BrownGovernance

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Governance Arrangements and the Legal Hierarchy

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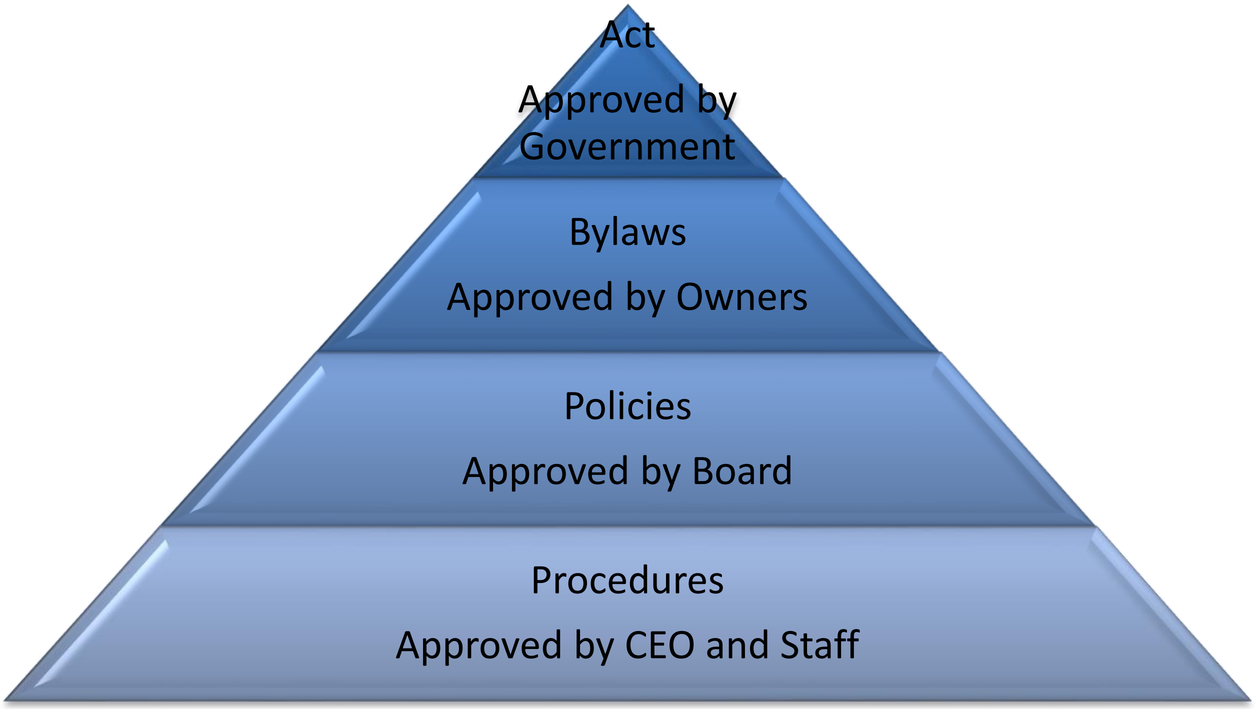
The Legal Hierarchy: The Act, Bylaws, Policies and Procedures



Policies and Procedures fit into a hierarchy of governing legal documents in a corporation:

1. **Statute** (incorporating Act) and incorporation documents (articles, charter or letters patent and subsequent amendments) – these are put in place when a corporation is first incorporated, and only rarely amended, for example if there is a substantive change in control, name or mandate.

2. **Unanimous Shareholders' Agreement** – at times, especially if there is a small number of shareholders (members in a not-for-profit corporation), they may all agree on some "hard and fast" rules of the corporation that may not be changed by, and must be followed by, the Board. These generally have to do with how the Board members will be selected, and the powers delegated by the owners to the Board vs. which powers will be retained or reserved by the owners. They may also deal with the allocation of capital and the distribution of surplus.

3. **By-Laws** – these are generally the "hard and fast" rules of the corporation, and typically are drafted or recommended by the Board, and then require owner (shareholder or member) approval to change; for example how shareholders and the board are constituted and can exercise their powers (meetings, voting, quorum, notice, etc.)

