Controlled Companies Briefing

WRITTEN BY
Yvan Allaire, Ph.D., FRSC

QUESTIONS FOR DIRECTORS TO ASK

Controlled Companies Briefing

WRITTEN BY
Yvan Allaire, Ph.D., FRSC

QUESTIONS FOR DIRECTORS TO ASK

Copyright © 2010
Canadian Institute of Chartered Accountants
277 Wellington Street West
Toronto, ON M5V 3H2

Printed in Canada
Disponible en français

All rights reserved. This publication is protected by copyright
and written permission is required to reproduce, store
in a retrieval system or transmit in any form or by any means
(electronic, mechanical, photocopying, recording, or otherwise).

For information regarding permission, please contact
permissions@cica.ca

Library and Archives Canada Cataloguing in Publication

Allaire, Yvan
Controlled companies briefing : questions for directors to ask / written by Yvan Allaire.

ISBN 978-1-55385-496-8

1. Directors of corporations--Canada--Miscellanea. 2. Affiliated corporations--Canada--Miscellanea. 3. Boards of directors--Canada--Miscellanea. 4. Corporate governance--Canada--Miscellanea.
I. Canadian Institute of Chartered Accountants II. Title.

HD2745.A46 2010   658.4'22   C2010-902886-4

Table of Contents

Preface 1

Introduction 3

Considerations for Prospective Board
Members of Controlled Companies. 4

Special Considerations Relating
to Dual Class Share Structures. 6

Protection of Minority Interests. 7

Board Composition in Controlled Companies. 8

Governance of Controlled Companies 9

Conclusion 11

Appendix A. 12

Appendix B. 14

Appendix C. 15

Appendix D. 16

Where to Find More Information. 17

Preface

The Risk Oversight and Governance Board (ROGB) of the Canadian Institute of Chartered Accountants (CICA) commissioned this briefing to assist corporate directors who serve, or are considering serving, on the board of a controlled company. This document focuses on publicly-listed companies.

A prospective director of a controlled corporation should know that the issues he/she is likely to face will be very different than in a widely held company, due to the influence of significant or controlling shareholders who may be in a position to control the outcome of voting on any shareholder issue.

This briefing discusses the benefits and risks unique to controlled companies, highlights the challenges associated with being a director of a controlled company, and presents potential governance issues of which directors should be aware. It offers questions that are intended to be a catalyst for useful dialogue amongst directors, with management or with outside advisors.

The ROGB acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, the author Dr. Yvan Allaire and the CICA staff who provided support to the project.

Brian Ferguson, FCA
Chair, Risk Oversight and Governance Board

Risk Oversight and Governance Board

Brian C. Ferguson, FCA, Chair
Bryan Held, FCA, ICD.D
Andrew J. MacDougall, LL.B.
Michael B. Meagher, FCA
Anne Marie O'Donovan, FCA
Sue Payne, FCA, C.Dir
Peter W. Roberts, FCA, CPA (Illinois), ICD.D
Debi Rosati, FCA, ICD.D
Catherine Smith, ICD.D, FICB

Directors Advisory Group

Giles Meikle, FCA, Chair
John Caldwell, CA
William Dimma, F.ICD, ICD.D
John T. Ferguson, FCA
Gordon Hall, FSA, ICD.D
Carol Hansell, LL.B.
Ronald W. Osborne, FCA
Thomas C. Peddie, FCA
Guylaine Saucier, CM, FCA
Hap Stephen, CA
Peter Stephenson, PhD, ICD.D

CICA Staff

Dave Pollard, CA
Vice President, Knowledge Development
Gigi Dawe
Principal, Risk Oversight and Governance
Beth Deazeley, LL.B.
Principal, Risk Oversight and Governance

Introduction

Definition of Controlled Company

The term "controlled" corporation generally refers to:

1. Companies in which a shareholder (or related shareholders) has more than 50% of the votes. This is referred to as "legal" or "absolute" control.
2. Companies in which a shareholder (or related shareholders) holds more than 20% but less than 50% of the votes. This is referred to as "effective control" because no transaction is likely to succeed without the assent of that shareholder.
3. Companies in which a significant shareholder (one who controls more than 10% of the votes but less than 20%) or their representative chairs the board of directors and/or a significant shareholder is the CEO or a key executive of the company.

Some consider a corporation to be "controlled" when a single shareholder owns sufficient shares to trigger a reporting obligation to the relevant securities commission (10% in Canada; 5% in the United States). However, share holding at that level is more accurately described as *significant* rather than controlling.

Prevalence of Controlled Corporations in Canada

A recent study found that 53% of the 253 Canadian companies of the S&P/TSX Index had at least one significant shareholder.[1] In 27% of these 253 companies, a single shareholder (or related shareholders) controlled more than 20% of the votes.

Of the 133 companies with significant shareholders, 32 (or 24%) had a representative of the shareholder on their board and 58 companies (or 44%) had representatives of the shareholder both on the board and participating in management.

Altogether in 90 of the 253 largest publicly listed Canadian companies, or close to 36%, a significant shareholder (or its representative) sits on the board and/or participates in management. This percentage is likely even higher among smaller public companies.

The voting power of these significant shareholders comes from direct holdings in 75% of companies and from a superior class of shares of the remaining 25%. (Table 1)

Table 1

Type of Shareholders with 10% or more of the votes in Canadian companies of the S&P/TSX (Number of firms)			
	Ordinary shares	Dual-class of shares	Total
Institutional Investors	47	0	**47**
Individuals and families	29	30	**59**
Another company	24	3	**27**
Total	**100**	**33**	**133**

Significant shareholders participating actively in the governance and/or management of controlled companies are typically individual entrepreneurs or family members, or representatives of a parent company. Institutional investors with a significant shareholding rarely assume board positions.

