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NO Scandal

In the post-Enron-WorldCom-Hollinger world, pressure is on boards and directors to reform themselves. But will a new course at the Rotman School help? Brian Tobin, Claude Lamoureux and other members of Canada's corporate elite are in the midst of finding out

by Jonathan Kay

Brian Tobin has served as Industry Minister, Fisheries Minister and Premier of Newfoundland. He has been on the boards of numerous corporations, including Magna International Developments Inc., and acts as adviser to several others. Few Canadian directors can match him for connections and accomplishments. But, though he'd never admit to it, on some level he's got to be a worried man.

In bygone years, as ex-politicians like Peter Lougheed can attest, the world of corporate directordom was easier, chumrier and not nearly as demanding. In the post-Enron, post-WorldCom, post-Hollinger corporate environment, however, small shareholders, regulators and big institutional players demand that directors watch their company's senior executives like hawks, and be ready to swoop in when even the tiniest scent of malfeasance is in the air. Consequently, sitting on a board has gotten a whole lot more complicated — and potentially dangerous to a director's reputation.

"Experience is important," says Tobin, who, among his other titles, is now CEO of Magna International Developments. "But it does not negate the need to remain current with best practices and corporate governance rules. The fact is, when things go wrong, claiming you were out of the loop or did not understand your role will not limit [your] liability."

This is why Tobin has gone back to school. Last fall, he joined the inaugural class of the Directors Education Program, a creation of both the University of Toronto's Rotman School of Management and the Institute of Corporate Directors (ICD). And as I learn when I sit in on their studies at the school's posh Executive Programs enclave one Saturday in February, he is hardly the only brand-name executive looking to upgrade his skills. Among his 34 fellow students in this first-of-its-kind program in Canada (there are already 35 in the U.S.) are Ogilvy Renault senior partner David Gavsie, Ontario Teachers' Pension Plan CEO Claude Lamoureux and Canadian Institute of Chartered Accountants president David Smith. In June, they are scheduled to receive their "Directors Education Certificate" and ICD accreditation. To see these people in the same room is an amazing sight, one that would have been unimaginable just a few years ago. No court decision, law or Ontario Securities Commission (OSC) pronouncement could say more about the changed state of corpo-

photography by Edward Pond

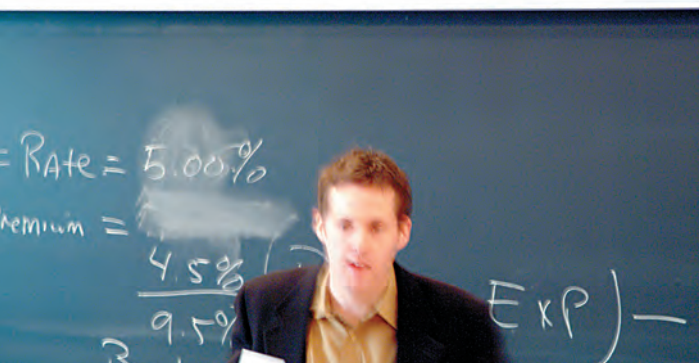


rate governance in this country than that three dozen power-brokers would skip the cottage, get up before sunrise on a weekend and end the day being lectured to and scribbling notes in a university classroom.

On the day I attend, the Directors Education Program is featuring two lectures: a presentation on the evaluation of corporate investments (by Rotman Business School professor and corporate governance expert Tim Rowley), and a summary of the leading research on CEO-board relations (by Professor Edward Zajac of the Kellogg School of Management, another governance expert).

