IN FACT AND IN LAW

Corporate Governance
Securities

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Recent Developments Respecting Corporate Governance and Directors' Liability

By André Laurin

Summary

- The directors' duty of care (objective standard)
- The directors' duty of loyalty does not extend to creditors
- The duty of care extends to other beneficiaries beyond the corporation
- Corporate governance = shield against directors' liability
- In the United States, directors are forced to contribute their personal funds toward settlements
- Changes are made to the proposed corporate governance rules and guidelines
- Our April 2004 bulletin was updated in January 2005 to reflect these changes (Please visit our website or request a paper copy)

Recent events have led to significant changes in the field of corporate governance and directors' liability.

The decision of the Supreme Court of Canada in the *Wise* case and partial settlements of proceedings in the *Worldcom* and *Enron* cases in the United States constitute major developments that, in the first case, clarifies the nature and scope of directors' duties under the *Canada Business Corporations Act* (CBCA) and, in the second case, initiates a trend which, if followed in Canada, would increase the risk level for directors.

On October 29, 2004, the Canadian Securities Administrators published modified proposed corporate governance rules and guidelines applicable to reporting issuers.

The following discussion provides more details respecting these developments.

Directors' Liability

The *Wise* Case

In its decision in the *Wise* case, the Supreme Court of Canada:

- clearly **distinguished** between the directors' duty of loyalty (or fiduciary duty) and their duty of care;
- indicated that directors **do not owe a duty of loyalty to creditors**, but that the duty of care extends to creditors (and therefore to other beneficiaries, beyond the simple duty to the corporation);
- ruled that **the standard of care is exclusively objective** ("a reasonably prudent person in comparable circumstances"), contrary to a prior decision (the *Soper* case) in which it was held that such standard was both subjective and objective;
- as for the **criteria that the courts must apply** when reviewing the directors' decision and the issue of compliance with the duty of care, the Court stated the following:

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"Directors and officers will not be held to be in breach of the duty of care under s. 122(1)(b) of the CBCA if they act prudently and on a reasonably informed basis. The decisions they make must be reasonable business decisions in light of all the circumstances about which the directors or officers knew or ought to have known." (paragraph 67)

and in so doing, drew closer to the business judgment rule used by U.S. courts, although some ambiguity remains with respect to the place that the reasonableness of the decision must take relative to the means taken; and

- explicitly confirmed the **relationship between corporate governance and directors' liability**:

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

A bulletin discussing the *Wise* decision, authored by Ian Rose and Odette Jobin-Laberge, is available on our website. The action against the directors and their liability insurer was dismissed. Our firm represented one of the defendants in this matter.

Worldcom* and *Enron

Newspapers reported at the end of the week of January 3, 2005 that *a majority of Worldcom directors will contribute a total of U.S.$18 million out of their personal funds, in excess of amounts already paid by their liability insurers while a majority of Enron directors will, in the same fashion, contribute a total of U.S.$13 million.*

Plaintiffs in both cases apparently required these disbursements be paid out of the directors' personal funds as a condition for settlement. These two cases may have a certain infectious effect. They may prompt liability insurers to increase their deductibles or require personal and proportional contributions.

One thing is certain: These two settlements will do nothing to assuage the concerns and fears of current and potential directors.

Update on the Corporate Governance Rules and Guidelines

An **update of our April 2004 newsletter** discussing *The New Corporate Governance Rules and Guidelines* is available on our website. This January 2005 update results from the October 29, 2004 publication of modified and harmonized proposals by the Canadian Securities Administrators.

We would particularly like to **draw your attention** to the following items:

- some rules have been in effect since March 30, 2004, including those pertaining to accounting principles, continuous disclosure, auditors and audit committees;
- the date of coming into force of the proposed guidelines is still unknown; however, according to Canadian Securities Administrators staff, **they will begin to apply** to any circulars or annual information forms, as the case may be, that are filed after the closing of **financial years ended June 30, 2005** or later;
- the Québec, Alberta and British Columbia authorities joined their counterparts in support of the amended proposals;
- the new proposals **do not bring major changes** but rather relax or clarify certain concepts by bringing the definition of independence closer to that of the NYSE and restructuring the provisions of *Multilateral Instrument 52-110 Audit Committees* pertaining to that definition and the presumptions of non-independence;
- the proposed amendments to *Multilateral Instrument 52-110 Audit Committees* are not in effect and therefore, the Multilateral Instrument, as adopted on March 30, 2004, remains in force in its original wording;
- the rules pertaining to disclosure of corporate governance practices underwent major changes, which are summarized below.

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Disclosure

In the event that the proposals are adopted, issuers will be subject to the following requirements with respect to the information to disclose and the disclosure vehicle:

- provide information respecting the subject of certain guidelines (except for venture issuers); issuers will no longer be required to explain the way, in which their practices differ from the guidelines and the reasons, for such difference;
- provide information on their corporate governance practices in their **management proxy circular**, if they solicit proxies, rather than in their annual information form, as was provided for in the first proposals; however, if an issuer does not solicit proxies, it will be required to disclose its corporate governance practices in its annual information form (or, in the case of a venture issuer, in its annual MD&A); and
- **disclose any other directorships held by its directors on the boards of other public issuers**, the list of independent directors and the list of non-independent directors, as well as the basis for concluding that the latter are not independent.

Issuers are also required, under Section 5.1 of *Multilateral Instrument 52-110 Audit Committees*, to provide information on their audit committee in their **annual information form**, as required in Form 52-110F1 (please note that the requirements are already in effect and apply to an issuer beginning on the earlier of the date of its first annual meeting after July 1, 2004 and July 1, 2005).

Lastly, we emphasize that as long as the new provisions are not in force, issuers (other than venture issuers) are still subject to the disclosure duties prescribed by the TSX (information to be disclosed **either in their management proxy circular or their annual report**).

Issuers therefore have decisions to make respecting information disclosure. They may choose to comply minimally with the requirements set out in the TSX and *Multilateral Instrument 52-110 Audit Committees* or go further or, while complying with the minimal requirements, provide the additional information that will probably be required under *National Instrument 58-101 Disclosure of Corporate Governance Practices*. Some issuers will also want to **incorporate all the information in more than one document** (in their circular and their annual information form and also, at least by reference, in their annual report).

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Notice to All Non-Reporting Issuers

Although these rules and guidelines will apply only to reporting issuers, they will undoubtedly serve as criteria and standards from which private companies, the cooperatives, Crown corporations, non-profit or charitable organisations and various other entities should draw their inspiration to adopt their own corporate governance practices to the extent possible.

Assistance or Copies of Other Newsletters

Our Corporate Governance team would be pleased to provide you with assistance and advice (verification, implementation or adaptation of measures, means, notices, presentations). We invite you to consult our website (http://www.laverydebilly.com) or our brochure entitled *Corporate Governance and the Protection of Directors - Customized Turnkey Services at Flat Rates for Companies and Organizations and their Directors.*

You can contact any of the following members of the Corporate Governance and Securities Law groups in relation to this bulletin.

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