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CANADIAN CORPORATE LAW

Corporate governance laws increase the liability of corporate directors.

A Director: To Be or Not To Be

Following the financial scandals of recent years, more and more lawsuits are instituted against corporate directors; hence: a scarcity of candidates for these positions. Corporate directorship can be a fascinating and prestigious occupation, but it nonetheless remains a potential risk and may lead to important consequences. The function of corporate director implies certain obligations, which are often poorly known or understood by the interested party. Indeed, several laws impose certain responsibilities upon directors toward (among other things) unpaid salaries of employees, deductions at source (sales taxes, CSST and employment insurance contributions, etc.). Indeed, several laws (among others: the *Companies Act*, as well as certain laws pertaining to labour relations, professional training, and workers management in the construction industry) indeed allow for unpaid sums by the company to be collected directly from the directors. Furthermore, one must not forget the laws pertaining to environmental protection.

Whether sitting on the board of a corporation or company (private or public, for-profit or not-for-profit), of a cooperative, or of a co-ownership (condominium) syndicate, the situation of each director differs, and the scope of his obligations and responsibilities varies according to the size and type of the organization on which board he is sitting. In this context, it becomes important, for an individual who contemplates doming the mantle of director, to be aware of the extent of the potential risks thereof, so as to protect himself against said risks.

In the present text, the term “business” should be understood as meaning: *any legal (or “moral”) person undertaking an economical activity.* In the limited scope of the present article, the authors have preferred not to address the various distinctions of directorship within legal persons, such as corporations, condominium syndicates, not-for-profit associations, and other cooperatives. Indeed, the principles set out below should apply broadly (with some adaptation) to many of these types of legal persons.

A) AREAS OF LIABILITY

Within a business, he function of the directors’ board is, in practice, to manage the operations, and to approve financial objectives as well as strategic orientations. In fulfilling this function, directors must keep in mind that they must always act in the best interest of the business in order to increase its value. With this in mind, the various corporate, fiscal, and civil laws lay upon a business’ directors a number of obligations and responsibilities. The foremost of these are: liability for unpaid salaries, a duty to act with due care and diligence, environmental liability, and any suretyship granted by the director to the business’ creditors.

1. Unpaid Salaries

Under Section 96 of the Québec *Companies Act* and Section 114 of the *Canada Business Corporations Act*, the director of a business constituted in the province of Québec can be held personally responsible for the payment of the salaries of the company’s employees if said company becomes insolvent.

The liability for unpaid salaries does not necessarily arise from a given act, fault, omission. Rather, the simple fact of sitting on the directors’ board at the time services were rendered by the employees suffices to trigger a director’s

liability. If such is not the case, and a given director's liability is invoked before a court of law, the burden will be on that director to demonstrate that he was not, in fact, a director at the time at which the salaries should have been paid.

In consequence, suffices to say that a director must pay particular attention to the payment of the employees' salary, especially if the business is facing dire financial straits.

2. Obligation To Act With Due Care And Diligence In The Best Interest Of The Business

The shareholders and creditors of Canadian corporations expect that their directors and executives will take reasonable business decisions so as to use the corporation's resources in a profitable manner. Yet, the directors must act "*in the best interests of the business*", and not "*in the best interests of the shareholders*". Indeed, the directors are the mandataries of the corporation, and not those of the shareholders. Jurisprudence teaches that the expression "*in the best interests of the business*" must be construed as the "*maximization of the value of the business*". Yet, the courts recognize that, beyond maximizing the corporation's value, the board of directors is acting in the best interests of the business when it takes into account "*notably, the interests of the shareholders, the employees, the suppliers, the creditors, the consumers, the governments, and the environment*". While this rule is easily conceived, its application can prove to be most difficult, considering the multitudinous and often divergent interests at stakes. This situation can become even more problematic when financial difficulties assail the business.

Obligation to Remain Informed — In his capacity, a director has access to all of the business' books, in matters of accounting or otherwise. Thus, he can, and indeed ***must***, scrutinize said books when such scrutiny is necessary to understand a proposition put before the board. If he does not possess the skill or knowledge necessary to understand and appraise these documents, he must obtain the necessary assistance, usually through the aid of experts competent in the matter at hand. Reference to outside counsel is also desirable when the director must examine a question beyond the scope of his personal expertise. (Take, as an example, a case in which an artist, acting as a director, must approve the construction of a new theater.)

