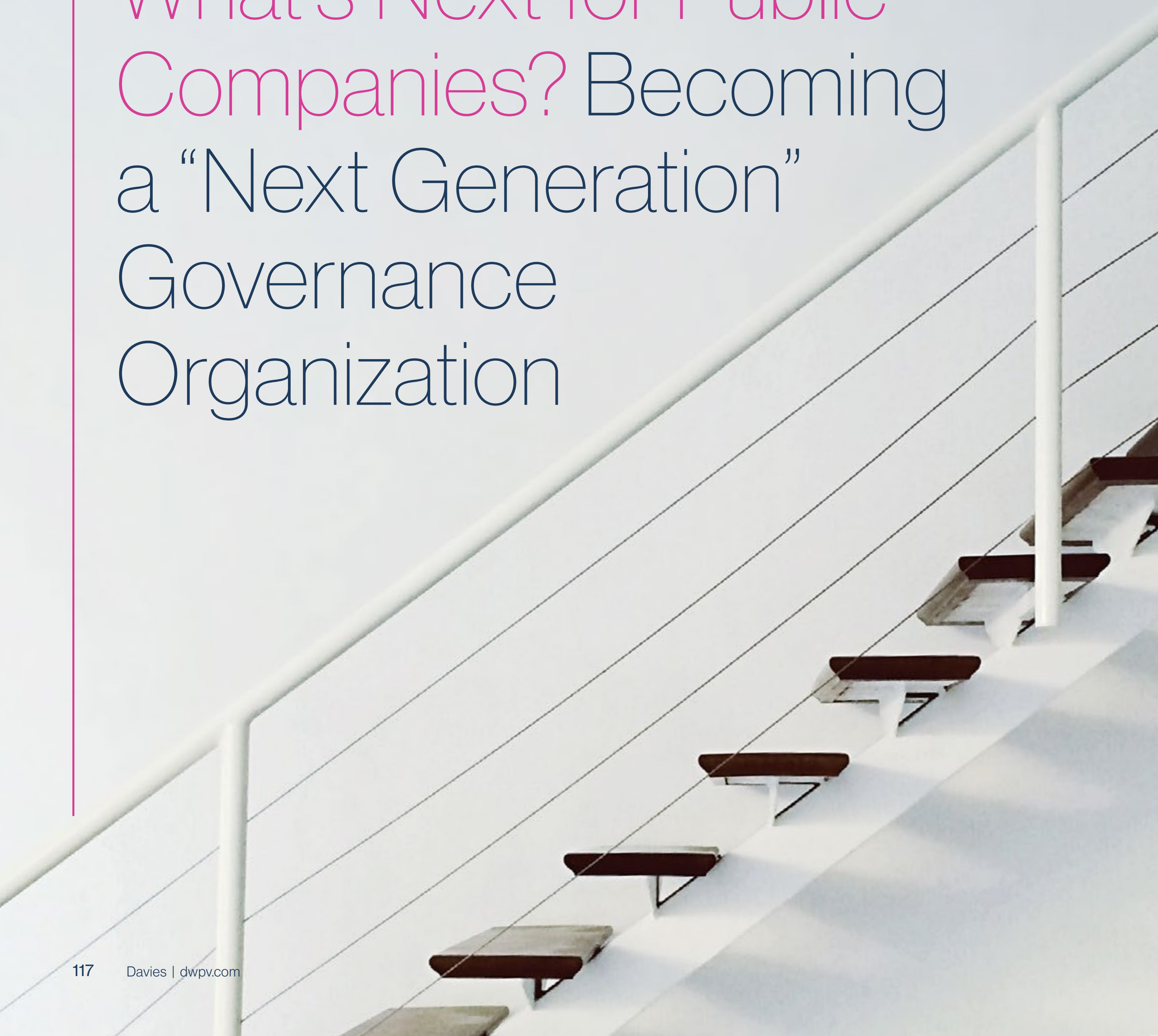
CHAPTER 09

What’s Next for Public Companies? Becoming a “Next Generation” Governance Organization



In this final chapter, we discuss how boards and senior management might respond to the ever-changing environments in which their companies operate, to maximize their viability and profitability in the near, medium and long terms. What does a “next generation” governance organization look like? We consider three critical elements to becoming a next generation organization, focusing on strategy, people, and shareholders and other stakeholders. We also cast a spotlight on the U.S. Business Roundtable’s recent expanded corporate purpose statement, articulating a commitment to all stakeholders of a corporation, and consider what this might mean for directors and officers in Canada. While directors and officers are not bound to give primacy to any particular stakeholder in exercising their fiduciary duties, we increasingly see companies being pressed to be “good corporate citizens,” failing which they risk damaging their brand and competitiveness and compromising their ability to generate sustained value.

