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SMEs, GOVERNANCE AND DIRECTORS

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TO REMEMBER

- ▶ The **establishment** of good **governance** practices is **useful** if not essential for SMEs, their directors, shareholders and managers.
- ▶ Good governance practices can protect directors against their risks of **liability**.
- ▶ **Governance** must be **adapted** to the realities of SMEs.
- ▶ This **adaptation** is achieved by a combination of **informal measures** and a few **formal measures**.

INTRODUCTION

Since the mid-1990s, the promotion of corporate governance has been the subject of various public and private initiatives in Canada. The first of them were aimed at reporting issuers. State-owned corporations and other public sector organizations were targeted next.

As a result of the example provided by these corporations and pressures from funding organizations, donors and sponsors, many not-for-profit organizations (NFPs) followed behind. Similarly, in the case of SMEs not listed on a stock exchange, institutional investors and outside directors also pressured these corporations to adopt minimal governance rules.

Governance is often **defined** as the set of **processes and systems** put in place to encourage effective functioning of the corporation and the creation of value. Governance includes clearly defined **mandates** for the various authorities within the corporation and the formulation of **expectations** as regards each of them.

Note that, under most if not all corporate laws, it is the **board** of directors that is **responsible for managing** the corporation's activities; **management** only has **delegated authority**.

In Quebec, up until now, the corporate laws have not imposed specific governance rules or suggested guidelines or directives for private or unlisted corporations. Nevertheless, the absence of binding rules does not make the implementation of good governance practices in SMEs any less relevant. On the contrary, the implementation of such practices can and should create value if governance is properly **adapted to the realities of the corporation and its shareholders**.

In addition, the Supreme Court of Canada has noted the importance of **governance** for the directors with respect to their potential **liability**:

[64] "The establishment of good corporate governance rules should be a shield that protects directors from allegations that they have breached their duty of care."¹ (emphasis added)

This bulletin is aimed mainly at **suggesting governance tools and precautions** that may be used in the special context of SMEs without burdening their functioning, while protecting their directors.

SMEs' REALITIES

The reality of most SMEs is quite **different** from that of reporting issuers, large private corporations, public organizations and NFPs.

Most SMEs have been created by one or more entrepreneurs who in many cases are also the corporation's managers. What these managers are looking for is mainly some advice or contacts rather than supervision by a board of directors. It is usually when there are several shareholders or the corporation needs a capital contribution in the form of subscriptions for shares that the managers find themselves directly or indirectly invited to form a board that is not made up solely of family members or friends.

It is quite obvious that most of these same managers prefer to devote their energy to improving the corporation's productivity and generating sales and revenues rather than spending time preparing documents for the board and participating in meetings with the directors. Furthermore, most of the managers must already comply with certain constraints imposed on them by lenders or institutional shareholders-investors and are not particularly inclined to add to their workload.

Also, in **cases where real boards are in place** in SMEs, the sizes of these boards, the usual closeness of the directors to the main shareholders as well as to those who proposed them as candidates, and the financial resources of SMEs, create a **different context** from that of other kinds of legal persons as regards the methods and characteristics of **governance**.

¹ *Peoples Inc. v. Wise* [2004] 3 S.C.R., 471.

Both governance and the way in which one takes on the responsibilities of being a director must take these realities into account.

SIMILARITY OF DUTIES AND POTENTIAL LIABILITIES OF DIRECTORS

The **general duties** of the directors of an SME, as well as **their specific and statutory obligations** are in every respect **identical** to those of directors of other legal persons subject, for example, to the additional obligations that are imposed on the directors of reporting issuers. Note that these duties and obligations **apply** to the **same extent** to **outside directors and to directors who are also shareholders or managers**. Therefore, a director-manager or director-shareholder cannot, in his capacity as a director, care about protecting only or mostly his own interests.

General duties

Thus, the directors of SMEs must comply with the following general duties:

- ▶ act honestly and in good faith with a view to the best interests of the SME ("**duty of loyalty**"); and
- ▶ act with prudence and diligence ("**duty of diligence**").

Liability

The rules of liability that apply to directors of SMEs are the same as those applicable to directors of other corporations. Thus, they may incur **contractual liability or, as the case may be, quasi-delictual liability toward the corporation and quasi-delictual liability toward third parties** if, due to their acts or omissions, they cause damage to the corporation or a third party. A breach of their duties may constitute not only a contractual fault but also a quasi-delictual fault in certain circumstances.