Much of the material is dry and complex. Rowley, for instance, dwells on a valuation equation that extends half the length of the blackboard. And Zajac puts up slides with titles such as “Diffusion of a Shareholder Value Orientation Among the 112 Largest German Corporations.” But overlying all this detail is an exhortation to diligence and personal integrity. The lecturers make clear that a director’s knowledge

This is not always a problem during normal times, when most boards typically cruise along sleepily, meeting rarely, and then only to approve resolutions prepared by management. But then a crisis emerges – perhaps an imminent bankruptcy, an ill-considered merger or acquisition proposal, a toxic compensation issue, a CEO who’s lost it — and the board must act to protect shareholder interests. Unfortunately, when this “moment of truth” arrives, too many boards find themselves paralyzed, unwilling to confront the management honchos with whom they’ve shared golf rounds and multi-martini lunches in more placid times.



Nothing says more about the growing concern over corporate governance than the sight of three dozen power-brokers being lectured to in a classroom

is useless if she lacks the wherewithal to apply it.

“The first question we ask the participants is: ‘What characterizes a good director?’” says Rowley. “The most common answer is: ‘The courage to ask tough questions.’ That is sometimes not easy. Directors need to have the social skill and will to do that. The program is designed to not only help directors determine what are the most penetrating questions, but how to design board processes and dynamics that foster these types of dialogues.”

As a matter of law, acting as a corporate director is simple. It requires only that office-holders fulfill (a) a “duty of care,” which calls for diligence and prudence in their oversight roles; and (b) a “duty of loyalty,” which prohibits self-dealing and requires that the director put the interests of the company first at all times. But in real-life situations, experts agree, these abstract ideals can become compromised by complacency, shyness, laziness, the urge toward conflict avoidance, and the sticky web of social and business links of “buddy boards.” (According to one study discussed by Zajac, more than 90% of U.S. directors surveyed knew their company’s CEO or a fellow board member at the time they joined the board.)

In the past, directors who rubber-stamped questionable resolutions were typically insulated by the so-called “business-judgment rule,” which prohibits courts from second-guessing business decisions made in good faith, even if they later proved to have been mistaken. But the wide deference granted under that principle has eroded greatly in recent years. As a result, directors face greater liability, which is reflected in rising insurance rates for both directors and officers in the United States. According to a comprehensive survey done by the consulting firm Towers Perrin in the United States, directors’ and officers’ liability insurance premiums rose by an average of about 120% between 2000 and 2003. Precise data is difficult to find for this country, but according to Udo Nixdorf, senior vice-president of Chubb Insurance Company of Canada, the pattern is much the same here. The dollar amounts involved are large: According to Nixdorf, D&O insurance for a large, publicly traded corporation in a mature industry now costs about \$10,000 to \$15,000 per million dollars of coverage, with most companies insuring themselves to \$100 million or more.

“There is now a much greater willingness among plaintiffs to

take on directors,” says Joseph Groia, a Toronto-based lawyer who often represents shareholders in class-action lawsuits against corporations. “Historically, if you look at the cases in this area, the attitude has been that, absent self-dealing or fraud, most directors have escaped liability. That is changing. And thanks to the fallout from Enron and [similar] scandals, judges are no longer protecting directors the way they once did.”

As an example, he points to *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.*, a 2002 Ontario case in which the members of the Repap Enterprises Inc. board were found to have acted unreasonably in permitting their own chairman and senior executive officer to ram through his own exorbitant compensation package. The decision set down the principle that board members must take an aggressive, even adversarial, role when there are grounds to suspect they are being duped by company officers. “The directors owed the



shareholders a higher duty to go slowly and educate [themselves] thoroughly,” the Ontario Superior Court of Justice ruled. “[Only one director] tried to address the unfavourable implications of the [compensation] agreement. ... Still, [he] did not do enough. He did not press his concerns forcefully enough. He did not formally dissent or otherwise act to protect the shareholders’ interests. This was his obligation even if he chose to resign.”

In other words, the directors on the board of Repap had failed in their moment of truth.

To help students avoid such failures, the Rotman directors course puts participants through a variety of role-playing case studies. These include the case of True-Value Drugstores Ltd. — a fictional company whose directors faced an all-too-real dilemma.