What Is a "Next Generation" Governance Organization?

In our ever-changing business environment, boards and management are being pressed to systematically develop strategic approaches to achieving next-level governance that support an overarching framework of accountability, both within the organization and to shareholders and relevant stakeholders, while balancing risk and ethics with a spirit of resilience, agility and innovation.

In our view, a next generation governance organization has three critical elements. First, it is a company that has a razor-sharp focus on its business strategy and aligns all decision-making with its strategic vision and direction, taking into account short-, medium- and long-term goals. Second, this organization is people centred, harnessing the efforts, insights and creativity of everyone throughout the organization to create value and achieve successful outcomes for the business. Finally, a next generation organization proactively engages with shareholders and other key stakeholders, carefully considering stakeholder interests as part of its corporate decision-making, to allow for sustainable value generation. We discuss each of these areas in greater detail below.

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MAINTAIN A RAZOR-SHARP FOCUS ON STRATEGY

A next generation governance organization focuses on strategy. It is a company that does not rest on its laurels or rely on historical advantages or strategies. Given that change is constant, boards of directors, senior management and companies that are too focused on their current business and operations and unwilling to anticipate and plan for what might be around the bend risk declining profitability and, in some cases, extinction. Forward-looking strategic value creation can help set one organization apart from another, allowing one company to thrive while another risks failure.[179]

Boards of next generation governance organizations are actively engaged in business strategy, attuned to the fact that a business model that is successful today may be vulnerable to external disruptions in the future.[180] While the CEO and the senior leadership team are responsible for developing and executing a company's strategy, governance structures should be put in place to ensure that the board also owns that strategy.

Too often, board and committee agendas are filled with backward-looking compliance items. As important as regulatory and legal compliance is, as is staying abreast of corporate governance best practices and evolving to respond to these changes, having a solely (or primarily) historical perspective can be frustrating for board members and management alike as it typically leaves little time at board meetings to talk about the future of the company. Strategy is often delegated to one- or two-day offsite sessions. However, strategy should be a continuous, iterative process, and the board should be involved in the formulation, execution and monitoring of that strategy, continuously challenging its key elements and inputs to ensure it remains relevant to the organization and responsive to the changing (and often rapidly changing) macro-environment in which the organization operates.

There is no one right formula for strategic planning, and the same company may use a different approach at different points in its business life cycle. In all cases, it is critical to the strategic planning process to have access to timely and reliable information on market and economic trends, geopolitical context, competitors and customer preferences. As discussed below, shareholder and stakeholder consultation is also extremely important and can yield real insights into the viability of the strategy and whether it is being effectively communicated to the market, customers and other stakeholders that have a real impact on the business. The strategic plan's time horizon will depend on the nature of the industry and the organization's particular stage in its life cycle, but it should not simply be based on the expected tenure of the current CEO.

At a board and committee governance operational level, time should be allocated at each quarterly board meeting to have generative strategic discussions. Also, meeting agenda items (whether a discussion item or a decision item) should be linked to a prong of the strategy and, where appropriate, noted in the agenda as such. If an agenda item does not tie into the company's strategy, directors should question why the board is spending valuable time (or whether it is spending too much time) on the particular item and adjust the corporate calendar accordingly.

When boards are approving capital expenditure programs, they should also ensure that each program aligns with the company's strategy and with where it needs to be in the next year, in five years and in 50 years. The board should evaluate the capital expenditure strategy and have confidence that the process used and the absolute dollar values arrived at are for infrastructure spending and research and development programs that will further the company's goals. For example, does the budget allocate sufficient funds for innovation, including measures to respond to disruptive products and processes that may be entirely outside of the organization's control?

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Spotlight: Blockbuster vs. Netflix: Anticipating Disruptive Technologies?