Appendix A provides information on how Canada compares to other countries in terms of the prevalence and importance of publicly-listed controlled corporations.

1 Allaire, Y. «*L'actionnariat des grandes entreprises canadiennes : quelques données*», Institute for Governance of Private and Public Organizations, August, 2008.

Benefits and Risks of Controlled Corporations

The publicly-traded company with a controlling shareholder generally benefits from this shareholder's commitment to and investment in the company. Often, the controlling shareholder is the founder of the company; he or she brings a wealth of knowledge and experience as well as immense energy and passion to the management and governance of the company.

A controlling shareholder also makes the company relatively immune to the pressures of transient, short-term investors and the threat of a hostile takeover, leading to benefits for other shareholders as well.[2] Given that the controlling shareholder has a large financial investment in the firm, any action on his/her part which has a negative impact on economic performance or seeds doubts about the leadership of the company will have a significant negative effect on his/her own wealth.

However, there are also risks involved with such a high level of shareholder control, the principal of which is that the controlling shareholder may take advantage of his/her situation to derive "private benefits". In order for the company to function effectively, this risk must be addressed and measures taken to protect minority shareholders.

Private benefits may be economic or non-economic in nature. The most obvious economic benefit may accrue from the controlling shareholder receiving a premium for selling the control of the company while other shareholders get no such benefit.

Another example is the case of related-party transactions; that is, a transaction between the company and the controlling shareholder. In the absence of proper supervision, such transactions may be framed in a way that unduly benefits the controlling shareholder.

Similarly, the controlling shareholder may be tempted to have the company assume expenses of a personal nature, resulting in other shareholders being responsible for part of the bill.

One further issue is succession when a founder-entrepreneur leaves a company. If the controlling shareholder wishes or commands that a relative assume leadership of the company, the board may be in a difficult position if they consider the candidate to be inadequate.

These issues are somewhat amplified in companies where a shareholder exercises control through a class of shares with superior voting rights, which will be discussed further below.

Some of these risks can be alleviated by sound corporate governance. In addition, Canadian laws and regulations contain measures to protect minority shareholders against improper actions by controlling shareholders.

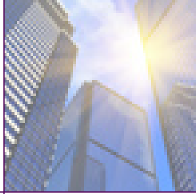
Considerations for Prospective Board Members of Controlled Companies

Degree of Control

Prospective directors of controlled companies should be aware that the issues they are likely to face will be very different than those encountered by boards of widely-held corporations. This will depend to some extent on the type or degree of control, for example:

- a single shareholder controls more than 50% of the votes, acts as chief executive of the company and sits on the board;
- a group of related shareholders controls more than 50% of the votes with some or all of these shareholders participating in management and sitting on the board;
- a corporate entity controls more than 50% of the votes and its representatives sit on the board;
- a single shareholder controls more than 50% of the votes and chairs the board but does not participate in the management of the company;

2 For example, Anderson, Ronald C. and David M. Reeb. "*Board Composition: Balancing Family Influence in S&P 500 Firms*", Journal of Economic Literature, August 2004; Anderson, Ronald C. and David M. Reeb. "*Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*", The Journal of Finance, vol. LVIII, no. 3, June 2003; Villalonga, Bélen and Raphael Amit. "*How Do Family Ownership, Control and Management Affect Firm Value*", Journal of Financial Economics, forthcoming, 2005.



- a significant shareholder controls between 20% and 50% of the votes and he/she, or their representative, chairs the board of directors;
- a significant shareholder controls between 20% and 50% of the votes and sits on the board;
- a significant shareholder controls between 10% and 20 % of the votes, participates in management and sits on the board.

The higher a company is located on the above list, the more complex and challenging the role of independent board member is likely to become. When control is exercised through a class of shares with superior votes, an additional set of issues is raised.

When invited to join the board of a controlled corporation, a prospective board member should consider the type and level of control exercised by a controlling shareholder or related shareholders. The more dominant the shareholder is, the more challenging the role of independent directors will be. When considering board membership, a prospective director must assess his or her willingness to stand up to or challenge the controlling shareholder. Such shareholders, particularly when they are the founder of the company or descendants of the founder, may have a strong sense of their superior understanding of the company. Controlled company boards are not the place for timid directors.

Standards of Governance

If the company is about to become public or has been publicly-listed for a short period of time, a prospective board member should assess whether the controlling shareholder has internalized the changes in governance and management style that the company's new status will require. It can be difficult for someone who has created and built a company to accept that others now have a say in running it. A wise entrepreneur will seek experienced directors who can help navigate in the new environment, but in fact some entrepreneurs may only go through the motions of implementing new governance requirements without changing the substance of how they run the company.

Independence of Board Members

A prospective board member should also assess whether the other independent board members are likely to exhibit real independence of mind and the strength of character to challenge the controlling shareholder when the situation warrants it. The manner of their selection is often telling. Ideally, independent directors would have been identified and approached by the governance/selection committee of the board. If the controlling shareholder proposed directors and made the final call on board membership, this should raise concerns as to the actual independence of these directors.

