Where are the Directors in a World in Crisis? ESG and corporate governance best practices

February 24, 2021

How do I modify my corporate governance procedures to improve long-term financial performance, while also improving environmental, social and governance (ESG) performance? On Feb. 22, 2021, Peter Dey and Sarah Kaplan answered this question in their report entitled "360º Governance: Where are the Directors in a World in Crisis?" (360º Governance).

Released by the University of Toronto's Rotman School of Management, 360º Governance provides a set of 13 corporate governance guidelines aimed at giving clarity on how boards can effectively consider the interests of all stakeholders and the rights of Indigenous Peoples in their decision making.

Background: The origins of Canadian corporate governance best practices

360º Governance borrows its framework heavily from Peter Dey's influential Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada titled "Where Were the Directors?" (the Dey Report).

Similar to the Dey Report, the guidelines do not mandate action by the board. Rather, they follow the same "comply or explain" approach to implementation that was used in the Dey Report.

Both the Dey Report and 360º Governance include a background section that frames the problem they are trying to address, before articulating a set of 13 corporate governance guidelines designed to help address those problems.

Dating back to the early 1990s, the Dey Report noted that there was skepticism among public shareholders regarding the adequacy of corporate governance of many public companies, and concluded that had corporations been more effectively governed, the risk of these recent corporate failures and the magnitude of losses that occurred would have been significantly reduced.

The Dey Report concluded that effective corporate governance will, in the long term, improve corporate performance and benefit shareholders. Improved corporate

performance is both in the best interests of shareholders and serves the public interest as well.

The report's impact was immediate. The Dey Report was subsequently adopted by the Toronto Stock Exchange, mandating that TSX-listed companies disclose annually whether and how the board of directors adhered to the 13 corporate governance guidelines (the TSX Governance Guidelines).

The TSX Governance Guidelines were in force from 1995 to 2005. In 2005, the Canadian Securities Administrators (the CSA) adopted the CSA Governance Guidelines, which expanded on and replaced the TSX Governance Guidelines. Today they include National Policy 58-201 – Corporate Governance Guidelines and National Instrument 58-101 – Disclosure of Corporate Governance Practices.

The policy rationale for the CSA Governance Guidelines is consistent with the policy rationale that underlined the recommendations in the Dey Report. That is, to provide the investing public with information and transparency concerning the corporate governance practices of an issuer so that investors can make informed investment and voting decisions in respect of a particular issuer.

With this history, it is not surprising that 360º Governance suggests near the end of the prologue that:

[W]e believe that boards of directors of all companies need to address and respond to the issues raised by the guidelines. We also anticipate that legislative or regulatory bodies may also seek to enact regulations or laws requiring compliance. It is our hope that these guidelines will serve as both a useful resource and an inspiration to corporate Canada and help lead Canada into a prosperous 21st century.

360º Governance: Adopting a stakeholder-centric view of corporate governance

In 2004, the Supreme Court of Canada affirmed that directors owe their fiduciary duty solely to the corporation, and not to any particular stakeholder group, in *Peoples Department Stores v Wise.*

In 2008 in *BCE Inc v 1976 Debentureholders* the Supreme Court went further, noting that in considering what is in the best interests of the corporation, directors may look to the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions.

While courts have generally shown deference to business judgement, stakeholders play an important role in Canadian corporate governance law.

Section 122(1.1) of the *Canada Business Corporations Act* states:

> **Best interests of the corporation**
> (1.1) When acting with a view to the best interests of the corporation under paragraph (1)(a), the directors and officers of the corporation may consider, but are not limited to, the following factors:

(a) the interests of
(i) shareholders,
(ii) employees,
(iii) retirees and pensioners,
(iv) creditors,
(v) consumers, and
(vi) governments;
(b) the environment; and
(c) the long-term interests of the corporation.

Historically, Dey and Kaplan note, the shareholder has occupied a large share of the board's attention. Their guidelines are intended to elevate the status of other stakeholders in the board's minds rather than reflect a bias against the shareholder.

In this context, 360º Governance begins by noting that "the year 2020 is forcing a reckoning about the role of the corporation in society, and along with it, the responsibilities of boards of directors to the corporation's myriad stakeholders."

Drawing in part from Kaplan's 2019 book titled *The 360º Corporation: From Stakeholder Trade-offs to Transformation*, Dey and Kaplan make the case for boards to take a broader ESG and stakeholder-centric view of corporate governance.

While acknowledging that corporations contribute jobs, innovation and economic growth to our country, Dey and Kaplan note that corporate operations have also contributed to creating or exacerbating social and environmental problems including climate change, income inequality, gender inequality, and the opioid crisis.

