



Institute for governance
of private and public organizations

The Independence of Board Members: A Quest for legitimacy

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Established in September 2005, the Institute for Governance of Private and Public Organizations (IGOPP) is a joint initiative of HEC Montréal and Concordia University (The John Molson School of Business). The Institute is committed to promoting strong corporate governance practices among organizations in Quebec and the rest of Canada.

Its operations focus primarily on key management activities, namely defining the corporate mission, evaluating strategic management and financial performance, recruiting and compensating officers and managing risk. It achieves this through:

- Policy papers
- Training
- Research
- Dissemination of information

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Help public and private organizations to adopt governance habits that create value by offering training, adopting public positions, conducting research and disseminating ideas.

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Through its original contributions, the IGOPP seeks to become a reference organization on governance issues in Quebec, Canada and around the world.

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This policy paper, the third of the Institute for Governance of Private and Public Organizations, was adopted by the Board of directors.

*Mr. Pierre Bernier, Executive Vice-President of the Autorité des marchés financiers du Québec, abstained because of the regulatory role of the Autorité.

Introduction

“Independent directors! That’s the answer; but what is the question?”

(Gordon, 2006)

Over the last twenty years, the concept of the “independent” director has become the cornerstone, indeed, for some, the philosopher’s stone, of “good” governance.

Responding to the concerns of large institutional investors during the 1980s, exchange-listed companies in Canada, the UK and the United States began modifying the composition of their boards to ensure that a majority of directors qualified as independent from management. By the end of the 1990s, more than 60% of board members were independent, at least by the standards of the time.

The independence of board members, already promoted and enforced by the various stock exchanges and securities commissions, was then given force of law, in some form or another, by statutes of the Sarbanes-Oxley type. The proportion of independent directors on the boards of listed companies in Canada and the United States now exceeds 70%.¹

In spite of its critical role in the new orthodoxy of “good governance,” the concept of independence remains somewhat vague and open to several interpretations. It is, in turn, a near synonym for “disinterested,” “outside director”, “unrelated,” or “non-executive” (Clarke, 2006). The Dey Committee (1994) proposed the term “unrelated director,” which it defined as:

[A] director who is independent of management and is free of any interest and any business or any other relationship which could, or could reasonably be perceived to, materially interfere with the director’s ability to act in the best interests of the corporation, other than interests and relationships arising from shareholdings.

Note that, in the opinion of the Dey Committee, being a major shareholder in no way contaminates a director’s “unrelated” status. The Dey Report defines a significant shareholder as one able to exercise a majority of votes.

The Saucier Committee (2001), like the Cadbury Report (1992) in the United Kingdom, uses the concept of independent director to mean an *outside* director, which is to say a *non-executive*. An *outside* director may be *related* or *unrelated*.

¹ Actually, in 2007, 81% for U.S. companies (S&P 500); 79% for the largest 100 Canadian companies, 75% for the 50 largest Quebec companies; 59% for the 150 largest U.K companies. (Spencer, Stewart, *Corporate Board Index*, 2007)

Independence and Performance

The singular role assigned to board independence, however defined, in achieving good governance has generated a large number of studies to assess the statistical evidence of a link between, on the one hand, the degree of independence of corporate boards of directors and, on the other hand, economic performance or some other indicators of governance effectiveness. On the whole, this quest has not been very fruitful.

Empirical studies provide little support for the notion that board independence improves company performance². Some studies, that of Bhagat and Black (2001) for instance, found that board independence may actually have a *negative* impact, while the presence on the board of major shareholders (i.e. shareholders owning more than 5% of outstanding shares), who by some definitions are non-independent, actually contributes significantly to a board's effectiveness.

Some studies, by focusing on more specific relationships (for instance, between the independence of audit committees and the quality of financial reporting) occasionally show that board independence may make a statistically significant contribution. (For a recent example, see the article by Panasian, Prevost and Bhabra published in 2008.)