Questions for Potential Directors to Ask

1. What is the nature and degree of control exercised by the controlling shareholder?
2. Does the controlling shareholder participate in management or on the board?
3. Does the company meet the governance requirements for a publicly-listed company both on paper and in practice?
4. How many other independent directors are currently on the board and how were they selected?
5. Will I be confident enough to use independent judgement and challenge the controlling shareholder when necessary?
6. Will there be sufficient support from the other independent directors when it is necessary to challenge the controlling shareholder?

Red flags
Some potential red flags that a prospective board member should watch for when considering joining the board of a controlled company include:

- **A high rate of turnover of board members and executives**, which may indicate conflict with the controlling shareholder. Any resignation of board members in mid-term should ring an alarm bell and lead to a careful enquiry about the cause of the resignation.
- **A controlling shareholder acting as chair of the board and CEO of the company**, as such concentration of power could make it very difficult for independent board members to fulfill their role. A strong lead director would be a minimal requirement in such situations.
- **A large number of related party transactions involving the controlling shareholder**, as these transactions are fraught with problems and divided interests.
- **Various family members of the controlling shareholder in senior positions**. While family control and succession may be a desirable course for the company, this must be well-planned and carefully implemented.

Special Considerations Relating to Dual Class Share Structures

Benefits and Risks

The motivation for issuing two classes of common shares is generally to allow an entrepreneur-founder to retain some degree of control over the company while at the same time relying on the issuance of shares to finance growth. Investors in these companies recognize that entrepreneurs bring more than capital to the company; they bring their inventiveness, drive, energy and passion, factors which account in large part for the company's success. These investors choose to cede some control in exchange for the benefit of retaining the talent of the founder, along with the opportunity to invest in (and profit from) a company which might otherwise not participate in the equity markets.

There is mixed opinion in the investment community about the advisability of dual-class share structures. Some only approve such structures in smaller companies, such as those listed on the TSX Venture Exchange. Others would impose a sunset clause rather than allow dual share structures to continue once the company is more established and the original founder is no longer involved.

A substantial risk related to the use of dual share structures is the ability for the controlling shareholder to sell their controlling interest at a premium while minority shareholders do not receive a similar offer. To protect minority shareholders, the Toronto Stock Exchange imposes a "coattail" provision on corporations with a dual class of shares which requires that, should the controlling shareholder accept an offer for his/her shares, the same offer must be extended to the shareholders of the other class of shares.[3]

Appendix B provides information on the prevalence of dual-class share structures in Canada.

Understanding the Dual Share Structure

Before joining the board of a controlled company in which control is achieved through a superior class of shares, potential directors should ensure that they have a good understanding of how the dual share structure works.

Directors should understand the nature of the two classes of shares and the rights attached to each class, such as voting rights and rights to elect board members. They should also ascertain whether both classes of shares are traded on the stock market and how they are valued.

Another important issue is the relationship between the percentage of the equity owned by the controlling shareholder (their economic interest) and the percentage of votes held (their voting power). A large discrepancy between economic interest and voting power raises the possibility

3 However, this rule does not apply to companies that issued two classes of shares prior to August 1st 1987.

of misalignment between the interests of the corporation and the interest of the controlling shareholder. An example of this is when a controlling shareholder legally controls a corporation while owning only a small percentage of the equity.

Appendix C provides information on voting power dilution resulting from dual-class share structures in Canadian companies.

Questions for Potential Directors to Ask

1. What is the nature of the difference between the share classes?
   (a) Do both classes have full rights to vote, differing only in the number of votes to which they are entitled?
   (b) Is there a class without voting rights?
   (c) Is there a provision allowing the class of shares with inferior voting rights to elect a certain number of board members?
   (d) Are both classes of shares traded on stock exchanges and, if so, how are they valued by the market?
2. Does the company have a strong coattail provision in place to protect minority shareholders in the event of the controlling shareholder selling his/her interest?
3. How does the controlling shareholder's voting power compare with his/her economic interest?

Protection of Minority Interests

There are several legal and regulatory measures which collectively provide a good measure of protection to minority shareholders of Canadian controlled corporations.

Several provisions of the *Canada Business Corporations Act* (CBCA) are designed to give minority shareholders a measure of protection and empowerment. For instance,

- shareholders representing not less than 5% of shares entitled to vote may submit nominees for election to the board (s.137)
- under certain conditions, a dissident shareholder may be entitled to be paid by the corporation the fair value of his/her shares (s.190)
- a shareholder who has cause to believe that the company and its board of directors are acting in a fraudulent manner may ask the court to order an investigation. This clause is often called the "oppression" clause (s.229)
- directors or officers of the corporation must disclose the nature and extent of any material interest in a transaction made or proposed with the corporation (s.120(1)). This provision becomes salient when significant shareholders participate in the management and governance of the corporation.

Canada ranks amongst the best countries in the world in terms of the protection of minority shareholders.[4] However, there are some additional measures which can provide added protection to minority shareholders. Directors considering joining the board of a controlled company should determine whether such measures are, or should be, in place.

1. **Stricter coattail provisions** — although the Toronto Stock Exchange (TSX) imposes a 'coattail' provision to protect minority shareholders should the controlling shareholder accept an offer to buy his/her shares, not all companies have adequate measures in place. For example, companies which issued dual class shares prior to August 1, 1987 are exempt from the 'coattail' imposed by the TSX. Also, there are some loopholes which may still allow controlling shareholders to reap a disproportionate benefit, for example if the controlling shares are sold to two parties who will jointly acquire control.
2. **Ability to elect directors** — Given the *standard* process to nominate and elect board members, a controlling shareholder with 50% or more of the votes will actually elect all members

4 Appendix D provides information on protection of minority shareholders in other countries.

of the board. Cumulative voting, permitted under Canadian laws, can increase the leverage of minority shareholders.

