

# CORPORATE GOVERNANCE AND THE IMPACT ON IT IMPOSED BY A CONTROLLING SHAREHOLDER

By Dirk Schlimm, Lisa Mezzetti and Bernard S. Sharfman<sup>1</sup>

## I. Introduction

A recent article by Professors Lucian Bebchuk and Assaf Hamdani has brought to the fore the idea that good corporate governance practices at a publicly held firm<sup>2</sup> will not necessarily be good practices at a publicly traded firm in which there is a controlling shareholder.<sup>3</sup> This is because board independence,<sup>4</sup> a key concept in structuring appropriate corporate governance practices, has a different meaning when a controlling shareholder is present. Corporate board members of a controlled company, even if meeting all of the currently

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<sup>1</sup> Mr. Schlimm is Principal at Jenoir Management Consultants in Toronto, Ontario. Mr. Schlimm's experience includes fifteen years at Husky Injection Molding Systems Ltd. where he was responsible for developing and implementing the company's corporate governance practices. Ms. Mezzetti is a Senior Partner with Cohen Milstein Sellers & Toll PLLC in Washington, DC. Ms. Mezzetti litigates cases that raise corporate governance issues. Mr. Sharfman is a graduate of the Georgetown University Law Center (2000) and has written a number of articles on the topics of corporate law and corporate governance.

<sup>2</sup> A publicly held firm is an economic organization "in which (i) management and residual claimant status (shareholding) are separable and separated functions; (ii) the residual claims (shares) are held by a number of persons; and (iii) the residual claims are freely transferable and neither entry to nor exit from the firm is restricted." Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW 461, 463 n.9 (1992).

<sup>3</sup> Lucian A. Bebchuk and Assaf Hamdani, *The Elusive Quest for Global Governance Standards*, 157 U. Pa. L. Rev. 1263 (2009). This idea is not new, but when Professor Bebchuk speaks an exceptionally large number of people are bound to take notice, including the authors of this article. See e.g., Deborah A. DeMott, *Guests at the Table?: Independent Directors in Family-Influenced Public Companies*, 33 IOWA J. CORP. L. 819 (2008).

<sup>4</sup> Professor Donald Langevoort defines "independence" as "a subjective concept that connotes a willingness to bring a high degree of rigor and skeptical objectivity to the evaluation of company management and its plans and proposals." DeMott, *supra* note 3, at 844.

mandated independence requirements and truly independent of the corporation's management,<sup>5</sup> may not be independent of the controlling shareholder.<sup>6</sup> If so, then these directors may be severely lacking in the ability to exercise "independence of mind," the ultimate purpose of board independence.<sup>7</sup> Therefore, where a controlling shareholder is present, board independence must mean independence from the controlling shareholder as well as the corporation.<sup>8</sup>

Board independence is also critical to corporate governance because it allows a board to properly fulfill its duties under the law. Corporate law requires the firm<sup>9</sup> to be led by a board of directors, not the controlling shareholder. Delaware General Corporation Law Section 141(a) provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise

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<sup>5</sup> The U.S. stock exchanges require that directors meet certain subjective and objective criteria before they can be considered independent. *See* NYSE, Inc., Listed Company Manual, §§ 303A.02 (setting out both subjective and objective tests for establishing director independence); NASDAQ, Inc., Marketplace Rules, RR. 5605(b), (d) and (e) (setting out both subjective and objective tests for establishing director independence). However, it is not a given that a controlled company will have implemented these independence requirements. Both the NYSE and the NASDAQ provide that a listed company of which more than 50% of the voting power is held by an individual, a group or another company need not comply with their respective independence requirements. *See* NYSE, Inc., Listed Company Manual, § 303A and NASDAQ, Inc., Marketplace Rule 5615-5.

<sup>6</sup> Bebchuk and Hamdani, *supra* note 3, at 37.

<sup>7</sup> John Roberts, Terry McNulty & Philip Stiles, *Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, 16 BRITISH J. MGT. S5, S19 (2005).

