Legal World of Directors and Officers

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Outline

Sources of Directors' and Officers' Duties and Responsibilities

Corporate statutes

- general legal framework

Case law

- important in understanding and evaluating directors' and officers' duties and other obligations

Securities laws

- some impose stringent requirements on director and officer conduct

Best practice considerations

- boards and management may prefer to observe higher standards than required

Public welfare statutes

- create personal liability for directors and officers where the business has failed to observe its legal responsibilities

Corporate Framework – Overview

•The corporate law framework is relatively general - intended to permit the flexibility necessary to adapt to the differing needs of corporations

•Who are the players?

- shareholders
- directors
- officers
- auditor

• Board manages (or supervises the management of) the business and affairs of the corporation (s. 102(1) CBCA)

• Officers appointed by directors and oversee the corporation's day-to-day operations (s. 121 CBCA)

Corporate Framework – Liability Standards

- Corporate law duties
  - fiduciary duty (duty of loyalty)
  - duty of care
- Duty to comply
  - corporate statute, articles, by-laws, unanimous shareholders' agreement
- Directors Defence to liability
  - good faith reliance
- Personal statutory liability
- Indemnification

Fiduciary Duty (Duty of Loyalty)

Directors and officers must act honestly and in good faith with a view to the best interests of the corporation (s. 122(1)(a) CBCA)

Origins in trust law – high standards of honesty, selflessness and loyalty

Characteristics of a fiduciary relationship include:

- fiduciary has scope for exercise of a power or discretion
- fiduciary can unilaterally exercise power or discretion and affect beneficiary's interests
- beneficiary peculiarly vulnerable to or at the mercy of fiduciary

Fiduciary Duty: To Whom Owed

Act honestly and in good faith

- corporate interests placed above personal interests

Duty owed to **<u>the corporation</u>**

- more than merely acting in the best interests of shareholders (although this is generally a good starting point)

No duty is owed <u>directly</u> to:

- majority or minority shareholders
- for nominee directors, the shareholder that nominated you
- creditors

Fiduciary Duty: To Whom Owed (cont'd)

<u>HOWEVER</u>, in acting in the "best interests of the corporation", directors and officers must take into account the interests of a number of stakeholders, including shareholders, creditors, employees, consumers, suppliers, government, community and the environment

In good times, most of these interests tend to be aligned; in challenging times, interests of various stakeholders can diverge

Directors and officers may owe a duty of <u>care</u> to certain of these stakeholders in that they cannot be blind to their interests

Fiduciary Duty: To Whom Owed (cont’d)

BCE v. Debentureholders (SCC 2008)

- Duty owed to the corporation and must focus on long-term interests, not just short-term profit or share value
- Corporation must act as a “good and responsible corporate citizen” considering the interests of all stakeholders, including shareholders, employees, creditors, consumers, government and the environment. Where the interests conflict, no one set of interests prevails over the others
- Interests of all competing groups cannot always be satisfied; boards will sometimes have to make decisions that will benefit some groups at the expense of others
- Business judgment rule requires courts to defer both to the choice of what interests to take into account and the balancing of those competing interests

Fiduciary Duty: Selected Applications

Avoidance of conflicts of interest

Prohibition on taking advantage of corporate opportunities

Acting for a proper purpose

Maintaining confidentiality

Fiduciary Duty: Conflicts of Interest

At common law, conflicts of interest were prohibited outright

This overly strict formulation has since been modified by statutory disclosure of interest provisions in corporate statutes (eg, s. 120 CBCA):

- applies if director or officer is party to contract or transaction, is a director or officer of a corporation that is a party to contract or transaction or has a material interest in a party to contract or transaction
- must disclose nature and extent of interest and record in minutes
- must not vote (subject to exceptions)
- must be fair to the corporation when approved
- if procedure not followed, contract can be set aside and accounting may be required

Fiduciary Duty: Taking Corporate Opportunities

Restrictions on directors and officers from taking advantage of business opportunities that the corporation might otherwise pursue

- application of rule against conflict of duty and interest
- accounting and disgorgement required

Factors to be considered in determining abuse of corporate opportunity include:

- position or office held
- nature of corporate opportunity – its “ripeness”
- amount of knowledge possessed and how it was obtained
- circumstances under which the relationship with the corporation is terminated to enable the director or officer to pursue an opportunity

Fiduciary Duty: Proper Purpose

- Acting for a proper purpose
  - directors and officers must exercise their powers for a “proper purpose”
  - preferable test is found in *Teck v. Millar*
    - must act in good faith in what they believed, on reasonable grounds, to be the interests of the company
    - actions of directors will be protected even where directors indirectly benefit

Fiduciary Duty – Confidentiality

Maintaining confidentiality of information

- never use the information you learn at the boardroom table or as an officer for any purpose unconnected with the organization
- keep all of the information you acquire confidential
- situations to watch:
  - nominee directors
  - serving on competing boards

Fiduciary Duties – Examples of Balancing Stakeholder Interests

Charitable gifts

- community relations, for example, may be important to the long-term interests of the business and its owners
- charitable gifts, however, to the pet charities of the CEO not acceptable

Awarding the CEO a large retirement bonus

- considerations might be tough to justify

Purchasing a major art collection for the corporation

- attractive surroundings are necessary to keep senior employees comfortable and loyal?
- important to customers/clients?