For the board of True-Value, the moment of truth came on Sunday, March 7, 1999. A publicly traded Canadian firm based in Ottawa, True-Value had expanded quickly in the 1970s and 1980s, gobbling up stores across Canada, New England and the American Midwest. But in recent years, according to the case study document distributed to the class, the firm’s fortunes had turned sour. Mail-order pharmacies and Wal-Mart had taken over much of the retail drug market. Many stores were now faltering, especially recently acquired U.S. outlets. The company had posted losses for each of the last three fiscal years. Creditors were getting nervous. And at least one supplier had demanded cash on delivery.

Just as worrying was the company’s management situation. Its CEO, chair and majority shareholder was Jimmy Simpson, the folksy son of founder Bill Simpson, who had built the True-Value chain up from a single family-run store in Kingston, Ont. In recent years, Jimmy had been arguing with his board and Barbara Hoffman, his chief operating officer. Hoffman had been warning for years that the company was bloated with underperforming assets, and eagerly sought to put a downsizing program, Profit 2000, before the board. But Jimmy opposed the plan and even moved to prevent the board from hearing her present details of it.

Against all evidence, he clung to the hope True-Value could grow its way back to profitability. According to one director, a close friend of the CEO, Jimmy was “experiencing a classic state of denial and emotional withdrawal. Suddenly, he sees his business is being threatened, and he is being hit very hard emotionally.”

Because of all this tumult, Nick Rennie, a True-Value director and audit committee member, brought his co-directors in for a special meeting. Two intertwined issues were on the table: the future of Jimmy and the correct plan to save the company. As Barbara and Jimmy waited nervously in nearby rooms for the board’s verdict, True-Value’s directors faced their moment of truth.

While the True-Value case study is a Rotman invention, the challenges it confronts apply to thousands of small and mid-sized Canadian companies still dominated by a founder or scion. “Our motivation for writing this case was to reflect a very common ownership structure in Canada and to provide students with an opportunity to think about governance issues when you have a majority shareholder not only owning the company, but running it,” says Rowley. “Governance issues are global. But we’ve customized it to the Canadian market, where there is a high percentage, relative to some countries, of family-owned or a controlling block.”

To hash out the True-Value case study, the class is divided into five groups of seven (I tag along with Tobin’s septet), and we go to huddle privately in what business schools now call “breakout rooms.” Collectively, each group member is to take on the identity of a rookie True-Value director, and then decide what position to adopt at the March 7, 1999, meeting.

At first, our small group gropes around in the dark. The problem is twofold: Jimmy’s refusal to permit a full hearing on Barbara’s plan; and the fact he has never spelled out his own pro-growth proposal in any sort of comprehensive way. As a result, the board was going on imperfect information. (I later found out from Rowley that this was deliberate: What we were doing was to try to simulate the situation in which a controlling figure is deliberately stingy with the information he or she would provide to the board, a not uncommon scenario.)

For a while, some of the group members without financial backgrounds struggle to decipher the many pages of True-Value financial data supplied as an appendix. But after a meandering discussion of profit and loss, Raymond Protti, the Toronto-based president of the Canadian Bankers Association, suggests to us that we need to take a broader view: “What we’re doing is assessing Jimmy’s performance — not on a year-to-year basis, but overall. We’re really asking: ‘What are we going to do with Jimmy?’”

Susan Wolburgh Jenah, vice-chair for the Ontario Securities Commission, agrees: “You can make the decision about Jimmy regardless of what strategy decision you want to make. Barbara is the successor behind the scenes. Maybe the time has come to make

a change at the top. There's a cultural shift. If Jimmy stays on the job, you know the problems are going to continue."

