CORPORATE GOVERNANCE RELATED STRATEGIES FOR DIRECTORS AND OFFICERS TO MITIGATE PERSONAL LIABILITY

(This is an edited version of the full paper)

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With the advent of class action suits, recent judicial decisions, and legislative changes, corporate directors and officers now face increased exposure to personal liability.

With mandatory disclosure of corporate governance practices, stakeholders are better informed about public companies. Institutional activism and regulatory and prosecutorial practice are also combining to produce more actions and claims against directors and officers.

Legislative penalties for non-compliance have also increased in a number of areas. The high cost of litigation, particularly class-action litigation, tends to create a bias towards settlement, which may itself encourage more class action claims.

Here are some corporate governance-related strategies and actions directors and officers can take to reduce their personal risk of liability.

1. BEFORE COMMITMENT

Before accepting an appointment, a person should conduct an extensive evaluation in a number of areas. This review should include public disclosures and investigation and assessment of the other members of the board and senior management.

Corporate culture should also be assessed. A culture of openness, where information is shared and where ethical conduct is required, will tend to limit the potential for situations that could give rise to liability. Corporations that implement a code of conduct applicable to directors, officers, and all employees acknowledge the importance of corporate culture. Provided the code of conduct is effectively implemented and any breaches enforced and disclosed, the code should limit future claims.

Before accepting a position, candidates should ensure their contract includes an indemnity against all costs, expenses, losses to the maximum extent permitted by law. The indemnity must continue after the director or officer ceases to hold the position, with respect to any liability connected with actions or decisions made while an officer or director. In some situations, it may be necessary that the indemnity be given by the parent company or major shareholder, in addition to that of the corporation.

2. CONDUCT

Directors are expected to act honestly and to consider the best interests of the corporation. Officers and directors must also consider the impact of corporate decisions on other stakeholders.

Under corporate statutes, directors are also required to demonstrate care, diligence, and skill in their duties. Conduct must meet the objective test of what a reasonable person would do in such situations. The standard of conduct and reasonableness of any action must be assessed in the context of the nature, size, and financial situation of a company.

As well, the standard of conduct and reasonableness of any action will be evaluated in the context of any industry parameters. The standard of reasonableness of the actions in particular areas, such as environmental matters, will also depend upon the conduct and practices of competitors and upon conduct and practices recommended by industry associations.

3. ACTIONS

It's essential that directors stay up-to-date on the business of the corporation. If a director or officer misses a meeting, they should speak to the chairman of the board or committee, or to another director, to find out what transpired. Since a director is deemed to have consented to any resolution passed at a meeting of the directors (whether or not they were present), a director must take steps to record a dissenting vote in order to avoid liability for that decision.

Upon joining a board, directors should expect a full orientation, including meetings with key officers and the chair of any committee of which they are to be a member. Orientation should include an opportunity to review and discuss any board-approved corporate policies. Having reviewed such policies, a new director must be satisfied that procedures are in place to implement them.

Certain situations, such as the declaration of dividends, loans or other financial assistance to related parties, mergers and acquisitions, require additional vigilance to avoid liabilities. In such situations, independent advice from professional advisors, such as accountants and lawyers, is a critical defensive strategy for directors and officers. Each year, directors should ensure the corporation's assets and business operations are adequately protected through policy and process. Where applicable, the corporation may also require product liability, fidelity, fiduciary, and other professional liability insurance.

4. CONFLICTS

To avoid liability, directors must also avoid situations that place them in a real or perceived conflict of interest. If the potential for conflict is great, it's better to decline or resign the appointment, as it may be difficult to adequately discharge the required duties. Potential conflicts should be disclosed in writing to the corporation and the board of directors at the time of appointment.

As specific potential conflict situations arise, the potential for conflict in that situation should also be disclosed and documented, and the director concerned should avoid discussing matters giving rise to an apparent conflict and not just decline to vote.

Directors must not take advantage of information obtained in the performance of their duties even when the corporation ultimately decides not to proceed with that opportunity. The director owes a duty and loyalty to the corporation as part of their fiduciary duty, and any corporate indemnity, insurance, or the business judgment rule may not be available for a breach of duty where the conduct is found to be in bad faith.

5. DUE DILIGENCE DEFENCE

In many cases where personal liability arises, directors and officers may be able to rely on the due diligence defence to avoid liability. There are five key elements to establishing this defence, which should be addressed by the director or officer in the context of any significant business decision.

1. Do I have the appropriate information to make this decision?
2. Have I spent sufficient time in order to make this decision?
3. Is anyone involved in the decision or providing information with respect to the decision in a conflict of interest?
4. Could an outside expert assist with making a better decision?
5. Is the decision being made reasonable in the circumstances?

In addition, all stakeholders impacted by the decision and any specific legal and regulatory requirements must be considered, evaluated, and fully understood in the context of the facts. The due diligence defence or a demonstration of the duty of care also requires that such investigations, deliberations and decisions are appropriately documented. Case law involving directors' and officers' liability claims often consider the effectiveness of decision-making processes followed by the board, based on written records and materials.