<sup>8</sup> DeMott *supra* note 3, at 844 (as stated by Professor DeMott, "[i]n particular, a prospective director whose perspective on the firm is defined by its controlling family may well satisfy formal definitions of independence but prove unable or unwilling to bring 'rigor and skeptical objectivity' to bear.").

<sup>9</sup> For purposes of this paper, unless otherwise specified, all references to "the corporation," "company," "controlled corporation" or "firm," refer to a publicly traded firm with a controlling shareholder.

provided in this chapter or in its certificate of incorporation."<sup>10</sup> Operational authority may be delegated to officers, but the board hires and fires those officers.<sup>11</sup> Officers may propose corporate policy, but ultimate approval rests with the directors.<sup>12</sup> Shareholders may ratify a board's action, but the board must first approve the decision.<sup>13</sup> Ultimate corporate authority rests with the board.<sup>14</sup>

However, identifying whether or not a board is truly independent is just the first step in evaluating the quality of corporate governance at a controlled corporation. After all, a controlling shareholder<sup>15</sup> still has the power to dominate an independent board through his direct voting power and by threats of removal.<sup>16</sup> Therefore, a proper evaluation requires knowledge of those corporate governance practices that a controlled company uses to monitor and manage the

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<sup>10</sup> DEL. CODE ANN. tit. 8, § 141(a) (2001).

<sup>11</sup> Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 468 (1992).

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.* Professor D. Gordon Smith offers the following rationale for the board's ultimate authority:

[D]irectors delegate much of their management authority to executive officers, but retain the responsibility of hiring, monitoring, and firing executive officers . . . . [T]he exercise of this responsibility by the board of directors rather than shareholders is justified by the fact that the board functions as a centralized decisionmaker in a corporation and in that role improves the efficiency and quality of decisions that otherwise would be made by shareholders.

D. Gordon Smith, *Corporate Governance and Managerial Incompetence: Lessons from Kmart*, 74 N.C. L. REV. 1037, 1046 (1996).

<sup>15</sup> In conformity with Bebchuk and Hamdani, we define a controlling shareholder “as one who owns or controls sufficient votes to effectively determine vote outcomes and influence corporate decision making.” Bebchuk and Hamdani, *supra* note 3, at n.8.

<sup>16</sup> DeMott *supra* note 3, at 836.

decision-making influence of the controlling shareholder. Furthermore, to make sure these practices are optimal, a subjective analysis of just how the controlling shareholder interacts with the board is required. In addition, the focus of such a subjective analysis must go primarily to an evaluation of the character of the controlling shareholder and his/her motivations regarding the welfare of the company.

This paper builds and expand on Bebchuk and Hamandi's work by exploring how the personality of the controlling shareholder will also play a role in determining the most optimal corporate governance practices. In doing so, this paper takes the perspective of an institutional investor who is a current or prospective shareholder of a controlled corporation and is trying to evaluate the company's corporate governance practices or determine what changes may be necessary at the controlled company to increase value to all shareholders. An institutional investor will often find it necessary to do so because a significant number of public companies worldwide have controlling shareholders. This ownership structure predominates outside the U.S.,<sup>17</sup> but it also exists to a significant degree in the U.S., where such firms make up a significant number, though a minority, of the Fortune 500.<sup>18</sup> Some notable companies with controlling shareholders include Google, Inc., Ford Motor Company and The New York Times Company. In addition, this paper focuses on corporate governance at a company where the controlling shareholder may have been the founder or a descendant of the founder and is still actively engaged in the running of the company, either as the Chief Executive Officer (CEO), the Chairman of the Board or as a member of the board.

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<sup>17</sup> Bebchuk and Hamdani, *supra* note 3, at 2.

<sup>18</sup> Professor DeMott estimates that a third of all Fortune 500 companies are "either controlled by individual founders or members of the founder's family or, more loosely, influenced by them." DeMott *supra* note 3, at 821.

