejudice the company's interests, but in that case, the company must disclose the percentage of the NEO's compensation that relates to the undisclosed information and how difficult it could be for the NEO, or how likely it will be for the company, to achieve the undisclosed goal. If any goals constitute non-GAAP financial measures, the company must disclose the way it calculates the goals from its financial statements. Companies should consider these disclosure requirements in formulating goals and adopting new compensation plans.
- The summary compensation table, which remains the main vehicle for executive compensation disclosure, must disclose total compensation for each NEO, including the dollar value of share and option awards (based on grant date fair value), non-equity incentive plan compensation and pension compensation amounts. The treatment of share and option awards differs from the US rules, which require disclosure of the compensation cost, as per the financial statements, in the summary compensation table.
- The identity of the NEOs is based on total compensation (excluding pensions) rather than just salary and bonus. Severance and other payments resulting from termination of employment are excluded from the calculation but other one-time compensation amounts (such as signing bonuses or equity replacement awards to new hires) are not.
- Retirement benefits must be quantified for each NEO under both defined benefit and defined contribution plans. This requirement addresses the criticism that the current pension benefits disclosure provides only general information on benefit entitlements for selected compensation levels and years of service but does not disclose the particular circumstances or entitlements of each NEO.
- The new rules call for detailed disclosure about incremental payments or other benefits for each NEO related to the following triggering events: retirement, resignation, termination, a change of control of the

company or a change in the NEO's responsibilities. Companies must quantify the potential payments on the assumption that the triggering event occurred at the end of the most recent fiscal year. (If the event occurred earlier in the year, actual payments and benefits will be disclosed rather than hypothetical payments.) These disclosure requirements are consistent with the US rules but substantially exceed current Canadian requirements and are intended to prevent investors from being surprised, after the fact, by the size of an NEO's severance or other payment package.

To comply with the new rules, most companies have undertaken a significant amount of work, involving legal, accounting and human resource advisors.

"Say on Pay" Proposals

In addition to overhauling executive compensation disclosure requirements, the movement toward shareholder participation in the substance of executive compensation decisions is gaining momentum in Canada. This is consistent with developments in the United States, where legislation has been introduced in the Senate that would entitle shareholders to a "say on pay," meaning an annual, non-binding, advisory vote on executive compensation. A vote is already required of companies receiving federal bailout funds. Many other US companies have included shareholder proposals related to executive compensation in their proxy circulars. And some companies have taken the next step of putting a resolution on executive compensation to their shareholders. "Say on pay" has been required by UK companies for several years, and this has led to the practice of issuers discussing and negotiating their compensation policies with large institutional shareholders to avoid a negative vote.

During the most recent annual meeting season, a significant number of Canada's largest financial institutions and other major issuers voluntarily decided to implement "say on pay" in the future. It remains to be seen whether a majority of Canadian companies will follow suit, given that many of them are small and medium-sized issuers or issuers with a major controlling shareholder for whom a vote on executive compensation might not make sense.

The Canadian Coalition for Good Governance (CCGG) has stated that it recommends all companies adopt "say on pay" as an important aspect of dialogue between shareholders and boards, "giving shareholders an opportunity to express directly to the board their satisfaction with the prior year's compensation plan and actual awards." The CCGG intends to consult with market participants to create a model shareholder resolution for boards to consider using in the future.

LIABILITY FOR PUBLIC COMPANY DISCLOSURE

Under Ontario's regime of statutory civil liability for secondary market disclosure, which came into force on December 31, 2005, companies, directors, officers and others have potential liability for misleading public disclosure and failing to make timely disclosure of material changes. This statutory regime is similar to the statutory liability regime that has existed for prospectuses for many years.

Fewer claims have been brought under the civil liability regime than were anticipated when it was introduced. Some speculate that this is because of the liability caps and strike suit protections that, for example, require a plaintiff to obtain leave of the court before bringing a lawsuit and to convince the court that the suit is being brought in good faith and has a reasonable possibility of success. The full impact of this new liability regime will not be known until the courts have considered its operation in various circumstances. In the meantime, the increased risk of personal liability for directors and officers has focused companies' attention on the need to have effective disclosure controls and procedures throughout the organization.

The additional pressure imposed by civil liability on disclosure decisions is being felt in the M&A context in particular. In 2008, the Ontario Securities Commission (OSC) released its decision *Re AiT Advanced Information Technologies Corp.*, determining that AiT had not breached the disclosure rules by failing to disclose its agreement with 3M Company until a definitive agreement was signed. The decision supports the approach generally taken by legal practitioners in Canada. Canadian securities legislation does not require an issuer to promptly disclose all material facts, only material changes. The distinction between material changes and material facts has been significant in analyzing whether an issuer must disclose a potential M&A deal, and the distinction was upheld by the OSC in this case. Until a material change occurs, the fact that the company is in negotiations may be a material fact, preventing insiders from trading, but there is no positive obligation to disclose until a material change occurs. The OSC took care to stress that there is no bright-line test for determining when a material change occurs, and in some cases it may occur before the definitive agreement is signed. However, if the transaction is surrounded by uncertainties and is still highly conditional, a commitment from only one party to proceed will not normally be sufficient to constitute a material change.