Dey and Kaplan note that:

- Given the severity of these problems, governments at all levels are changing the regulatory and legal rules applicable to Canadian corporations.
- Investors are showing an interest in a firm's broader ESG performance, with more than 30 per cent of investments now held in an ESG vehicle or something similar, a proportion that is estimated to grow to 50 per cent by 2050.
- Recent research shows that companies that adopt formal sustainability policies and those with higher ESG ratings tied specifically to material impacts have better financial returns than their peers.
- High ESG scores are now a competitive advantage in the war for talent.
- Customers are also demanding that their suppliers respond to societal challenges, in both the business to client (B2C) and business to business (B2B) space.
- Climate change creates risks that can have a material impact on financial performance. An increasing number of companies are reporting material effects on earnings caused by weather-related damages to physical plant or supply chain disruptions.

The thirteen guidelines

In this context, Dey and Kaplan present their 13 guidelines to form the basis of modern Canadian board competencies.

The guidelines were drafted to apply to all organizations, regardless of their legal form, and not just large, publicly traded companies.

The guidelines incorporate guidance already offered by other prominent organizations in Canada and around the world, such as the UNPRI (Principles for Responsible Investing), the Canadian Coalition for Good Governance, the Taskforce on Climate-related Financial Disclosure (TCFD), the Reconciliation & Responsible Investment Initiative, the Institute for Corporate Directors, the Canadian Gender and Good Governance Alliance, the World Economic Forum's 4Ps (principles of governance, planet, people, prosperity), the Ontario Capital Markets Modernization Taskforce, the United Nations "Protect, Respect and Remedy" Framework, the OECD Guidelines for Multinational Enterprises and many others.

The guidelines are as follows:

1. **Corporate purpose:** Establish a corporate purpose that addresses all stakeholders.
2. **Board's duty:** Emphasize the board's duty to exercise its powers in the long-term best interests of the corporation, which by necessity considers the interests of all the corporation's stakeholders.
3. **Definition of stakeholders:** Clearly define the stakeholders that contribute to the operation of the corporation's business or could be impacted by those operations by assessing the impacts of the corporation's products or services across their lifecycle.
4. **Indigenous peoples:** Many Indigenous peoples reject the designation "stakeholder," which implies their interests may be balanced with other interests. In this context, it is important for boards to understand the unique history and special rights of Indigenous peoples, as well as the need for engaging with and, if appropriate, getting their consent.
5. **Reporting on stakeholder impact:** Integrate reporting of stakeholder impacts as part of annual reporting, which is supported by metrics designed to track and prove progress.
6. **Stakeholder committee:** Establish a separate stakeholder committee to oversee the veracity of the reporting on stakeholder impact and to have a larger strategic responsibility to monitor stakeholder interests and the related risks and opportunities.
7. **Stakeholder conflicts:** In the event of conflict among different stakeholders, develop processes designed to ensure that competing interests are identified and considered, with an objective of treating all stakeholders fairly.
8. **Compensation policies:** Ensure that management compensation is aligned with achieving the corporate purpose and the long-term sustainability of the corporation.
9. **Board refreshment:** To ensure that boards gain the competencies and diverse perspectives needed to address these 21st century challenges, adopt rigorous processes of board refreshment, including term limits, and revised skills matrices for assessing current board members or recruiting new ones.
10. **Board diversity:** Develop targets for the board that include the appropriate mix of backgrounds and lived experiences, representative of the communities in which the corporation operates. Include targets for representation of women on the board and track progress towards those targets, and report on representation

of other underrepresented groups including Indigenous Peoples, persons with disabilities, and members of visible minorities.

11. **Organizational diversity:** Establish clear policies, specific targets and timelines for achieving diversity throughout the organization through better representation of women, visible minorities, Indigenous peoples, people with disabilities and other underrepresented groups.
12. **Climate change:** Develop and disclose its policy for addressing climate change and climate related-risks and opportunities, as well as disclosure of the processes by which board committees consider climate-related issues when reviewing strategic choices and how the board monitors and oversees progress against goals and targets for addressing these issues.
13. **Corporate activism:** Ensure a process is in place for the board and CEO to identify and deliberate about key issues with social or political implications, and, if agreed, for the corporation – typically through its CEO – to state its position on key issues.

Takeaways

360º Governance provides practical step-by-step guidelines that boards, management and companies can implement to address stakeholder impacts and, ideally, improve ESG performance.

It introduces a systematic approach to stakeholder interests and a stakeholder-centric view of corporate governance that compliments and expands beyond the shareholder-focused concerns that gave rise to the original Dey Report.

Smaller companies (publicly traded or not) may be concerned that they simply do not have the resources to take on more governance responsibilities, or that additional governance requirements might dampen innovation or entrepreneurship.

However, good governance can help all corporations, including smaller companies, gain credibility, enhance their reputation, attract talent, gain access to capital on better terms, appeal to customers, prevent fraud or other unethical behaviour and withstand market shocks.

In this way, 360º Governance is an opportunity rather than a burden.

If you would like to discuss how to implement these recommendations in your corporate governance practices, please reach out to any of the key contacts listed below.

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