## II. Theoretical Issues Concerning a Controlling Shareholder

In a publicly held company where there are a large and diverse number of shareholders, a classic agency problem is created because of the separation of ownership and control – will the managers work for the shareholders or advance their own interests?<sup>19</sup> Inserting the presence of a controlling shareholder into the mix may help reduce these agency costs, if he uses his clout to monitor the activities of management,<sup>20</sup> either by becoming the Chief Executive Officer (CEO), actively participating as a board member or having one more of his agents representing his interests on the board. However, the presence of a controlling shareholder can also create agency problems between the controlling and non-controlling shareholders<sup>21</sup> and other stakeholders in the firm. This problem arises if the controlling shareholder tries to use his authority to transfer corporate resources to himself for personal consumption or gain in which the non-controlling shareholders do not proportionally benefit,<sup>22</sup> and/or results in harm to the corporation.

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<sup>19</sup> Ronald J. Gilson and Jeffrey N. Gordon, *Doctrines and Markets: Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785 (2003). A complete definition of these agency costs would include not only “the costs resulting from managers misusing their position,” but also “the costs of monitoring and disciplining them to try and prevent abuse,” MARGARET M. BLAIR, *OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY* 97 (1995).

<sup>20</sup> Gilson and Gordon, *supra* note 19, at 785.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

There are two types of private benefits of control: pecuniary and non-pecuniary.<sup>23</sup> Pecuniary benefits include “tunneling transactions,” corporate perks and theft.<sup>24</sup> Non-pecuniary benefits include “forms of psychic and other benefits that, without more, involve no transfer of real company resources and do not disproportionately dilute the value of the company's stock to a diversified investor.”<sup>25</sup> For example, non-pecuniary benefits may derive from having control of a major national newspaper through which the controlling shareholder may have the opportunity to influence national opinion.<sup>26</sup> Or, one can receive the non-pecuniary benefits of placing family members in executive positions whether or not they are qualified.<sup>27</sup>

While the ability of a controlling shareholder to take advantage of non-pecuniary benefits may seem less pernicious, the result can be just as financially harmful to non-controlling shareholders and other stakeholders since the controlling shareholder who takes advantage of either type of benefit, pecuniary or non-pecuniary, may be effectively “maximizing the

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<sup>23</sup> Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomys*, 119 HARV. L. REV. 1641, 1663 (2006).

<sup>24</sup> *Id.* Tunneling refers to “contractual dealings with the company, like transfer pricing, that favor the controlling shareholder.” Gilson and Gordon, *supra* note 19, at 787.

<sup>25</sup> Gilson, *supra* note 23, at 1663-64.

<sup>26</sup> *Id.* at 1667.

<sup>27</sup> DeMott *supra* note 3, at 837. For a famous example of a controlling shareholder reaping non-pecuniary benefits, see *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968). In *Shlensky*, a derivative suit was filed against the board of directors of the Chicago Cubs because Philip K. Wrigley, board member and 80% owner of the Cubs, refused to allow the installation of lights in Wrigley field because he did not want to upset the local community, even though it was expected that the playing of night games at Wrigley field would help return the team to profitability. *Id.* at 777.

controlling shareholder's utility," but not necessarily "maximizing the value of the corporation."<sup>28</sup>

### **III. The Value of an Independent Board**

Limiting the potential agency costs created by the presence of a controlling shareholder (i.e., the costs incurred by the controlling shareholder if he tries to use his authority to utilize corporate resources for himself<sup>29</sup>) must be considered a primary function of a corporate board. Moreover, because "no other set of actors within the corporation is systematically unaffiliated with its senior management and controlling shareholders,"<sup>30</sup> an independent board will be in the best position to objectively monitor the activities of the controlling shareholder, making sure he is not unfairly enriching himself at the expense of the corporation and other shareholders.

#### *The Importance of a Strong Legal System*

Critical to the success of an independent board's monitoring efforts will be the laws that support such monitoring. Professors Dahya, Dimitrov and McDonnell posit that the board must have the legal authority to do their job well. This includes the individual board members facing legal liability if they do not curb self-dealing by controlling shareholders.<sup>31</sup> In the United States,

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<sup>28</sup> Gilson, *supra* note 23, at 1665.

<sup>29</sup> Gilson and Gordon, *supra* note 19, at 785.