6. BUSINESS JUDGMENT RULE

Business ventures have been recognized by the courts to involve risk-taking, and many regulatory authorities have moved towards a risk assessment process. The courts and regulators recognize that many business decisions must be made based on imperfect information and with inadequate time. The business judgment rule reflects these realities, but generally recognizes that the more effort put into a decision, the more protection from liability will be afforded.

While the courts have been unwilling to remake business decisions, they are clearly willing to determine the degree of effort and standards of conduct that apply in a given situation. Case law in Canada applying the business judgment rule focuses more on the process involved in the decision-making than the merits of the decision. In Canada, unlike the U.S., the business judgment rule does not include a presumption that board decisions are made on an informed basis, in good faith, with honest belief the action was taken in the best interest of the company. As such, plaintiffs in Canada don't have to rebut a presumption the directors acted properly or establish that the directors were grossly negligent.

7. SHARED RESPONSIBILITY

The shared responsibility of directors and officers for the management of the corporation is a source of their shared risk of potential personal liability. Directors may have some defensive advantage in that they are entitled to rely in good faith on management in making certain decisions. Officers may be held to a higher standard because of their closeness to the decision-making process, industry knowledge, and control over implementation.

To avoid liability, both management and the board will benefit from an environment that supports informed, independent decisions directed at the achievement of business

objectives, such as in-camera sessions and independent advisers. The recent corporate governance requirements of a disclosure policy and committee tend to mitigate some of the risk of additional liability associated with public disclosure, including liability in the secondary market, and support the performance of the board's duties to the shareholders.

8. STANDARDS

While the objective standard has been held to apply in Canada, in order to avoid liability directors and officers should assume in their decision-making and related requirements that a subjective standard might apply. A subjective standard can be summarized as what would be expected of a director or officer with their particular background, expertise, ability, and training.

Directors and officers should assume that increased personal exposure may occur as a result of serving on particular committees, by virtue of their training, or because of their increased exposure to direct access to critical information, and take action accordingly. Their background may create reliance or give rise to deference in the others involved in the decision-making.

Officers serving as directors on the board of the parent or its subsidiaries because of their connection to management may not qualify as "independent," and, in fact, may find these situations additionally difficult. They should expect to have their judgment questioned based on personal conflict (if they stand to benefit as employees from the board decision) or subject to a higher standard (if they have access to more information relevant to a decision than the other directors).

9. THIRD-PARTY ADVICE

Many corporate governance requirements focus on the need for director independence from management in decision-making. The ability to demonstrate and rely on independent advice from outside experts is an important strategy available to both directors and officers. The existence of such advice tends to demonstrate due care in decision-making, performance of fiduciary duties, and supports reliance on the business judgment rule or statutory protection.

Securities law requirements involving liability for misrepresentation in public disclosure documents specifically allow for some protection from personal liability through the use of experts. External advice may help directors and officers establish a reasonable belief that certain conduct is lawful, and greater corporate indemnification.

In order for the board to rely on expert advice, that expert must be retained by, and report directly to, the board. The board must have an opportunity to thoroughly analyze the information and question the expert's advice in private.

10. OTHER CORPORATE GOVERNANCE PRACTICES

Director recruitment provides an opportunity for existing directors and officers to limit their future liability. The board of directors needs to determine the appropriate size for the board to perform its functions, and must determine the competencies and skills the board requires as a whole. This information should drive the process and recruitment of new directors, who

should contribute to the effective decision-making abilities of the board, and, hopefully, assist with the mitigation of corporate risk.

Required corporate governance disclosure also focuses on the increased importance of share ownership by directors and officers and a greater alignment with the interests of shareholders. Increased share ownership by directors and officers may support the performance of duty of care and reasonableness of business decisions over time.

In the same vein, governance requirements with respect to board education and orientation also have the objective of creating better directors, who will, hopefully, make better decisions and provide fewer of the disappointing results which precipitate legal actions. Fully informed shareholders and “full, true, and plain disclosure” requirements should also have the effect of limiting corporate and director and officer related lawsuits.

11. TRANSPARENCY AND ACCOUNTABILITY

Corporate governance requires a board to direct and empower management to behave in a way which supports the creation and maintenance of shareholder value without the board involving itself in the day-to-day management of the corporation. The board is also accountable for ensuring the appropriate processes exist and are followed to implement such policies. The adoption and public disclosure of corporate governance practices by corporations only works where the practices are actually implemented by corporations.

The adoption of evolving best practices in corporate governance, in addition to the requirements of various regulators, may provide some indirect additional protection to directors and officers from personal liability.

12. CONCLUSION

For many public companies, with operations in multiple jurisdictions, the commitment in effort and scarce resources to corporate governance-related requirements in recent years has been extreme. However intangible the return on this investment for the corporation in the short term, directors and officers should remember that corporate governance requirements provide opportunities for better managing risks that threaten the profitability, if not the existence, of the corporation.

Directors and officers are encouraged to adopt these practices out of enlightened mutual self-interest, if performance of their statutory duties, the greater public good or regulatory necessity is not motivation enough.