At its prime, Blockbuster had thousands of retail outlets and tens of thousands of employees. It had a multi-billion-dollar valuation in 2004 but then went bankrupt in 2010 and now has only one store in the world.[181] What happened? According to some sources, Blockbuster was the master of its own demise.[182] Blockbuster's initial business model of a bricks-and-mortar video rental business, which subsequently expanded organically to include convenience store features, had thrived by responding to consumers' desire for, essentially, time-shifting entertainment options, with all of the top titles in film readily available at consumers' fingertips. However, some argue that Blockbuster failed not only because of the emergence of digital technologies but also because it did not anticipate and change the fundamentals of its business model in the face of a changing business environment and evolving consumer demands.

In 2000, Netflix came on the scene. The founder of the then-fledgling company contacted Blockbuster to propose a partnership to Blockbuster's CEO and his team at the time. He proposed that Netflix run Blockbuster's brand online and Blockbuster would, in turn, promote Netflix in its stores. Netflix's proposal was rejected.[183] Netflix disrupted Blockbuster's business model first by mailing DVDs to customers and then by streaming films to customers directly into their homes. Netflix, among other new entrants including Redbox and Hulu, gave customers the same product – access to movies – without customers having to leave their homes. In response, Blockbuster continued to run its business much in the same manner it had previously – running its stores and treating its employees as if it were a convenience store, but not recognizing that its model was no longer convenient.[184] Blockbuster did eventually launch its own digital service, but by then it was too late. Blockbuster's unwillingness to change its business model, focused on physical rentals from retail stores, turned out to be one of its greatest threats. Today, Netflix is a US$127-billion company, about 25 times the value of what Blockbuster was worth at its peak in 2004.[185]

While the emergence of Netflix's disruptive digital technology was one key reason for Blockbuster's ultimate demise, it was not the only reason. Reports suggest that changing consumer views played a part in Blockbuster's decline: consumers had become unhappy with Blockbuster's model, the profitability of which in part relied on penalizing customers with late fees on rentals.[186] These late fees could double or triple the cost of renting a video, introducing friction into the consumer relationship, yet they remained a significant aspect of Blockbuster's business model despite competitive pressures. In 2000, Blockbuster drew in US$800 million through late fees alone – 16% of revenue for that year.[187] This figure dropped to US$134 million in 2009, representing 3% of revenues, perhaps reflecting a strategy shift in the face of Netflix's flat-fee system that came all too late for the company.[188]

Had Blockbuster been more attuned to the network of consumers that made up its brand and industry, it might have been better able to adapt and respond more swiftly to the evolving business environment and consumer needs. With a greater appetite to innovate to respond to the changing needs of its core business – its customers – Blockbuster might have been better positioned to prevail. Another report suggests that a key factor in Blockbuster's failure was its reluctance to change its strategy. A former UK chief marketing officer for Blockbuster provided his perspective on the biggest lesson to be taken from the Blockbuster story: "On a simplistic level, it's that if a business is in decline you need to look at what the alternative is. Instead of putting all your resource into an ailing business strategy, sometimes it is better to accept it won't be the same anymore and hit reset. Even if you're going to take a big financial hit, making a fundamental change could be more lucrative in the future."[189]

Leaders of companies cannot be expected to predict the future, but, even at the time, Blockbuster was too unwilling to adapt to what was becoming an entirely different set of customer expectations. When it comes to consuming video content, it seems that convenience is what motivates customer choice, and there was too much in the Blockbuster business model that got in the way of convenience. The case of Blockbuster is a perfect example of how depending entirely on past performance for future planning can be fatal to a company when it is faced with disruptive competitors. This reinforces the importance of including long-term perspectives in strategic planning.

An issuer's overall strategy should dictate all key decision-making, including how valuable board and committee resources are spent, as well as the issuer's capital expenditures, geographic footprint, product lines and people strategy, which is discussed next.

TAKE A PEOPLE-CENTRED APPROACH

A next generation governance organization is people centred. It harnesses the power of diverse people to bring their best thinking to the table to operate, challenge, imagine, experiment and create. It embraces the concept of recruiting, retaining, promoting and recognizing the best talent at all levels, from the board to the CEO, in senior management and throughout the company. Employees and teams should be given the resources, time and support to innovate and take measured but not undue risks. And, importantly, a next generation organization values and rewards ethical and responsible behaviour.[190]

> The board of directors is also responsible for overseeing the issuer's overall people strategy and compensation philosophy. We recommend that boards (or their human resources committees) receive rigorous, regular reporting on key HR matters, including external HR trends, key HR internal data (e.g., employee engagement, turnover, internal promotions versus external hires, etc.) and key HR risks.