However, the jurisprudence confirms that directors acting upon professional advice (lawyers, accountants, etc.) can invoke reasonable diligence as a defense, in order to exonerate themselves from their personal liability arising from their directorship. This concept reinforces current trends in business governance in providing an incentive for directors to reinforce the quality of their management by resorting to professional advice. Indeed, resorting to outside expertise can often exonerate a director from liabilities he would otherwise have to assume.

In other word, a director cannot simply rubber-stamp recommendations submitted to the board by the business' various executives. His duty to exercise due care and diligence weights upon him to take decisions that are profitable to the business; the executives themselves do not have such obligations. Furthermore, the liability of a director regarding the decisions he makes shall be proportionate to his competence and personal experience.

3. Liability With Regards To The Environment

The *Environment Quality Act* (Québec) allows the Québec Minister of Environment to order a business to take action (for example: decontaminate a parcel of soil); if the business refuses to comply, its directors can, and will, be held personally responsible for the cost that the Ministry of Environment will incur in proceeding with the required work in the business' stead. Also, the *Canada Environment Protection Act* provides for solidary civil liability between directors, when they allow their business to dump toxic products in the environment

Moreover, if an infraction to such a ministerial order is authorized or encouraged by a director, or if that director authorizes or encourages the emission or deposit of contaminants contrarily to law, penal charges can be brought against that director. That director would then be exposed to substantial fines; the law even prescribes prison sentences for such infractions.

Furthermore, a director's liability could even be retained in cases where he would only tolerate a situation potentially harmful to the environment (for example: storing contaminants), regardless of any direct fault from that director.

4. Suretyship Granted by a Director

If a director or executive of a business leaves his functions, is he released from a suretyship he has signed in favor of a creditor of the business? Except in certain, very specific circumstances, the answer is no. ***As a general rule***, the resignation of a director or executive does not put an end to any suretyship he consented.

In this case, how can this director or executive protect himself and avoid, after his resignation, being held personally responsible under the suretyship he contracted? A partial answer is found under Article 2363 of the *Civil Code of Québec*, which reads as follows: *"A suretyship attached to the performance of special duties is terminated upon cessation of the duties."* Then, how to benefit from Article 2363 *C.C.Q.* and insure that a director will be released from his suretyship upon his resignation?

When a director or executive contracts a suretyship, it would be wise to specify:

1. That the director contracts that suretyship in his quality as director or president of the business, and not in a personal quality;

2. That the suretyship being contracted shall be terminated as soon as he will cease to act as president or director of the business.

The application of these simple recommendations should only improve the position of the director or the executive and should avoid nasty surprises subsequent to farewell diners.

B) PROTECTION MECANISMS

In the present conjecture, it has become difficult for any business to recruit good candidates for its directors' board. In consequence, a business must offer to potential directors certain guaranties of financial indemnity, up to eventually taking up their defense, against personal lawsuits for the actions and decisions they would take while in function. In the authors' opinion, any person should insure that she receives sufficient such guaranties before accepting to sit on a directing board, in order to circumscribe the risks pertaining to this function. Without such necessary precautions, it would be reckless to accept the post of director considering the present legislation.

Yet, it is important to note that a director could not receive an indemnity from the business should he incur a financial liability as a result of his own gross negligence or intentional misconduct. Furthermore, the director can lose benefit of the indemnification guaranties if he finds himself in a situation of conflict of interests with regard to other functions (or to his own personal interest) that he would concurrently occupy; hence, a duty to act with *diligence* and in the interest of the business

1. The Legislation

The ***Canada Business Corporations Act*** and the ***Companies Act*** (Québec) allow a company to hold indemn its directors for their defense fees and, if applicable, the amount of any eventual condemnation. Nonetheless, in the absence of a formal undertaking on the part of the business to indemnify the director, a decision of the board of directors (ever dependent upon the good will of that body) is required for the creation of effective guaranties. For this reason, it would be more advantageous were the business to adopt a true obligation to indemnify in favor of its directors.

2. The Indemnification By-Law

A company can (and, desirably, should) adopt a *regulating by-law pertaining to indemnification of a director*. Such by-law being part of the internal regulation of the business, it would provide for situations in which the business has to indemnify a director, independently of the board of directors' will. The *director's indemnification by-law* should apply not only to the faults and omissions of the individual director, but also to those of other directors, executives, or employees for which the director could be held responsible. Before accepting a director's mandate, a person should thus make sure the existence of such a by-law.

