



A. CORPORATE GOVERNANCE

In a companion Grey Book in this series on corporate compliance we introduced directors and officers, and their roles in the management, operational accountability and day-to-day decision-making of small-medium sized enterprises. See **“Corporate Governance: Small-Medium Enterprises”** in our **Grey Book Corporate Compliance Series**. In this Grey Book we want to expand on the legal duties and liabilities of directors and officers within the corporate structure of private companies and enterprises. Many of the principles discussed here in relation to SMEs will apply equally to larger private corporations. Publicly-traded companies are subject to additional corporate and securities requirements.

Officers and Directors

By way of introduction, corporate governance, simply put, deals with how corporations make decisions, i.e. how they are managed and how decisions are made within the enterprise. As a rule, shareholders elect the **board of directors**. The *directors* are responsible for the overall management and direction of the company. They are responsible for installing the CEO and holding the CEO accountable for the management and results of the business; reviewing and approving the strategic direction of the corporation proposed by management; and overseeing execution of the strategy. In practice, this typically means overseeing or monitoring the decisions of the executive management team while the managers deal with day-to-day operations. The *officers* are typically drawn from the ranks of senior management, particularly in SMEs. Therefore, in practice, the directors are typically responsible for overseeing executive decisions of the corporate officers themselves (CFO, COO, VPs, etc.).

As noted in our companion Grey Book on **“Corporate Governance”**, in many closely-held corporations, these offices often merge in the same individuals. In many of these, 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, 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 and other duties as an officer or director begin is critical to effective corporate governance and minimization of personal liability (even in closely-held corporations where people wear multiple hats and occupy multiple offices that pull them in different directions.)

While the roles of officers and directors are theoretically different, and that theoretical difference becomes increasingly blurred as the company grows, they share many of the same duties and liabilities. We will therefore address these duties and liabilities generically, pointing out the critical differences and how they vary as we go along.

B. DUTIES OF DIRECTORS & OFFICERS

Very briefly, both directors and officers owe the same or modified *fiduciary duty* and *duty of care* to the corporation and its critical stakeholders, and 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.

Fiduciary duties

The fiduciary duty owed by directors and officers to 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 statutory codification of this duty, in the context of directors, states that directors must act *“honestly and in good faith with a view to the best interests of the corporation.”* The common law equivalent applicable to both officers and directors is substantially the same. The standard does not vary according to the size of the company or the sophistication of the director (or officer).

While this may seem intuitive and self-evident at first, it can and often does pose substantial dilemmas when a director or officer is faced with a decision that might benefit him or her *personally*, or the shareholder that placed him or her on the board. Even if, after careful consideration, the director or officer in good conscience concludes that the personal benefit will not result in any economic detriment or harm to the company, he or she might still be in breach of their fiduciary duty if personal gain or benefit is to be derived from going forward with the decision.

One example of this conflict might be where the director or officer wishes the corporation to do business with another company in which he or she own shares. Another example is where the director or officer misappropriates a corporate opportunity they learned of by virtue of their relationship with the company and it is one that the company itself might have an interest in pursuing. This is the famous *Canaero* scenario. The duty is strictly enforced, and neither directors nor officers can contract out of their fiduciary obligations. These situations can create significant personal liability for the unwary director or officer (even after they leave the company), and legal advice should be sought early.

Duty of care

The statutory version of this duty states that every director must “*exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances*”. There is no direct equivalent duty for officers; however, officers are held to a general common law duty of care that increases with their rank and functions. It is not a duty of perfection, but one of *reasonableness*. This standard of reasonableness is a recognition of the fact that there is risk in the running of a business. It is a duty owed primarily to the corporation and its shareholders. That duty has been expanded, however, quite recently, by the Supreme Court of Canada, to include creditors, suppliers, employees and other stakeholders. As for the “skill” required of directors, while courts will deal harshly with directors who turn a blind eye to difficulties, as a rule directors are only expected to use the skills they do possess diligently for the benefit of the company.

Directors can also take comfort in the “business judgment rule” which in effect shields directors against being second-guessed with the benefit of hindsight by shareholders or the courts if they acted honestly and in good faith, prudently and on reasonable grounds in making their decision. Directors should ensure that they have and follow a formal process for making decisions, that they take the time necessary to review the basis of these decisions (including expert reports), and that they document the steps they took in reaching their decision. This rule was given added weight in the recent Supreme Court of Canada decision in *Peoples v Wise*, [2004] 3 S.C.R. 461.

C. LIABILITIES OF DIRECTORS & OFFICERS

There are literally dozens, if not hundreds, of statutes that impose personal liability on directors (and almost as many on officers). Directors and officers can be exposed to significant personal liabilities if they fail to carry out their duties as required by law. 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.

It should be noted, however, that neither directors nor officers will be held automatically liable for the actions of the corporation. They are not guarantors of the corporation’s conduct. For the most part, if they discharge their duties honestly, prudently, in good faith and on reasonable grounds, even if the results turn out badly, their due diligence will provide them with a good defence. Documenting their due diligence will go a long way toward mitigating that risk. Seeking corporate indemnifications, supported by D&O insurance, will also assist in mitigating that risk. Directors, however, will remain personally liable for unremitted taxes and source deductions, and unpaid employee wages.

The above outline of directors’ & officers’ liability 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.

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