Statistics aside, seasoned observers with many years of experience as board members have voiced scathing opinions about making director independence the sacred cow of good governance. To quote but one, Warren Buffet (2002) writes:

"Over the span of 40 years, I have been on 19 public company boards (excluding Berkshire's) and have interacted with perhaps 250 directors. Most of them were "independent" as defined by today's rules. But the great majority of these directors lacked at least one of the three qualities I value (business savvy, interested, shareholder-oriented). As a result, their contribution to shareholder well-being was minimal at best and, too often, negative. These people, decent and intelligent though they were, simply did not know enough about the business and/or care enough about shareholders to question foolish acquisitions or egregious compensation" (p. 17)

Indeed, the imbroglio at Hollinger International offers a sober reminder of the limitations of board independence: in the company's report filed with the SEC for the year 2002 (Form 14A dated March 26th, 2003), the section on transactions between related parties mentions *six times in four pages* that all transactions between Hollinger and its related parties (Conrad Black and company) were *approved by the audit committee and independent directors*.

² See, among others, Dalton, Daily, Elstrand and Johnson (1998); Patterson (2000); Bhagat, Carey and Elson (1999); Bhagat and Black (2001); Allaire (2003, 2006); and Romano (2004)

The fact that empirical studies provide at best weak support for the crucial notion that director independence leads to better performance for companies has been most troublesome to some governance advocates. They often argue, and it is arguable, that this lack of empirical support points to, either, a poor definition of what independence means, or, to the loose, porous criteria adopted to qualify members as independent.

That argument often translates in an expanding list of requirements and a tightening up of the conditions for qualifying directors as independent. More often, it leads to the conclusion that, in effect, what independence really means is *independence of mind* and *strength of character*.

While obviously important, such personal attributes cannot be assessed nor measured by an outside observer. Therefore, it may be, as it has been written, that the *concept of independence is without interest when it is measurable and interesting only when it is incommensurable* (Allaire, 2003; 2005).

No doubt, if it were even conceivable, board members should be assessed for their independence of mind and strength of character. It would also be useful to know about a director's social networks and friendships with members of management, the subtle ways a director's independence might be compromised or threatened. However, this type of information is too qualitative and subjective to form the basis for a formal, external, enforceable, definition of independence. These factors, however, may easily be ascertained by nominating-governance committees of the board.

Structure of Shareholding in Exchange-listed Canadian Corporations

The fact that many publicly listed Canadian companies have important shareholders actively engaged in their management and governance raises important issues of representation on the board of such companies. In several jurisdictions, the fact that these board members are not considered independent has led to barring them from sitting on standing committees of the board. The Saucier Committee saw fit to distinguish between *an outside director related to the company* and *an outside director related to a significant shareholder*. The committee recommended that the notion of *significant shareholder* be revised to account for the full spectrum of Canadian ownership but did not propose a new definition.

Data compiled for this policy paper show the importance of the issue. An assessment of the 253 Canadian firms making up the S&P/TSX Index (that is, the largest listed corporations in Canada) reveals that 53% of them have at least one shareholder with 10% or more of the votes. (Allaire, 2008). These companies represent 40% of the market capitalization of the S&P/TSX Index. Table 1 shows the distribution of companies according to the percentage of votes held by their largest shareholder(s).

Table 1

Distribution of Canadian firms according to voting power of largest shareholder(s)

(253 listed firms in the S&P/TSX Index-July 2008)

Source : ALLAIRE, Y. , 2008

Percentage of votes	% Firms	Number of firms	% of total market cap of the S&P/TSX
10% to 20%	26	65	13
20% to 30%	5	12	1
30% to 50%	4	11	3
Over 50%	18	45	23
None with 10% or more	47	120	60
	100%	253	100%

Some 53% of the S&P/TSX Index companies have a shareholder controlling at least 10% of total votes. As Table 2 shows, these important shareholders are most often individual and families. Institutional investors represent about one third of these important shareholders.

Table 2

The Nature of Shareholding: Type of Shareholders with 10% or more of the votes in Canadian companies of the S&P/TSX

Source : ALLAIRE, Y. , 2008

Institutional Investors	35%
Individuals and families	44%
Another company	21%
(133 companies)	100%

The voting power of these significant shareholders, as shown in Table 3, comes from direct holdings in three quarters of the cases and from a superior class of shares in a quarter of companies.

Table 3

The Source of Control: Type of Shareholders with 10% or more of the votes in Canadian companies of the S&P/TSX

(Number of firms)

Source : ALLAIRE, Y. , 2008

	Direct control	Control through dual-class share structures	Total
Institutional Investors	47	0	47
Individuals and families	29	30	59
Another company	24	3	27
Total	100	33	133

Most of the institutional holdings fell in the category *10% to 20% of voting power*. In line with their policy and stance as shareholders, these institutional investors are represented on the board of directors in only a few cases (actually 8 out of 47).