<sup>30</sup> DeMott *supra* note 3, at 847.

<sup>31</sup> Jay Dahya, Orlin Dimitrov, and John J. McConnell, *Does Board Independence Matter in Companies with Controlling Shareholders?*, 21 J. APPLIED CORP. FIN. 67, 68-69 (No. 1, Winter 2009).

this necessarily implicates both the directors' and the controlling shareholders' duties of care and loyalty to the corporation and all shareholders.<sup>32</sup> Moreover, controlling shareholders may have special obligations to treat the other shareholders fairly when entering into transactions with the corporation.<sup>33</sup>

However, while having the proper legal framework to encourage board members to curb self-dealing on the part of the controlling shareholder is a given in the United States, United Kingdom and Canada, it is the exception in most other countries.<sup>34</sup> This is of significance to institutional investors in the making of their investment decisions because academic studies have revealed valuation discounts for publicly traded companies based in countries that provide weak legal protection for minority shareholders.<sup>35</sup> Without sufficient legal deterrents, controlling shareholders have both the incentive and the ability to opportunistically use or, in the worst case, abscond with corporate assets.

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<sup>32</sup> Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27, 33-34 (1999). In addition, controlling shareholders have additional duties to deal fairly with the corporation.

<sup>33</sup> In the context of a parent and its subsidiary, *see Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971). In the context of an individual or individuals being the controlling shareholder(s) as well as being member(s) of the board, *see Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971).

<sup>34</sup> Dahya, Dimitrov and McConnell, *supra* note 31, at 71.

<sup>35</sup> *Id.* at 67.

## *Contributing to Shareholder Wealth Maximization*

The value of board independence in the presence of a controlling shareholder goes beyond monitoring. It can also bring back into board decision-making something very important to institutional investors: an emphasis on shareholder wealth maximization for all shareholders. As discussed above, the controlling shareholder may not be interested in this corporate goal and try to benefit himself in either pecuniary or non-pecuniary ways to the detriment of other shareholders. This is where a board composed of independent directors can make a significant difference.

According to Professor Jeffrey Gordon, independent directors, unlike the insiders and interested outsiders who dominated corporate boards in the 1950s, are less committed to management and its vision.<sup>36</sup> Instead, they look to outside performance signals, such as information provided by the stock market, to assess the performance of the firm.<sup>37</sup> This focus has been enhanced by SEC disclosure requirements and more transparent accounting standards, allowing corporate information that once had been known only to insiders to become reflected in stock prices, meaning they have become much better providers of information on company

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<sup>36</sup> Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1563 (2007).

<sup>37</sup> *Id.*

performance.<sup>38</sup> The overriding effect is to commit the firm to a shareholder wealth maximizing strategy as best measured by stock price performance.<sup>39</sup>

To what degree corporate boards are truly committed to shareholder wealth maximization is still a matter of debate;<sup>40</sup> nevertheless, Professor Gordon has made a strong argument that independent boards are now much more compelled to measure company performance with stock market indicators and therefore have become more aligned with the interests of shareholders and not management. It also can be assumed that a parallel shift has occurred with respect to independent boards and controlling shareholders, helping to align the interests of the board with all shareholders, not just the controlling shareholder.

#### **IV. The Impact of a Controlling Shareholder on Corporate Governance Practices**

There are numerous corporate governance practices that are presumed to be optimal in a publicly traded corporation; these include having an independent majority of the board, majority voting, annual election of directors, allowing the board to meet in executive session without the presence of executive management and requiring shareholder approval to amend bylaws. In addition, corporate governance is normally enhanced when there is an absence of the following:

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<sup>38</sup> *Id.* at 1541.

<sup>39</sup> *Id.*

<sup>40</sup> Not everyone agrees that shareholder primacy currently dominates the public company boardroom. *See, e.g.,* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999).

a poison pill, charter provisions that allow directors to be removed only for cause and supermajority voting requirements for shareholders.