The Institute for Governance of Private and Public Organizations (IGOPP) has recommended that minority shareholders *elect at least one-third of board members* in all controlled corporations, whether the control is achieved through a superior class of shares or not.

It is incumbent upon the governance committee and the board to propose candidates who will receive strong support from minority shareholders. Of course, the ability to vote for each individual director is a pre-requisite condition.

Board Composition in Controlled Companies

Independence

Director independence is widely regarded as key to good governance. The requirement that a majority of directors be independent of management is now enshrined in regulations from the Canadian Securities Administrators in Canada and in the *Sarbanes-Oxley Act of 2002* in the United States. The proportion of independent directors on the boards of listed companies in Canada and the United States now exceeds 70%.[5]

Directors are generally considered to be independent to the extent that:

- they do not have business relationships with the company and its management,
- they do not receive favours of a substantial sort from management or from the company, and
- their own pecuniary interests do not conflict with their fiduciary responsibilities.

This concept of independence applies equally to controlled corporations, however in these companies, the majority of directors should also be independent of the controlling shareholder.

However, it can be difficult to determine what actually constitutes independence. Examples abound of boards which met technical definitions of independence and yet clearly failed to demonstrate independence of mind or exercise independent judgement.

An additional challenge is that, as businesses become more and more complex, it becomes increasingly difficult for directors who have no ties to management to fully understand the complexities of the business and the potential impacts on stakeholders.

The IGOPP has proposed an alternate framework which may assist directors in considering board composition in controlled companies. It proposes assessing directors in terms of *legitimacy* and *credibility*.

Legitimacy

Legitimacy refers to the reputation that the board and its directors enjoy in the eyes of shareholders and other stakeholders. Only a legitimate board has the moral authority to act as the supervisor and monitor of management.

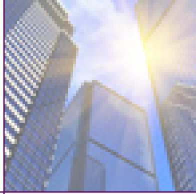
Independence from management is a necessary condition of legitimacy, as it provides assurance that the directors' judgment will not be influenced, nor appear to be influenced, by personal interests rather than by the interests of company stakeholders.

However, simple independence from management is not enough. Even a director with no ties to management will not be viewed as a legitimate director if the process through which that director came on to the board is flawed.[6] The way directors are nominated and elected may either enhance or cast doubt on their legitimacy.

It is incumbent upon directors to consider ways of improving the selection and election of board members for their company. Measures such as cumulative voting, individual and majority voting and nomination of candidates by shareholders representing 5% of the votes are all aimed at strengthening the legitimacy of boards.

5 In 2008, these percentages were 82% for U.S. companies (S&P 500); 79% for the largest 100 Canadian companies, 62% for the 150 largest U.K. companies. (Spencer Stuart Board Index 2009)

6 Allaire, Y. *The Independence of Board of Directors: A Quest for Legitimacy*, SSRN, 2008.



Credibility

While legitimacy is an important element of board composition, the other key element is credibility. Only a credible board really adds value and enhances the performance of a corporation.

The *credibility* of board members hinges on their collective experience and expertise relevant to the specific issues and challenges of the organization they have been selected to govern.

Significant Shareholders on the Board

The boards of public companies with significant shareholders need to combine two forms of legitimacy on their board:

- the legitimacy flowing from independence from management and from the significant shareholder as well as a nomination/election process that gives real voice to minority shareholders, which comes from the independent directors;
- the legitimacy from having created and built the company and from having a large investment at stake in the company, which can come from the participation of a significant shareholder.

Significant shareholders playing an active role in the governance of a company can bring a high degree of *legitimacy* to the board by virtue of their capital commitment. They can also bring a high level of *credibility* because of their knowledge of the company.

However, significant shareholders are generally not regarded as independent, and so their participation on standing committees (audit, compensation, nomination or their equivalent) is a contentious issue and is discouraged by some regulatory bodies.[7]

Controlling shareholders (or their representatives) should not be considered independent when they are part of management, but when a controlling shareholder is involved only in the governance of the company, it can be highly effective to have that person sit on some of the key committees of the board to provide the benefit of their in-depth knowledge of the company.

Governance of Controlled Companies

Once a director agrees to join the board of a controlled public company, there are particular governance issues which he/she should be aware of.

What are the duties and responsibilities of directors of controlled companies?

The duties and responsibilities of directors of a controlled corporation are no different, from a legal perspective, from those of directors on the board of a widely-held company. Directors have a fiduciary duty to act honestly and in good faith with a view to the best interests of the corporation, and a duty of care which requires them to be diligent in supervising and managing the corporation's affairs.[8]

When serving on the board of a controlled company, it is important for directors to remember the focus on acting in the best interests of the corporation, rather than shareholders. The Supreme Court of Canada elaborated on this duty as follows:

> *There is no principle that one set of interests—for example the interests of shareholders—should prevail over another set of interests. Everything depends on the particular situation faced by the directors and whether, having regard to that situation, they exercised business judgment in a responsible way.*[9]

Boards of directors are called upon to weigh and balance the interests of various stakeholders. This duty can be particularly challenging in controlled corporations in which a significant or majority shareholder sits on the board.

