ALL A BOARD!

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The Risks of Being a Director : James Baillie and Cornell Wright

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Despite the intensity of continuing public discussion of corporate governance issues, remarkably little attention has been paid to the liability position of individual directors. We believe this will change. Directors are increasingly realizing that "it can't happen to me" is a dangerous and even foolhardy approach. It can happen to you, no matter how conscientious you are.

At the risk of over-simplification, there are two broad types of exposure you should consider. There is, first of all, the over-arching responsibility and related liability for honouring fiduciary obligations: acting in good faith and dealing appropriately with conflicts of interest. To this general standard, legislators and regulators in Canada, more so than in other countries, have added a host of specific statutory liabilities, which can be divided by whether or not a "due diligence" defense is available.

Details vary depending on the jurisdiction of incorporation, but the range of matters for which a director can be held liable unless he or she can establish a due diligence defense is very wide: improper payment of a dividend; environmental matters; various employee claims; unremitted taxes—the list goes on. Likewise, there is a range of absolute liability matters for which even due diligence is not a defense. The principal one is a liability to employees for up to six months of accrued and unpaid wages.

Never become a director of a public corporation that does not have procedures in place to bulletproof directors to the maximum possible extent against these liabilities. For example, there should be proper board decision-making processes. Appropriate advisors should be consulted and their views reflected in minutes of meetings. Management should regularly provide the board with certificates as to the amount of exposure to the various types of statutory liabilities. Payroll cycles should not be unduly stretched out, so as to avoid having substantial amounts of wages accrued and unpaid. Above all, before you accept a directorate, you should be satisfied that the corporation has a culture of compliance and that relevant information will not be kept from you.

Directors can avoid certain specific statutory liabilities, and minimize exposure to liability for a breach of the more general fiduciary responsibility, by relying in good faith on the financial statements provided by management, or on an expert. However, directors cannot be unquestioning recipients of financial statements or other information from management. You should always ask yourself if you have reasonable grounds to question the content of a statement or other information or management's interpretation of the information. With respect to the advice or opinions of experts, take steps to satisfy yourself that the expert has the appropriate qualifications and expertise to advise on the particular issue, and that management has given the expert access to all relevant information.

These precautions are all necessary. However, even cumulatively, they are not sufficient to give complete assurance that you will be protected from liability. Anyone can initiate a lawsuit at any time. There is a significant "strike bar" of lawyers in the United States, with counterparts developing in Canada, who are on the alert for any basis, however remote, for a claim that might lead to a cash settlement. At the very least, even if you are completely satisfied that you would be exonerated in any such litigation, you should worry about legal

fees.

Under the various corporate statutes, a public corporation is permitted to indemnify its directors. The details vary among the jurisdictions. The meaning, scope and overall adequacy of the various statutory indemnification provisions are the subject of much debate and, accordingly, you should also be certain that the by-laws of your corporation provide for indemnification to the maximum permissible extent. This should be buttressed by a formal letter to you from the corporation confirming the availability and scope of your indemnification. This letter can be key to your protection if, for example, you are dislodged as a director following a hostile takeover bid.

But what if the corporation can't (or, for some reason, won't) honour its indemnification commitment? Here, we turn to directors' and officers' ("D&O") insurance. There is no doubt that a conscientious director sleeps more soundly when a good D&O insurance policy is in place. But if this is the criterion for sleeping soundly, then more and more directors should be having restless nights.

D&O insurers are becoming increasingly reluctant to provide coverage to small public corporations. Companies with coverage are discovering that their insurers' "due diligence" inquiries are becoming as important as the work of any regulator in enforcing compliance with good corporate governance norms. In addition, the number of carve-outs from coverage is increasing. "Run-off coverage" (coverage for claims made after the policy expires but based on facts occurring while the policy was effective), which used to be routinely available, is now often omitted from the policy. Above all, the cost of coverage is increasing exponentially. For directors in many small corporations, deciding whether to spend the large amount of money required for D&O insurance premiums can be a significant fiduciary question.

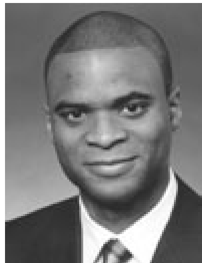
Where you do rely on D&O insurance, ask questions. Is the insurer (or insurers— frequently there are layers of coverage with different insurers) creditworthy? What is the reputation of the insurer in the marketplace for responding to claims? What is the policy limit? Are legal fees fees covered? Where the fees are covered, are they deducted from the coverage available for the substantive claim? What are the carve-outs from coverage? Who are the insured's? In many cases, a D&O policy covers the public corporation itself and might also cover its affiliated corporations, so there is the potential for the directors to have to share coverage with many other insured's. In fact, the action of becoming a director can, of itself, trigger liabilities. Is there a severability clause that would protect you if the corporation or one of your fellow directors fails to disclose all relevant information or makes a misrepresentation to the insurer? You should have answers to these questions before you accept the directorate.

The D&O insurance situation is becoming sufficiently serious that some corporations and some directors are considering alternatives. One possibility is to put corporate funds into a directors' trust, isolated from corporate assets and available as a response to any claims that might be made. Some D&O insurers, particularly in the United States, are offering personal umbrella policies ("PUPs"), which is insurance taken out by the individual director to cover all of his or her directorates, rather than by the corporation itself. Each of these has its benefits and disadvantages. They merit careful analysis.

We mentioned earlier that the propensity for statutory provisions that create personal liability

for directors is greater in Canada than in other countries. In our view, this propensity is thoroughly invidious. The prospect of statutory personal liability can discourage competent individuals from becoming directors. Perversely, the prospect of personal liability can encourage directors to resign if a corporation begins to encounter financial difficulties, the very time when arguably their services might be most needed. The imposition of liability without a due diligence defense is particularly offensive because it creates the potential for huge personal exposure, notwithstanding that a director may have acted reasonably in the circumstances in a position of significant responsibility. This prospect exists in other countries, but in Canada we have carried it to an extreme.

Being a director is clearly not for the faint of heart. However, despite the risks inherent in the position, our conclusion is not that you should refuse to become a director. Rather, before taking on this responsibility, we suggest that you carefully consider, and if necessary seek advice on, the significant risks involved and the steps you can and should take to minimize your exposure. Unless you are confident that the corporation has a culture of compliance and that reasonable measures have been taken to protect and indemnify you, the opportunity to join a board might not be worth the risk.



James Baillie is counsel and Cornell Wright is an associate with Torys LLP. Both are based in the firm’s Toronto office.

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