



IMPORTANT CONSIDERATIONS FOR CORPORATE DIRECTORS

Many individuals who are asked to serve as directors of private corporations incorporated under Ontario corporate laws are often unaware of what is involved in properly becoming, serving and resigning as a director.

This short publication briefly explains:

- (a) the process of becoming and resigning as a director,*
- (b) director responsibilities and related personal exposure; and*
- (c) methods to discharge director duties and manage the risk of personal liability.*

This article is based upon the relevant provisions of the *Business Corporations Act* (Ontario) (the “OBCA”) (although similar rules and principles existing in respect of companies incorporated under the federal *Canada Business Corporations Act* with certain exceptions).

Election & Resignation of Directors

Board Size and Eligibility Requirements: The shareholders of a corporation elect the director(s). The number of directors to be elected will be set out in the Articles of the corporation. Where the Articles permit a range for the size of the board of directors, the shareholders will initially determine the number of directors to be elected. Only individuals may serve as directors and each such individual must be (subject to the residency rules below) at least 18 years old, not a bankrupt and of sound mind.

Residency Requirements: If the corporation has only one (1) director, that director must be a “resident Canadian” as defined in the OBCA. If there are two (2) directors, one (1) of them must be a resident Canadian. If there are three (3) or more directors, a majority of them must be resident Canadians.

Election Formalities: In order to formally elect a director, either (a) the shareholders of the corporation must all sign a resolution electing such director or (b) a proper meeting of the shareholders must be held, at which meeting the director(s) are elected by a majority vote of the shareholders. In either case, either the resolution or the minutes of the shareholders’ meeting must be inserted into the corporation’s minute book.

Consent to Act: A director must formally consent in writing to being elected as a director, or such election is not effective. Normally a director will sign a written form of consent which is inserted into the corporation’s minute book.

De Facto Directors: Notwithstanding the formal director election process, an individual may be **deemed to be a director** if they generally perform the duties of a director. Such a “de facto” director can be subject to all of the obligations and liabilities of a formally elected director.

Resignation/Removal Procedures: A director ceases to be a director by either formally resigning or by being removed by the shareholders of the corporation. The resignation by a director should be in writing and should be dated and delivered to the corporation's head office. Such resignation may be effective immediately or at some future date as so indicated in such written resignation. Best practice is to ensure a copy of such written resignation is both (a) "delivered" via registered mail or courier to the corporation (with a copy to corporate counsel if known) and (b) inserted in the corporation's minute book. Note however that a director who is named in the articles of incorporation cannot resign prior to the first meeting of shareholders of the corporation unless his or her replacement has been elected or appointed at the effective date of resignation. While not essential to properly effecting such resignation or removal, it is both prudent practice and highly recommended for such resigning or removed director to ensure that the corporation comply with its obligations under the *Corporations Information Act* (Ontario) ("CIA") and file the requisite Notice of Change form. Such filing will reflect such director resignation (or removal) as of its effective date in the public record. In cases where Canada Revenue Agency ("CRA") seeks to impose a corporate-related tax obligation upon directors personally (e.g., failure to remit collected GST or failure to deduct and remit employee source amounts) CRA will typically obtain a list of current directors and officers from the public records populated by the filings under the CIA.

Director Liability

A director of a corporation accepts certain duties and personal liabilities, which liabilities are typically (but not always) avoided by shareholders or officers of the corporation. These liabilities are imposed on the director under common law and by statute.

(a) *Fiduciary Duty; Duty of Care*

At common law, a director has certain higher "fiduciary" duties to the corporation. To a large extent, these duties have been articulated and codified in the OBCA. Accordingly, directors have a statutory duty of care to at all times act "honestly and in good faith with a view to the best interests of the corporation." These obligations are very broad and need to be carefully considered. Such fiduciary duties prohibit a director from preferring his or her own personal interests where they may conflict with the best interests of the corporation (i.e. a "conflict of interest"). For example, where a corporation of which an individual is a director intends to enter into a material contract or transaction with another entity, and the director has a material interest in such other entity, the director would be required to disclose that he or she has a conflict and abstain from participating in any vote on any resolution to approve such contract or transaction. Moreover, directors are generally prohibited from taking advantage of, diverting and/or usurping any corporate opportunity for their personal benefit.

In addition to avoiding clear "conflict of interest" situations, a director must further "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." Directors must evaluate the actions they are taking or are being asked to consider and exercise due care in deciding on any particular course of action. Directors will not be held responsible for mere mistakes made honestly. However, a director can be held responsible where he or she did not exercise due care in making his or her decisions.