In *Kerr v. Danier Leather*, the Supreme Court of Canada held that the "business judgment rule" does not protect disclosure decisions under securities laws against judicial second-guessing. The OSC recognized this principle in *AiT*, finding that the determination of when or whether a material change occurred could not be subordinated to the board's business judgment regarding the potential negative impact of disclosure. However, the OSC went on to say that if a board's governance process in making disclosure decisions is effective, it would be difficult to interfere with the judgments produced by that process.

SHAREHOLDER APPROVAL OF SIGNIFICANT TRANSACTIONS

The Toronto Stock Exchange (TSX) is proposing to amend its rules to require a listed company to obtain shareholder approval for an acquisition of another public company if the transaction involves the issuance of more than 50 per cent of the listed company's outstanding shares (on a non-diluted basis). The TSX believes that shareholders should have the opportunity to vote on public company acquisitions that are highly dilutive, notwithstanding that requiring shareholder approval will likely lead to increased acquisition costs and deal uncertainty. Other major stock exchanges, including the NYSE and London Stock Exchange, have similar requirements.

This development will have a significant effect on public company M&A transactions in Canada. The TSX proposal comes in the wake of the recent ruling by the OSC requiring approval by the shareholders of HudBay Minerals prior to completing its proposed highly dilutive acquisition of Lundin Mining. The OSC decision led to the withdrawal of the transaction.

The TSX will continue to require that a listed company obtain shareholder approval to acquire a private company when the number of shares required to pay the purchase price will exceed 25 per cent of the listed company's outstanding shares (on a non-diluted basis). The TSX will also retain the ability to require shareholder approval on a discretionary basis, having regard to other factors. However, the TSX expects that its use of this discretion will be more limited as a result of the new bright-line threshold. Comments on the proposal were due by May 4, 2009.

CORPORATE GOVERNANCE IN THE M&A CONTEXT

Directors' Duties After *BCE*

The Supreme Court of Canada released its reasons for decision in the *BCE* case in December 2008. The reasons had been awaited by Canadian M&A practitioners because the case offered a perfect vehicle for the Court to provide much-needed guidance on the difficult question of directors' duties in the context of change-of-control transactions.

In June 2007, BCE announced that it had entered into a leveraged buyout (LBO) agreement with a group of private equity investors. The investors proposed to acquire all the outstanding shares of BCE at a price of $42.75 per common share, a 40 per cent premium for BCE's common shareholders. The agreement contemplated the addition of a substantial amount of new debt. In anticipation of this transaction, the market value of the outstanding bonds fell about 20 per cent, or $1 billion. The bondholders opposed the transaction, asserting that the proposed plan of arrangement should not be approved by the Court at the fairness hearing because the plan was not fair and reasonable in light of its adverse effect on their interests.

The fundamental issue in the case was the scope of the BCE directors' duties in the context of this LBO transaction in which the shareholders' interest – obtaining the highest price possible for their shares – conflicted with the bondholders' interest – maintaining the credit rating and value of their bonds. BCE's special committee had defined its objective as maximizing shareholder value while respecting bondholders' contractual rights.

The Court allowed the transaction to proceed (although it ultimately did not do so for other reasons), but the Court rejected the duty to maximize shareholder value in the context of change-of-control transactions (the so-called Revlon duty derived from Delaware jurisprudence) in favour of a nebulous duty to treat all affected stakeholders fairly, commensurate with "the corporation's duties as a responsible citizen."

While largely accepting the bondholders' view of the directors' duties, the Court ruled against the bondholders because they did not have a reasonable expectation to anything more than the contractual rights enshrined in the trust indenture under which their bonds were issued.

By rejecting the shareholder primacy model yet endorsing the conduct of the BCE board, which had defined its objective in precisely those terms (subject only to satisfying contractual obligations to bondholders), the Court has sent a somewhat mixed message to market participants. But the decision makes one thing clear: the decisions of directors are to be given a high degree of deference. As long as directors get their process right, respect legal rights and consider the interests of all stakeholders affected by their decision, their balancing of conflicting stakeholder interests in determining the best interests of the corporation will be treated as a matter of business judgment not to be overturned by the courts unless it falls outside the range of reasonableness.

Independence of Financial Advisors

Directors, themselves subject to close scrutiny regarding independence, are increasingly vigilant regarding the potential for conflicts among their advisors. In the M&A context, this has led more boards and special committees to take the cautious approach of retaining separate advisors who have no roles or relationships with other parties in the transaction.