---

7 Sarbanes-Oxley forbids the participation of significant shareholders on the audit committee but is silent about the other committees. The American stock exchanges (NYSE and NASDAQ) and the U.S. Securities and Exchange Commission have issued governance rules that also prevent significant shareholders from membership on the other committees.

8 Canada Business Corporations Act s. 122(1), Quebec Bill 63, *Peoples Department Stores Inc. v. Wise* (2004) S.C.C.

9 *BCE-Bell Canada v. Debenture Holders* (2008) S.C.C.

What is the role of independent board members in the governance of controlled corporations?

A major difference between widely-held companies and controlled companies is that in controlled companies, independent board members must act as the arbiter between the interests of minority shareholders and the interests of the controlling shareholder, and also sometimes between the controlling shareholder and management. In addition to the overall responsibility for the supervision and monitoring of management, independent board members must ensure that the controlling shareholder does not derive "private benefits" at the expense of minority shareholders.

Independent board members, particularly in a young company, may also play a very useful role of guiding and coaching the founder-CEO of the company as well as compensating for his/her relative inexperience about some aspects of managing a publicly-listed company.

Independent directors play a critical role in the oversight of related-party transactions and CEO succession.

Related-party Transactions

Related-party transactions should be reviewed by a committee of directors who are independent of both management and the controlling shareholder, and then approved by the full board. A full accounting of such transactions must be included in the annual Management Information Circular.

When conducting their review, the independent board members must assess the advisability of the transaction in light of their responsibility to act in the best interests of the corporation. The committee should retain the services of independent financial and legal advisers and obtain or confirm information from reliable sources, rather than relying solely on information provided by management or the controlling shareholder.

The saga of Hollinger International provides useful lessons for independent board members reviewing transactions between a controlling shareholder and the corporation, and demonstrates the consequences when a board fails to follow appropriate procedures when reviewing related-party transactions.

CEO Succession

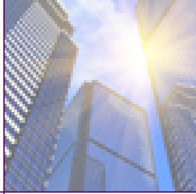
The issue of CEO succession is often difficult and sensitive in controlled corporations.

There are benefits to family control extending beyond the founder into second or third generations, particularly when family members play an active role on the board but employ a professional manager as CEO. Many successful corporations have been built and governed by the descendants of the original founder.

However, leadership succession in family controlled companies is an issue of legitimate concern for minority shareholders. Clearly, descendants of the founder should not be arbitrarily barred from succession to the CEO position because of their relationship, but neither should a founder be given an absolute right to appoint his/her successor when the company has a large number of investors and is publicly traded.

It is the board's duty to ensure that a well designed succession plan is in place for the senior management of the corporation. It is incumbent upon the board to ensure that qualified people are being prepared for the most senior leadership positions, including that of CEO. The board must ensure that a development program is in place to prepare potential CEO candidates for the position.

Whenever a relative of the controlling shareholder is a likely candidate for the CEO position, it should be the independent members of the board who define the profile of ability and experience desired in the next CEO in light of the company's future challenges. The merits of all viable candidates should be considered and discussed thoroughly with the controlling shareholder.
A well established succession plan will provide the board with sound arguments to support its choice of CEO.



The chair of the selection committee may report on the process adopted to select the new CEO at the annual meeting of shareholders following a CEO transition. Following the process above can help assure minority shareholders that their interests were protected.

When must an independent director resign from the board of a controlled company?

Probably the most difficult and anguishing issue for an independent board member of a controlled corporation is when they disagree with a controlling shareholder on a fundamental issue. When all attempts at persuasion have failed and when the issue bears on the best interests of the corporation and its minority shareholders, it may be that the only option remaining is to resign from the board.

A board member may also decide to resign due to a combination of actions, decisions, attitudes, and events, or a pattern of evidence indicating that the controlling shareholder does not respect the role and fiduciary obligations of the independent directors.

A public, mid-mandate resignation sends a powerful signal that something is awry. The threat of public resignation by a director may be an effective way of persuading a controlling shareholder on a sensitive issue. The threat of several members resigning is an even more powerful argument. Resignation, or the threat of resignation, is often an independent director's only effective leverage in a corporation in which one shareholder (or related shareholders) has absolute control of the votes. It should be used wisely and courageously.

When resigning, board members may be discrete (i.e. simply not standing for re-election), and this option may appear attractive in order to avoid media attention and reputational risk. However, by resigning without giving a reason, board members may fail to fully discharge their fiduciary duty to the company and its minority shareholders.

Conclusion

Controlled corporations, whether controlled directly or through a class of superior voting shares, play a significant role in Canada's industrial structure, comprising some of the country's largest and most successful companies.

The stability of ownership and management's ability to plan and manage for the longer term are attractive features of these companies, provided minority shareholders are well protected. That is a key role of independent board members. These directors must perform a balancing act, play arbiter in difficult situations, show firmness and courage at critical times and manifest character and independence of mind at all times. All in all, it is a valuable and challenging role.