For the 86 companies with important shareholders *who are not institutional investors*, this shareholder was represented on the board of directors in 82 cases. That is, *in close to one third of all large Canadian companies, at least one board member was a significant shareholder or a representative of that shareholder!*

Furthermore, in 58 of these 86 companies, the significant shareholder was active, or was represented, in the management of the company.

From the vantage point of economic history, it will appear curious that, for a period of time, important shareholders were not considered *independent* and therefore became somehow illegitimate to look after the affairs of companies in which they had invested so much of their money, time and energy.

Assessing the independence of board members

There are two distinct approaches to the determination of board member independence.

The first method consists of requiring that corporate boards themselves provide a formal declaration affirming whether or not each director is independent. In most jurisdictions, this method has become mandatory.

The board must then define the status of each director in accordance with specific, objective criteria, usually those put forth by regulatory agencies or security exchanges. That determination suffers from the limitations mentioned earlier. However, in coming to its determination of a director's independence, a board, given its intimate knowledge of each member, could, in theory at least, consider factors that are more qualitative, personal or behavioural in nature, in addition to more formal and public criteria. Indeed, some companies actually do just that in the evaluation of board members, but this information is rarely made public.

A second line of argument states that instead of viewing independence as a personal attribute, it should be considered as *contextual*, dependent on specific cases and concrete decisions before the board.

This approach is taken by some courts, in particular by those in Delaware, where more than 60% of major U.S. corporations have their legal headquarters. Here, independence is based on a detailed examination of the circumstances of an issue or transaction, of the relationships between the parties involved and of conflicts of interest likely to influence decisions to the detriment of shareholders.

Instead of relying on an abstract definition used to categorize each board member as independent or not, these courts prefer to look at each case on its own merits. So it is that Vice Chancellor Strine of the Delaware Court of Chancery has stated his preference for "a flexible, fact-based approach to the determination of directorial independence." He went on to add:

This contextual approach is strength of our law, as even the best minds have yet to devise across-the-board definitions that capture all the circumstances in which the independence of directors may be questioned. By taking into account all circumstances, the Delaware approach undoubtedly results in some level of indeterminacy, but with the compensating benefit that independence determinations are tailored to the precise situation at issue. (2003; in re Oracle Corp. Derivative Litigation)

However, this approach relies on measures taken only after a board has reached a decision, as well as on shareholders' vigilance and willingness to take action should any questionable circumstances arise. It also requires a judicial system that is very knowledgeable in such matters and able to swiftly issue its judgments.

The emphasis on board independence — on the presence of *truly* independent board members — arises from the hypothesis that such a board will keep company management focused on the interests of stakeholders and, in the case of exchange-listed companies, on creating value for its shareholders.

A board that includes members truly independent of mind is more likely to be vigilant about the reliability of the information provided to financial markets and to act quickly to replace an under-performing chief executive (Gordon, 2006). While such a board has real value in practice, it is difficult for an outside observer to assess this property of a board and for researchers to capture this subtle quality in quantitative studies.

Taking into consideration the foregoing, this paper makes specific suggestions for an appropriate definition and scope for the concept of independence, as well as for its practical implementation. A fundamental principle underpins this policy paper: two distinct properties are essential for any board of directors: *legitimacy* and *credibility* (Allaire and Firsirotu, 2003; 2004).

The legitimacy of board members

This policy paper takes the position that board members must be endowed with legitimacy. Only when a board is legitimate may it assert its authority over the management of the organization. That legitimacy flows from two sources:

1. *Legitimacy based on independence from management as well as on a nomination and election process that ensures adequate representation for the organization's stakeholders, and in the case of exchange-listed companies, for its shareholders.* These board members are formally independent from management and from all significant shareholders, if any. Stakeholders, in the case of public organizations, and shareholders, in the case of exchange-listed companies, must believe that those appointed or elected to the board represent well their interests.

Several measures have been proposed to enhance corporate democracy, such as cumulative voting, nomination of candidates for board seat by large shareholders, individual and majority voting for candidates to the board, etc. All measures aimed at strengthening the legitimacy of boards deserve a vigorous support from those committed to improving the quality of governance in our private and public organizations.