While boards have traditionally focused on talent at the CEO level as part of their oversight responsibilities for CEO-succession planning, the board is also responsible for overseeing its own talent pipeline. The board should be asking whether the board itself collectively has the diversity of experience, skills and backgrounds needed for the company to thrive and achieve its goals. For example, as we discussed in *Davies Governance Insights 2018*,[191] does the board have the appropriate level of human resources (HR) expertise to assist it with overseeing its human capital management? When recruiting for the board, consider a wide range of factors, including the issuer's customer base, employee demographics and geographical operations. In addition to hard skills and experience, the board should also consider what interpersonal qualities or styles the board is currently missing and may need as the company looks forward. We include an in-depth look at many of the considerations relevant to building high-performing boards in Chapter 5, In Focus: Building High-Performing Boards.

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- Does the company have the right talent internally to engage with local communities in the company's foreign operations?
- Does the company have the right skills in the existing team to deliver its products or services with a greater digital mindset?
- Does the existing team have the necessary skills and capabilities to address cybersecurity risks?

Who is hired or promoted should be dictated, in part, by what the company needs to achieve, again having regard to different time horizons.

Importantly, the board, CEO and senior leadership of a next generation governance organization are responsible for ensuring a culture that encourages, rewards and incentivizes ethical and accountable behaviour by all employees. This tone, like many other corporate imperatives, is set at the top. Boards and management should actively demonstrate the ethical norms that they expect all employees to follow. The board should also ensure that employees are provided with the tools and resources necessary to help them interpret and navigate ethical dilemmas, including access to key contacts and opportunities to test how they would react to various ethical dilemmas. At minimum, this begins with ensuring that user-friendly codes of business conduct for directors, officers, employees and, increasingly, suppliers are readily available and that employees are trained, using practical examples, to understand their responsibilities. This also requires having in place effective whistleblower programs to ensure that unethical or illegal conduct, or allegations of such conduct, are promptly brought to light, investigated and resolved. Boards should also ensure that ethical behaviour is rewarded. This can be accomplished through a variety of measures, including by establishing performance metrics tied to ethical behaviour within the hiring and promotion programs.

CONSIDER SHAREHOLDER AND BROADER STAKEHOLDER INTERESTS

Next generation governance organizations increasingly recognize that the profitability and long-term viability of their businesses depend on a wide range of stakeholders, including shareholders, customers, suppliers and the communities in which their businesses operate. Boards, CEOs and senior leadership teams of next generation organizations typically work hard to create governance structures that allow for proactive and engaged dialogue with relevant stakeholders and for meaningful consideration of their interests.

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Spotlight: Business Roundtable Makes Commitment to All Corporate Stakeholders

In August 2019, the Business Roundtable (an association of CEOs of major U.S. corporations) issued its *Statement on the Purpose of a Corporation* (Statement), espousing a commitment to all stakeholders of corporations, including their customers, employees, suppliers, communities and shareholders.[192] The Statement is intended to reflect a modern standard for corporate responsibility and represents the first time since the Business Roundtable started issuing its Principles of Corporate Governance that it has departed from endorsing the principles of shareholder primacy – that corporations exist principally to serve shareholders. The Business Roundtable indicates that its new expanded language on corporate purpose more accurately describes the ways in which it and its member CEOs endeavour to create value for all stakeholders, who are “essential” and “whose long-term interests are inseparable.”[193]

The Business Roundtable urges leading investors to support companies that build long-term value by investing in their employees and communities, and the Statement’s signatories have committed to:

- delivering value to customers, including meeting or exceeding customer expectations;
- investing in employees, including through fair compensation and fostering diversity and inclusion, dignity and respect;
- dealing fairly and ethically with suppliers, including serving as good partners with those companies that help them meet their missions;
- supporting the communities in which they work, including by embracing sustainable practices; and
- generating long-term value for shareholders, including through transparent and effective engagement.