Appendix A

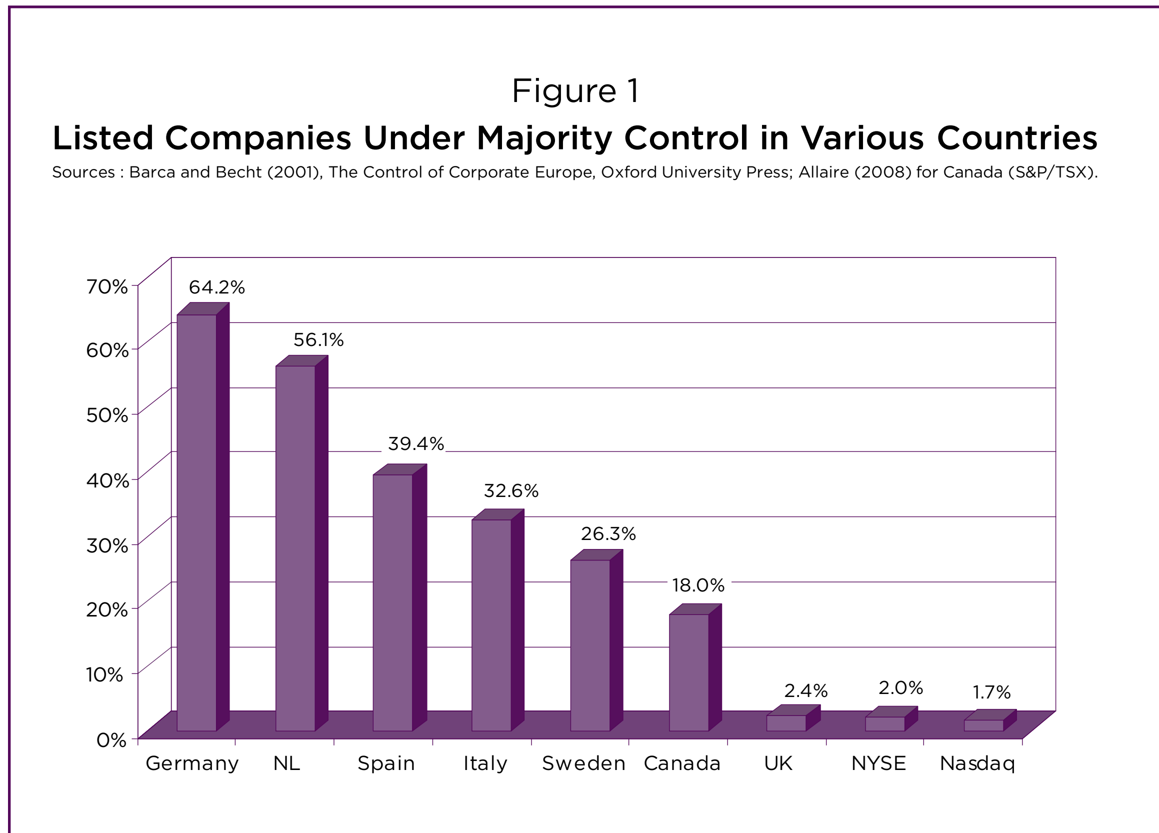
Prevalence of Controlled Corporations in Canada and Internationally

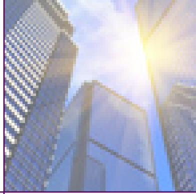
Figure 1 demonstrates how Canada compares to other countries with respect to the prevalence of controlled corporations. Publicly-listed controlled companies are rare in the United Kingdom and in the United States but are quite prevalent in other European countries. Canada is located somewhere between the two extremes.

Figure 1

Listed Companies Under Majority Control in Various Countries

Sources : Barca and Becht (2001), The Control of Corporate Europe, Oxford University Press; Allaire (2008) for Canada (S&P/TSX).

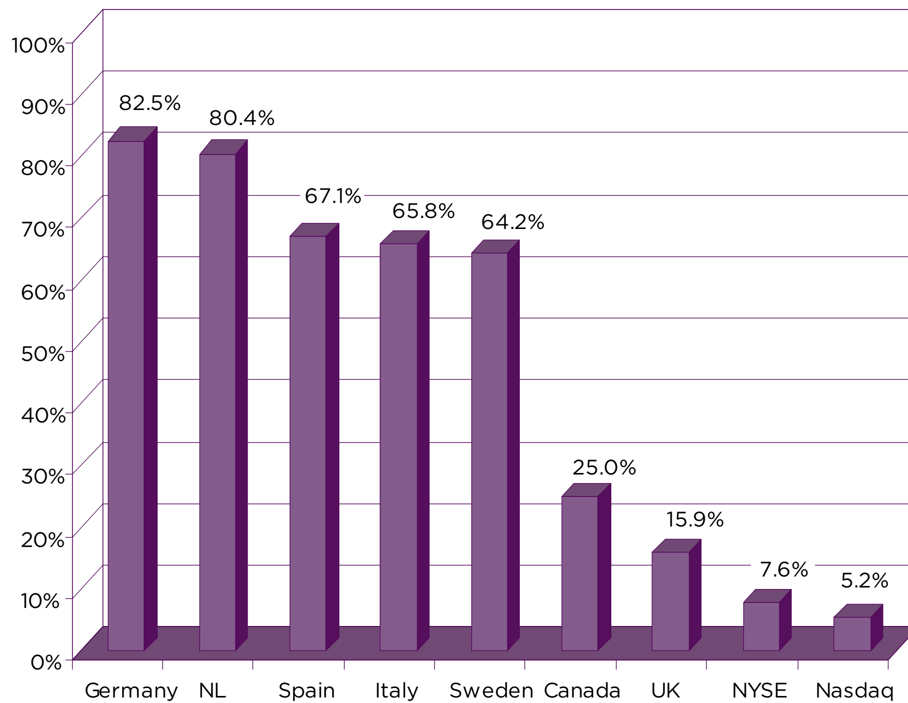




The result is roughly the same for the distribution of companies with a blocking minority shareholder, that is, one with 25% or more of the votes, as shown in Figure 2. In this case, however, Canada is closer to the UK than to the European countries, where blocking minorities are very common.