(b) *Statutory Liabilities*

There are many applicable statutes, both provincial and federal, that impose personal liabilities on directors. For example, directors have potential personal exposure in the following circumstances:

- paying dividends to shareholders or redeeming shares while a corporation is insolvent under the OBCA;
- failure to pay employee wages and vacation pay under the OBCA;
- failure to collect and remit GST under the *Excise Tax Act* (Canada) or provincial sales tax under the *Retail Sales Tax Act* (Ontario);
- failure to collect and remit employee withholdings under various employment and pension related statutes;
- if the corporation commits an offense under the *Environmental Protection Act 1999* (Canada), a director can be held liable whether or not the corporation is prosecuted or convicted;
- any remedy under Part V of the *Consumer Protection Act, 2002* (Ontario) can be enforced against a director of the offending corporation; and
- failure to comply with reporting requirements under the *Securities Act* (Ontario).

The foregoing is not an exhaustive list, but merely illustrative of various statutory liabilities for directors.

(c) *Common Law Liability For Intentional Conduct, Etc.*

As a result of recent case law, director can now be found personally liable for negligent misrepresentations made to third parties with respect to the corporation and may not have the benefit/protection of the “corporate shield” in such cases.

Although a detailed analysis of common law liability is outside the scope of this publication, a director must be aware that he or she has obligations not only to the corporation itself but may also have obligations to corporate creditors and other stakeholders in certain circumstances.

Risk Management

So what can a director do to minimize his or her personal exposure?

There are a number of steps directors and corporations can take to avoid or manage director liabilities including:

- (a) Should you agree to act as a director? As a general rule, an individual should not agree to serve as a director of a private corporation where he or she (a) is not a shareholder of such corporation and/or (b) is not in a position (or is not prepared) to take the necessary steps to receive regular information about the corporation’s finances and business/affairs and monitor financial and other risks. If the facts

are such that it is impossible or impractical to monitor the risks, you should decline an opportunity to serve as a director (or, if applicable, first director) of a private corporation.

- (b) Know your duties and be diligent. The statutory responsibility of a director is "...to manage or supervise the management of the business and affairs of the corporation..." Being a director is not merely a figurehead position or a means of "rubber-stamping" the objectives and plans of management or corporate shareholders. It is important for a director to read all information provided in advance of directors' meetings, ask questions and exercise due diligence. If a director feels that more information is required in order to make a decision or in order to become familiar with the operations of the corporation, he or she should request same from the management of the corporation. If a decision is made by the board of directors which a director disagrees with, such dissenting director should ensure that his or her dissent is recorded in the minutes of such meeting. Some statutes provide a form of "due diligence" defense to a director's liability, but this defense will usually only be available to a director if he or she makes reasonable attempts to inform himself or herself of all relevant facts prior to any decision.
- (c) Obtain regular detailed management reports. At each board meeting (and more frequently if desired or especially in circumstances of financial difficulty), directors should request and receive from senior management (i.e., the Chief Financial Officer and the Chief Executive Officer) a signed statement attesting to and certifying certain important facts such as (a) the collection and remittance of GST, employee source deductions and any other statutory payments, (b) the timely payment of employee wages, bonuses and vacation pay, (c) the timely payment of all insurance premiums (including any premiums relating to directors' liability policies), (d) the absence of any existing or pending litigation or third party claims/disputes and (e) the absence of any existing or pending governmental or regulatory claims, proceedings or disputes.
- (d) Obtain and rely upon professional/expert advice where required. If a director determines that professional advice (e.g. accounting, engineering, insurance, legal, valuation etc.) is required in order to make an informed decision, such advice should be obtained prior to making such decision. A director is not expected to be an expert in all areas and should obtain professional advice where required.
- (e) Obtain an express written indemnity. In accordance with Section 136(1) of the OBCA, a corporation may indemnify directors for any liability incurred as a result of such individual acting as a director, provided that (a) the director acted honestly and in good faith with a view to the best interests of the corporation and (b) in the case of a criminal or administrative action resulting in a monetary penalty, the director had reasonable grounds for believing that his or her conduct was lawful. At a minimum, a director should obtain a written indemnity for such matters from the corporation. In addition, if a parent corporation or major shareholder exists (or another related corporation that is a creditor to the corporation) that may have additional financial resources, the director should

consider having such other person provide a guarantee for the primary indemnity of the corporation.

- (f) Obtain insurance. In accordance with the OBCA, a corporation may obtain a policy of insurance that insures the director against certain personal liability; however, such insurance will typically not cover a director where he or she fails to act honestly and in good faith with a view to the best interest of the corporation. The insurance industry has a number of private corporation D&O insurance products with differing levels of coverage depending upon the circumstances. While the cost of private company D&O insurance was once prohibitive, there are some reasonably priced alternatives which a competent insurance agent can more fully advise on.
- (g) If in doubt, resign. If management consistently refuses to provide enough information to the director in order for the director to make an informed decision, or if actions are consistently taken by the corporation with which the director disagrees with or is concerned about, the director should consider prompt resignation where possible.

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