

Good Cop - Bad Cop?

The Role of the Independent Director

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INDEPENDENT DIRECTORS SERVE A VITAL role in assuring effective corporate governance. They are often sponsored by CEOs or founding shareholders and are expected to carry the primary responsibility for governance and strategic oversight on behalf of public shareholders. Most often, independent directors and related parties, such as controlling shareholders, have an alignment of interests to execute the organization's corporate strategy and maximize shareholder value.

What happens, however, when a related-party transaction is contemplated in which the interests of independent directors' and related parties completely diverge? In these circumstances, independent or special committees are usually formed to review and advise on the transactions. Often, this review and its conclusions put the independent directors directly at odds with their original sponsors.

Such situations squeeze the independent director into the unfamiliar territory of the good cop/bad cop scenario. If the independent directors do their job well, it may be good for the public shareholder – potentially bad for the related parties.

In the wee hours of Nov. 15, 2010, Fred Mifflin and David Pyper, two partners of Blair Franklin Capital Partners Inc., presented to the Edmonton Chapter of the Institute of Corporate Directors real-life situations where circumstances required independent directors to assess and carefully consider their mandated duty and responsibility, in uncomfortable circumstances with related parties.

Background

Securities' regulations and best practices require director independence to assist in delivering effective corporate governance. Independence of the board from management is one of the important tenets of corporate governance. In situations where directors are sponsored by the founding shareholders or incumbent CEOs, they may have a close relationship

with management. Generally, in Canadian law there are at least three categories of directors that are viewed as being independent from management or a particular stakeholder. These include outside directors, unrelated directors, and independent directors. The definition of "independence" can be established by the board for its corporation, or it could rely on defining certain relationships and other tests that disqualify an individual as being independent.

In most cases, independent directors and insiders share an alignment of interests. There are, however, many related-party transactions that may put independent directors at odds with their sponsors. Such transactions could include going private, or non-arm's-length or management-sponsored events.

What happens in these situations? Multilateral Instrument 61-101 requires as good practice that independent committees to be formed to deal with material related-party transactions. In such situations, the committee would obtain independent legal and financial advice. To be independent, the committee should satisfy itself that the advisor is not associated with an interested party; part of the soliciting dealer group; or an external auditor. It should also ensure the advisor has no financial interest in the completion of the transaction. The committee should also ensure that executive compensation is not dependent on the conclusion reached. A recent Ontario Securities Commission decision relating to HudBay Minerals Inc. also cautioned boards not to rely exclusively on opinions provided by advisors who are incentivized to obtain a certain transaction outcome.

It is evident that the above related-party transactions can frequently create opposing financial motivations which, in turn, generate the circumstances for conflicting interests to collide. How is this situation resolved by the independent director in real-life situations? A number of situations, including those described below, were identified and reviewed.

Viceroy Homes of Port Hope, Ont., is a manufacturer of prefabricated homes for domestic and international markets. It was controlled by one family, which held an 80% voting control and a 36% economic interest. An unsolicited bid was received from a foreign party to purchase the public shares at a 35% premium to the previous trades. The controlling family did not tender the shares but instead granted the potential purchaser an opportunity to purchase the family shares at a much higher price for three years. Certain family members were to remain with the company under management contracts.

A committee of independent directors was formed to provide a recommendation to shareholders. The committee's due diligence included an independent valuation and an engagement with major public shareholders and the bidder in an attempt to re-negotiate the transaction. The independent valuation indicated that the original offer price was below fair value. The transaction closed at a higher price for the public shareholders, while the benefits to the family were adjusted to be more reasonable from the perspective of the public shareholders.

In another case, Toronto-based Public Storage Canada operated 28 self-storage facilities throughout Canada. One family effectively controlled the company and indicated to the board it had an interest in taking the company private. At that time, the units were trading at \$14. An independent committee of directors was formed and independent financial expertise was asked to prepare a valuation and a fairness opinion. On the basis of this advice, the committee members informed the family of its intention to reject the initial offer and not tender their shares to the family's bid. Ultimately, the transaction was completed at a price higher than the initial bid, representing a 48% premium to the pre-announcement trading level.

In both cases, the independent director's committees did their job.

Lessons Learned

Any director who is asked to sit on a board by a majority shareholder, a sitting CEO, or other related parties should consider the situation carefully and realize that there may be circumstances where certain related-party transactions will put them at odds. Such circumstances may also cause divisions within the board and create discomfort for independent directors

who feel an obligation to their sponsor to act in a manner which is not fully aligned with the director's duty of care.

In related-party transactions, one way to carry out this duty is to assemble a special committee of directors who are independent for the purpose of the transaction, and for them to seek independent legal, financial and other applicable advice. The record shows this system can be a powerful tool in enabling independent directors to do their job.

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