Independence from management is a necessary, but not sufficient, condition of legitimacy. It does provide a relative insurance that the director's judgment will not be influenced, *nor appear to be influenced*, by his or her interests rather than by the interests of company shareholders or, in the case of public organizations, by the interests of its stakeholders.

Let us be clear. The concept of independence meant first and foremost *independence from management*. It was driven by outrage at the weak oversight of management by co-opted, docile boards. The Enron, Global Crossing and WorldCom fiascos, all companies without controlling shareholders, turned the concept of board independence from management into a mantra, a sine qua non, of good governance.

In point of fact, no one whose personal interests (other than as a shareholder) depend significantly on decisions made by company management or the board can legitimately represent the interests of company shareholders; but the absence of such relationships does not *ipso facto* make an "independent" person into a legitimate director if the process through which one comes to the board is flawed and disrespectful of elementary democratic principles (Allaire, 2007).

In organizations without shareholders or in exchange-listed companies without a significant shareholder, it makes good sense, and is a basic source of legitimacy, that a majority of board members and all members of standing committees (audit, governance and human resources) should be fully and strictly independent of management. The ways and means of nominating and electing such independent directors may further enhance, or cast doubt on, their legitimacy.

2. *Legitimacy based on important, committed shareholding.* Significant shareholders actively engaged in the governance of the company, are bearers of great legitimacy. It is a tenet of our economic system that shareholders with large economic interests in a company will play an important role in their governance, if they so wish. Who, under most circumstances, has more legitimacy to assert his or her authority over management than a shareholder with large stakes in the company?

The boards of exchange-listed companies with significant shareholders need to combine both forms of legitimacy. That is a rather unexceptional point of view. Yet, belatedly and on the basis of shaky arguments, the concept of board independence was broadened to include *independence from significant shareholders*. That is, a majority of the board members and all members of standing committees should be independent not only of management but also of significant shareholders.

This notion took roots, strangely enough, in the United States, where there are far fewer cases than in Canada of concentrated ownership and of large shareholders active in the management or governance of exchange-listed companies. Because the issue is somewhat secondary in the U.S., their governance framework can tolerate some ambiguity and even contradictions when dealing with the issue of independence in such companies. That is clearly the case with the positions of the New York Stock Exchange, the SEC and NASDAQ (Clarke, 2006). We cannot afford to be so lax in Canada.

For instance, in the cases where a shareholder controls more than 50% of the votes, all in all quite rare in the U.S. but a significant reality in Canada (as shown above, close to 18% of large listed companies), American authorities are vacillating and ambiguous about the appropriate governance. The New York Stock Exchange is clearly interpreting the concept of independence as referring only to management. Given that a shareholder with absolute control of a company's votes can appoint, fire, and replace management at will, he or she does not need to be protected from inappropriate behaviour on the part of company executives. Minority shareholders are protected by the legal system and the courts, as they should be. Therefore, the New York Exchange exempted these companies from the "board independence" requirements imposed on others.

The SEC, however, seems to restrict the status of independent board member to those who are both independent of management and unrelated to any significant shareholder (the notion of significant shareholder is not clearly defined, but a 10% ownership appears to be the threshold). Some legal experts in the United States are sharply critical of this position:

[T]his view of independent directors seems to see them as ideally having no consistent incentives whatsoever. While clearing away visible ties to management interests, it fails to substitute a tie to the interests of any other constituency. Consequently, it is hard to see how such directors can be expected to act in any predictable way other than in avoiding obvious (and punishable) illegalities, and the purpose of having them on the board seems suddenly obscure. The lack of any serious underlying theory of independent director motivation is startlingly manifest. (Clarke, 2006; p. 16)

This policy paper takes the position that significant shareholders who play an active role in the management and governance of the company *are decidedly legitimate board members* and should be recognized as such. Their direct participation on boards and on standing committees should be *proportional to their economic interests in the company* (that is, the percentage of the company's shareholder equity that they own). The board should count on a sufficient number and proportion of members (never less than a third) who are independent both of management and of these substantial shareholders.

Framed as one source of legitimacy, the concept of independence gains a restricted but critical role in the functioning of a board. Indeed, *only through its legitimacy does a board acquire authority over the management of an organization.*

The credibility of board members

The *credibility* of a board hinges on its collective experience and expertise relevant to the specific issues and challenges of the organization. A director's individual credibility results from his or her specific expertise and experience, grounded in independent thinking. A director may further his credibility if, immediately upon joining the board, he or she invests the time and intellectual effort required to understand company operations, its business model and its drivers of economic or social value.