The OSC's reasons for its recent ruling that led to the withdrawal of HudBay Minerals' proposed acquisition of Lundin Mining included some controversial comments about potential conflicts of financial advisors who are compensated on the basis of the success of a transaction. In its reasons, the OSC stated that large success fees "create a financial incentive for an advisor to facilitate the successful completion of a transaction when the principal focus should be on the financial evaluation of the transaction from the perspective of shareholders." The OSC went on to say that a fairness opinion prepared by an advisor who is paid a success fee "does not assist a special committee of independent directors in demonstrating the due care they have taken in complying with their fiduciary duties in approving a transaction."

In practice, advisors' fees are negotiated, and there are commercial reasons why boards and their advisors tend to prefer a success-based fee structure. Directors take into account the potential conflict created by those fee structures in assessing how much weight they should give to the opinion, and they disclose the potential conflict so that shareholders are also aware of this. In the face of the OSC's categorical statement that special committees cannot rely on a fairness opinion given by an advisor who is paid a success fee, we expect that directors will more frequently require a fairness opinion from a second firm of financial advisors that is not entitled to a success fee on the transaction. We believe the OSC staff may consider issuing guidance that would reflect a more nuanced view.

PROXY ACCESS IN THE UNITED STATES

The SEC is proposing to give shareholders of US public companies the right to have their nominees for election as directors included on the company's proxy alongside the board's nominees. This development is significant because it means that shareholders wishing to nominate a director would no longer have to incur the expense of mailing their own proxy circular. The proposal does not apply to foreign private issuers (including Canadian issuers) because they are not subject to the SEC's proxy rules. However, this development could result in Canadian lawmakers and securities regulators considering a similar proxy access rule in Canada.

Under the SEC's proposal, shareholders would have to meet certain eligibility requirements, including having held the issuer's voting securities for at least one year, owning a certain minimum percentage of shares and certifying that they do not currently intend to change control of the company or gain more than minority representation on the board (although they could change their minds once their nominees are in place). One or more candidates could be nominated, provided that in the case of multiple nominations, the total number of nominees would make up less than 25 per cent of the company's board. Nominees would have to meet the independence criteria of the applicable stock exchange (but would not need to be independent of their nominators).

Proxy access for shareholders has been a topic of debate by the SEC, US courts and market participants over the past several years. Most institutional shareholders strongly favour proxy access as a matter of shareholder democracy and board accountability, particularly in light of current hot-button issues like executive compensation and risk management. Others are critical of proxy access on the basis that it could give shareholders, especially small groups that may be promoting a special interest, a means of disrupting the board nomination process.

RELATIONSHIP BETWEEN THE BOARD, MANAGEMENT AND SHAREHOLDERS

This new regulatory environment, together with the additional investor and media scrutiny of corporate governance practices, has altered the dynamics at the board level, among executives in management, and between the board, management and shareholders. As a result, more independent directors (especially those considered "financially literate") are being sought. Directors are taking their responsibilities more seriously and demanding timely and relevant information, firm meeting dates, an annual board agenda and leadership through the board's involvement in important strategic decisions. Many boards now have an independent lead director who acts as a point of contact for the independent directors on the board. Directors are also increasing their use of advisors – both regular corporate advisors and independent advisors – to deal with complex accounting, compensation, legal and human resources issues.

Directors are paying more attention to D&O insurance coverage and becoming more sophisticated in their demands for coverage. Apart from limits, D&O issues now include careful attention to the divergent needs of, and the potential for conflicts among, the company, management and outside directors. Boards are much more involved in D&O decisions and are increasingly requesting legal representation to ensure that they are adequately protected.

In addition to proxy access and "say on pay," broader shareholder rights legislation has recently been introduced in the US Senate that has the potential to further alter the traditional domains of decision making among boards, management and shareholders. The proposed legislation would, among other things, require listed companies to maintain certain corporate governance standards, including separating the chair and CEO roles, having mandatory annual elections for every director (no staggered boards), having majority voting policies for directors and having a fully independent risk committee responsible for establishing and evaluating the issuer's risk-management practices. By imposing additional mandatory requirements, the proposed legislation would, if adopted, move the US approach to corporate governance further from Canada's more principles-based approach.

Cornell Wright practises corporate and securities law with a focus on M&A and corporate finance, both public and private. He also advises companies, boards of directors and shareholders on corporate governance matters. Cornell has represented some of Canada's largest companies on their most significant transactions. He was admitted to the Ontario Bar in 2002 and obtained his LLB and MBA from the University of Toronto in 2000.

Leslie McCallum's practice focuses on capital markets and mergers and acquisitions. She focuses on developing precedents and client communications, tracking new Canadian and US legal developments, research and consulting with the firm's lawyers, primarily on cross-border matters. Leslie has represented issuers and underwriters in cross-border equity and debt financings, and regularly advises on compliance with US and Canadian securities laws.

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