Moreover, the laws and regulations impose certain **specific and statutory obligations and liabilities** on directors, for instance:

- ▶ toward the employees for up to six months of unpaid salaries;
- ▶ toward the tax authorities for GST, QST and deductions at source that have not been remitted;
- ▶ toward consumers, within the meaning of the *Consumer Protection Act* (Quebec), who have paid in advance for a product or service to be delivered more than two months after the entering into of the contract and that has not been delivered, if the amount of the advance payments has not been deposited in a trust account².

Impact of unanimous shareholders' agreements

In a number of SMEs, some of the directors' powers are in the hands of the shareholders by virtue of a unanimous shareholders' agreement. However, if the directors must vote, or in fact vote, on a given issue, their **potential liability** remains. It also remains in cases of specific and statutory liabilities imposed by law.

RISKS OF LIABILITY

The size of the corporation, the nature of its activities and its solvency are **factors that influence** its risks of liability.

The corporation's risks of liability have a definite impact on the directors' risks of liability or at least on the extent of the financial consequences of a finding of liability. However, the **financial and human resources** devoted to governance by a large corporation are usually greater than those that an SME can allocate to it. Therefore, an outside director of an SME can find himself in a situation where the corporation does **not make it possible** for him to be as **diligent** as he would have wished or to obtain the **tools** and information that he should have in his possession to **fulfil his duties and responsibilities**. Furthermore, his **compensation** is usually modest compared with that of a director of a large corporation, possibly making his risk disproportionate to his remuneration received.

THE TWO CRUCIAL MEASURES

At the outset, we wish to emphasize that it is of crucial importance that an outside director:

- ▶ make sure of the **integrity of the managers**, and
- ▶ **work together and closely with the other outside directors**.

In fact, there are limits to what an outside director can check. Therefore, he depends in a significant way on the **disclosures made by the managers** of important facts that may influence the decisions that he is called upon to make. Similarly, collaboration between the outside directors enables each of them to have the same picture of the situation, the concerns, and the useful measures to recommend to management, and to make a more dynamic contribution.

A DIRECTOR'S FIVE MAIN OBJECTIVES

With a view to adequately fulfilling his duties and, by the very fact of doing so, reducing his risks, a director, and more particularly an outside director, should pursue five main objectives:

- 1° have a good **understanding of the corporation**, its activities and its environment, **validate** its **strategic plan** and **make a real contribution** that creates value and contributes to the long-term survival of the corporation;
- 2° make sure that the corporation **complies with the law** and its contractual obligations;
- 3° see to it that the corporation **identifies and manages its risks** and prepares for changes in senior management;
- 4° have a good **understanding of** existing and potential **conflicts of interest** between the various shareholders and the other stakeholders, more particularly at the time of a deal or transaction and **make sure** that the interests of the corporation prevail in compliance with the law and its contracts while also considering, to the extent possible, the reconcilable interests of the stakeholders (shareholders, employees, customers, suppliers, governments, communities ...) and favouring equitable treatment of these stakeholders;

² However, defences may be available.

- 5° **protect himself against the risks of personal liability**, more particularly as regards the specific sources of liability under the law (unpaid salaries, failure to remit deductions at source, GST or QST, etc.) by obtaining for this purpose, among other things,
- ▶ certificates of compliance from management;
 - ▶ liability insurance coverage;
 - ▶ indemnification undertakings both from the corporation and one or more shareholders;

and, in the event of **financial difficulties** or insolvency, by **tightening up the supervision of management**, by increasing the frequency of certifications, by obtaining **indemnification undertakings** from one or more shareholders and by requiring from the trustee and, if need be, from the court, **maximum available protection** under the laws concerning insolvency or bankruptcy or, in the absence of adequate protection, by resigning.

INFORMAL MEASURES

In the case of SMEs, the **informal measures** take on **more importance** than in the case of large corporations and can make up for, at least in part, an insufficiency of formal measures, and thus attain an adequate level of governance.

So, an external director has an interest in:

- (a) **visiting** the corporation's facilities, and **talking** occasionally with its **key employees** and its main **customers and suppliers**;
- (b) **meeting** individually and regularly with the president and the other main **managers** and, on these occasions, for example:
 - (i) pro-actively seeking information about the managers' **concerns and projects**;
 - (ii) in the case of **important planned transactions**, asking questions about the reasons justifying such planned transaction, the other hypotheses that have been eliminated and the **expected return** on the investment;

- (c) **passing on documents**, information, references and ideas to the president, as well as the names of useful persons to whom he could introduce the president;
- (d) **talking** regularly between meetings with the **other external directors**, to exchange with them the information gathered on all sides from the managers, customers, suppliers and third parties, and to discuss their respective concerns;
- (e) **informing himself** regularly about the corporation's field of activities, including information concerning its competitors and market realities and prospects;
- (f) **preparing**, with the other outside directors, a **list of persons who could eventually replace the senior managers**, if need be, as well as a **list of potential buyers or strategic partners**, and keeping these lists up to date so as to be ready to propose other working hypotheses to be studied in view of possible recommendations by management concerning these subjects; and
- (g) **suggesting candidates for directorship**, with whom he could work effectively.