On the basis of these figures, controlled publicly listed companies represent 5% to 7% of American companies, 25% of Canadian companies and more than 66% of continental European companies.

Figure 2
Listed Companies with a Blocking Minority
(At least 25% of Votes)



Appendix B

Dual-Class Share Structures in Canada

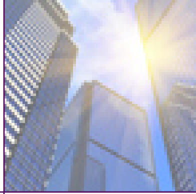
Dual-class share structures are a common feature among Canadian publicly-traded corporations. As of April 2005, 96 companies (or 6.57%) of the 1,459 listed on the TSX had a dual-class share structure.[10] Of these 96 companies, one third were domiciled in Quebec, and the remaining two-thirds in the rest of Canada, mainly Ontario.

The frequency of dual-class structures has declined steadily since 1988 when there were 177 companies with dual-class structure; there were 164 in 1993 and 148 in 1998.[11]

Among the largest Canadian companies with shareholders holding more than 10% of the votes, approximately 25% had issued two classes of common shares. These represent 13% of all companies on the S&P/TSX Index. In 20 of these 33 cases, there is a class of shares with multiple votes (usually ten votes, although there are many variations) and one with a single vote. In 13 cases, there is a class of voting shares and another class of non-voting shares.

10 National Union of Public and General Employees. "*The Disadvantages of Dual-Class Structures to Public Shareholders*", 2005.

11 Amoako-Adu, Ben, Brian F. Smith, and Kalimipalli Madhu, "*Concentrated and Dispersed Ownership Structures and Q Ratio: Dual and Single Class Shares*", Working Paper, Wilfrid Laurier University School of Business and Economics, September 30, 2005.



Appendix C

Voting Power Dilution From Dual Class Share Structures

The voting power dilution resulting from dual-class shares varies enormously among Canadian companies. In 2005, the median voting power dilution was 4.38, meaning that the median controlling shareholder had 4.38 times more votes than the percentage of the equity he/she owned.

The following table shows the relationship between the ratio of multiple votes and the percentage of voting equity required for the absolute control of a company by a shareholder who owns all superior voting shares:

Voting Power of Superior Shares	% of Equity for Absolute Control
20 to 1	4.8%
10 to 1	9.1%
5 to 1	16.7%
4 to 1	20.0%

The IGOPP advocates that absolute or "legal" control (50% plus of the votes) should not be achieved with less than 20% of the equity. In other words, absolute or legal control through a dual class of shares should only occur when the shareholder has at least effective control of the company.

Appendix D

Protection of Minority Shareholders

A good indicator of the quality of protection afforded to minority shareholders of controlled corporations is the premium the market places on the class of shares owned principally by the controlling shareholder. Absent a proper legal framework of protection, the premium (and conversely the discount on the class of shares owned by minority shareholders) is as large as the market understands the latitude enjoyed by the controlling shareholder to extract "private benefits" from the company to be. The following table presents international data on the premium accruing to the class of share with superior voting power.

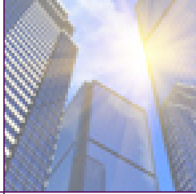
Private Benefits of Control in Different Countries

Country	Voting Premium (%)
Australia	23
France	28
Sweden	1
Germany	10
Mexico	46
Italy	29
United Kingdom	10
United States	2
Canada	3

Sources: Nenova (2003); Deck and Zingales (2004); Morck et al. (2005)

© Allaire 2007

This table provides a stark measure of the degree of protection provided to minority shareholders. Clearly, Canada scores very high on that aspect of governance, on a par with the United States. Countries with poor protection of minority rights, such as Mexico and Italy (at the time; several measures have been enacted since), are characterized by a huge premium accruing to controlling shareholders which, conversely, means large discounts on the shares held by other shareholders. The "coattail" provision in place since 1987 is a key contributor to this Canadian performance.



Where to Find More Information

CICA Publications on governance*

The Director Series

The 20 Questions Series

20 Questions Directors and Audit Committees Should Ask about IFRS Conversions

20 Questions Directors Should Ask about Building a Board

20 Questions Directors Should Ask about CEO Succession

20 Questions Directors Should Ask about Codes of Conduct

20 Questions Directors Should Ask about Crisis Management

20 Questions Directors Should Ask about Crown Corporation Governance

20 Questions Directors Should Ask about Director Compensation

20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance

20 Questions Directors Should Ask about Executive Compensation

20 Questions Directors Should Ask about Governance Assessments

20 Questions Directors Should Ask about Internal Audit (2nd ed)

20 Questions Directors Should Ask about IT

20 Questions Directors Should Ask about Management's Discussion and Analysis (2nd ed)

20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing

20 Questions Directors Should Ask about Risk (2nd ed)

20 Questions Directors Should Ask about the Role of the Human Resources and Compensation Committee

20 Questions Directors Should Ask about their Role in Pension Governance

20 Questions Directors Should Ask about Special Committees

20 Questions Directors Should Ask about Strategy (2nd ed)

Director Briefings

Climate Change Briefing — Questions for Directors to Ask

Long-term Performance Briefing — Questions for Directors to Ask

Director Alerts

Executive Compensation Disclosure — questions directors should ask

Fraud Risk in Difficult Economic Times — questions for directors to ask

Human Resource and Compensation Issues during the Financial Crisis — questions for directors to ask