3. The Indemnification Agreement

The only weak point of the internal regulation by-law is that it is susceptible to ulterior modification or cancellation by the board of directors, without the consent of the individual director. In addition to a by-law (which could be unilaterally modified), the authors suggest instead the adoption of an *indemnification agreement* between the business and each of its directors. Such an agreement constitutes a contract, in consequence of which the director can require the business to assume his defense fees and any eventual pecuniary condemnation.

A sensible director will obtain from the business a letter of indemnification, pursuing to which the business agrees to hold the director harmless of all damages or claims to which he could be subject within the scope of his office as director or of any events related to said office.

4. Liability Insurance

Of course, if the business proves to be insolvent, *indemnification agreements* and *by-laws* have a restricted usefulness, as the business would not then have access to the funds required to indemnify the director; hence a need for liability insurance.

Indeed, the board of directors can engage the business to subscribe a liability insurance policy; a director can also personally subscribe such a policy. As to the premiums associated to this insurance, it normally falls upon the business to assume them, considering that it is in the business' best interest that the director takes on his office.

Liability insurance aims to indemnify a director for his personal liability. It also serves to refund the business for any sums it had to pay in order to indemnify its directors or its officers. The goal is to obtain an insurance policy that covers any liability arising from the actions, omissions, or errors of a director in the exercise of his duties, as well as the liability arising from statutory responsibilities. Such policies do not cover dishonest, fraudulent, or reprehensible acts, nor do they cover the liability from acts or omissions prior to the date on which they take effect.

When legal proceedings are instituted against a director following a risk covered by the policy, the insurer will assume the costs of the director's defense and will pay any eventual condemnation. This presupposes, of course, that the director has respected the terms of the insurance policy and that the grounds of the lawsuit are covered by that policy. *The advantage of a liability insurance policy is that it provides protection for the director regardless of the solvency of the business.*

However, the authors are not of the opinion that subscribing to a liability insurance policy (to the advantage of the directors) is essential. Indeed, in certain cases, the premiums for such a policy could be prohibitively onerous considering the low risk and limited activities of the business. Still, it remains essential that the board of directors discuss, at the very least, the opportune nature of subscribing to such a policy, and that an informed decision be reached about this issue.

5. The *Legal Publicity of* Legal *Persons Act*

When a director leaves his functions, it is primordial to make sure that his departure is notified to all parties concerned, i.e. made public. Under the *Act Respecting the Legal Publicity of Sole Proprietorships, Partnerships and Legal Persons* ("*Legal Publicity of Legal Persons Act*"), a legal person (the business) that operates in the province of Québec, or is set up in that province, is obliged to file with the Registraire des Entreprises (literally "Registar of Businesses") a declaration of immatriculation or an initial declaration. These declarations contain, among other things, the name of each director. The records of the Registrar being public, it must be noted that the information divulged in such declarations and communicated to the Registrar is deemed to constitute proof thereof toward third parties of good faith. This legal presumption can lead to unfortunate situations when the divulged information is erroneous, or yet, when that information has not been updated in a timely fashion following the resignation of a director.

If a person still appears as a director in the records of the Registrar after her resignation, that person remains a *bona fide* member of the board of directors as far as third parties are concerned, and thus exposed to liability even though she is no longer in office. In certain cases, the courts have allowed to contradict the information shown in the registry when the liability of a resigned director was invoked. However, in such cases, the burden sits squarely on the shoulders of the former director to prove that he was no longer a director at the time pertinent to the lawsuit.

When one resigns from his post as director, it is thus of prime importance to insure that all required steps were taken so that the public records of the Registrar reflect that resignation.

Conclusion

In this day and age, the duties and responsibilities of directors are ever increasing, as society becomes more and more demanding (and less and less complaisant) toward the directors of a business. In this context, the watchwords of a director are "prevention" and "vigilance". On one hand, he must make sure that the business is well structured and that the indemnification engagements (whether an indemnification agreement or a liability insurance policy) required to protect directors are duly undertaken. On the other hand, the director can reduce the risk of his liability entering into play by asking the officers of the company to provide a certificate confirming that the business has duly paid the salary for all employees and that all applicable deductions at source were made. While sitting on the board of directors, the director must obtain all pertinent information so as to make knowledgeable decisions on all issues put before him. He must also act with diligence. If he does not agree with one of the board's decision, he must insist that his opposition be put down on the minutes of the board meeting and incorporated within the business' minute book. Lastly, upon the end of his term as director, he must verify that the public records kept by the Registraire des Entreprises are updated and duly show the **date** of his resignation or departure.

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