### *Best Practices*

However, what we normally consider best practices are not so when a controlling shareholder is present. The presence of a controlling shareholder moves the focus of agency costs from executive management to the controlling shareholder. We are now most worried about controlling the possible bad behavior of the controlling shareholder, not the executive management team. This change in focus means the following in regard to best practices:

- board member independence now has to be evaluated in terms of the controlling shareholder as well the corporation;
- the annual election of directors and the absence of charter provisions which allow directors to be removed only for cause smoothes the way for a controlling shareholder to force the termination of disobedient directors and puts pressure on individual board members to obey the controlling shareholder or be ousted. Instead, it would better to have staggered boards in combination with charter amendments protecting directors from dismissal prior to the expiration of their term except for cause;<sup>41</sup>
- the company should require the Chairman of the Board to be independent of both the controlling shareholder and CEO;
- it should not allow the controlling shareholder to be on the board nominating committee;

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<sup>41</sup> DeMott, *supra* note 3, at n.87.

- it should not allow family members of the controlling shareholder to serve on the executive management team;
- a number of presumed best practices become inconsequential such as majority voting, meeting in executive session (controlling shareholder on board, but not part of executive management), shareholder approval of bylaws, shareholder nomination of directors and the absence of a poison pill; and
- a supermajority voting requirement for shareholders becomes a necessity in order to give some voice to minority shareholders.

Such practices not only help keep the controlling shareholder from engaging in opportunistic behavior, but also supports the board's role as an independent decision-making body within the corporation.

## **V. Understanding the Controlling Shareholder**

In the worst case scenario, where the controlling shareholder uses every opportunity to abuse his position and steal value or opportunities from the corporation, impose his whim and will on the corporation, and steamroll his directors into submission and timid compliance, implementing the above list of best practices and more must be considered a necessity. For example, consider the situation Hollinger International, Inc. faced due to the actions of Conrad Black, the company's former controlling shareholder.<sup>42</sup> Fortunately, the realization of this worst

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<sup>42</sup> At Hollinger, Mr. Black, the ultimate holder of 72% of shareholder voting interests, was not shy about expressing the sentiment that if the other shareholders did not like how he ran the company, they could take a hike. See RICHARD SIKLOS, *SHADES OF BLACK. CONRAD BLACK – HIS RISE AND FALL*, at p. ix., McClelland & Stewart Ltd (2004). Black was eventually

case scenario is as rare as is the controlling shareholder who performs, in the words of management scholar Jim Collins, as a “Level Five Leader.”<sup>43</sup> This controlling shareholder would apply all of his passion and ambition to see his company succeed without any regard for personal glory, agenda or vanity. In the process, he would highly value and respect the judgment and counsel of his independent directors.

The practical reality is that most controlling shareholders, who can be assumed to be driven and powerful people, fall somewhere in between these two extremes.<sup>44</sup> If so, the board will be working with a strong-willed person, who has a sense of ownership, high level of identification with the company and is driven to succeed no matter what. Such a controlling shareholder will want to convince the board that his ideas are best for the company rather than just telling them what to do.<sup>45</sup> He will realize that “buy in” will ease implementation whereas

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imprisoned for his role in the theft of \$6.1 million from Hollinger and knowingly removing documents sought by U.S. authorities from his Toronto office. Andrew Harris, *Ex-Hollinger Chief Conrad Black Entered Prison Today*, Bloomberg.com (March 2, 2008), available at <http://www.bloomberg.com/apps/news?pid=20601082&sid=aTRCPP8GnvKk&refer=canada>. It is notable, however, that a year into his jail term, Conrad Black did win the right to have his appeal heard by the US supreme court. Andrew Clark, *Supreme court to hear Conrad Black appeal*, The Guardian (19 May 2009), available at <http://www.guardian.co.uk/business/2009/may/19/black-wins-supreme-court-review>

<sup>43</sup> JIM COLLINS, *GOOD TO GREAT, WHY SOME COMPANIES MAKE THE LEAP ... AND OTHERS DON'T*, at 17-40, Harperbusiness (2001).