4. **Policies** – these deal with the more important aspects of a corporation's strategic issues, and typically require board approval to change. These are the "red lines" that a Board

puts in place for management to follow between board meetings. Policies reflect the tolerances that the Board has for management to take risks and make decisions. Examples of board level policies may be the delegation of authority to management (CEO), capital expenditure and high level procurement rules and thresholds, conflicts of interest and code of conduct of the Board and staff, and disclosure of material facts and changes.

5. **Procedures** – these deal with the day-to-day running of the corporation's operations, and typically require management approval to change; for example, cheque signing, bank reconciliations, HR procedures such as hiring and grievance procedures, advertising guidelines, etc. etc.

Five basic principles of governance help us to decide what belongs in which of these:

- **The Principle of Independence**: means that each of the main parties in governance – the owners (shareholders/members), the Board (governors) and the management (CEO) ought to be able to think and act independently of one another, each being responsible for their own area of expertise and calling. In general, this means the owners putting in place the governance structure, including choosing the Board and Auditors and holding them accountable; the Board actually running the governance system, setting the strategic direction of the corporation and gaining reasonable assurance that it is moving substantially in that direction; management actually running the operational system, the system by which products and services are produced and distributed to the clients of the corporation.

- **The Principle of Empowerment**: means that we push decision-making as far down into an organization as we can, consistent with the capacity of the parties at each lower level. As much as possible, we put things in procedures, unless the board MUST be involved, then we'd put these in policies, unless the shareholder(s) MUST be involved, then we'd put these in by-laws or a Unanimous Shareholders' Agreement. Often our tendency is to enshrine things in by-laws/USA and policies, but we ought to resist this urge, since it restricts flexibility and therefore the ability of the board to govern and management to manage the organization in a climate of continuous change and volatility. While each party has legal "power" over the parties below it on the hierarchy, by delegating as many of these powers as practical will "empower" and enable the other parties to be more effective and efficient (getting the right things done, for less cost – since each level of governance usually operates at a lower cost.)

- **The Principle of Accountability**: means that each party ought to be accountable (counted on) for the outcomes and consequences of the decisions that it was empowered to make.

These ought to mirror one another – to the extent that one party seeks to hold another accountable, it should delegate sufficient authority and resources to them to actually make those decisions. Conversely, if a party chooses to withhold delegation, to "draw the line" at a higher level of authority, then it should not hold the other party accountable, it remains accountable itself for the consequences of that choice.

- **The Principle of Alignment**: means that the relative powers and authority of each party ought to reflect their relative stake at risk in the enterprise. To the extent that a set of owners or class or stakeholders is being asked to accept a higher risk, their powers (authority and influence) ought to increase accordingly. Owners ensure this alignment by how they word the Bylaws (and Unanimous Shareholders' Agreement, if any.) The Board is typically viewed as the proxy for the voices of non-owner stakeholders if their voices are not integrated into the governance arrangements in other ways (e.g. Bylaws.) This principle also means that each set of documents must be consistent with, and flow from (cascade) the documents above it in the hierarchy. By-Laws must follow, and give effect to, Statute and incorporation documents. Policies must follow, and give effect to, By-Laws. Procedures must follow, and give effect to, Policies. From time to time, for the sake of clarity, we may have some duplication/overlap between documents, but we should avoid this as much as possible, since it creates the potential for conflicts if we later change one and not the other. For example, the By-Laws may cite the powers and duties of directors, even though these are in Statute, simply to be clear as many directors don't know the law. And Policies might restate the names and composition of core Board Committees and Officers that are already in By-Laws, for the sake of completeness in explaining committee mandates and functioning.

- **The Principle of Transparency**: means that the governance arrangements ought to be clear, simple and explicit. Others looking in should be able to see what the governance arrangements are should therefore be able to choose whether to put a stake at risk, to increase or decrease this stake. Governance arrangements should not be secret, they should be published and available for all to scrutinize and assess.