CERTAIN FORMAL MEASURES

In addition to the **certifications** discussed above, certain simple measures can establish a way of operating that promotes the work of external directors.

We wish to mention, among others,

- (a) the use of an external director as the **chairman of the board** or, at least, as the **chairman of the meetings**;
- (b) the use of a **corporate secretary** or a secretary of the meeting, who takes notes of the deliberations and prepares the minutes;
- (c) the adoption of a **model agenda** (follow up on previous decisions or matters arising therefrom, certificates and declarations from management, reports concerning certain subjects such as workplace accidents, the environment...) that facilitates proper supervision of management's activities, but above all the expression of questions and comments by the directors and real discussion of important issues;
- (d) the communication to management **prior** to each meeting of the **subjects** that the external director wishes to have included on the **agenda**;
- (e) the use of requests to management to **invite** certain **managers and/or outside advisors** (lawyers, accountants and other specialists) of the corporation to attend certain meetings of the board and asking them appropriate questions during the meetings to obtain the desired confirmations;
- (f) during the meetings, **the making of a statement** by an outside director of **his understanding** of the information gathered from the president or other managers at the time of prior informal meetings, followed by a request that the president and other managers confirm the correctness of such understanding;
- (g) the use of requests to **note in the minutes** the content of such understanding as validated by the president and the answers of both the managers and the outside advisors of the corporation obtained during the meetings or informally;
- (h) the obtaining and study of **important contracts** before approving them;
- (i) the use of requests for and the obtaining of, both regularly and in a more targeted way at the time of an important transaction or contract, **confirmations by management** concerning compliance with the law and the absence of conflicts of interests or false declarations, and of recommendations and advice from outside experts in these respects;
- (j) the adoption and monitoring of **framework policies** (for example: psychological harassment policy, code of ethics, etc.) and **control systems**;
- (k) the holding of **meetings of the directors outside the presence of management**; and
- (l) the obtaining of the **certificates, insurance coverage and indemnification undertakings** described above in the context of objective No. 5 in the section "A director's five main objectives" of this bulletin.

Many of these suggestions are aimed in particular at replacing the studies and reports that the managers of large corporations prepare and provide to their boards of directors and at enabling the directors to **demonstrate that they are acting with reasonable diligence** in the performance of their duties.

INTEREST OF THE SHAREHOLDER-MANAGER IN PROMOTING GOOD GOVERNANCE

A shareholder-manager can derive substantial benefits from the establishment of good governance practices.

The following are some non-exhaustive examples:

- ▶ the corporation of which he is a manager will probably be able to increase its **credibility** in the eyes of lenders and investors;
- ▶ he will be able to **recruit** better individuals to become directors;
- ▶ in the event of the sale of the business, potential **purchasers** will be **less fearful**;
- ▶ as a director, he will **increase his own protection** with respect to his potential liability;
- ▶ the corporation's **risk of being sued will be reduced**;
- ▶ these governance practices will force him to be **more systematic** and to develop **more effective monitoring tools and control systems**;
- ▶ but, above all, he will benefit from **help and valuable advice** from his co-directors.

These benefits, among others, should tilt the scales in favour of the implementation of good governance practices.

Note that the **ability of a manager to listen to and accept criticism** is recognized as one of the major skills of a **true leader**.

Moreover, the fears that a shareholder-manager may have should be quickly eliminated by the power that he may hold, in many cases, in his capacity as a shareholder (quite often the majority shareholder), including the power to change the make-up of the board of directors (not re-electing directors or even removing them at a special meeting of the shareholders held for that purpose).

CONCLUSION

One must never forget that under the laws governing corporations, it is the board of directors that has the responsibility to manage the corporation and that delegation to the managers does not relieve the board of directors from its responsibility in the last resort in many cases.

It is therefore important that a director of an SME finds the means to fulfil his duties and to play his part fully, but above all that in practice he fulfils his responsibilities adequately with the primary objective of creating value.

Both the shareholders and the managers and directors have an interest in implementing good governance practices adapted to the realities of their SME.

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P.S. The authors of this text have published several bulletins on various aspects of governance and directors' duties. The reader can acquaint himself with them at lavery.ca/publications and select "André Laurin".

These bulletins supplement this text.

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