<sup>44</sup> Professor Jeffrey Pfeffer takes the “contrarian” view that in some settings it will take a “tyrannical”/ “egomaniacal” person to succeed. See Jeffrey Pfeffer, *In Defense of the Boss From Hell*, 8 Business 2.0, at 70 (Issue 2, March 2007).

<sup>45</sup> Ted Rogers, the late founder and controlling shareholder of Rogers Communication Inc. told the story of how he was overruled by his board when he wanted his cable company to invest in the cellular phone business in 1983. Rogers was proud of how his “strong and independent” board stood up to him. Nevertheless, by using his own money, he pursued the opportunity to enter the wireless business. The irony of this episode was that Rogers’ instinct

ordering compliance breeds resentment. This dynamic will force the controlling shareholder to think through his ideas, prevent major snap decisions, and open the opportunity for generating more and better options.<sup>46</sup> In other words, the directors will more than likely have an opportunity to provide counsel, influence the controlling shareholder's thinking and move forward in real alignment.

Moreover, although it is true that the controlling shareholder has ultimate control over who sits on the board, nominating his own candidates from the floor if necessary, it cannot be assumed that every controlling shareholder will only want to surround themselves with sycophants. For example, the controlling shareholder may have the desire to assemble a high caliber board because it both benefits him and "his" company and (on a less complementary issue) because star power on the board strokes his ego.<sup>47</sup> In addition, many powerful people are

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was correct and wireless eventually became the most successful part of the Rogers' empire. *See* TED ROGERS, *RELENTLESS, THE TRUE STORY OF THE MAN BEHIND ROGERS COMMUNICATIONS*, at 139, HarperCollins (2008).

<sup>46</sup> Peter Drucker teaches that effective decision-makers create dissension and disagreement, rather than consensus. He recounts the story of Alfred P. Sloan, who postponed a decision of one of his top committees because everyone was in complete agreement. Sloan knew that proceeding to the right decision demands adequate disagreement. *See* PETER DRUCKER, *THE EFFECTIVE EXECUTIVE, THE DEFINITE GUIDE TO GETTING THE RIGHT THINGS DONE*, at 148, Collins (1967). *See also*, Bernard S. Sharfman and Steven J. Toll, *Dysfunctional Deference and Board Composition: Lessons from Enron*, 103 NW. U. L. REV. COLLOQUY 153 (2008) (arguing that a lack of board discussion led to errors in decision-making as a result of extreme board deference to executive management).

<sup>47</sup> Conrad Black is probably the most colorful example of a controlling shareholder who used board composition to stroke his ego. His board was a star-studded assembly of tycoons and pundits with whom Black could hold his own Bilderberg Group-style gatherings. *See* Siklos, *supra* note 42, at 187. When his empire began to crumble Black asked Henry Kissinger, who attended the board meeting by phone, whether he had just voted against him. When Kissinger said 'yes' Conrad replied: "Et tu, Brute." Deference to the controlling shareholder definitely has its limits, especially when things go bad. *Id.* at xii.

smart enough to surround themselves with people whom they believe are smarter than they. As a result, the controlling shareholder may try the best he can to retain his independent directors and view the threat of resignation by a key independent director as a cause for grave concern. Finally, resignations “en masse” may be a credible threat to the controlling shareholder as it could do damage to his net worth by sending a negative signal to the stock market, while also tarnishing his image as a leader.<sup>48</sup>

It is also important to keep in mind that the passion, drive and ingenuity of a controlling shareholder may be the secret to superior company performance, accruing to the benefit of all shareholders and other stakeholders. Therefore, the benefits derived from the presence of a “benevolent dictator” may mean that the corporation is better off by seriously considering whether to implement all of the best practices described above. At the same time, the controlling shareholder (especially coming from full ownership) may never lose his attitude of “l’entreprise c’est moi,” i.e., never accepting that he is no longer the “owner” of the corporation, and as a result, not adequately respecting the interests of other stakeholders, especially other shareholders.