As an anti-Jimmy consensus develops, a dissenting voice speaks out. Lyle Hepburn, a Toronto lawyer specializing in public mining and mineral exploration companies, makes this point: "Jimmy is the controlling shareholder, the chairman, the CEO. In addition, many members of the board support Jimmy and/or his business strategy. Accordingly, it would be extremely unlikely that a movement by those members of the board wishing to fire Jimmy at this stage would be successful," he says. "I do not believe that such a confrontational approach would be appropriate at this time. Based on the information provided, I am not convinced that Jimmy is entirely responsible for the recent losses. My suggestion is that we meet with Jimmy and management to hear their respective strate-

gies. After we have considered the alternate strategies, we vote on what we consider to be the best strategy, not the person."

Back in class, each group presents its recommendations. The Tobin group takes the toughest anti-Jimmy line. But all the others revolve around moving Jimmy out of the CEO's role — with the plurality view being that, rather than dumping him outright, he should be kept on in some sort of ceremonial, community-outreach role in order to help assuage his ego.

Oddly, while the lawyer is thinking politics, the politician is thinking law. "We can fire him, Lyle," says Tobin. "You've got the next general meeting with him running the slate. But for the moment, we have the ability, if we want to exercise it, to push him aside. The issue is, we're down to cash on suppliers. We're bleeding badly. He only lets us discuss what he wants us to discuss. We have possible legal liability, fiduciary obligations to the shareholders that we can't fully exercise in the current environment. So you either leave the board and tender your resignation. Or you fulfill your duties. It's one or the other. If we believe we can fulfill that with him as the chair, fine. If we can't, and the evidence suggests we can't, we almost have no choice but to remove. ... I know what I'd do. I'd get ready to vote to remove Jimmy."

Jake Scudamore, a Toronto-based corporate consultant, thinks the company's financial crisis may actually be an asset. "This is the driver," he says. "They can't get any more money from the banks and they're out of cash. We're asking, 'Is there a sense of urgency?' Yes. Okay, phase two: How do we get the board, which is aligned emotionally with Jimmy, to go along with change?" Scudamore then pauses, and offers this answer: "You advise them that the bank is at the door, and we'll all be replaced tomorrow if we don't. It's no longer us against them. You're moving it to a third party."

At this point, Scudamore is interrupted, mid-sentence, when the door opens. It's "Jimmy."

"Good to see you guys at the club a couple of nights ago," says the tall, middle-aged man, smiling broadly. "This is a good time to have friends, guys like you." The schmoozy back-slapping patter immediately puts everyone in the room into stitches. (Later in the day, Jimmy — in reality, a veteran corporate director who prefers that his name not be used — would tell me he's seen all-too-many Jimmies in his time, certainly enough to get their sh*t down pat.)

"I've learned a lot in the last while," Jimmy continues soberly. "This has been a tough go — the acquisition route. And I'm the

first to admit that we made some mistakes here and there. But I think growth is the key and I see a lot of good stuff coming. I feel good about things."

"Where's the cash?" demands Tobin.

"Whoa, hey — that's what the finance guys are there for, Brian," says Jimmy, raising his hands to his chest as if to deflect invisible arrows. "They'll find it. C'mon, let's separate the roles here. Get on with doing your job. I go down and talk to these bankers. It drives me nuts. They're always so negative. You know, sightlines of a gnat. You just gotta stay the course! You gotta have faith!"

But faith is in short supply. Though entertaining, Jimmy's appearance does little to save his virtual job. Aside from Lyle, everyone agrees that Jimmy should be fired as CEO and his COO, Barbara Hoffman, should get the job on an interim basis.

It is difficult to imagine that, in real life, Magna director Brian Tobin would ever take on Frank Stronach with the same ferocity with which I saw him take on "Jimmy"

SO YOU WANT TO BE A DIRECTOR?

Then see how you score in our quickie quiz

>1. Who is responsible for "attesting" to the accuracy of the corporation's financial statements?

- A. Audit committee
- B. Audit committee chairperson
- C. CEO
- D. Auditor
- E. Internal auditor
- F. Board of directors

>2. Who appoints the auditor?