Whether directors and officers of corporations may, or must, consider the interests of stakeholders other than shareholders is a debate we have grown

familiar with in Canada over the past 20 years. The Supreme Court of Canada gave the green light many years ago to directors and officers to consider the interests of stakeholders when exercising their fiduciary duties, when it stated in its groundbreaking decision in *BCE Inc. v 1976 Debentureholders*[194](*BCE*): "it may also be appropriate, although not mandatory, to consider the impact of corporate decisions on shareholders or particular groups of stakeholders," including "the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment."[195] The Court thus upheld the principle that the fiduciary duty is owed not to any particular constituency but to the corporation as a whole. The Court described this duty as a "broad, contextual concept" with an eye to the long-term best interests of the corporation.[196]

Recent amendments to the *Canada Business Corporations Act* (CBCA), discussed further in Chapter 1, CBCA Reforms: Canadian Government Codifies Corporate Governance Practices, have largely codified this aspect of the *BCE* decision (while adding reference to retirees and pensioners within the group of stakeholders), by providing that in satisfying their duty to act in the best interests of the corporation, directors and officers *may*, but are not required to, consider the interests of shareholders, employees, retirees and pensioners, creditors, consumers and governments; the environment; and the long-term interests of the corporation. Consistent with the CBCA amendments and law established under *BCE*, while the Business Roundtable suggests that its signatories will consider the interests of stakeholders, it certainly does not create any obligations to do so or pronounce upon which stakeholders should, when balancing competing interests, be given primacy.

Further details about the Business Roundtable's expanded corporate purpose statement can be found in our bulletin *Business Roundtable Issues Expanded "Corporate Purpose" Statement, with Commitment to All Stakeholder Interests*.[197]

Even while recognizing that under Canadian corporate law, shareholders elect the directors, and that under securities law, a shareholder primacy focus remains, next generation companies should strive to be attuned to and to engage with a broad range of stakeholders who matter to the success of the company. The stakeholders most relevant to an organization will invariably differ depending on the issuer's size, stage, industry and a host of other factors, but increasingly their interests can have direct and impactful effects on a company's viability and profitability.

In this context, boards should ensure that their issuers have strong and regular lines of communication with key shareholders, customers, suppliers and communities in which the businesses operate. Consider these questions, for example: Is the company attuned to customers' expectations regarding trade-offs on price, quality, delivery and training? Is the company listening to and, where appropriate, being responsive to community members' concerns about noise, safety or environmental issues? A board should ensure that there are processes in place for the company to dialogue with key shareholders and stakeholders so that they can effectively communicate the company's goals and priorities and receive stakeholder input on key issues and concerns. Importantly, stakeholder engagement should not be left until times when a crisis arises; boards should ensure that engagement is taking place systematically and that there are regular reports to the board on these processes. And boards should consider when and how to facilitate engagement between non-executive directors and stakeholders on issues that may not be appropriate to filter through management. In Chapter 8, Innovative Tools for Convenient and Transparent Disclosure and Effective Engagement, we discuss a host of tools and innovative techniques that issuers can leverage to help maximize the effectiveness of their communications and engagement programs.

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In addition, issuers should strive to contextualize quarterly financial earnings results with other indicators of value and success by, for example, tracking and disclosing a handful of non-financial indicators of their companies' value. Doing so can provide the market with a more robust picture of the company and its success that reflects both shareholder and other stakeholder interests. Providing analysts and the markets with information that the board and management *want* to convey about the company, and not only information that analysts and markets *expect or require*, can lead to more effective engagement and build support for the company's strategy.

Finally, boards should ensure that executive compensation programs reflect the importance of stakeholders to the success of their business. In addition to establishing financial metrics to assess executive performance, consider whether it might be appropriate to use a handful of non-financial metrics, such as customer satisfaction, employee engagement and/or other environmental, social and governance measures, as part of the performance standards expected to be achieved.

Our Take: Next Generation Organizations Have Enhanced Viability and Profitability

Increasingly, public companies in Canada and abroad are facing more pressure to act as good corporate citizens and to evidence these actions, having regard to a wide range of considerations and stakeholders. Evolving your business into a next generation governance organization may be one way to respond to these requests. Next generation organizations do not take their eye off their strategy, and they ensure that all decision-making is aligned with their strategic vision. They value their employees as being core to achieving business success and provide them with the resources needed to operate, create, innovate and take measured risks. And, finally, next generation organizations ensure that they have the requisite processes in place to meaningfully dialogue with shareholders and key stakeholders, and to consider and balance a range of stakeholders' interests in corporate decision-making, to allow for sustainable value generation. In doing so, next generation organizations may find themselves building more stable, stronger and more transparent organizations, with cultures that make them more resilient, agile and innovative in the face of ever and rapidly evolving business, economic and geopolitical environments and changing customer preferences and demands.

Notes

Chapter 9 – What's Next for Public Companies? Becoming a "Next Generation" Governance Organization

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