## **VI. Evaluating the Independent Board**

Given this understanding of a controlling shareholder, institutional investors will look for directors that are both financially and emotionally independent. However, having a majority of independent directors that meet objective criteria of independence from both the company’s

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<sup>48</sup> DeMott *supra* note 3, at 836.

management and the controlling shareholder achieves nothing unless these independent directors also exercise “independence of mind.”<sup>49</sup> A good case in point might be Raymond Seitz, former United States ambassador to the United Kingdom, who was personally asked by Conrad Black, “as a friend,” to join the independent committee of Hollinger International’s board that had been formed to probe the allegations of wrongdoing at the company.<sup>50</sup> Somewhat surprisingly, despite his friendship and obvious empathy for Black, Ambassador Seitz proved to be independent of mind as evidenced by the following quote: “I had absolutely no interest at all in hanging Conrad out to dry or breaking Conrad’s back. [But] these things were wrong and needed to be righted – simple as that.”<sup>51</sup> Therefore, assessing independence cannot be done by checking a box; rather, it requires getting to know the person and what they are made of.

Furthermore, an effective independent director will have the “soft” skills and experience to effectively engage a powerful controlling shareholder. As Jeffrey Pfeffer points out in his classic work, *Managing with Power*, effectively engaging larger than life people, such as legendary CBS Chairman Bill Paley, requires a unique blend of sensitivity, flexibility, ability to tolerate conflict, and willingness to submerge one’s ego.<sup>52</sup> In doing so, effective directors will show respect for the controlling shareholder and his accomplishments (e.g. as company founder),

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<sup>49</sup> John Roberts, Terry McNulty & Philip Stiles, *Beyond Agency Conceptions of the Work of the Non-Executive Director: Creating Accountability in the Boardroom*, 16 BRITISH J. MGT. S5, S19 (2005).

<sup>50</sup> Siklos, *supra* note 42, at 424.

<sup>51</sup> *Id.*

<sup>52</sup> JEFFREY PFEFFER, *MANAGING WITH POWER – POLITICS AND INFLUENCE IN ORGANIZATIONS*, at 165-185 (1994).

they will be excellent listeners, and they will communicate with clarity -- in other words, they will engage in diplomacy to get things done.<sup>53</sup> They will, however, have a standard that cannot be crossed regardless of what happens. This is critical as powerful people need a counterweight to balance their forceful personality,<sup>54</sup> or, as Michael Wolff puts it in his biography of Rupert Murdoch, “someone who can protect them from themselves.”<sup>55</sup>

## VII. Looking Out for Red Flags

To identify the extent to which different corporate governance practices are needed due to the presence of a controlling shareholder, institutional investors will be on the look-out for red flags that indicate an abuse of power by the controlling shareholder. The following is a non-exclusive list of such red flags:

- **The Pursuit of Unconventional Strategies:** In his book, *How the Mighty Fall*, Jim Collins tells us to beware of a company that is pursuing strategies that do not fit with the company’s core values, run counter to that which have proven successful in the past, or that defy economic logic.<sup>56</sup> Some of those strategies may even be characterized as

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<sup>53</sup> ROGER FISHER AND SCOTT BROWN, *GETTING TOGETHER – BUILDING RELATIONSHIPS AS WE NEGOTIATE*, at 9 (1989).

<sup>54</sup> BOB KAPLAN AND ROB KAISER, *THE VERSATILE LEADER*, at 129 -133 (2006).

<sup>55</sup> MICHAEL WOLFF, *THE MAN WHO OWNS THE NEWS – INSIDE THE SECRET WORLD OF RUPERT MURDOCH*, at 163 (2008).

<sup>56</sup> Jim Collins describes the pursuit of these strategies as the “undisciplined pursuit of more” and is evidence that the company has fallen into what he considers the second stage of decline. JIM COLLINS, *HOW THE MIGHTY FALL*, at 45 (2009).

business “hobbies” of the controlling shareholder. For example, in 1998, Magna International Inc., the large Canadian auto-parts supplier that recently made headlines by buying GM’s European Opel unit<sup>57</sup>, purchased Santa Anita, a thoroughbred racetrack near Los Angeles, California. Eventually, this and other high profile race tracks were spun off as a separate company. The controlling shareholder described the venture, which has since applied for bankruptcy protection, as “a labor of love”.<sup>58</sup>

