Corporate Governance
Small-Medium Enterprises

A. Business Corporations

Businesses come in many forms, shapes and sizes, i.e. everything from individual contractors or consultants operating as sole proprietorships, "mom & pop" operations and small partnerships, to small, medium and large global corporations and joint ventures. Exactly which form or structure of enterprise or venture is best for any particular business at any point in time varies. And it can and often will change over time as the business grows or seeks financing. Choosing the right legal structure for your business is one of the first critical decisions any entrepreneur or start-up business must address very early. Leaving that question unanswered can result in significant, unanticipated legal or tax liability for the participants. A little planning around the right legal structure can go a long way in mitigating that risk. See ***"Choosing the Right Business Structure"*** in our **Grey Book Corporate Compliance Series**. Our purpose in this Grey Book is to introduce the *corporate* structure and the role of corporate governance in that structure. We will also touch briefly on the duties and liabilities of the *officers* and *directors* of business corporations in this Grey Book.

Corporations are also known as "companies". A "corporation" or "company" is an artificial legal person in the eyes of the law. It is a creature of statute. It has a separate legal existence of its own, distinct from that of its founders, incorporators, officers, directors and shareholders. It can do almost everything an ordinary person can do (except eat, drink or sleep, brush its teeth or think for itself), including negotiate and sign contracts, buy and sell inventory, products and services, hire and fire, sue and be sued. But it can only do these things through the living agency of people. The corporation as a legal entity cannot do these things itself; it must rely on real people with real hands, real minds and real hearts to do them for it. Enter the officers and directors, the board of directors and corporate governance.

B. Corporate Governance

What is *corporate governance*, and why does it matter to the local entrepreneur or small-medium business? Isn't that something the "big boys" need to worry about more than do SMEs (small-medium enterprises)? Corporate governance, simply put, deals with how corporations make decisions, i.e. how they are managed and how decisions are made within the enterprise. Corporations are not necessarily large, multi-million dollar enterprises. In fact, the vast majority of businesses today fall into the small-medium size enterprise category. Regardless of their size, or whether they are non-profit or for-profit enterprises, they share a number of things in common. The most notable is that they are governed by a board of directors. Therefore, corporate governance is just as relevant to SMEs as to their larger counterparts.

The corporation, as noted earlier, is a separate legal entity from its shareholders, directors and officers. This has profound implications for all corporations, large and small. The legal structure of the corporation separates *ownership* from *management*. The shareholders, for all practical purposes, are the "owners" of the corporation. It is they who decide who the directors will be. But aside from this (except in closely-held corporations with unanimous shareholders agreements), they have very little say in how decisions are made or how the business is run.

In many closely-held corporations, the shareholders are virtually indistinguishable from the directors and officers as the same individuals wear a number of different hats and occupy multiple offices, exercising powers related to their different functions at different times, often without realizing it. This can create tension and the risk of conflicts of interests for the unwary director or officer who thinks more like a shareholder in executing his or her management functions than an officer or director. Knowing where the shareholder's interest ends and his or her fiduciary duties as an officer or director begins is critical to effective corporate governance and to minimization of personal liability (even in closely-held corporations where people wear multiple hats and occupy multiple offices that pull them in different directions.)

Board of Directors

The directors are elected by the shareholders. In most closely-held companies the shareholders are the founders and principal investors. This means that in most closely-held companies the shareholders elect themselves to the board of directors (BOD). The BOD sits at the top of the corporate decision-making hierarchy. Its principal role is to ensure that the enterprise is managed and operated honestly and in good faith, with a view to the best interests of the corporation, in compliance with all laws, regulations and accountability standards governing the corporation, its industry and regulatory framework. The directors derive their powers and duties to manage or supervise the management of the corporation from the corporate statutes (federal or provincial) under which the corporation is created.

The board's main functions include:

(a) installing the right chief executive officer (CEO) and holding the CEO accountable for the management and results of the business;

(b) approving the strategic direction or corporate strategy by management for the corporation;

(c) monitoring the way management executes the strategy and operates the business of the corporation; and

(d) depending on the size of the corporation and the board, establishing an independent audit committee and such other committees as may be required to fulfill the responsibilities of the board;

Corporate governance, in short, deals with how directors are elected, how the corporation is managed, the standards of care and performance required of the corporation's officers and directors, as well as their duties, accountabilities and liabilities to the corporation, its shareholders, employees and other stakeholders (including regulatory authorities).

Executive Management

Typically, the CEO appoints his or her executive management team, most notably the Chief Financial Officer, Chief Operating Officer, and executive Vice Presidents. In many cases, beginning with the CEO, one or more of these will be *officers* of the corporation. It is to them that the day-to-day management of the enterprise is entrusted by the board. This is true whether the corporation is a small private corporation or a widely-held, publicly traded company.

C. Duties & Liabilities

While there are practical and theoretical distinctions between the duties and liabilities of directors and officers, for the purposes of this Grey Book primer on "Corporate Governance for SMEs", it is important to realize that both officers and directors share a number of the same duties and liabilities. We will touch only briefly on these in this Grey Book. Our companion Grey Book ***"Directors & Officers: Duties and Liabilities"*** will expand on and further differentiate these critical roles for directors and officers of SMEs .

Very briefly, both directors and officers owe the same or slightly modified *fiduciary duty* and *duty of care* to the corporation and its critical stakeholders, and they must discharge their responsibilities in accordance with these duties. These duties are found both in the corporate statutes and in the common law. As noted earlier, it is the duty of the directors "to manage or supervise the management of the business and affairs of the corporation", while the officers ("senior management") are charged with carrying out the day-to-day management of the company. In other words, it is the duty of the BOD to monitor the management activities of the officers, i.e. of senior management.

The fiduciary duty owed by directors and officers of the corporation includes the duty of loyalty, honesty and good faith, as well as the duty to avoid any conflict of interests between the officer's or director's personal or economic interests and those of the corporation. In the event of any conflict, it is his or her duty to the corporation that must prevail. The duty of care, on the other hand, is the duty to exercise care, skill and diligence in making corporate decisions. Both these duties are codified in the applicable corporate statutes, and are expanded upon in our companion Grey Book.

Liabilities may include disgorgement of profits or other benefits for misappropriated corporate opportunities or breach of trust, and civil or even criminal liability for fraud, unpaid taxes and statutory remittances, or environmental violations, and, in the case of directors, for unpaid employee wages. See our companion Grey Books for further details.

The above outline of corporate governance for SMEs is intended as a basic introduction for entrepreneurs, business executives, officers and directors. It is not intended as legal advice. Consult your solicitors if you have any specific questions.