The ABCP Liquidity Crunch — questions directors should ask

The Global Financial Meltdown — questions for directors to ask

The Not-for-Profit Director Series

NPO 20 Questions Series

20 Questions Directors of Not-for-profit Organizations Should Ask about Board Recruitment, Development and Assessment

20 Questions Directors of Not-for-profit Organizations Should Ask about Fiduciary Duty

20 Questions Directors of Not-for-profit Organizations Should Ask about Governance

20 Questions Directors of Not-for-profit Organizations Should Ask about Risk

20 Questions Directors of Not-for-profit Organizations Should Ask about Strategy and Planning

Liability Indemnification and Insurance for Directors of Not-for-Profit Organizations

NPO Director Alerts

Increasing public scrutiny of not-for-profit organizations—questions for directors to ask

Pandemic Preparation and Response — questions for directors to ask

The CFO Series

Deciding to Go Public: What CFOs Need to Know

Financial Aspects of Governance: What Boards Should Expect from CFOs

How CFOs are Adapting to Today's Realities

IFRS Conversions: What CFOs Need to Know and Do

Risk Management: What Boards Should Expect from CFOs

Strategic Planning: What Boards Should Expect from CFOs

The Control Environment Series

CEO and CFO Certification: Improving Transparency and Accountability

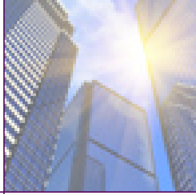
Internal Control: The Next Wave of Certification. Helping Smaller Public Companies with Certification and Disclosure about Design of Internal Control over Financial Reporting

Internal Control 2006: The Next Wave of Certification — Guidance for Directors

Internal Control 2006: The Next Wave of Certification — Guidance for Management

Understanding Disclosure Controls and Procedures: Helping CEOs and CFOs Respond to the Need for Better Disclosure

*Available at www.rogb.ca



Other Publications

Allaire, Y. *The Independence of Board of Directors: A Quest for Legitimacy,* SSRN, 2008

Allaire, Y. «*L'actionnariat des grandes entreprises canadiennes : quelques données*», Institute for Governance of Private and Public Organizations, August, 2008

Amoako-Adu, Ben, Brian F. Smith, and Kalimipalli Madhu, "*Concentrated and Dispersed Ownership Structures and Q Ratio: Dual and Single Class Shares*", Working Paper, Wilfrid Laurier University School of Business and Economics, September 30, 2005

Anderson, Ronald C. and David M. Reeb. "*Board Composition: Balancing Family Influence in S&P 500 firms*", Journal of Economic Literature, August 2004

Anderson, Ronald C. and David M. Reeb. "*Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*", The Journal of Finance, vol. LVIII, no. 3, June 2003

Barca, F. and M. Becht, *The Control of Corporate Europe*, Oxford University Press, December 2002.

Dyck, A., and L. Zingales. *Private benefits of Control: An international Comparison*. The journal of Finance, Vol. 59, 2004

Morck, R., D. Wolfenzon and B. Yeung, *Corporate Governance, Economic Entrenchment and Growth*, Journal of Economic Literature, Vol.43, 2005

National Union of Public and General Employees. "*The Disadvantages of Dual-Class Structures to Public Shareholders*", 2005

Nenova, T. *The Value of corporate voting rights and control: A cross-country analysis*. Journal of Financial Economics, Vol. 68, No 3, 2003

Villalonga, Bélen and Raphael Amit. "*How Do Family Ownership, Control and Management Affect Firm Value", Journal of Financial Economics*, forthcoming, 2005

About the Author

PROFESSOR YVAN ALLAIRE, PhD (MIT), FRSC
Dr. Allaire is Chairman of the Board of the Institute for Governance of Private and Public Organizations (HÉC-Concordia), Professor emeritus of strategy, UQÀM and a Fellow of the Royal Society of Canada.

Professor Allaire is a member of the World Economic Forum, Council on Global Business issues. He was selected as one of Canada's six Business Gurus by the Financial Post Magazine (April 2009).

Professor Allaire was a Member of the board, Caisse de dépôt et placements du Québec and chairman of its governance and ethics committee. He is a member of the National Committee for Canada of The Aga Khan Foundation and a member of the board of Le Conseil des relations internationales de Montréal (CORIM). He has also been a member of the board of several publicly listed and not-for-profit organizations including CGI Group, Bombardier, Fondation Chagnon and CRSH.

Dr. Allaire is Senior Fellow, C.D. Howe Institute; member of Advisory Committee, Controller General of Canada. In 2003, Dr. Allaire chaired the Quebec Government working group on the modernization of governance for State-owned Corporations.

Dr. Allaire was a founding partner, and was chairman (until 1994), of the Secor Group, a Canadian strategy consulting firm; he was Executive Vice-President of Bombardier Inc. from 1996-2001.

Professor Allaire is the author of several books and many articles on strategy and governance. He holds a B.Sc. Com. (Summa cum laude) and an MBA from the Université de Sherbrooke, and a PhD from the Sloan School of Management, MIT.

Professor Allaire received in 1997 a doctorate *honoris causa* from the Academy of Economic Sciences of Bucharest. In 2001, he was chosen as one of 12 "High Performers" by the Revue *Commerce* and received the "Award of Distinction" from the John Molson School of Business (Concordia University).

ISBN-13: 978-1-55385-496-8
9 781553 854968
04000062

CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS
277 WELLINGTON STREET WEST
TORONTO, ON CANADA
M5V 3H2
416.977.3222
WWW.CICA.CA