- **Excessive Turnover:** Too much turnover on both the board and in the executive ranks may be an indication that the controlling shareholder does not value debate. A resignation outside the regular appointment cycle is a red flag and the accompanying press release merits careful study or further inquiry.
- **Related-Party Transactions:** An evaluation of related-party transactions with the controlling shareholder is critical to understanding the adequacy of board monitoring. Do these transactions appear reasonable or do they indicate weak independent directors? These transactions include charitable donations for which the controlling shareholder has a personal interest. For example, the controlling shareholder may have the company

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<sup>57</sup> While the transaction appeared all but complete in October of 2009 it was held back after the European Union expressed concerns that Germany improperly favored Magna’s bid. The EU Commission is currently seeking confirmation from GM that it picked Magna without political influence from Germany. See Chris Reiter, *GM Delays Signing of Magna-Opel Deal until Next Month (Update 1)*, *Bloomberg October 23, 2009* available at <http://www.bloomberg.com/apps/news?pid=20670001&sid=akrO7E75wvks>

<sup>58</sup> Greg Keenan, *Stronach’s dream dies with MEC filing*, *The Globe and Mail*, Report on Business (April 10, 2009), available at <http://www.theglobeandmail.com/report-on-business/stronachs-dream-dies-with-mec-filing/article975181/>.

make a major donation to “his” charity; the controlling shareholder may not see this as an issue because he does not think he is benefitting personally.

- **Independent Lead Director:** If the controlling shareholder is both CEO and Chairman of the board, is there an official or unofficial independent lead director who has the authority and stature to take the controlling shareholder quietly aside and objectively express concern about the controlling shareholder’s strategic plans and operational decisions – and will the controlling shareholder listen?
- **Executive Compensation:** If the controlling shareholder has an employment contract with the company, it is important that the board negotiate the contract through an independent committee with advice from outside counsel and compensation consultants directly engaged by the committee. In addition, if the company has transitioned from private to public ownership with the founder becoming the controlling shareholder, does the compensation arrangement reflect the new reality that the founder is no longer the owner? In the founder’s mind, there may be little differentiation between him and the company. For example, social functions, trips and other expenses can be seen by the founder as serving the business when in fact they are personal items.<sup>59</sup>

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<sup>59</sup> An example of such opportunistic behavior on the part of a controlling shareholder can be found in the statement of claim filed in Ontario's Superior Court of Justice by Brick Brewing Company against its founder and former Chairman, Jim Brickman. The statement alleges that Mr. Brickman put his wife on the payroll, enrolled her in the company’s retirement savings program, and paid her personal gasoline bills with company monies even though she never worked for the company. It also alleges that Mr. Brickman charged personal expenses (including trips, clothes and meals) to the company, and took for himself an average of six cases of beer a week over a four year period, or approximately 1,300 cases. Scott Deveau and Eric Lam, *Brick Brewery, former CEO in \$1M battle*, National Post (June 3, 2009), available at <http://www.nationalpost.com/scripts/story.html?id=1656718>.

- **Limits of Authority:** If the controlling shareholder is the CEO, what are his “limits of authority” when it comes to board involvement? A review of committee charters will reveal what issues need to be reviewed independently, *e.g.*, hiring and termination of senior officers, director nominations, major investments, strategic decisions, etc. A review of committee reports will reveal the board’s ability to retain independent counsel and other professional advisors.

## VII. Summary

The presence of a controlling shareholder can dramatically change best corporate governance practices. How extensive these changes need to be depends on the character of the controlling shareholder and the ability of an independent board (a board independent not only of the corporation but also of the controlling shareholder) to effectively handle its relationship with this very special shareholder. Institutional investors will identify red flags that may indicate controlling shareholder opportunism and then try to persuade the board to improve its corporate governance practices. Minimally, making these red flags known to other shareholders and stakeholders will help put pressure on the board to correct bad practices and change the ways of the inappropriately opportunistic controlling shareholder, protecting value for all shareholders and other stakeholders.

