Global Asset Management

A Different Kind of Democracy in Canadian Boardrooms

The U.S. President James Buchanan once remarked that he liked the noise of democracy. The rough and tumble of the U.S. political system is undoubtedly noisy, but unfortunately the same can't be said for electing corporate boards in Canada. Corporate democracy in Canada is a decidedly quiet process by comparison. While shareholders do have the ability to vote in director elections, that vote has traditionally had virtually no meaning and no influence on the outcome. Some might say that when it comes to electing corporate directors in Canada, it is less a democracy and more a dictatorship. In this article, we will look at how corporate democracy works in Canada and some recent and proposed reforms to the system that are aimed at putting at least some of the power back in the hands of shareholders.

Majority vs. plurality voting

Corporate boards play an important role in our capital markets. Public company boards are tasked with protecting the interests of the shareholders (the owners of a company). They do this by appointing management to oversee the day-to-day operations, and then monitor the performance of those managers. If management fails to act in the best interest of shareholders, the board is there to step in and restore order. Effectively, corporate boards are elected by shareholders to act as their agents and represent their interests.

In most places (including the U.K., Europe, Australia, and almost all developed and developing markets), corporate boards are elected by shareholders using a majority vote standard. This means that each shareholder gets to vote "for" or "against" each director nominee, and a nominee is elected to the board if they receive a majority of votes "for." Conversely, if they receive a majority of votes "against," they are not elected to the board. If there are more nominees than board seats, the nominees with the most "for" votes will win. Majority voting is appealing as it is simple, transparent, fair, and gives the shareholders an effective voice in deciding who will represent their interests on the board.

The alternative system to majority voting is called plurality voting, and this is the system that is used in Canada and the U.S. Under plurality voting, shareholders only have the option of voting "for" or "withhold" for director nominees. What this means in practical terms is that there are no "against" votes recorded for a director and therefore a single "for" vote is all that is required to elect a director to the board. For example, you could have a situation where the only shares voted "for" a director are the shares owned by that director, and they would still be elected to the board. Under this system, shareholders have no way to vote a director off a board, only to vote them onto a board.

To the casual observer these two systems may seem similar, but in reality they are quite different and those differences have very real implications for shareholders. By eliminating the ability of shareholders to remove a director, plurality voting also removes an important link that ensures directors are accountable to shareholders. That accountability mechanism helps boards and individual directors focus on whose interest they represent; management or shareholders.

The rise of the zombie directors

Over recent years, shareholder frustration with plurality voting has been growing. Shareholders have come to realize that their lack of an effective voice in director elections means that boards are not accountable to shareholders. When boards become entrenched or too closely aligned with management and no longer represent the interests of shareholders, there is very little in practical terms that shareholders can do to remove individual directors or a whole board[1]. About 10 years ago, large Canadian shareholders through the Canadian Coalition for Good Governance (CCGG) began to engage with Canadian companies asking them to voluntarily adopt a majority voting policy. The policy would require a director who received less than a majority of "for" votes to offer their resignation to the board, and the board would accept the resignation barring exceptional circumstances. The CCGG's efforts have been paying off over recent years as more and more Canadian companies have been adopting such a policy.

[1] The only way to remove a board is through a proxy battle where an alternative board would be proposed by a dissident shareholder or group of shareholders, and the company and the dissident would compete for shareholder votes. This is a very expensive and complex process.

The CCGG has also been advocating a change to Canadian companies' legislation as a long-term and ideal solution to the problem, but as an interim measure the voluntary majority voting policy was a good first step.

A recent positive development was that the Toronto Stock Exchange (TSX) adopted a rule requiring all companies listed on the TSX to adopt a majority voting policy, and 2015 was the first year where this rule was applied. The requirements were similar to many of the voluntary policies that had already been adopted by companies in that the director was required to offer their resignation if they did not receive a majority "for" vote and the resignation would be accepted unless there were "exceptional" circumstances. However, it appears that "exceptional" is a lot more common than we would have expected. In 2015, of the 21 directors who received less than a majority "for" vote and submitted their resignations to their boards, only seven of those resignations were accepted. The other 14 were rejected due to "exceptional" circumstances. These directors, who continue to sit on a board where shareholders have clearly indicated that they should not, are referred to as "zombie directors." When we exclude small companies and look at just the senior TSX listed companies, the numbers are even less encouraging; of the 10 directors who received less than a majority vote, only one has resigned. Despite the good intentions of the TSX rule, democracy is still proving elusive in Canadian boardrooms.

Future changes

What the experiences of 2015 tell us is that perhaps the only way to effectively implement majority voting in Canada will be to change the federal and provincial legislation to remove plurality voting and implement a majority voting requirement with no exceptions, as we see in other jurisdictions.

Canadian companies have expressed concerns about a legislative change, specifically; weak boards that lack the required skills when directors have been removed, and "failed elections" where too few directors are elected to constitute a board. While these are valid concerns, there are solutions. For example, if there is a failed election, a second shareholder meeting can be held to elect directors. If additional expertise is required on a board, a new director can be appointed immediately and then confirmed at the next director election. What we see in countries like the U.K. and Australia, where they have always used a majority voting standard, is that there are no practical drawbacks with majority voting with the advantage that boards are more engaged and responsive to shareholders. This in turn makes for better boards and more efficient capital markets.

It is perplexing that Canada and the U.S. should be so out of step with the rest of the world on such a fundamental issue of corporate governance. Whatever the historical reasons for this, the time has come to adopt majority voting in Canada in a way that gives shareholders an effective voice in how their companies are governed. What Canadian public companies have now is a TSX rule that gives them a lot of discretion in how they apply majority voting. If Canadian companies continue to ignore the spirit of the TSX rule, then they may have a legislated rule imposed on them that would remove that discretion. It is now up to Canadian companies to decide which they would prefer, but it is increasingly apparent that Canadian shareholders will get an effective voice in director elections, one way or another.

ZOMBIE DIRECTORS

"Zombie director" is a term used to describe a situation in which a director receives less than 50% "for" votes in a director election but continues to sit on the board.

QUEBECOR INC.

At the 2015 Quebecor Inc. AGM, director nominee Michel Levigne received 30% "for" votes and 70% "withhold" due to concerns regarding his role as the chair of the compensation committee of the board that approved a $7.8 million severance package for the former CEO. Mr. Levigne tendered his resignation to the board in compliance with the TSX rule, but the chair of the Quebecor board, Brian Mulroney, rejected the resignation as he felt Mr. Levigne was unfairly targeted and the issue was in the past. Mr. Levigne continues to sit on the Quebecor board.

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