The true test of a board's credibility comes from the respect and trust the board inspires to management; it manifests itself in the fact that management believes discussions with the board are fruitful, bring new perspectives and viewpoints, add value to the decision process.

A credible director is an engaged one who is respected by other board members, who does not hesitate to raise difficult questions and to insist that key issues be addressed by the board. The credible director shares his or her experience with management, offers counsel but makes sure to remain independent from management.

Credibility cannot be measured. It is virtually impossible for an outside observer to assess a board member's credibility; yet this quality is glaringly obvious to anyone sitting on a board. The unfortunate fact that many board members lack credibility explains the weak performance and the limited value of governance in too many organizations.

It may well happen that a highly credible director may not be completely independent in the strict sense of the term (e.g., because he or she has served as an officer in the same industry within the last three years).

While it is legitimacy that gives a board the authority to impose its will on management, it is credibility that makes a board effective and value-creating.

It is therefore rather futile to search for a statistical relationship between board independence and company performance, since independence is one condition for board legitimacy but does not, *per se*, contribute to board credibility and thus to company performance.

The governance of all organizations and institutions ranges on a continuum from "neither legitimate nor credible" to "legitimate and credible", with every possible combination in between. That is, from incompetent dictatorship to effective and representative governance.

Recommendations

From these considerations emerge specific recommendations to clarify the meaning and role of board independence and, thereby, improve the governance of any organization.

1. Any organization governed by a board of directors must strive to constitute a board that is both *legitimate* and *credible*; only in this way will boards of directors play the role expected of them;
2. Board legitimacy will be strengthened through a selection, nomination or election process that ensures board members will have no interest other than that of stakeholders, especially those of shareholders in the case of exchange-listed companies.
3. A majority of members appointed or elected to the board should derive their legitimacy from one of two different sources of legitimacy:
 - **Type I legitimacy:** directors who are independent from management and, if applicable, from any shareholders owning more than 10% of the common equity of the firm. The board, on the recommendation of its governance/nomination committee, needs to declare whether or not each board member is independent. To this end:
 - » The board must review professional and personal relationships between each director and the organization and its management, as well as between each director and any significant shareholders. The board and its governance committee must be strict in making this determination so as to grant the status of independent only to members who are free from any constraint in their judgment and in their decision-making.
 - » The board and its governance committee must be alert to the circumstantial nature of independence, which could mean that a director who is independent by definition may not be truly independent in some specific situations.
 - **Type II legitimacy:** directors who are, or represent, shareholders owning more than 10% of the common shareholders' equity but who are not acting as managers of the company.
4. For organizations without shareholders or with no active shareholder owning more than 10% of the common equity, boards should include a clear majority of Type 1 members and all standing committees should be made up exclusively of Type 1 members.
5. For companies with significant shareholders (10% and over of the common equity) actively engaged in the company, boards and their committees should include Type II members in a proportion equivalent to the share of equity held by these shareholders (their economic interest).
6. For companies where voting power exceeds economic interests because of a class of superior voting shares, the recommendations of the Institute's Policy Paper no. 1 on multiple voting shares remain highly relevant.

Recommendations

7. Companies with a significant shareholder (controlling more than 10% of common equity) who is actively involved in company management or governance should form a standing committee made up exclusively of Type 1 directors to review all transactions between the company and the significant shareholder. As is the case with other standing committees, this committee would report to shareholders annually on such transactions, if any.

These recommendations, if implemented, would give to the concept of independence a specific role, a restricted but essential one, in the governance of organizations. Indeed, the strict independence of members endows boards with a form of legitimacy, which is necessary for them to fully discharge their fiduciary responsibilities.

We are of the opinion that significant shareholders playing an active role in the governance of a company also bring a high degree of legitimacy to the board. This type of legitimacy deserves full recognition. These shareholders should be represented on the board and on standing committees in proportion to their economic interests in the company.

We conclude by repeating an earlier observation:

Only a credible board will contribute significantly to the success of the organization. Only a legitimate board has the effective authority to impose its will on management.

The concept of the independent director must be anchored in the quest for *board legitimacy*.

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