Duty of Care

Duty to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (s. 122(1)(b) CBCA)

- an objective standard
- higher standard than at common law

Duty of Care (cont'd)

- No particular skill level required
  - directors and officers must employ skill and knowledge they possess
  - higher standard of care expected of those that possess greater knowledge or skill (e.g., officers, audit committee members)
  - must be diligent in attending to the affairs of the corporation (e.g., attend meetings and briefings, tours of facilities, become knowledgeable about corporation's business)
- May be dependent on the factual aspects of the circumstances surrounding the actions of the director or officer (e.g. YBM Magnex)

Standard of Review: Business Judgment Rule

Courts will defer to business judgment of Board and management in determining whether it has discharged its duties

Where a Board and/or management has made a business decision honestly, prudently, in good faith and on reasonable grounds, the court should not (and will not) second-guess the judgment of the Board and/or management

Decision can be wrong so long as the decision was the product of a good, deliberate, independent process

Standard of Review Business Judgment Rule (cont'd)

Board and/or management not automatically entitled to protection of the business judgment rule – it must be earned

Courts can look critically at process Board and/or management followed and whether decision was reasonable

- <u>process</u> is a big determinant of reasonableness
- where the process misses the point, the protection of the business judgment rule may not be available

Business Judgment Rule – Director's Toolkit

When will a Court defer to the board's and/or management's business judgment?

- decision made by disinterested and independent directors
- avoid conflicts of interest; use independent committee in non-arm's length situations
- appropriate time spent on decision
- review of critical deal documents or summaries
- advice sought from outside experts
- decision made for a proper corporate purpose
- board insists it be presented with alternatives
- board has opportunity to (and does) ask questions

Minutes of meeting should try to evidence that these elements were satisfied

Aids to Good Decision Making: Permitted Reliance by Directors

Boards entitled to rely on third parties to assist in making decisions

Board is heavily dependent on the corporation’s officers to provide information

Absent grounds for suspicion, directors will generally be justified in trusting that the person to whom the duties have been delegated will perform their duties honestly and competently

Deemed to have complied with duties where rely in good faith on:

- financial statements represented by officer or auditor to fairly reflect financial condition of the corporation
- report of a professional (s. 123(5) CBCA)

Aids to Good Decision Making: Permitted Reliance by Directors (cont'd)

Good faith reliance includes:

- being reasonably satisfied as to expertise of professional person
- carefully reading and considering written reports presented by experts

Courts have said "…*directors will be held liable for the misdeeds of officials of the company only if they have been personally negligent or if they have acted unreasonably in relying on officials whose honesty and competence they have reason to suspect…I note that the case law cited by the appellant establishes that reliance on counsel's advice (even if it leads to a deleterious result) will strongly militate against a finding of mala fides or fiduciary breach*…"

Aids to Good Decision Making: Due Diligence by Directors

Due diligence defined:

- conducting a reasonable investigation to have reasonable grounds to believe a decision is an appropriate one

Obligates each director to be informed and puts the onus on the individual director to become informed

Starts with high level systems, controls and processes regulating how decisions are made but also includes the nuts and bolts of informed decision making around individual issues

Procedurally due diligence is a defence but substantively it defines the appropriate standard of care

Aids to Good Decision Making: Due Diligence by Directors (cont'd)

Written policies and procedures can be a useful due diligence element, but they must be used with caution

- can support case for amount of time spent considering proper course of action
- often involve expert advice
- must be complied with, or exceptions made after due process followed - failure to comply could create a presumption inadequate process for decision

Key Principles for Quality Decision Making

Underlying quality of materials and information is important

- effectiveness of systems and controls and internal reporting
- consider reliability of all information

Use and reliance on expert advisers where appropriate; care should be taken as to who is instructing advisers

Awareness of conflict of interest

- ensure independent majority makes the decision
- effective use of committees to “prep” the board

Key Principles for Quality Decision Making (cont'd)

- Consideration of alternatives
  - insist management present alternatives where appropriate so board has choices
  - balanced assessment of pros and cons
- Dealing with time pressures
  - avoid making decisions under pressure where possible
  - ensure that sufficient time is spent on decisions relative to their importance
- **<u>Ask lots of questions!</u>**

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