- A. Management
- B. Shareholders
- C. Audit committee
- D. Board of directors
- E. Internal auditor
- F. Audit committee chairperson

>3. What is the difference between a board member's duty of care and fiduciary duty?

Answers 1: F, 2: B, 3: According to Carol Hansell's book, *What Directors Need to Know*, fiduciary duty requires directors to act honestly and in good faith with a view to the best interests of the corporation. This means that directors must favour the interests of the corporation over all other interests. This duty is intended to provide some confidence that directors will not manipulate the corporation for their own (or others') benefit. The duty of care concerns the performance requirements for directors and states that each director must exercise the care and skill any reasonable person would in comparable situations. In lay terms, directors are expected to apply the full extent of their skills and experience to their roles on the board. — *Tim Rowley, Rotman School of Management*

DIRECTORS ED. 101

What you get for your money: a Rotman case study

The ICD Corporate Governance College at the University of Toronto's Rotman School of Management says that it "trains directors to meet and exceed heightened expectations for good corporate governance." The program, which costs \$12,000, is held over four weekends and participants are exposed to "best practices" in several areas. They include: board responsibilities and ethics; board functions and composition; financial reporting and auditing systems; the role of the audit committee; relations with management; management appointments; monitoring, assessing and development of management compensation issues; and trends in programs relevant to legislation and governance board strategy and execution. The program is next offered beginning in September 2004. For more information visit www.rotman.utoronto.ca/execprog/dep.

After the class, I speak with Bernard Wilson, vice-chair of PriceWaterhouseCoopers LLP and chairman of the ICD. He was pleased most students seemed eager to confront Jimmy. "Being a director today should not be about getting into a group where you're necessarily going to make a lot of friends," he says. "In fact, there'll be times when you actually aggravate some board members because you stand on principle and exhibit courage. When boards perform poorly, a lot of the time it's because members had some inkling things were wrong, but they didn't rock the boat. They wanted to be one of the boys, one of the group. Well, a board is not a team. If the 'team' is eager to get out and catch their plane, they might be angry when you raise a sensitive point just as they're ready to wrap up. But you've got to raise it. Ultimately, it's about courage — the courage to speak up, to admit

when you don't understand something, to ask a question you know could embarrass someone."

As Wilson sees it, his course will help produce nothing less than a new profession. "If you look back in history," he continues, accountants and lawyers didn't have to have any kind of accreditation. "But as [the centuries] passed, people wanted to create standards. If you went to a doctor, you wanted the doctor to have a certain level of training, and didn't just hang out a tile. This is what we want to do for directors, which has now become a very complex and important job. I will hazard a guess that 15 years down the road, most directors of large companies will be accredited."

"By you?" I ask.

"Yes. By us."

But while credentials are nice, it remains to be seen whether the course will

really help directors make the right call when the moment of truth arrives. In most cases, directors know what their theoretical obligations are. It is social and institutional pressures that lead them astray, and since the Rotman course is just starting up, there is no evidence that it will help students conquer those factors. Will, say, Claude Lamoureux speak up if things go wrong at Domtar Inc.? For that matter, how will Brian Tobin react if problems arise at Magna? Role-playing is one thing, real life another. And even after taking this course, it is difficult to imagine that Tobin (or anyone else on his board) would take on Frank Stronach the way I saw him take on Jimmy.

Still, Zajac — a freelancer who has no institutional connection to the Rotman School — gives high marks to the program. "As an educator, I'm obviously going to be optimistic about the value of education," he says. "This is the same sort of thing as, 'Can business ethics be taught?' And the majority view is, 'Yeah, it can be.'"

Moreover, as he sees it, the timing could not be better: "With movements like this," he says, "there is always some kind of triggering mechanism. Sometimes it takes a crisis or scandal to make change — a window of opportunity to discuss issues that otherwise would have remained silent. I always thought corporate governance was interesting. But now it's become more interesting to lots of people. I don't think interest will remain as high as it is now. But I don't think it's a passing fad either." **B**